Monetary policy in strange times
266

Jon Faust
JHU
http://e105.org/e607

April 20, 2016

- **Making monetary policy**
  - For 8 years we have been in very strange times
  - After 8 years, folks begin to wonder if this is the ‘new normal’
  - Or at least what the ‘new normal’ will be.
- **Thus,**
  - I’m not going to assign much if anything from the text about monetary policy making
  - Much of that is not directly relevant right now and won’t be relevant for many years.
- **What is a central bank?**
- **Central banks: many roles**
  - Has respondibility for *montetary policy*

    We’ll spend most of the lecture on this
  - Lender of last resort

    Remember: commercial banks are the backstop liquidity provider to the rest of the economy and central banks are the backstop liquidity provider to banks.
  - Often a regulator of banks or other institutions
  - Sometimes various other roles
- **Today: monetary policy**
- **Central banks and monetary policy**

- Partial definition:

  From a monetary policy standpoint, a central bank is a governmental body at the center of the financial system that possesses powerful policy tools that can be used to loosen or tighten financial conditions

- We need to fill out what many terms mean

  center of the financial system, powerful tools, tighten/loosen financial conditions

▶ **What is 'tighten financial conditions'?**

- Cause interest rates generally and temporarily rise or rise more quickly

  (but perhaps not all rates)

- Cause asset prices to generally and temporarily fall or rise more slowly

  e.g., prices on stock market, house prices, etc.

- Cause the value of the home currency to rise
- Cause lending conditions to become generally and temporarily more stringent

  e.g., lenders screen more aggressively

- That is, through a wide variety of channels make the financial situation of the economy less conducive to rapid growth.

▶ **What is 'loosen financial conditions'?**

- The opposite of tighten

▶ **Aside:: Usage note...**

- Tighter also called 'less accommodative'
- Looser also called 'more accommodative'

▶ **But how?**

- What are these tools? How do they work?
- set these questions aside for a moment
- Focus on the linkage from financial conditions to the macroeconomy.

▶ **From financial conditions to the economy**

- Affecting financial conditions is not an end in itself.
- Central banks are generally charged with promoting 2 goals

- 1. Low and stable price inflation
- 2. Healthy pace of economic activity
- Note: some central banks have only the inflation objective.

  E.g., the ECB

- But most of these in practice, de facto have an economic activity goal

▶ **What is a 'healthy pace'?**

- Neither too fast nor too slow. Just right.

  Like driving a car on the interstate: to slow, you might get hit; too fast you might lose control.

- Economists use describe 'just right' with phrases like:
  - Fed speak:'the pace of activity that maintains maximum sustainable employment'
  - Inflation at the NAIRU
  - Producing at the level of *potential output*

▶ **Relation between financial conditions and dual mandate**

- Tighter financial conditions tend to
  - put downward pressure on inflation
  - and downward pressure on the pace of economic activity
- Looser conditions promote faster activity and higher inflation

▶ **Pop quiz**

- For several recent years, inflation has tended to be [too low/too high]?

  too low

- For several recent years, the pace of economic activity has tended to be [too fast/too slow]?

  too slow

- Thus, the Fed has been using its tools to make financial conditions [looser/tighter] than they would otherwise have been?

  Looser.

▶ **You now know the essence of monetary policymaking**

▶ **The essence for a central banker**

- Assess as best you can where the pace of activity and inflation are relative to desired levels

- If something is amiss, temporarily tighten or loosen financial conditions to promote a return to the desired outcome.
- Can't force things or make it happen, but you can make financial conditions more conducive of the desired outcome.

▶ **The Current Policy statement of Fed**

- –

  > Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen.... Inflation is expected to remain low in the near term, in part because of earlier declines in energy prices, but to rise to 2 percent over the medium term ...

- –

  > In determining the timing and size of future adjustments to the target range for the federal funds rate, the Committee will assess realized and expected economic conditions relative to its objectives of maximum employment and 2 percent inflation. This assessment will take into account a wide range of information, including measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial and international developments.

- The full statement

  go

  http://www.federalreserve.gov/newsevents/press/monetary/20160316a.htm

▶ **One problem all central banks face**

- The central bank's tools tend to push inflation and financial conditions both in the same direction

  lower inflation and slower pace of activity OR higher inflation and faster pace activity

- The central bank has no tool to simultaneously push inflation up and the pace of economic activity down.

  thus, tricky to know what to do when the two goals call for opposite policies

- This has not been a problem for most of the period since the crisis.

▶ **A problem in the near future?**

- Some now see the U.S. as at or rising above maximum sustainable employment
- But inflation is still too low.

- Thus, intense debates are starting between those who think we need
  - tighter policy to avoid 'overheating' the labor market
  - continued loose or looser policy to stimulate inflation

▶ **What are these CB tools? How do they work?**

▶ **Normal times**

- We used to have a standard story
- But it has not be relevant for 8 years or so and probably will not be relevant again for several more years.
- So I'm not emphasizing it today

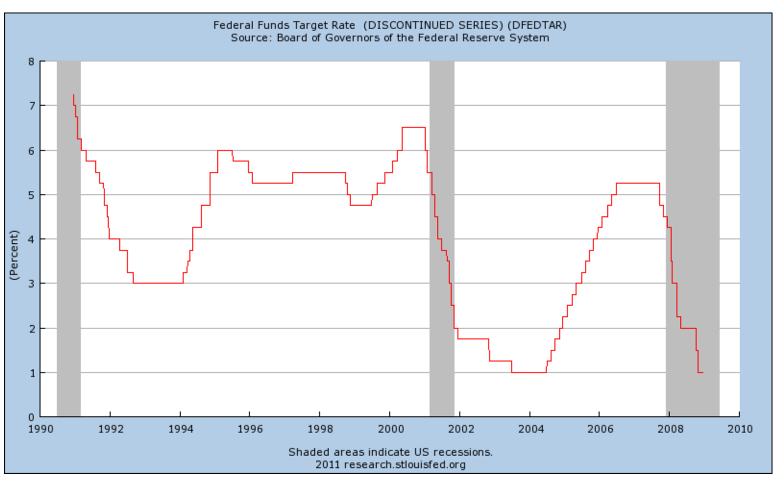
▶ **Nutshell verison: normal times**

- If Fed wants to temporarily tighten financial conditions, it raises the federal funds rate temporarily before returning it to some 'neutral value'
- Remember the federal funds rate is the rate that banks pay each other to borrow reserves on an overnight basis.
- Raising the federal funds rate and signalling to the market that this rate will be persistently higher leads to all the implications listed above for tighter conditions.

▶ **Of course,**

- If, Fed wants to loosen conditions, it lowers the federal funds rate for a time.

▶ **For example,**



▶ **The present (strange) situation: at the end of that figure, the rate dropped effectively to zero where it stayed until Dec. 2015. (Target range now 25 to 50 basis points)**

- ▶ **Strange (but becoming awfully familiar) times**
  - Since the end of 2008, the federal Funds rate has been at or very near zero.
  - Because both the labor market and inflation weak, we want conditions to be more accommodative

    Thus, if we could we would lower the funds rate further.

  - Since can't push rates (much) lower, Fed turned to 'unconventional tools'
- ▶ **Conventional unconventional tools**
  - There are lots of unconventional tools, but until very recently central banks mainly used two:
  - Forward guidance: communication about the likely course of policy in the rather distant future
  - Large-scale purchases of longer-term securities

    Known affectionately as LSAPs (large-scale asset purchases)

  - I call these two conventional unconventional policy

    since they've become conventional over nearly a decade.

  - Unconventional unconventional tools are things like negative rates and directly purchasing corporate debt

    Two things the ECB started recently

- ▶ **Forward guidance**
  - The key: affect expectations of policy several years down the road
- ▶ **January 2012 policy statement**
  - –

    the Committee also decided today to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that exceptionally low levels for the federal funds rate are likely to be warranted at least through mid-2015.

- ▶ **Decemeber 2012 policy statement**
  - –

    The Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committees 2 percent longer-run goal

▶ **Forward guidance: two versions**

- Descriptive

  simply tell folks what you think is likely to happen

- Prescriptive

  Dictate that the central bank will, in the future, do something that it won't want to do (we'll explain)

▶ **Descriptive forward guidance**

- Suppose that the private sector doesn't know just how loose you think it will be appropriate for policy to be in the future.
- You tell them: You don't get it. You are expecting much tighter policy than we think will be likely.
- If folks are convinced, they will come to believe in more accommodative policy and this in turn may stimulate the economy.

  Through all the channels described above.

- Nothing deep here
- This is just good public policy: help folks understand the likely course of policy in the future.
- This will only tend to boost the economy at times when folks are incorrectly expecting tight policy in the future.
- If folks already understand policy, telling them again won't change anything.

▶ **Prescriptive forward guidance**

- Suppose the central bank promises that in the future at a time when there is no strong reason to boost the economy, the central bank will nonetheless boost the economy.
- I think of this as promising to throw a party two years in the future

  Even though you know you won't want to throw the party when the time comes.

- That is, you promise to stimulate an economic boom as soon as you have the power to do so.

  That is, once interest rates are no longer at zero.

- Through various channels, if peope revise UP their assessment of conditions a few years down the road, they will choose to consume and invest more today.
- Suppose you are a broke student with no prospects of earning any money
- Suppose I promise you a gift of $200,000 a year starting in 2 years.

- If this promise is credible, you will probably be more willing to borrow and consume more today
- Credible information raising the chance of good good times in the future should stimulate activity today.

  In macro class we would go through many channels, but I'll stick with the simple intuition just given.

- **But notice**
  - Suppose the Fed makes the promise and folks believe it and spend more and as a result employment and inflation return to desired levels.
  - Now it comes time for the party.
  - The Fed will be tempted to say, hey, we don't have a problem.
  - Stimulating the economy now could lead to overheating and excesses
  - Thus, the Fed decides against promoting the boom.
  - In this case, the Fed has conned the public
- **FACT**
  - No central bank to date has tried prescriptive guidance
  - Many central bankers have said they don't believe that they could credibly promise to deliver on the future boom
  - Many central banks have used descriptive rather than prescriptive forward guidane

    But this mainly provides a net boost when folks are misperceiving how tight policy will be in the future.
- **Aside:: Time inconsistent**
  - Promises that make sense today, but that you won't want to deliver on when the time comes are called time inconsistent.
  - Big literature on this.
  - Kydland and Prescott got the Nobel prize in part for analyzing this sort of problem.
- **Aside:: TBTF**
  - TBTF: to big to fail is another example
  - Government has incentive to promise 'no bailouts' today

    If this promise were credible, firms might behave more prudently

- When the TBTF bank fails, the government has the incentive to break the promise and deliver the bailout if, e.g., the alternative is the Great Depression.

▶ **LSAPs**

- LSAPs work much more like conventional policy.
- Short-term rates are at/near lower bound
- But longer-term rates are still well above zero

    And longer-term rates may be more closely tied to economic activity than short rate.

▶ **LSAPs**

- **LSAPs work much more like conventional policy.**
- **Short-term rates are at/near lower bound**
- **But longer-term rates are still well above zero**

    And longer-term rates may be more closely tied to economic activity than short rate.

- **The idea**
    - **Buy a whole bunch (large-scale) of, say, 10-year government bonds**
    - **Effectively shifts out the demand curve for these bonds**
    - **Demand out implies price up (that is, yield down).**
- **Completing the LSAP story**
    - **Tends to drive up the price (drive down the yield) of all substitutes as well**

        as demand shifts to those substitutes
    - **Lower yields make conditions more accommodative.**
- **So do LSAPs really work?**
    - **This argument about how LSAPs might work is fully coherent**
    - **But just how big an effect you can get for your, say, trillion dollars in asset purchases is not known.**

        Some folks think the effects are trivially small, others think they are substantial.
- **That's is for a whirlwind summary of monetary policy in strange times.**