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The Convergence of Monetary Policy Strategy

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The Convergence of Monetary Policy Strategy

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30th Dubrovnik Economic Conference

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The Fed and ECB Monetary Strategy today:

- **The Goals today are:**
- **Price stability** – Average Inflation Target (AIT) of 2%; symmetric?
- **Maximum potential growth** or/and employment
- **Support Financial Stability** and supervise large financial institutions
- **Substantial Open Market Operations (OMO or CE and QE) at (ZLB)** Zero Lower Bound and common EXIT policy

How these have been implemented following the financial crisis of 2008-9?

- **What are the milestones** for the convergence of monetary strategy in the West?
- **How might the long run R* impact the strategy?**

Where are we today?

- **Powell (May 14) reiterates that the Fed expects to keep rates (5.5%) higher for longer**
  - "We did not expect this to be a smooth road. But these [inflation readings] were higher than I think anybody expected," Powell said. "What that has told us is that we'll need to be patient and let restrictive policy do its work." (Bloomberg)
- **The ECB takes a similar position (4.0%) – but started to reduce June 6th to 3.75**
  - "We consider that the key ECB interest rates are at levels that are making a substantial contribution to the ongoing disinflation process. Our future decisions will ensure that our policy rates will stay sufficiently restrictive for as long as necessary." (Lagarde, April 11, ECB press conference)
- **Are these policy rates restrictive enough? Need clarity?**

The announced Strategy of Price Stability: The Fed move to Inflation Targeting

- **June 2009** – First Economic Projections (SEP)– **Long run PCE inflation 1.5 to 2.0 percent;** no projections of Federal Fund Rate
- **January 2012:**
  - **First Statement on Long-run Goals and Monetary Policy Strategy Every January**
  - First **long run** SEP - **PCE inflation 2.0%** and first **Dot Graph Target FFR at Year End** – Long run FFR 4.25% and **R* is 2.25%**
  - **Research: Taylor Rule** (Bernanke AEA 2010) and **DSGE** model are useful tools for policy

Main evolution of Fed Strategy : Powel JH August 2020

- **Average (not flexible) Inflation Targeting (AIT): Symmetric or biased downward**
  - "following periods when inflation has been running below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time"
- **Importance of long run expectations**
  - "actions to achieve both sides of [the] dual mandate will be most effective if longer-term inflation expectations remain well anchored at **2 percent**"
- **Prevent deflation and allow for space to cut rates**
  - if inflation expectations fall below [2%], interest rates would decline in tandem. In turn, we would have less scope to cut interest rates during an economic downturn"
- **R* = the long run real rate is 0.5% (with some! uncertainty)**

ECB move to Average Inflation Targeting

- **1998 mandate**: the maintenance of price stability will be the primary objective of the ECB. Therefore, the ECB's monetary policy strategy will focus strictly on this objective. (**no dual mandate**)
  - "**Price stability** shall be defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of **below 2%.**"
- **July 2021 strategic review**: "…**price stability** is best maintained by aiming for **2 per cent symmetric inflation** over the medium term." (**adoption of AIT**)
- Goal is **anchoring the inflation target in the medium term**.
- Does not publish estimates of LR interest rates unlike Fed
- **R* is estimated** around 0 with some uncertainty (Smets)
- **Research: Taylor Rule** and **DSGE** model are useful tools for policy

Fed and ECB role in control of financial risk enhanced substantially following Great Recession

- **Fed** begins regulating systemically **important financial institutions** (**Dodd-Frank act** - July 2011)
  - "Living wills" to ensure orderly resolution of systemically important financial institutions and annual stress tests
- **ECB** shares responsibility for **regulating large banks** under the "single supervisory mechanism" (October 2013). First step towards the EU banking union initiated in response to the Great Recession

Bank of England and Bank of Israel

- **Bank of England Inflation Target 1 – 3%** primary mandate with potential output as secondary goal (1997**): April 2013 – U turn to financial risk supervision**
- **Bank of Israel's (~2000): Inflation Target 1 – 3%** price stability first, with potential output and employment as secondary goals. **In 2018**, add additional role in **financial risk oversight**
- **Is a range of 1 - 3% equivalent to 2% AIT?**
- **Bank of Japan adopted inflation target of 2%** - January **2013**

The Bernanke Strategy for a large negative shock (LSE lecture January 13, 2009)

- **Cut interest rates to the zero** lower bound
- Credit easing (CE) - **response to increasing spreads** and dysfunction in credit markets and currency swap agreements to reduce excessive spreads and shore up financial stability
- Quantitative Easing (QE) is the next step to reduce longer-term interest rates, continues into 2014
- **Forward guidance** which further reduces long-term interest rates
- **Exit strategy**: Inflation is up towards 2%, financial markets working well – **stop QE but continue refinancing, raise rate and later start QT**
- **OMO** - Implemented dramatically in Covid-19 pandemic

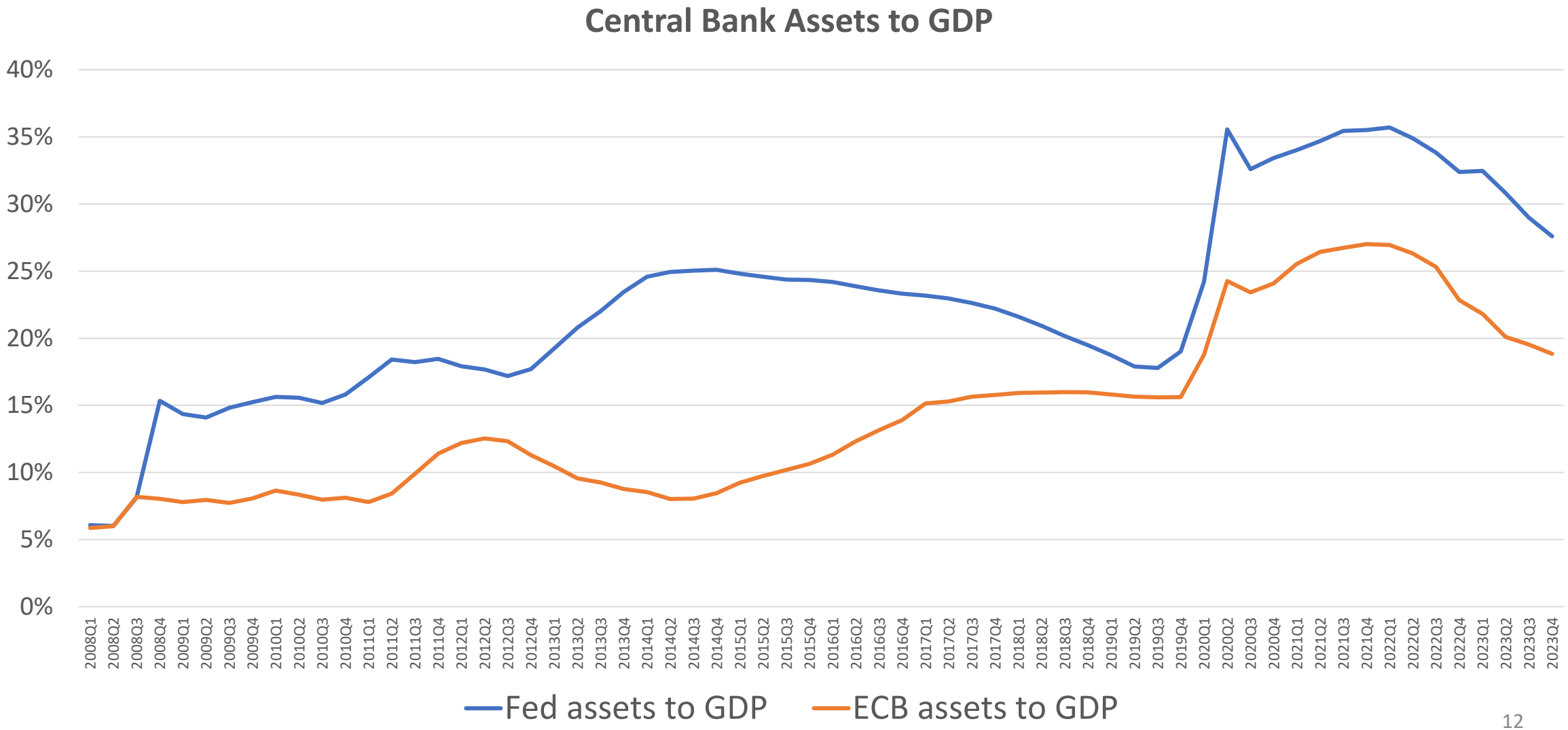
Draghi adopts the Bernanke Strategy (and saved the Euro…)

- **Trichet period** (2007-2011) – no clear strategy
- Reduced rates almost to zero in 2008 **but raised rates when the Euro crisis started**
- **Draghi period one**: cuts rates to zero, starts LTRO (Dec. 2011)
- Pledges to do **"whatever it takes"** to save the Euro (**July 2012**)
- **Draghi period two**: following Jackson Hole 2014 lecture, starts QE 1 in response to feared deflation (**first step of Bernanke strategy**)
- **Lagarde**, response to Covid: cut rates to zero and begins massive QE almost immediately: Follows Bernanke Strategy

Covid response - Fed and ECB convergence!

- **Fed** cuts rate to 0%-0.25% by March 2020 and begins avalanche of open market operations at the same time
- **ECB** rate was already zero, began massive QE (APP) at the same time as the Fed
- **All CB follow same strategy:** substantial accommodation and intervention responses to Covid -19 Crisis

US and EU CB assets, % of GDP



Fed and ECB exit from Covid: Late response to unexpected inflation

- **Fed:** September 2021: PCE **inflation nearly 5%,** announcement:
  - "If progress continues broadly as expected, the Committee judges that a **moderation in the pace of asset purchases** may soon be warranted." ..**Inflation is temporary**??..
- **Fed** ended QE in March 2022, **ECB** in June
- **Fed** hiked rate on March 15, 2022; **ECB** in July – inflation higher
- **Fed** QT began in June 2022; **ECB** in December
- **Both stopped QE too late** and raised rates quickly as inflation already decreased
- **Stopped raising rates once real interest rates were sharply positive**
- **BoE and BoI followed similar strategies;** BoI stopped QE much earlier

Is the Fed's monetary policy today restrictive?

- The short-term real rate is given by

  (FFR (5.5%)– expected inflation (2.4%)) = **3.1% - Is that restrictive?**

Using R* = 0.6% from SEP it seems right; Hence,

"**Theory" restrictive rate is 2.5%** = (5.5%-2.4%) - 0.6% = **short real rate – long real rate**

However, market does not agree to R* = 0.6%!

- **Market** long term TIPS is around **2.25%** and **long run nominal rate 4.5%**
- The Cleveland FED projects 10 year **real interest rate of 2.1%** and inflation **of 2.4%** - Nominal **long-run rate of 4.5%**
- **Restrictive policy rate using the market is 0.9% = 3.1% - 2.2%** :
- **Is that high enough to reach 2% inflation?**
- **What is the correct R*?** Theory or the market implied real rate?

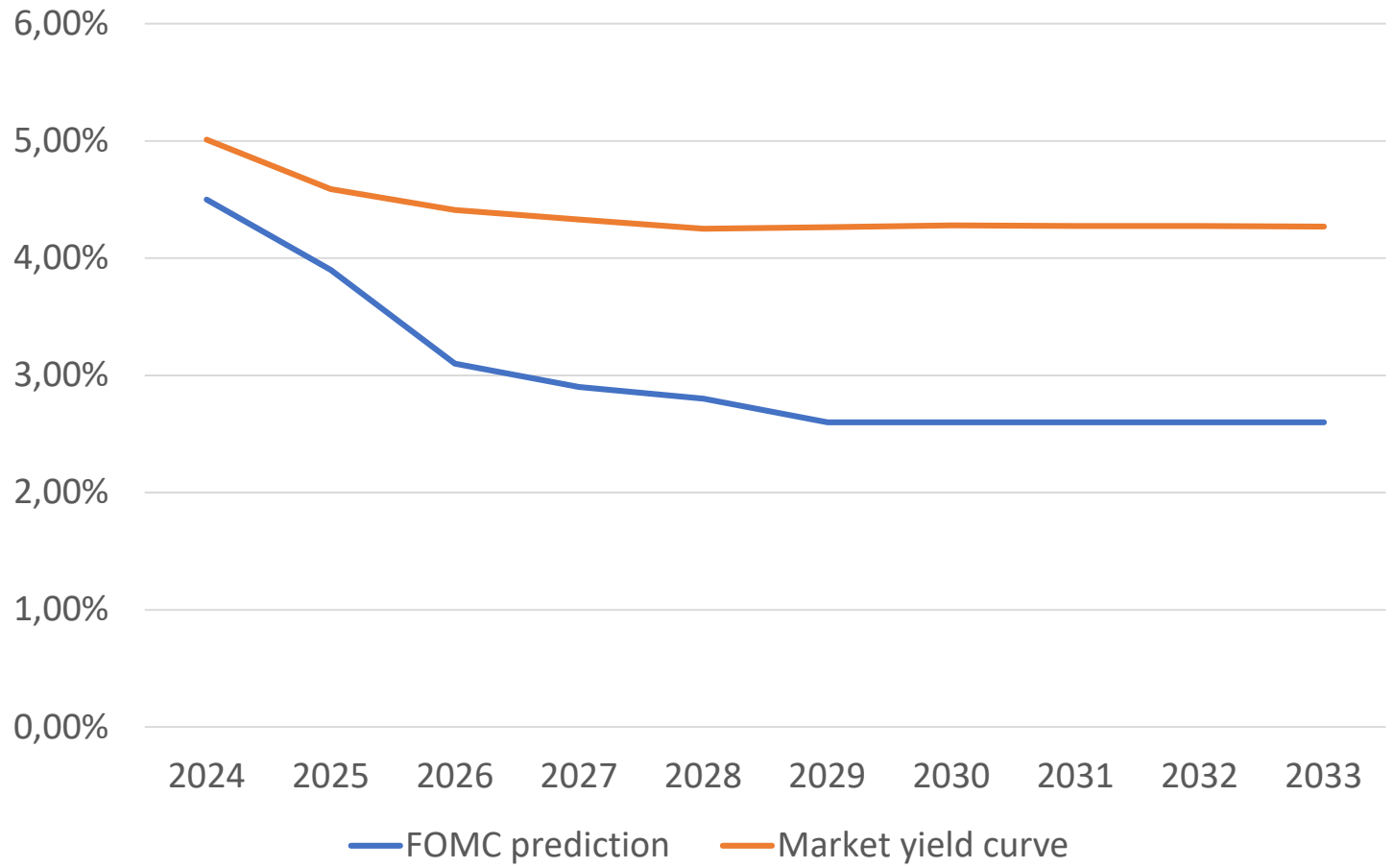
How about the ECB*?

- German inflation-protected bonds have a current real yield **~0.4%,** implying a longer run interest rate of 2.4% that is close to current long-term bund yield.
- **ECB research** estimates of **R*** are close to zero (no official forecast)
- **Using market R* the restrictive rate is - (3.75%-2.4%) – 0.4% = 0.95%**
- **ECB** policy appears to be as restrictive as Fed by **both market and theory estimates of R***!
- **Is 0.95% restrictive enough** to reduce inflation to 2%?

*Use the ECB deposit rate

The Market yield curve does not match the Dot graph – why?

- According to March FOMC statement, expected FFR at the end of 2024, 2025, and 2026 are 4.6%, 3.9%, and 3.1% respectively - market yields over this period are 4.8%-5.4%

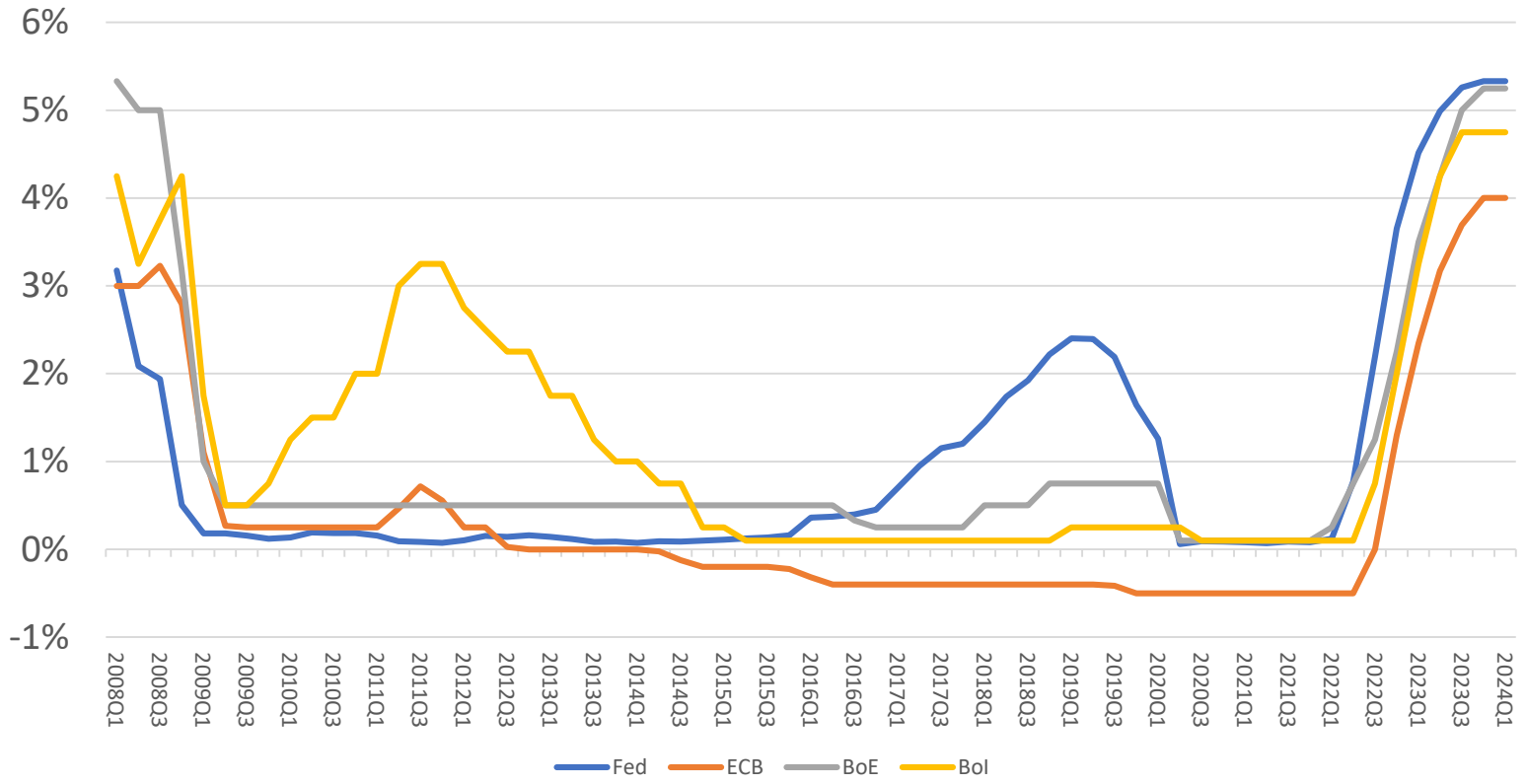


Comments

- Fed MEDIAN may not be representative – range of long run rate is 2.4%-3.8%, and the upper end of the range is closer to market expectations
- Powell: “we are navigating by the stars under cloudy skies”
- **Paul Krugman**: “On interest rates I am fanatically confused. Anyone who claims to know for sure what the answer is to that, is deluding themselves.” (Bloomberg, May 21, 2024)

Looking at rates we do not see convergence of Monetary Strategy until Covid-19 pandemic –rates are not the only story of Monetary Strategy in response to shock

Interest rate trajectories since the great recession



Could R* be diverging between US and EU since Covid? Potential answers

- **After GR:** secular stagnation and demographic change was the main focus – growth and R* were low – but NY Fed graph is confusing…
- **New reality of Investment needs: AI**, energy transition, heightened defence needs – may denominate demography and **increase R* in the US …as market predicts**
- **US is growing much faster than Europe**: 2021H2-2023 US 21.2% EU 5%
- **Fiscal dominance and political risks** – Fed may have to finance US deficits in the future – more likely than Europe?

Thank You

Appendix Graphs