Unconventional Monetary Policy: An interim assessment

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Discussion

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October 20th 2021

Main message

- Much to agree with RR
- However, after more than 10 years of practice of UMP we should recognize the new reality and the new operational framework
- As a consequence need to ask the question which are relevant for making the new operational framework effective and robust rather than throwing the water with the baby

New reality

- Recognition that financial frictions are pervasive also in normal time
- Central banks have new responsibilities beside monetary policy but they also have more instruments. We have learned that:
  - Central banks have a market making role beyond the traditional lender of last resort role
  - Balance sheets large and used pro-actively also away from the ZLB
  - With interest on reserves may have large expansion of monetary base without inflation

But new consensus comes with risks

- Credit risk:
  - liquidity shocks not easily distinguishable from credit shocks
- Crowding out of market activity
- Central banks “over-burdened”
- Implications for central bank independence and governance

No way back

- Excess demand for safe assets will continue to be large because of:
  - precautionary savings
  - demographics
  - deleveraging
  - uncertainty
  - New risks are emerging with uncertain effects on the economy (climate, technology, health)
  - Legacy debt will be with us for a long time

How do we deal with the questions raised by RR?

Two types of Unconventional Monetary Policies

Unconventional Monetary Policies work both as substitute and complement of interest rate policy

I. "Passive" unconventional [Complement to int rate policies]
   - "market making"
   - Evidence points to effectiveness
   - These are generally supportive of financial stability

II. "Active "unconventional [Substitute of int rate policies]
   - Aimed at reducing returns on safe assets
   - QUESTIONS: (i) do they work? (2) tradeoffs between financial stability and price stability may arise; (3) dealing with the fiscal footprint?

Let's talk about "active" policies

- "Active" policies may consist in the complementary use of <u>different tools</u> aimed at controlling the <u>entire</u> yield curve

- Therefore complex interactions between macro and financial risks

Two effects:

(i) redistribution of risk
(ii) total supply of risks

- Both matter for monetary policy and financial stability

Monetary policy and financial stability: Tradeoffs – supply and demand for risk

- Both supply and demand matter for the amount of risk in the system

Monetary policy and fiscal implications - fiscal footprint

- With large balance sheets, large public debt, low equilibrium interest rate, interactions between monetary and fiscal policies have become more sizeable
- Central Banks’ fiscal footprint has grown

Conditions for success – three relevant questions – 3 questions

Q1. Macroeconomic effectiveness. What are the conditions?

Q2. Management of risks. How?

Q3. Can the “bad risk taking” be handled with regulatory tools?

Where does this leave us?

- We need to clarify what the new framework is about.
  - Lots of confusion and this is potentially dangerous, especially in current circumstances
- Relevant questions:
  - Size of the balance sheet? Apply the "Friedman rule"
  - Clarify relationship between instruments and translate into an operational target: the risk free yield curve is a good candidate
  - Need framework to relate primary and secondary objectives (e.g. price and financial stability) when there are trade-offs
  - Cannot rely on Chinese wall between fiscal, financial and monetary authorities. Governance!
  - But needs to retain the key insight of inflation targeting, that is the key role for commitment to a nominal anchor and expectation management

Read the CEPR report : The ECB Strategy: the 2021 review and its future !!