Monetary Policy Roundtable

On 25 June 2015, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their thirteenth Monetary Policy Roundtable. These events provide a forum for economists to discuss key issues relevant to monetary policy in the United Kingdom.[1] As with previous Roundtable discussions, participants included a range of economists from private sector financial institutions, academia, public sector bodies and industry associations. There were two topics of discussion:

- what are the global drivers of inflation? and
- why are real interest rates so low?

This note summarises the main issues raised by participants.[2] The Roundtables are conducted under 'Chatham House Rule' and so opinions expressed at the meeting are not attributed to individuals. This summary does not represent the views of the Bank of England, the Monetary Policy Committee or the CEPR.

What are the global drivers of inflation?

Inflation had been low internationally in the period preceding the Roundtable, particularly in advanced countries. For example, in the United Kingdom the latest CPI inflation outturn at the time of the Roundtable was just 0.1% (for the twelve months to May 2015). In contrast, UK CPI inflation had averaged 1.8% during 2000–08 and 3.1% in the period 2009–13.

From a monetary policy perspective, identifying the drivers of inflation is important because of the lags between a change in monetary policy and its effects on inflation. When inflation is pushed away from target due to factors that are likely to persist, a monetary policy response may be warranted to bring inflation back towards the target. In contrast, monetary policy makers may 'look through' a period where inflation is temporarily away from target and not adjust policy on the basis of factors that are judged likely to be transitory.

In that context, the first session of the Roundtable discussed participants' views of the likely drivers of recent and future inflation. The three speakers highlighted negative output gaps and falls in commodity prices as having contributed to low inflation in recent years. They also discussed additional drivers, including the possibility of more persistent factors such as an extended period of stagnant demand growth across countries.

It was generally agreed that negative output gaps (the estimated gap between economic output and potential economic output) had contributed to low inflation in advanced economies since the dramatic falls in economic activity in 2008–09. Central banks had responded by providing unprecedented monetary stimulus, which was likely to have stimulated economic activity. But in general it was likely that output remained below potential output in many economies, which was likely to be a drag on inflation. Some participants cautioned against viewing the relationship between inflation and output gaps in a deterministic way, however. Historical relationships between output gaps and inflation were not stable; in the past, similar rates of inflation had been observed alongside very different estimated levels of the output gap. This suggested that other factors were often more important drivers of fluctuations in inflation.

Speakers also pointed to commodity prices as an obvious driver of lower inflation in the recent period. Oil prices had fallen sharply in 2014 Q4 following OPEC's decision to maintain production rather than cutting output in the face of additional energy supply from other sources and falling prices. The key question was how oil prices were likely to evolve in the future and hence the outlook for supply and demand in that market.

One speaker noted that global demand for oil had remained strong, partly in response to the fall in prices. Global oil demand had increased by more than would have been suggested by changes in global GDP growth alone. And the increase in demand had been broad-based: from consumers as well as firms, and from across many regions of the world. The speaker argued that there was scope for further increases in demand, particularly from some developing countries.

On the other hand, strong oil supply was likely to keep prices low in the near term. This partly reflected record output from Saudi Arabia and also a reluctance of some OPEC countries to

(1) This report was prepared by David Elliott of the Markets Directorate of the Bank, together with Joanna Konings and Jon Relleen of the Monetary Analysis Directorate.
(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

reduce supply given the importance of the income stream for their public finances. Time lags between falls in oil prices and reductions in supply by non-OPEC producers would also act to keep prices low for a period. However, reductions in supply capacity were eventually likely to affect oil production, helping to support prices in the medium term. Rising production costs could also support prices and over time it was suggested that the oil price may return to around US$100 per barrel.

In light of the different factors influencing the price of oil, participants discussed what would be the most appropriate forecasting method to use. The Bank's forecasting convention assumes that oil prices evolve in line with the latest futures curve, although this approach has well-known limitations, particularly for forecasting at longer horizons. Some participants argued for a structural approach based on oil production costs and other supply considerations. It was agreed that these approaches could be informative, although some argued that the futures curve was probably at least as good as alternative approaches for forecasting over the short to medium-term horizons most relevant for monetary policy.

Participants also highlighted some longer-term, persistent drivers of low inflation. One speaker related low inflation to concerns about a prolonged period of stagnant nominal demand growth, perhaps related to wealth being concentrated in the hands of those with a high propensity to save. The process of economic rebalancing within the euro area was also mentioned. Some European countries running large and persistent current account deficits might become more competitive by having persistently lower inflation than their major trading partners. If inflation was relatively low in countries running surpluses it might have to be even lower in deficit countries. This rebalancing was likely to be a long-term process, so any effect on inflation might be persistent.

Another speaker argued that movements in inflation expectations might indicate market concerns about output remaining below its potential level, and the associated disinflationary pressure. Each of the different measures of inflation expectations had strengths and weaknesses, but the financial market-based five-year, five-year forward inflation rate should give an indication of central bank credibility as it embodies inflation expectations at a time horizon when temporary influences on inflation, such as a fall in the oil price, should have disappeared. Implied five-year inflation rates five years forward were lower than historical averages in the euro area and to a lesser extent in the United States, although not in the United Kingdom.

The speaker argued that falls in five-year, five-year forward inflation rates during 2014 and the early part of 2015 had partly reflected market concerns about the willingness and/or ability of central banks to bring about conditions that would return inflation to target. Against a backdrop of low inflation, concerns may arise if central banks are not perceived to be easing policy sufficiently, or there are questions about the effectiveness of monetary policy close to the lower bound for policy rates.

In summary, the drivers of inflation highlighted in the first session included a range of factors, some of which were likely to be transitory, such as previous falls in oil prices, along with factors that may be more persistent. On balance, the mix of drivers suggested that inflation was likely to rise as the temporary factors dissipated, as long as monetary policy makers could demonstrate their willingness and ability to return inflation towards targeted levels.

Why are real interest rates so low?

In the second session of the Roundtable, participants discussed what factors had driven falls in the level of real interest rates. Real interest rates in advanced economies had fallen significantly since the 1980s, and in recent years the real yields available on index-linked government bonds had often been negative.[1]

The key question for monetary policy makers was what signal they should take from this. For example, did it reflect structural, or at least very persistent, changes in macroeconomic conditions? And did the low level of forward-looking real yields indicate that economic growth was expected to be weak for a protracted period, or were real yields being influenced by other factors such as risk premia? In that context, participants discussed the potential role of fundamental macroeconomic factors as well as technical financial market factors, and whether these factors were likely to be temporary or permanent.

Speakers suggested several interrelated macroeconomic factors that could have led to lower real interest rates. These included a slowdown in productivity growth, demographic changes and deleveraging following the financial crisis.

Several participants argued that low real interest rates could reflect reduced productivity growth, which had been slow by historical standards in several advanced economies over recent years. However, productivity had been reasonably strong before the financial crisis so this could not explain the falls in real yields prior to the crisis. And there were mixed views on whether productivity growth would continue to be weak going forward. For example, one speaker suggested that a more optimistic view was that technological innovations would lead to large productivity gains in the future. Some participants also suggested that current productivity might not be as low as official estimates suggested, as technological

(1) See, for example, King, M and Low, D (2014), 'Measuring the 'world' real interest rate', *NBER Working Paper No. 19887*.

innovation could have made productivity growth more difficult to observe and measure.

A number of participants argued that demographic factors could be contributing to low real interest rates. For example, longer retirement periods might incentivise individuals to increase their level of saving, which would tend to push down real interest rates. Absent reforms such as significant increases in the age of retirement, this factor could persistently reduce interest rates. One speaker argued that the increasing number of retirees could be related to changes in corporate behaviour that might also slow productivity growth. Specifically, retirees may be more interested in income than capital gains, and so favour buying shares in companies that pay large dividends rather than firms that direct a large proportion of their earnings towards capital expenditure. This could help to explain why ratios of dividends to earnings have increased in recent years, while investment has been relatively weak. And continued low investment might signal weak productivity growth in the future.

Some speakers suggested that deleveraging following the financial crisis, where borrowers sought to repay large debts accumulated before the crisis, had also reduced real interest rates. This argument suggested that some of the reduction in real interest rates might be temporary — reversing once the deleveraging cycle and recovery from the financial crisis were complete. That said, there was evidence that it takes a particularly long time for economies to recover from financial crises, so the effects could last a reasonably long time.

In addition, participants discussed several financial market factors that could be contributing to low real interest rates. These factors generally concerned the effect of investors' decisions on the demand for bonds, either due to risk preferences or regulations that encouraged holding bonds.

For example, one participant suggested that Solvency II, a new regulatory regime for European insurance companies, had increased the extent to which these firms bought bonds to hedge their liabilities, supporting the prices of those bonds and so reducing their yields. Others discussed how regulation and concerns about counterparty credit risk had led to more trades being collateralised, generating greater demand for high-quality bonds to be used as collateral. And some participants argued that investors had increased their allocation to bonds in order to reduce the riskiness of their balance sheets, while others noted that some central banks had contributed to the high global demand for bonds through asset purchase programmes.

These types of factors may have reduced the risk premium built into the price paid for a bond, also known as the 'term premium'. One speaker presented survey and model-based evidence suggesting that the majority of the reduction in real rates in recent years reflected falls in term premia, rather than falls in expectations for future interest rates. This speaker also pointed out that long-term interest rates can be volatile, meaning that they may not give a consistently clean read on structural macroeconomic developments.

Several participants suggested that although there was a large quantity of government bonds outstanding, fewer sovereigns were considered to be risk-free than in the past. This meant that purchases of bonds for collateral or to hedge risks were concentrated among a smaller number of the highest-quality sovereign issuers, exacerbating the falls in market interest rates for those countries. One contact pointed out that if these sovereigns were to reduce debt issuance, there could be further falls in the yields on their bonds.

Participants also discussed the fact that while interest rates were low, returns on other asset classes such as equities had not fallen to the same extent. This was in contrast to previous episodes of low interest rates, which had tended to involve low returns across most assets. Broadly speaking, asset returns should be linked to the marginal product of capital, so the apparent disparity between returns on bonds and on other assets might suggest that factors specific to the bond market were at play. For example, some participants thought that investors now attached a higher value to the hedging characteristics of government bonds, whose returns might be expected to negatively covary with returns available elsewhere. Alternatively, changes in regulation or central bank policies such as quantitative easing could have pushed government bond yields below where they would otherwise have been.

The very high degree of international comovement between advanced-economy government bond yields was also discussed. This suggested that moves in yields were largely driven by global rather than country-specific factors. That seemed consistent with increases in trade and financial linkages between countries over recent decades, which were likely to have amplified spillovers from shocks in one country to another, and the increasingly global focus of investors.

It was also pointed out that the current low level of yields was not dramatically out of line with experience over a much longer period, such as the past 100 years or more. It may be the case that yields in the 1970s and 1980s were in fact unusually high. And so the recent falls in yields could reflect a move back towards very long-run averages.

Overall, most participants agreed that there was a great deal of uncertainty about what signal to take from the low levels of real interest rates. To the extent that they reflected fundamental macroeconomic factors, it was possible that they gave a negative signal about the long-term growth potential of the global economy. On the other hand, some of the

financial market factors suggested that yields could move sharply upwards if investor behaviour changed or there were significant adjustments to central bank policy. It was generally agreed that global factors were key determinants of real interest rates, given the high level of correlation between yields across countries, and that the apparent differential between yields on government bonds and those available on other assets was a puzzle that warranted further consideration.