

Monetary Policy Roundtable

On 26 February 2016, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their fourteenth 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 is the role of asset prices in assessing the UK economic outlook?; and
- to what extent is the United Kingdom affected by the global financial cycle?

This note summarises the main issues raised by participants.⁽²⁾

What is the role of asset prices in assessing the UK economic outlook?

Asset prices had fallen during most of the period preceding the Roundtable. Advanced-economy share prices had fallen sharply since the beginning of 2016. Long-term sovereign bond yields had declined. Corporate bond spreads, particularly high-yield spreads, had widened. Commodity prices had also fallen further.

Understanding why asset prices change and what that might mean for the real economy is important for monetary policy makers. To what extent were asset prices being driven by concerns about growth in emerging markets and China? What was the influence of the divergence between US and euro-area monetary policy? A particular concern at the time of the Roundtable was whether the widespread decline in asset prices was suggestive of a material slowdown in future global growth.

In that context, the first session of the Roundtable discussed the role of asset prices in assessing the UK economic outlook. The three speakers discussed how asset prices are linked to the real economy and the value of using them to assess where the economy is currently and where it might be heading.

It was generally agreed that asset prices can be used as leading indicators of the real economy. That is because they are a key link in the monetary transmission mechanism. For example,

wealth affects consumption and housing investment in the United Kingdom. Some participants noted that this effect will depend on how wealth is distributed across households, who might have different marginal propensities to consume, while others also noted that there is much heterogeneity between countries, most likely as a result of institutional differences. Asset prices also affect business investment via the cost of capital as well as stock market volatility. The discussion noted, though, that equity yields might not always reflect the financing costs of investment, implying that they may not always be a good leading indicator.

Even if asset prices do not have well-established structural links to the real economy, they can still be valuable in assessing the current state of the economy. They aggregate the different views of investors, are available on an almost continuous basis and are not subject to revision, unlike many macroeconomic indicators.

But asset prices are also volatile and noisy which makes extracting signals difficult in practice. They often exhibit persistence and sometimes are available only over short samples. Links to output and inflation tend to be unstable, especially out-of-sample. The discussion recognised that, in practice, adding asset prices to naive time-series models did not improve their ability to forecast macroeconomic variables. Asset prices are also strongly correlated internationally which makes it difficult to distinguish between domestic and international drivers. Some participants noted that, for forecasting purposes, factor analysis (which reduces large information sets to a few variables) can add value. Still, it is sometimes important to be able to differentiate between factors, particularly for policymakers. For example, asset prices reflect risk, liquidity and other premia, as well as expectations about future income streams. Differentiating between these various factors is important as they have different implications for the economy.

Speakers cautioned against relying only on asset prices for interpreting movements in macroeconomic variables. This was illustrated by a simple structural VAR relationship

(1) This report was prepared by Srdan Tatomir of the Monetary Analysis Directorate of the Bank, and Rana Sajedi of the International Directorate. The Roundtables are conducted under the '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.

(2) For both this and previous summaries, see www.bankofengland.co.uk/publications/Pages/other/monetary/roundtable/default.aspx.

between yields, equity prices and the sterling exchange rate. The results suggested that there was a significant role for domestic demand in sterling's appreciation during 2013–15. But it was unclear whether this was due to a fall in risk aversion or an improvement in productivity. Different effects might warrant different monetary policy responses. This is why it is important to corroborate signals from asset prices with information from goods and labour markets.

The discussion moved on to the relationship between the term spread, equity prices and economic activity. The term spread, which is the difference between three-month and ten-year rates, has proved to be informative about output and inflation across many countries and time periods in the past. In contrast, equity indicators such as share prices, price to earnings and dividend ratios have tended to perform relatively poorly as leading indicators. This is probably because share prices encompass different factors such as expected earnings, discount rates, equity risk premia and liquidity premia. The discount rate and the equity risk premium are more informative about future macroeconomic variables when accounted for separately. Stock market liquidity also seems to be important. There was evidence that more cyclical stocks (such as financial companies) perform better than aggregate indices as indicators of the economic outlook.

Asset prices can also provide useful information on inflation. Term spreads, once decomposed into liquidity and risk premia as well as interest rate and inflation rate expectations, help predict inflation. But modelling the different factors within term premia can be technically challenging. Expected inflation rates inferred from inflation-linked bonds can sometimes improve inflation forecasts, although participants noted that liquidity premia and market structure can make it challenging to extract signals in these markets. And option prices can provide insights into uncertainty about future inflation rates.

In summary, the first session highlighted the value of using asset prices in assessing the economic outlook. There are advantages in using them as leading indicators of the business cycle and potentially understanding which factors might be driving changes in the economy. But extracting signals and trends can be difficult in practice and needs to be combined with information from the real economy to interpret movements in macroeconomic variables.

To what extent is the United Kingdom affected by the global financial cycle?

The second session looked at the global financial cycle (GFC). Some participants stressed that the GFC should be thought of as the comovement of asset prices and capital flows around the world. While this is related to US monetary policy, the GFC should not simply be taken as the international

transmission of US monetary policy shocks. One driver of the GFC is movements in the VIX (a popular measure of the implied volatility of S&P 500 index options). The VIX is only partially explained by US monetary policy shocks, but is itself an important driver of international capital flows. Hence there is a need to understand the fundamental drivers of global risk factors and risk aversion, which affect the VIX. It was stressed that one advantage of this way of thinking, compared to simply looking at the transmission of US monetary policy shocks, is that rather than considering the United States as separate to the rest of the global system, the response of US monetary policy to global developments can be incorporated into the narrative of the GFC.

Nonetheless, there is still a case for considering the GFC as the propagation of a shock originating in one country, as this allows for the consideration of specific channels of transmission, including bilateral linkages and second-round effects. One starting point for looking at the transmission mechanisms of the GFC is to consider US monetary policy as the trigger. It was agreed that global banks played an important role in this transmission, particularly through foreign currency exposures. When banks borrow in US dollars and lend in domestic currency, as in many emerging market economies (EMEs), a tightening in US monetary policy, which causes a depreciation of the domestic currency, worsens the balance sheets of these banks: the value of liabilities increase and bank net worth falls. This lowers investment, which offsets the positive effects on output from the depreciation, and in some cases could also lead to bank failure and banking crises.

While these direct effects are more pertinent for EMEs, they transmit to the United Kingdom due to second-round effects. In fact, EMEs are becoming increasingly important since UK banks now have large exposures to EMEs, as large as their exposures to the United States or the euro area. When UK banks hold risky positions in both domestic and foreign markets, changes in EME asset markets will affect UK banks' demand for UK assets and, so, transmit to credit conditions in the United Kingdom, putting pressure on sterling. In this way, the balance sheets of global banks act to transmit the GFC. Participants also discussed the global nature of UK asset markets. Many of the largest issuers of equity and bonds in UK asset markets are not domiciled in the United Kingdom, nor have a large fraction of their sales in the United Kingdom. Hence global factors are key in driving UK asset markets, both since the global financial crisis and looking ahead.

How vulnerable are countries to foreign exchange mismatch effects? One speaker showed that, since the mid-2000s, major EMEs no longer had a net short position in foreign currency. This could suggest that EME bank net worth was no longer vulnerable to US monetary policy, although it was noted that this could be a fallacy of composition with a large

long position in the public sector hiding large short positions in the financial sector.

Moreover, regarding the transmission of the GFC through exchange rates, it was shown that there was no evidence of high correlation between exchange rates and risk aversion. Recent studies have shown that the effect of monetary policy on exchange rates can be ambiguous, with a case study of the first bout of quantitative easing in the United States showing that this episode of monetary loosening caused an appreciation of the US dollar, possibly because it was carried out at a time of high uncertainty when the signalling role of monetary policy was important for building confidence. The European Central Bank's Outright Monetary Transactions in 2012 arguably had a similar effect. More generally, it was noted that while policy rates may be correlated across countries, this did not necessarily translate to correlation in real variables because monetary policy had different effects in different countries depending, for example, on the structure of private agents' assets and liabilities.

What are the policy implications of the GFC? Several participants stated that the view that the GFC created a 'dilemma' for monetary policy independence was not necessarily correct. Nonetheless, to the extent that exchange rate volatility propagated the GFC, this changed the trade-offs for monetary policy, potentially increasing the desire for exchange rate stabilisation. In terms of financial stability, it was clear that external risks have become important, with a possibility of contagion through global banks. In this case, several participants advocated the usual doctrine of 'two objectives, two instruments', meaning that macroprudential tools should be used to address financial stability, in order to enable monetary policy to target traditional macro and monetary stability objectives.

In terms of specific macroprudential tools, one speaker suggested that, unlike for traditional financial contagion, reducing leverage in the domestic financial sector did not seem to limit vulnerability to the GFC, suggesting there are additional mechanisms at play. Other speakers cited research advocating EMEs imposing cyclical capital controls on foreign borrowing or using loan to value ratios to affect the asset side of balance sheets. It was noted that macroprudential measures were generally discussed in relation to EMEs, in part because there was less empirical evidence for advanced economies. However, one aspect of policy that is more relevant to advanced economies was the role of increasing regulation and unconventional policy instruments. Some participants suggested that central banks were increasing volatility in markets because of regulation that reduced liquidity, possibly driving prices away from fundamentals. More generally, the increased uncertainty about policy, divergence of the cycle or policy stance among major countries, and the use of unconventional policy tools that make central banks active players in asset markets, all directly affect risk appetite and propagate the GFC. Participants stressed that these effects were part of a transition towards a safer system, with the financial sector collectively learning about the new regulatory landscape. In the long run, with the normalisation of monetary policy and central banks' balance sheets, these effects would be expected to fade.

Overall, it is clear that there remains a lot of scope for research to understand the GFC. This includes defining precisely what is meant by the GFC, understanding its fundamental drivers, the channels of its transmission to macroeconomic and financial variables, and, ultimately, its policy implications.