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Report

Monetary Policy Roundtable



Monetary Policy Roundtable

On 8 November 2018, the Bank of England and the Centre for Economic Policy Research (CEPR) hosted their 17th 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:

- current issues around unconventional monetary policy; and
- the outlook for equilibrium interest rates.

This report summarises the main issues raised by participants.

Current issues around unconventional monetary policy

Over the past decade, central banks in many economies have expanded their monetary policy toolkits to encompass a wider range of instruments. These have included purchases of government bonds and private sector assets, providing direct funding for banks and targeting interest rates at multiple horizons — known as yield curve control.

These unconventional policy tools were introduced to provide economic support and stimulus at a time when central banks' traditional monetary policy instrument — the short-term nominal interest rate — was unable to be reduced sufficiently, constrained by the lower bound. In many cases this coincided with periods of disruption in financial markets and a deteriorating economic outlook. What is more, the relatively novel and untested nature of these instruments meant that there was little historic evidence to inform their design and calibration.

Ten years later the context is much changed. At the time of the roundtable, a number of central banks had shifted their emphasis from the search for further means of easing monetary conditions to thinking of how best to tighten them when appropriate, and financial market functioning was much improved compared with the financial crises of recent years. Alongside this, understanding of unconventional monetary policy tools has been enriched by the increasing number of case studies from which to learn and a growing body of economic research.

Against this backdrop, the first session focused on issues around unconventional monetary policy that are of particular relevance currently.

Exactly how unconventional policy tools affect the economy remains a matter of debate. For instance, among participants, views differed over whether quantitative easing operates predominantly through providing a signal about the future path of interest rates or by changing the relative supplies of assets and inducing investors to rebalance their portfolios. It is likely that the relative importance of these channels is not constant, either across countries, or through time, and depends on the particular design features of the policy, the structure of the economy in question and the state of the world into which the policy is being introduced.

Questions around unwinding unconventional measures have become increasingly relevant as economic cycles have progressed and the focus of some policymakers has moved towards monetary tightening. Participants discussed the potential for differences in how unconventional policies affected the economy in periods of easing versus periods of tightening. There were at least two reasons to think that unwinding unconventional policies may

(1) This report was prepared by Olga Maizels and Jack Meaning of the Monetary Analysis Directorate of the Bank. 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.

have less of an impact on financial markets and the wider economy than was observed when they were being expanded.

First, in an easing phase short-term nominal interest rates are constrained by their lower bound, and so unconventional measures were working to fill the space this constraint leaves. However, no such constraint exists on interest rates in the tightening phase. To the extent that the two forms of policy are seen as substitutes for one another, any tightening of one should then be offset by an expected looser path for the other, leading to a reduced, or net zero impact on the economy as a whole.

Second, many unconventional monetary policy instruments were introduced during periods of significant market dysfunction. Economic theory would suggest that this would amplify the channels through which unconventional measures work, making them more effective. In a world in which markets were generally functioning well, one would expect less impact from changes in the central bank's balance sheet. This state-contingency complicates policymaking as it is difficult to accurately know the extent to which markets are impaired in real time. A number of the speakers also highlighted that central bank interventions themselves have been a possible driver of the reduction in market dysfunction. Were this to be the case, and were the underlying problems to remain unresolved, unwinding the policies could lead to a resurgence of disruption and a larger tightening.

Taking a longer view, participants discussed what the role of unconventional policy instruments should be in the future. There was consensus that unconventional instruments now represent a fundamental part of the policymaker's toolkit. However, most believed that their use should be reserved for periods in which the short-term nominal interest rate was constrained by its lower bound. Should the documented decline in equilibrium interest rates persist then it was likely that short-term interest rates would be constrained in this way more frequently, and so policymakers would need alternative instruments to help stabilise the economy. While disagreement over the precise transmission mechanism exists, the weight of evidence suggests that unconventional policies were successful in attenuating the worst of the economic downturns they sought to counteract.

However, many participants thought that incorporating unconventional instruments on a more permanent basis would not be without risk. As mentioned by a number of the speakers, interventions such as buying large quantities of government bonds have the potential to bring with them a number of risks to central banks. For one, they may blur the lines between the monetary and fiscal authorities; the central bank would become a more significant player in the market for government debt, and purchasing long-term government bonds funded by short-term central bank liabilities changes the size and timing of cash flows from the government to the central bank, and *vice versa*. Both of these features could present risks to the perceived independence of monetary policy if not handled well. One speaker highlighted that the Bank of England's explicit arrangement, under which HM Treasury provide an indemnity to central bank purchases of government debt and which details the conditions for cash flows, went a significant way to mitigating this risk.

More generally there was discussion of the lessons that had been learned from unconventional monetary policies thus far and how they might inform the monetary framework of the future. Expanded balance sheets have allowed central banks to satiate demand for liquidity without harming the functioning of money markets. Continuing to satiate demand for liquidity in this way would imply larger central bank balance sheets but may present benefits to policymakers if it allows them to reduce inefficiencies in the provision of money by more closely approximating the Friedman Rule.⁽²⁾

All three speakers in this session talked to the need to consider unconventional monetary policy in an international context. An obvious example of this was understanding the implications for exchange rates. One speaker presented evidence that, counter to what might be expected, loosening of unconventional monetary policies in the US was associated with an appreciation of the US dollar. This result could be rationalised if investors took a strong signal from unconventional policy that the Federal Reserve believed the economic outlook was weaker than previously thought, and so revised down their expectations of future growth and inflation

(2) The Friedman Rule states that the central bank should set the marginal cost of holding money equal to its marginal cost of production. In this case it implies paying interest on reserves equal to the central bank's policy rate and satiating demand with as many reserves as banks want at that rate. It is often referred to as a 'floor system'.

accordingly. One consequence of this empirical finding was that unconventional policies in the US have driven a wealth transfer from the US to the rest of the world — an ‘exorbitant duty’ — which would offset some of the stimulatory impact they were intended to have.

A second example of the importance of the international dimension of unconventional policy is that the structure of the euro area — multiple countries with a single monetary authority — could give rise to some specific channels of transmission. In this case asset purchases and central bank loans could be a way for the central bank to intermediate cross-border financial activity within the currency union when private markets are unable or unwilling to do so. Indeed, one of the speakers put forward evidence supporting the view that this had been a significant feature of the ECB’s unconventional policies.

The outlook for equilibrium interest rates

During the second session, participants discussed the outlook for global equilibrium interest rates. The equilibrium interest rate is the interest rate that, if the economy starts from a position with no output gap and inflation at the target, would sustain output at potential and inflation at the target. But as described in the August 2018 *Inflation Report*,⁽³⁾ setting the interest rate equal to the equilibrium rate is not always sufficient to meet the inflation target in the medium term. Indeed, there are times when monetary policymakers may have to set the policy rate either below or above the equilibrium rate. For instance, if output were below potential, monetary policymakers may set the policy rate below the equilibrium rate for a period of time in order to return output to potential. Similarly, if output were above potential, the policy rate may be set above the equilibrium rate. The equilibrium interest rate can provide an indication of the outlook for interest rates over the coming years.

Although the equilibrium interest rate cannot be directly observed, it can be estimated using a range of methods, for instance by using macroeconomic models or data on market-based measures implied by long-term government bond yields. Nevertheless, it is difficult to estimate it with precision.

The equilibrium interest rate is not constant over time and is likely to vary given structural changes or shorter-term influences on the economy. Indeed, participants estimated that, on some measures, world real equilibrium interest rates — equilibrium interest rates adjusted for inflation — have likely fallen from an average of around 4%–5% in the 1980s to around zero now. There was no single clear driver behind the fall and instead speakers discussed a range of potential factors that may have played a role.

One possible cause of low real rates that participants discussed was the effect of slow-moving financial cycles on the economy. These are often associated with credit and asset price growth in the boom phase, followed by deep recessions, falling asset prices and balance sheet repair in the crisis phase. Periods in which asset prices and wealth increased rapidly have at times been followed by financial crises and periods of deleveraging, whereby households and firms strengthened their balance sheets. The reduction in debt levels was in turn believed to have put downward pressure on real interest rates. Two notable examples when deleveraging was argued to have been particularly marked were during the 1930s Great Depression and following the global financial crisis of 2008–09.

Participants also discussed other potential drivers which may have lowered equilibrium interest rates. One stylised way of thinking about the equilibrium interest rate is that it is the rate that balances the supply of savings in an economy with the demand to use these savings for investment. When interest rates are high, saving becomes more desirable, while borrowing to invest becomes less desirable (and *vice versa* when interest rates are low).

In this framework, changes to either saving or investment behaviour can impact the interest rate that is required to balance the market. For example, a structural change in the economy that increased the desire of households or firms to save for a given interest rate would create excess savings relative to the demand to use these savings as investment. In order to bring savings and investment back into balance, the interest rate would need to fall to encourage more investment.

(3) See Box 6 on pages 39–43 of the [August 2018 Inflation Report](#).

Participants noted a number of structural changes in the economy which may have contributed to lower equilibrium interest rates.

On the one hand were factors that may have increased desired levels of saving. One of these was changing global demographics. Individuals tend to accumulate savings over their working lives in order to finance spending during retirement. Longer life expectancy meant that people were likely to spend a longer period of time in retirement, increasing the need for saving. A lower birth rate has also meant that a greater proportion of the population is at stages of life associated with high savings rates.

But, while the speakers acknowledged that demographics were likely to have played at least some role in lowering equilibrium interest rates, some believed that their effect was often overstated. Structural changes, for instance people staying in employment for longer, were argued to have offset some of the impact of population ageing. The speakers also noted that it was difficult to find consistent empirical relationships between demographic factors and moves in equilibrium rates.

Other signs of higher desired savings rates discussed were the accumulation of foreign exchange reserves by a number of emerging market economies, as well as a build-up of large cash buffers by some large corporates since the financial crisis.

On the other hand, some factors were likely to have decreased the demand for capital and investment. For instance, the fall in the price of technology and a further shift in the structure of many economies away from capital-intensive manufacturing and towards the services sector meant that the cost of starting a new business or investing to expand has fallen for many firms. This would have reduced the demand for capital from many firms and put downward pressure on equilibrium interest rates. Slower expected productivity growth may also have dampened the demand for investment.

There is also a possibility that the financial crisis may have led individuals to reassess their perceived probability of another extreme event, both encouraging saving and discouraging investment and in turn putting downward pressure on interest rates.

Whatever the causes behind low equilibrium rates, most participants agreed that they were likely to remain below their historical averages for some time to come, given the slow-moving nature of the drivers.

Participants discussed whether the current period of low real rates was unusual from a longer-term historic perspective. Data on real yields on advanced economy safe assets from the past six centuries show that real yields have fluctuated over time, at times sharply. And while the current period of low real yields stands out, there have been other periods in the past when real yields have been as low as they are currently, or even lower. That said, real yields appear to have trended down gently over the past half a millennium or so and perhaps the recent fall in real rates should be seen as part of this long-term trend. Indeed, viewed in this context, the period of high real rates around the 1980s may have been as unusual as their subsequent fall.

There was also debate as to whether monetary policy had the potential to raise the equilibrium real interest rate. On the one hand, some participants noted that most of the factors that were thought to have driven real rates lower, such as demographic changes or the demand for and cost of investment, were structural phenomena that monetary policy had limited effect on. As such, there was a limit to how much central banks could impact equilibrium real rates. On the other hand, some participants argued that monetary policy could have some influence on equilibrium rates through its impact on financial cycles.

Finally, participants discussed whether the equilibrium interest rate was a useful concept in central bank communications. There were certainly difficulties, such as the uncertainty around any estimates of the equilibrium rate and the relative complexity in explaining it to the public. But overall participants thought it served as a helpful anchor for interest rate expectations and formed a valuable part of central banks' forward guidance.