

ÁNGEL UBIDE

THE PARADOX OF RISK

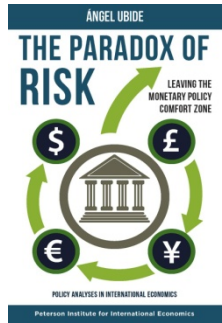
LEAVING THE
MONETARY POLICY
COMFORT ZONE



POLICY ANALYSES IN INTERNATIONAL ECONOMICS

Peterson Institute for International Economics

The Paradox of Risk



- “All courses of action are risky, so prudence is not in avoiding danger, but in calculating risk and acting decisively”.
 - When private sector is very risk averse, public sector must take risks
 - Being too conservative creates a riskier outcome.

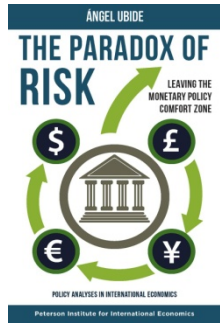
The Power of Narratives



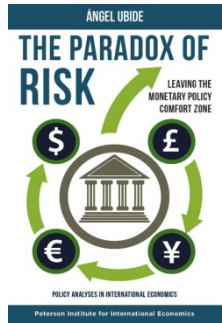
- Increase in risk aversion driven by narratives
 - “Debt is bad” -> fiscal austerity
 - “Not under my watch” -> regulatory tightening and focus on downside risks
 - “Central banks don’t get it”, “central banks help banks”-> political attacks on central banks
- ⇒ Monetary policy the only game in town, facing strong headwinds.

Monetary Policy Has Worked

- It affected financial conditions as expected
 - Lower rates, higher asset prices, weaker fx
- And boosted growth and inflation
 - GDP above peak, “missing deflation”
- But it could have done better
 - Late and not enough easing
 - Self imposed constraints

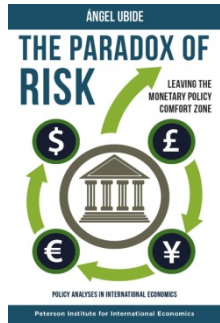


Monetary Policy Has Worked

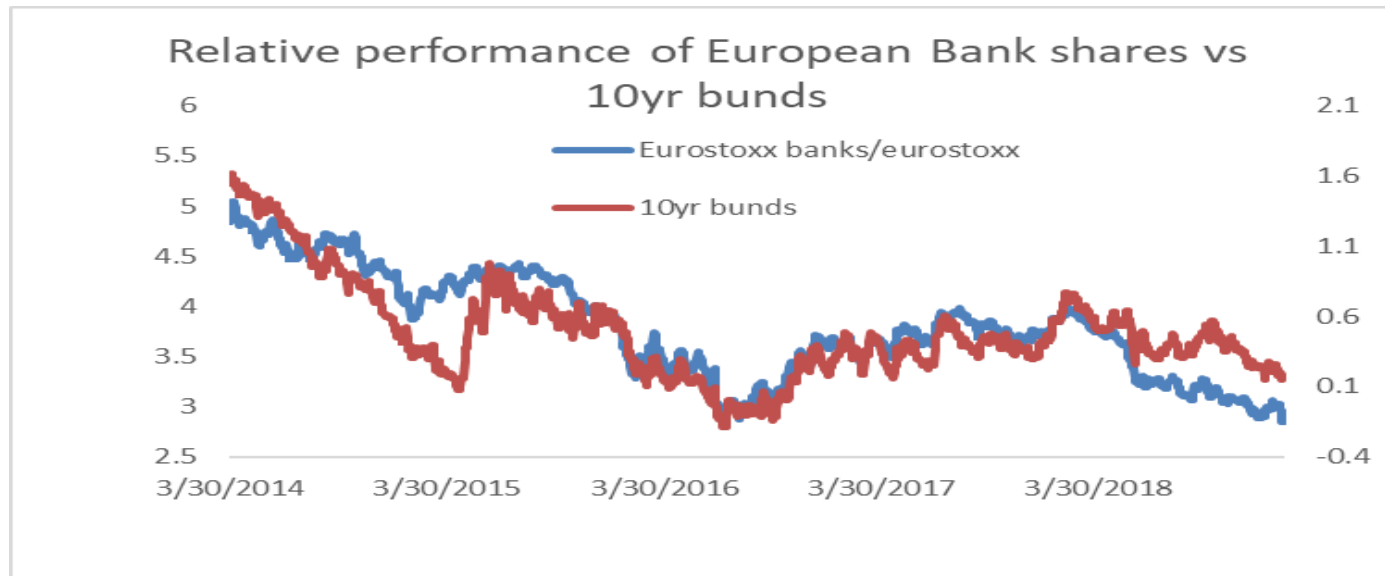


- It worked better when providing insurance on the outlook => goal oriented
- *Economic decisions = Outlook * uncertainty*
 - Normal times – stable uncertainty, fine tune outlook
 - Crisis/bubble – uncertainty dominates
 - => best if state contingent, open ended
 - => best if credibly symmetric vs goals

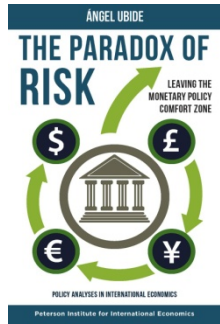
Monetary Policy Has Worked



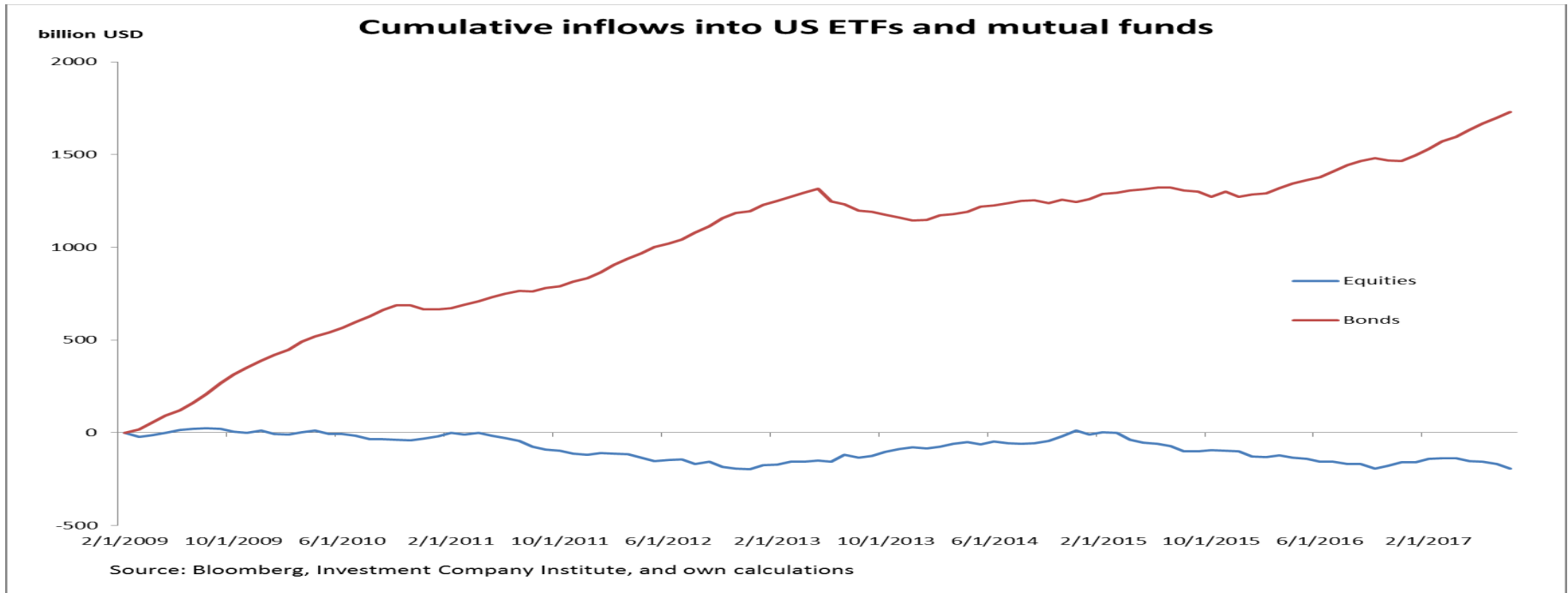
- Do negative interest rates ease policy?
 - Amplify QE by changing the reference point
 - Too much of a good thing? The reversal rate
 - June 2015-May 2018: corr = 0.9



Monetary Policy Has Worked

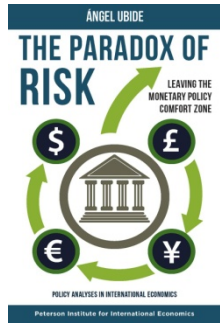


- Is buying safe assets efficient?
 - Limits to portfolio rebalancing => buy risky assets?
 - Safe asset scarcity => need fiscal policy?



Without Major Side Effects

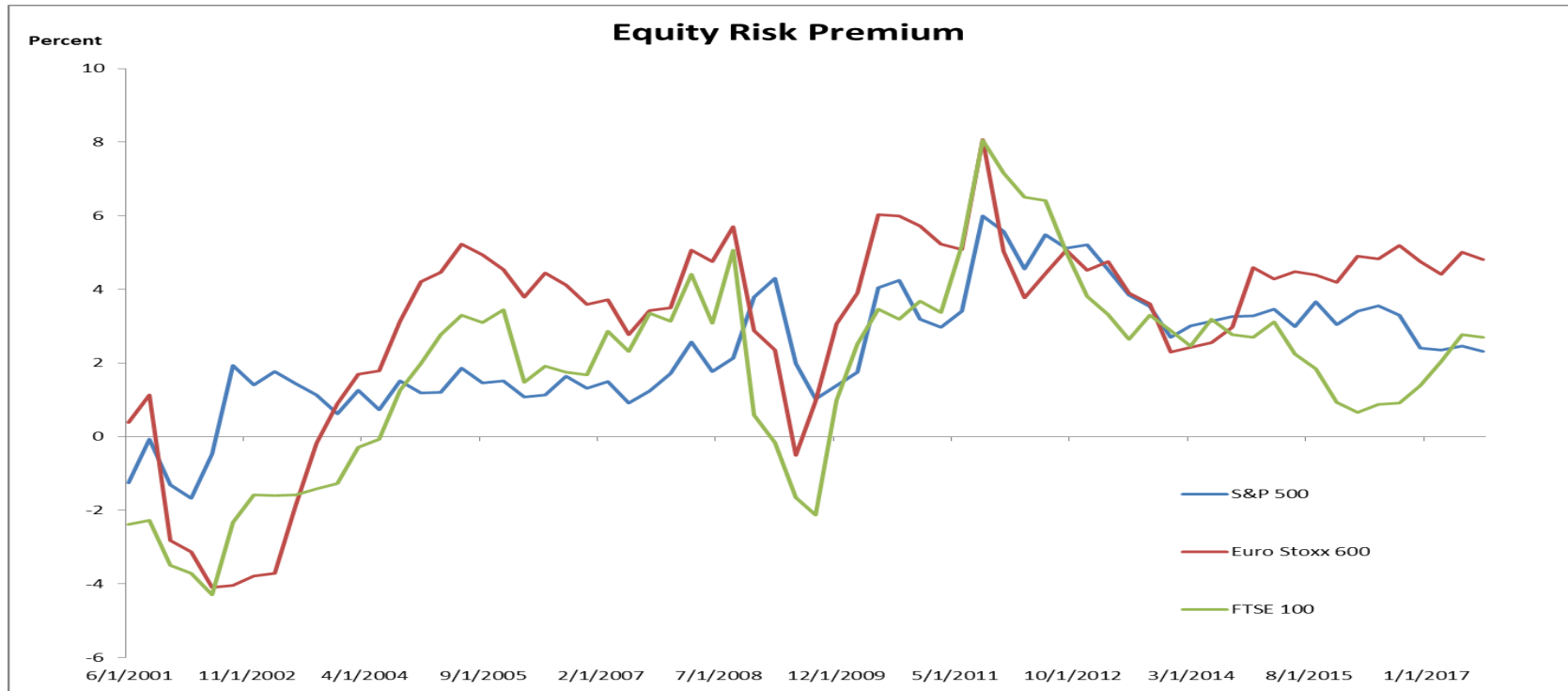
- Inflation hasn't accelerated
 - Inflation is not a monetary phenomenon
- Fiscal policy too tight
 - QE didn't create fiscal moral hazard
- Not major driver of inequality
 - Unemployment main driver of inequality



Without Major Side Effects



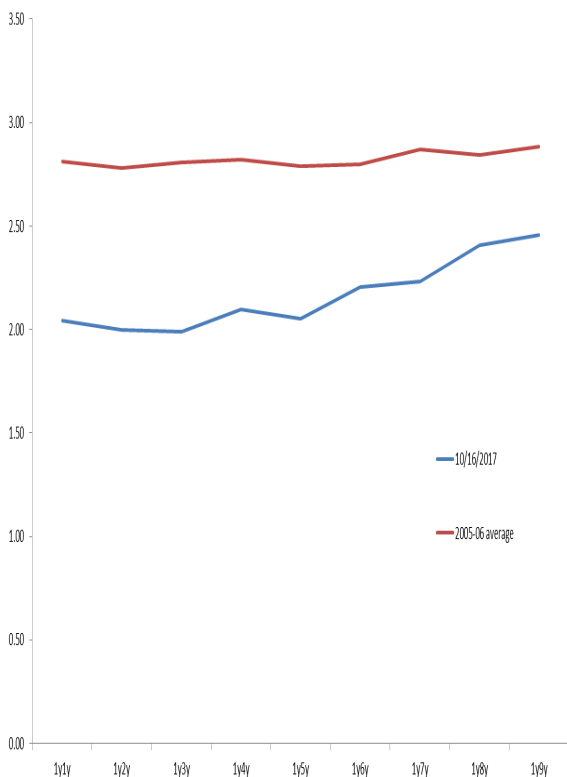
- Main channel of policy was reducing risk aversion. Yet equity risk premia remains high.



No Room For Complacency

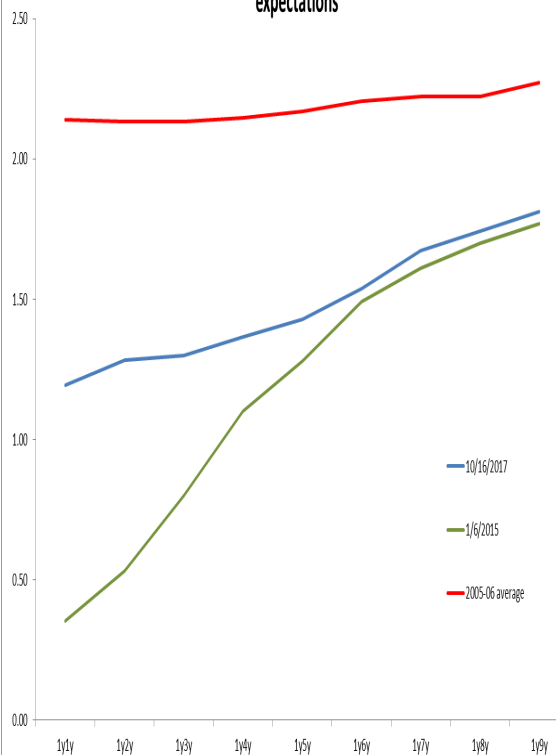


Figure 4.19a Term structure of US market implied inflation expectations



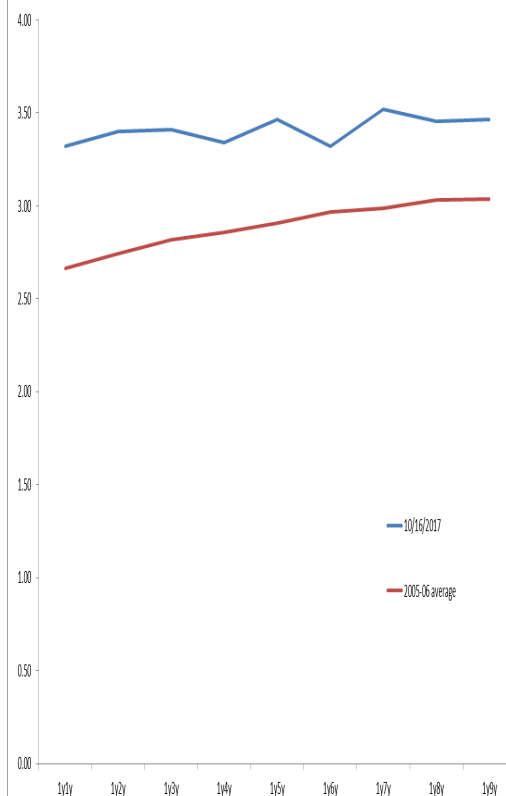
Source: Bloomberg and own calculations

Figure 4.19b Term structure of market implied euro area inflation expectations



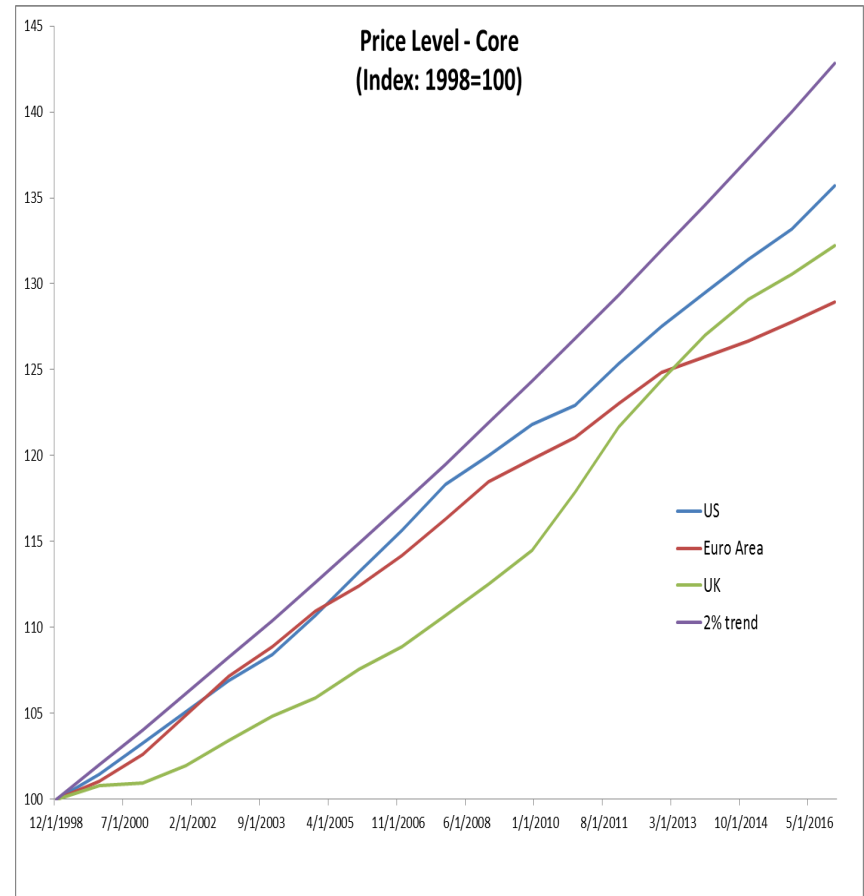
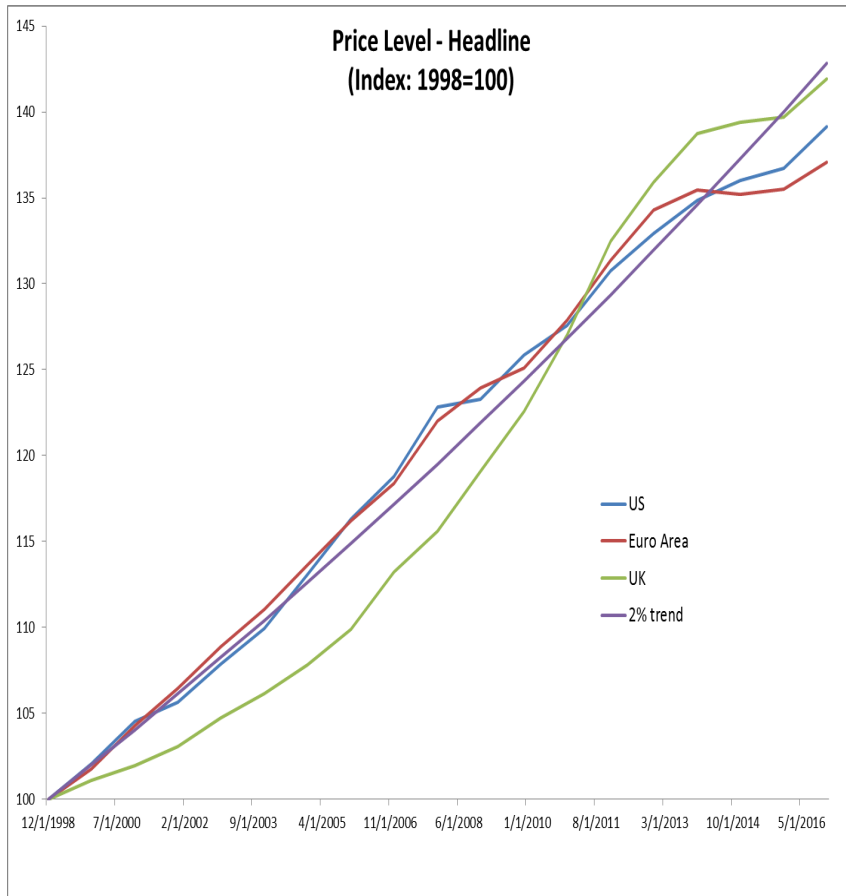
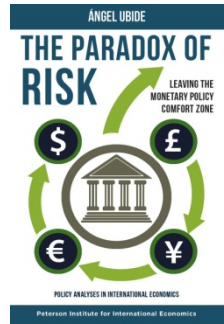
Source: Bloomberg and own calculations

Figure 4.19c Term structure of market implied UK inflation expectations



Source: Bloomberg and own calculations

No Room For Complacency

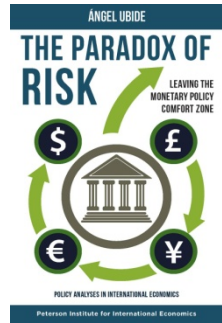


Monetary Policy for all Seasons

- A program of opportunistic reflation
- Adopt dual mandates
 - Maximize growth subject to price stability
- Carry large balance sheets, buy all type of assets
- Cyclically adjusted forward guidance
- Improve communication – quit calling it unconventional



Monetary Policy for all Seasons



- **A program of opportunistic reflation**

- If 2% good for small shocks and higher r^* \Rightarrow then 2% too low today

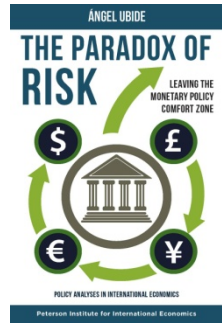
- Need more room to cut real rates – or accept bigger output gaps

- Trade off: higher inflation target vs more negative rates or more active fiscal policy

- \Rightarrow First overshoot 2% to anchor 2% target

- \Rightarrow Then accommodate to new, higher target.

Monetary Policy for all Seasons



- **Adopt dual mandates, at least de facto**
 - Hysteresis => demand affects potential growth
 - Flatter, non accelerationist Phillips Curve => no need for bust after boom
 - Democratic accountability
- => Maximize growth subject to price stability

Monetary Policy for all Seasons



- **Carry large balance sheets, with all type of assets**
 - IOER breaks link between balance sheet and inflation
 - Excess reserves improve financial stability
 - Better targeting of specific risks

Monetary Policy for all Seasons



- **Cyclically adjusted forward guidance**
 - Help stabilize leverage
 - *Leverage = $f(\text{rates}, \text{uncertainty})$*
 - If too high uncertainty, explicit forward guidance
 - If too low uncertainty, minimal forward guidance
 - => limit carry trades

Monetary Policy for all Seasons

- **Improve communication**
 - Stop calling it “unconventional”
 - Stop calling it “exit”
 - => reduce stigma, improve effectiveness.



The Future is Here

- The Brexit easing
 - An insurance package
- Abenomics
 - Fiscal policy in the lead
- Inflation is an economic policy phenomenon
 - ⇒ focus on the policy mix
 - Income policies



Final Thought

- Symmetric risk management to achieve goals
- Avoid behavioral biases in policy making
 - Overconfidence \Rightarrow take $E(\pi)$ for granted
 - Anchoring effect
 - 1970s inflation \Rightarrow too much worry about inflation
 - Greek crisis \Rightarrow too much fiscal austerity
 - Endowment effect
 - Overweight cost of changing inflation target
 - Overweight cost of changing fiscal rules
- Don't settle for good enough

