Geneva Report 18
What Else Can Central Banks Do?

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Available at www.icmb.org
Frequency and Cost of ZLB

- \( i_{\text{avg}} = r^* + \pi^e \)

- Lower neutral real rates and lower inflation since 1980s: The lower bound constraint has become frequent reality
Cost of ZLB

Simple macro model gives quantification for the US:

• $r^* = 1\%$ and $\pi^e = 2\%$

• $i$ will hit zero often - whenever unemployment exceeds NAIRU by 1.1pp

• Figure: The severe recession of 2008, $i^* = -6\%$
Policy Implications / Structure of Report

• Focus of Report: What can central banks do to meet their mandates when constrained by ZLB?

• Unconventional monetary policy necessary in future
  • Negative interest rates (NIR)
  • Quantitative easing (QE) (incl. helicopter money)
  • Forward guidance on policy or inflation

• Policies to reduce the incidence of the ZLB
  • Raising the inflation target
  • Periodic re-examination of inflation targets

• Long view: Monetary policy in post-cash economies
Negative Interest Rates (NIR)

- Recent experiences in five countries suggest:
  - NIR transmits largely as expected (anomalies in banking)
  - Rates can be cut further below zero
  - Side effects tend to be overstated
Quantitative Easing (QE)

- Literature unambiguously shows QE lowers bond yields.
- Adverse side effects tend to be overstated.
  - Notably, fiscal implications are benign.
- Previous programs had stimulus equivalent to cut in short rate of 2 or 3%...
- .. and scope for more in many countries.
- Assets other than government bonds can be brought into the mix.
Quantitative Easing (QE)

Table 3.2  Scope for quantitative easing in major advanced economies (2015Q4, percent of GDP)

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<th>Central bank assets</th>
<th>Total securities</th>
<th>Domestic bonds and international bonds in local currency</th>
<th>Stock market</th>
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Forward Guidance on Inflation

• A credible promise of higher future inflation can reduce current real interest rates.

• Forward guidance has worked, within limits.

• A higher inflation target can be a powerful commitment device for raising inflation expectations.

• Forceful communication, credible supporting policies and continued policy adjustment needed to convince markets.
Abenomics

Figure 3.14 Inflation and inflation expectations in Japan

Note: Core inflation is based on consumer prices excluding fresh food, energy, and consumption taxes. Long-term survey is six- to ten-year ahead inflation expectations of professional forecasters (April and October). The vertical line is at April 2013. Data are for January 2010 through April 2016.

Sources: Bank of Japan and Consensus Forecasts.
Monetary Stimulus and Financial Stability

• Risk of exuberance similar for conventional and unconventional monetary easing

• Search for yield, excess leverage

• Macropru tools are best for financial stability, but questions as to effectiveness

• Monetary policy blunt instrument

• ZLB more likely to occur in conditions of low exuberance.
Raising the Inflation Target

• Limits to QE, NIR and forward guidance are suggestive of benefits to preempting the liquidity trap.

• Low targets reduce normal nominal interest rates, increase the ZLB incidence and target undershooting.

• Low targets may have become inconsistent with central banks' macro stability mandates.

• Inconsistency is likely to persist or worsen, unless neutral real interest rate reverses downward trend.
Target Credibility

• The most credible target is the one most consistent with the mandate.

• Link inflation target to the mandate. Analysis should factor in risks and costs of liquidity trap.

• Targets should not be fixed forever. Cost and benefits change over time and across countries.
  • For example, the neutral real interest rate may change.

• Periodic re-examination of inflation targets ensures continued consistency with mandates.
The Post-cash Economy

- The liquidity trap is created by the availability of cash.
- Cash is needed as a means of payment.
- New payments technologies reduce the need for cash.
- If cash can be phased out, liquidity traps will be obsolete, and optimal inflation targets will likely be lower.
- Diminished use of cash raises issues of social inclusion, privacy of payments and digital security.
The Post-cash Economy

- Some countries' payments systems are quickly becoming cashless.
Conclusions

1. Recovery was too slow, needed more or faster stimulus

2. Central banks have firepower in a liquidity trap
   • Reduce policy rates below zero
   • Expand scale and scope of QE
   • Commit to higher future inflation if credible

3. Raise inflation targets and introduce recurrent reviews
   • Current low targets may be inconsistent with CB mandates

4. Long view: ZLB obsolete in Post-cash economies