What Else Can Central Banks Do?

Laurence Ball, Joseph Gagnon, Patrick Honohan and Signe Krogstrup

Comments by:

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At Jackson Hole Chairman Yellen suggested tools are available in the event of recession.

BGHK say “why wait?”

* Unconventional policy can use up more resource slack

* Higher inflation goal can bump up zero lower bound (ZLB) insurance

* This report is a thoughtful, informative, and authoritative analysis of central bank policies--both actual and possible options at ZLB.
Comments

I. Historical context: Nuances

(i) Assessing the effects of post-crisis policies,
(ii) Sustained negative real rates episodes (iii) Disentangling trends and cycles and the elusive quest for potential output

II. Post-crisis financial regulation: Missing

(i) Changes too big to ignore (ii) interactions with monetary policy

III. Policy recommendations: Discussion

(i) Raising the inflation target, (ii) more fiscal policy at the central bank (iii) post-cash world.
Assessing the effects of post-crisis policies: The counterfactual

- BGHK provide a clear and comprehensive summary of the literature on the effects of QE and post-crisis monetary policy. But what could a counterfactual of no easing possibly look like for 2008-2016?

- Since the beginning of the 1930s the advanced economies had not experienced such a deep and synchronous financial and economic crisis.

- If the 1930s are a benchmark for the headwinds faced by central banks after 2008, conventional and QE policies have delivered MORE than they are often credited for (ZLB notwithstanding)

Reinhart
Minimum inflation (or maximum deflation), 22 advanced economies in the aftermath of global financial crises

Percent per annum

Reinhart

2008-2016, deflation red bars, inflation blue bars

1930-1939

US, 2009
UK, 2015
Switzerland, 2015
Sweden, 2014
Spain, 2015
Portugal, 2015
Norway, 2012
NZ, 2015
Netherlands, 2015
Japan, 2009
Italy, 2015
Ireland, 2009
Iceland, 2015
Greece, 2014
Germany, 2015
France, 2009
Finland, 2015
Denmark, 2015
Canada, 2009
Belgium, 2009
Austria, 2009
Australia, 2015
US, 1932
UK, 1931
Switzerland, 1932
Sweden, 1931
Spain, 1933
Portugal, 1931
Norway, 1931
NZ, 1932
Netherlands, 1932
Japan, 1931
Italy, 1931
Ireland, 1931
Iceland, 1931
Greece, 1930
Germany, 1932
France, 1932
Finland, 1930
Denmark, 1931
Canada, 1931
Belgium, 1932
Austria, 1931
Australia, 1932
The incidence of negative real long-term interest rates in advanced economies, 1900-2016

Delivering negative real rates was impossible in the 1930s—but not post 2008
Sustained negative real rates episodes are not new (see previous chart)

- Some episodes, such as the 1970s, these were the byproduct of rising (and sometimes unexpected) inflation

- However the post-WWII-late 1960s spell of persistent negative real rates was largely due to the ability of central banks AND financial regulation to keep nominal rates low. In the advanced economies, median inflation oscillated in 1½-4½ percent.

- Perhaps, there are aspects of this era worth further study.
The incidence of negative real short-term interest rates in advanced economies, 1945-2016

Rates are on 3-month T-bills or 2-year bonds advanced economies, 1945-2016

Real Interest rate on T-bills

Share of observations at or below:

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<tr>
<td>-1 percent</td>
<td>-33.9</td>
<td>-5.7</td>
<td>-28.8</td>
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<tr>
<td>0</td>
<td>-47.8</td>
<td>-11.3</td>
<td>-57.7</td>
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<tr>
<td>1 percent</td>
<td>-62.8</td>
<td>-23.1</td>
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<td>2 percent</td>
<td>-76.5</td>
<td>-38.8</td>
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Percent of observations

Percent of observations at or below:

real interest rate on 3-month T-bills (percent)
Disentangling trends and cycles and the elusive quest for potential output

- BGHK often convey the impression that central banks **REALLY KNOW** what potential output is. Further, policy should not be satisfied with anything less than a zero output gap.

- The unhappy experience of the 1970s post-oil shock policies of chasing an elusive and outdated estimate of potential output comes to mind.

- The markdown to growth projections by official institutions post 2008 crisis are legion...

- Potential output growth for the US has recently been marked lower, to 1 ½ % by the CBO.

- Perhaps a more nuanced view?
Vintages of IMF forecasts for world GDP growth (percent)

Source: IMF, World Economic Outlook (various)
Post-crisis financial regulation

- While this is a study of monetary policy in the era of ultra low interest rates, monetary policy has not been the only policy affecting interest rates after the crisis.

- Financial regulation has been significantly altered since the crisis in most advanced economies and contributed to downward pressure on rates. A salient feature of regulatory changes has been that it has fed the demand for government paper by financial institutions. It has increased the costs of financial intermediation. The latest FOMC minutes also acknowledges this point.

- According to some recent studies, bank disintermediation of certain activities and the new risks this poses has implications for the desired size of the central bank balance sheet and its maturity composition.

- Would have liked BGHK views on this topic.

Reinhart
SEC Adopts Money Market Fund Reform Rules

Like prior measures, this has increased the demand for government paper. Other examples are numerous...

From prime to government funds

Upcoming reforms prompted a major MMF shift from prime funds to government funds this year.

Source: ICI and Haver Analytics.
Policy recommendations

*Raising the inflation target:*

- As Blanchard, Rogoff and Summers (in alphabetical order) earlier, BGHK endorse such a move.
- In addition to the arguments made by the aforementioned (which I subscribe to), for the past 6 years I have highlighting that in some episodes of very high public debt financial repression (FR) coupled with a steady dose of modest inflation has contributed to debt reduction.
Fiscal effects of monetary policy in the era of financial repression (Reinhart and Sbrancia, 2011, 2015)

- For the advanced economies, real interest rates were negative roughly ½ of the time during 1945-1980.

- “Financial repression” was most successful in liquidating debts when accompanied by a steady dose of inflation.

- Average annual interest expense savings as a percent of GDP (FR tax) ranged from about 1 to 5 percent of GDP for the full 1945-1980 sample.

- The modern estimates may be comparable (or larger if contingent liabilities are included in the calculus)…
Fiscal policy at the central bank: Helicopter money and negative interest rates

- Negative interest rates are a **tax on banks** (which are passed on to depositors and borrowers).

- **Helicopter money**: As an exclusive central bank action, it presumes a fiscal role. Central bank subsidies/future taxes on such a scale without the action of the government and the consent of the voters smacks of “taxation without representation.”
There is more than one way to lose central bank independence

- In the classic fiscal dominance story the central bank is the passive financier of the government.
- In helicopter money, a pro-active central bank can be both government and financier. The central bank steps in to substitute what inept fiscal policy(makers) will not do (this is 2008-2016 on steroids). The central bank loses independence of its own volition.
- Of course, the central bank can always really lose independence (de jure) if the fiscal inepts that wrote their charter in the first place decide its time to redraft it.

Reinhart
An observation on the trajectory to a post-cash world

- As documented in the paper, the evidence suggests that the transition to a cashless society is already “organically” underway.

- However, adopting measures to penalize cash holdings is a different matter. At this stage, the concerns with modern cash hoarding become somewhat reminiscent of the fear of gold hoarding in the US in the early 1930s. That episode culminated with President Roosevelt passing a law requiring the surrender of all gold coins, gold bullion, and gold certificates to the government by May 1, 1933. The limitation on gold ownership in the U.S. was repealed after President Ford signed a bill legalizing private ownership of gold which went into effect December 31, 1974.