

# **BIS WORKING PARTY ON DOMESTIC MONETARY POLICY**

## **Macroeconomic outlook and policy options at the zero lower bound. *What role can other macroeconomic policy play?***

Óscar Arce

Director General, Banco de España

Basel

18 November 2019



## The nature of the limits of monetary policy. Two alternatives:

- **Neo-Fisherian effects.** For a given  $r^*$ , a very persistent drop in the policy rate (e.g. Japan) will ultimately imply a drop in inflation in order to clear goods and credit markets (Schmitt-Grohé and Uribe 2010, 2014; Cochrane 2017)
- **Low and decreasing natural interest rate ( $r^*$ ).** if  $r^*$  is sufficiently negative, the nominal rate may reach the ELB / reversal rate, implying an actual real rate  $> r^*$  (Holston, Laubach & Williams, 2017).

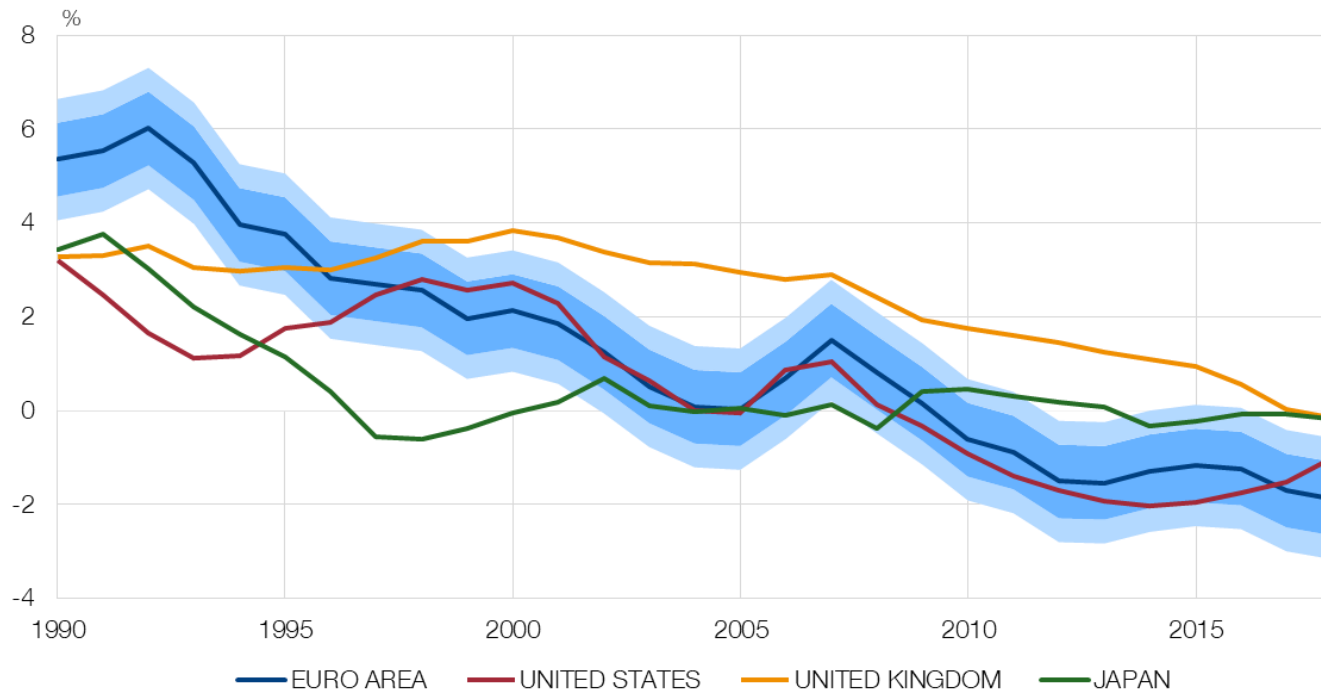
## The collateral effects of very expansionary monetary policy. Some alternatives:

- **Excessive risk-taking / financial exuberance.** Low interest rates due to lax monetary policy could foster excessive credit concession and risk-taking
- **Damaged bank profitability.** Due to maturity mismatches and zero lower bound on retail deposit -> “reversal rate” (Brunnermeier and Koby 2018)

Sustained decline in recent decades, reflecting different structural factors:

- demographics (e.g. [Eggertsson and Mehrotra, 2014](#)),
- low productivity growth ([Gordon, 2015](#)),
- safe asset scarcity ([Caballero and Farhi, 2017](#)), etc.

**NATURAL INTEREST RATE ESTIMATES FOR THE MAIN ADVANCED ECONOMIES**



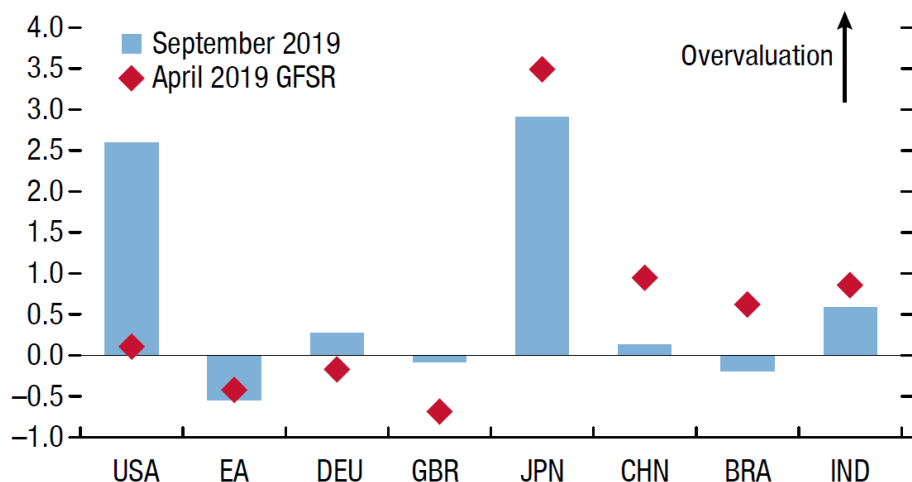
SOURCE : *Banco de España Annual Report 2018*, based on the model of [Fiorentini, Galesi, Pérez-Quirós and Sentana \(2018\)](#). The bands for the euro area refer to confidence levels of 68% and 90%.

# MP-LED EXCESSIVE RISK TAKING AND FINANCIAL EXUBERANCE

- True, an expansionary monetary policy stance has led to an acute decline of long-term yields and may have also encouraged **more financial risk-taking and a further buildup of financial vulnerabilities ...**
  - Increased holdings of riskier and less liquid securities by non-bank financial sector.
  - Stretched valuations in some specific risky asset markets.
  - Rising debt burdens in some countries' corporate sector.
- ... **BUT these vulnerabilities are not necessarily larger in those economies with the most accommodative policies.**

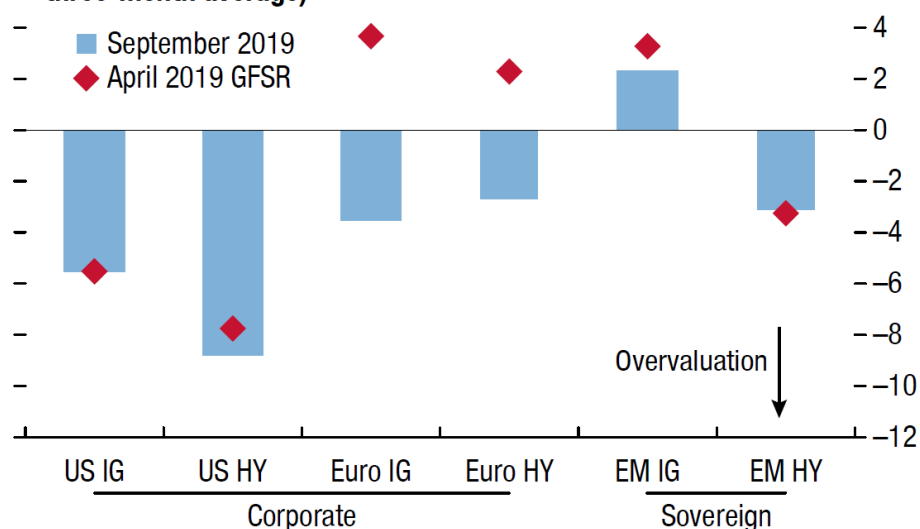
Equity valuations appear stretched in some countries ...

**3. Global Equity Markets: Price Relative to Fair Value**  
(Percent, scaled by standard deviation of returns, three-month average)



... and bond spreads are too compressed relative to fundamentals.

**4. Global Bonds: Spread Relative to Fair Value**  
(Basis points, scaled by standard deviation of spread changes, three-month average)

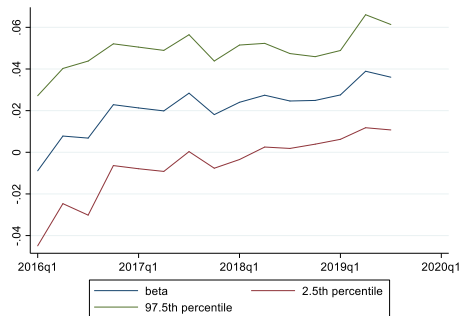


SOURCE: IMF Global Financial Stability Report (October 2019).

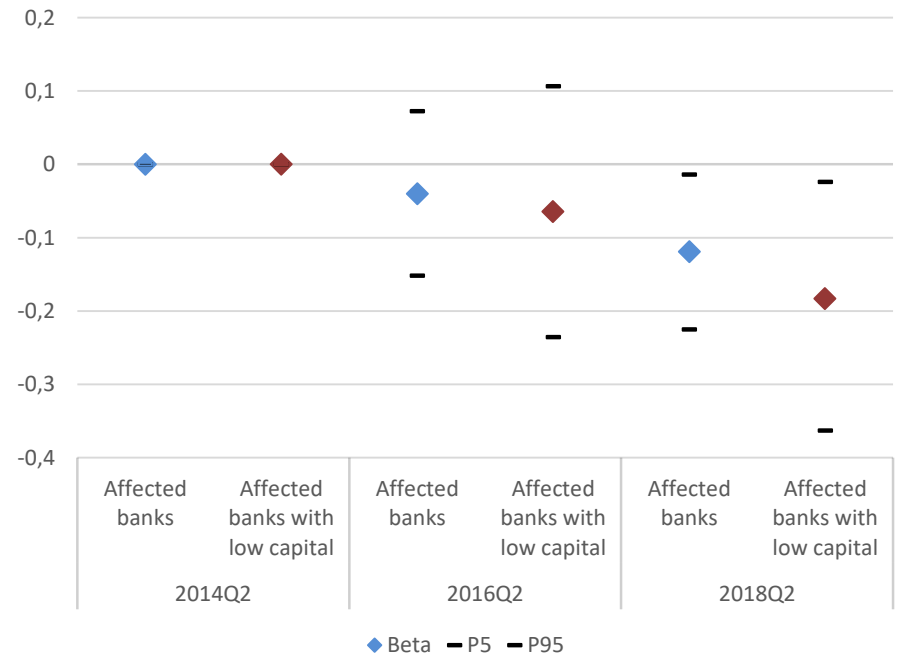
# IN THE EURO AREA, THE REVERSAL RATE MAY BE MORE RELEVANT, ESPECIALLY FOR POORLY CAPITALIZED BANKS

- In the euro area, the probability that banks tighten **credit standards** has increased since the introduction of negative deposit facility rate in 2014.
- The persistence of negative interest rates may push poorly capitalized banks towards their own **reversal rate** (Spanish sub-sample).

**Probability that affected banks tighten credit standards (Euro area)**



**Credit supply of affected and poorly capitalized banks (Spain)**



SOURCE: Arce et al. (2018), Banco de España

1. **Monetary policy:** Keep pushing down  $r$  towards  $r^*$

2. **Policies for rising  $r^*$ :**

- Fiscal policy can achieve a more growth-friendly composition of public finances (e.g. **public investment** geared towards increases in productivity)
- Push innovations and **structural reforms** to improve the functioning of factor and product markets can boost potential growth rate ([Andrés, Arce and Thomas, 2017](#) vs [Eggertsson 2014](#)).

3. **Policies for pushing down the reversal rate:**

- **Macroprudential and prudential policies:** Increase the resilience of the financial sector and encourage banking strategies that improve adequate capitalization and profitability in a low interest rate environment ([Arce et al, 2019](#)).
- **Two-tier system** for reserve remuneration to alleviate the cost for the banks.

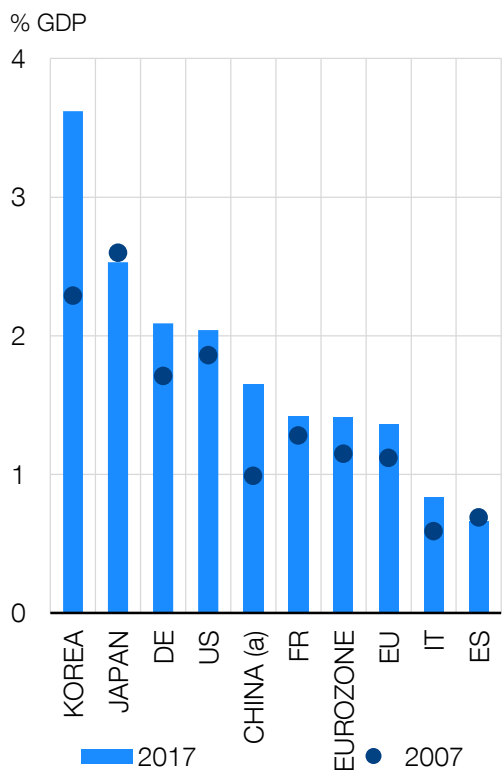
4. **Countercyclical policy-mix.** As MP likely to remain constrained, more focus on:

- **Countercyclical fiscal stabilization policies**
- **(EMU) Stronger risk-sharing mechanisms** (EDIS, European unemployment scheme, deeper financial integration...)

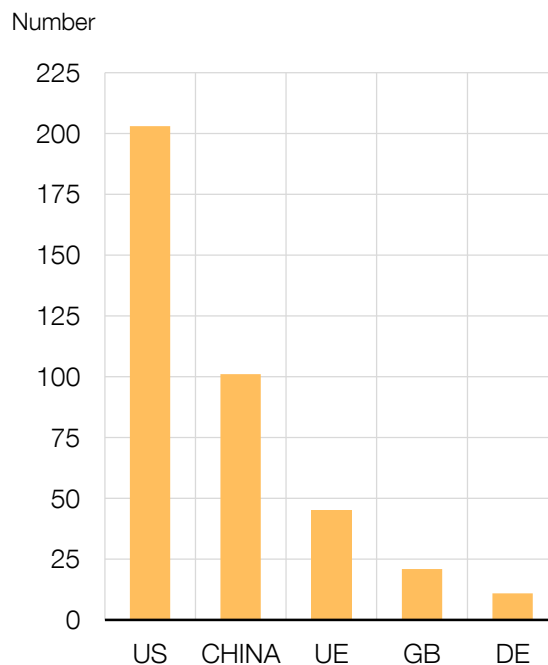
# THE CASE OF EMU: LOW PUBLIC INVESTMENT DEVOTED TO INCREASE LOW PRODUCTIVITY

- Fiscal policy can achieve a more **growth-friendly composition of public finances** (e.g. public investment geared towards increases in productivity)
- The promotion of innovation and **structural reforms** that improve the functioning of factor and product markets can boost potential growth rate ([Andrés, Arce and Thomas, 2017](#))

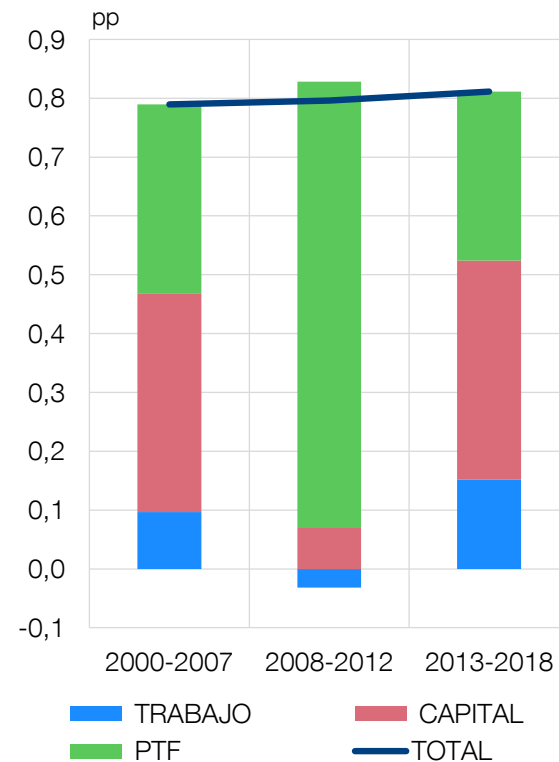
**R&D EXPENDITURE  
BUSINESS ENTERPRISE SECTOR**



**"UNICORN" COMPANIES**



**POTENTIAL GROWTH DIFFERENTIAL  
EMU vs US**



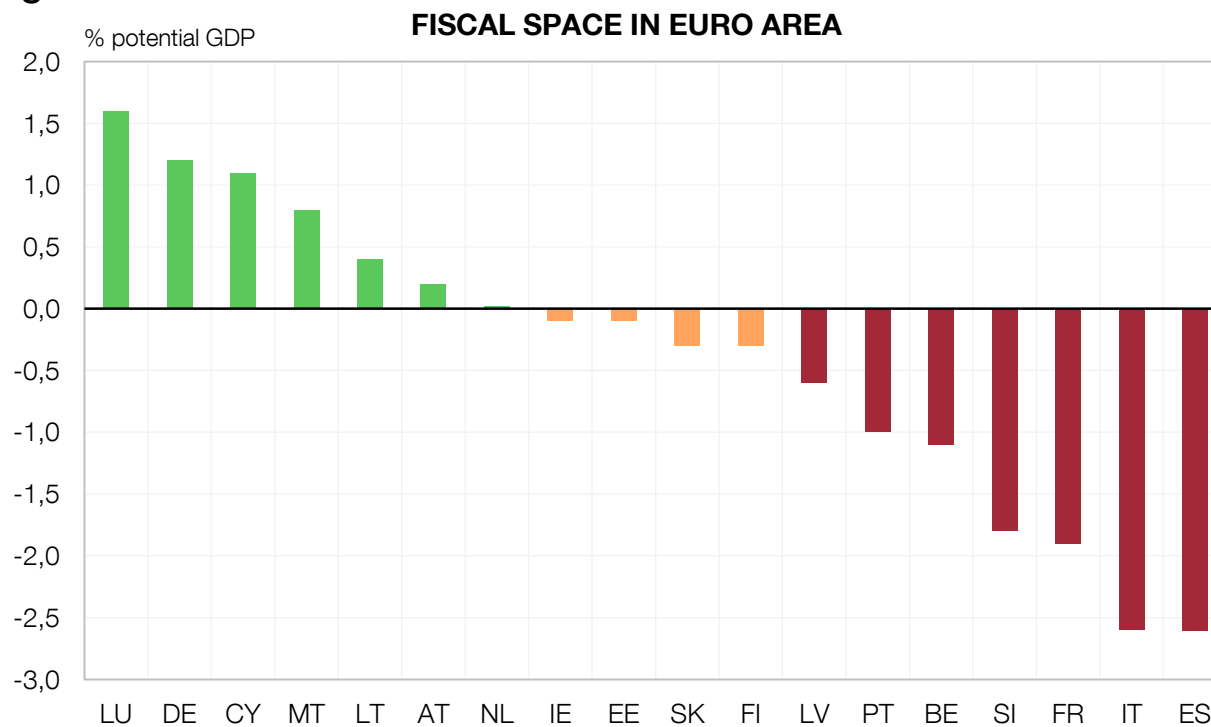
Sources: CB-insights, Eurostat and OECD

(a) Private Companies Valued at \$1B+, October 2019

(b) Average 2016-2017 because of lack of data availability

# COUNTERCYCLICAL FISCAL POLICY AT THE ZLB

- At ELB, discretionary fiscal policy is **more effective** (higher multipliers and spillovers within a monetary union) (Arce, Hurtado and Thomas, 2016; Ramey, 2019)
- But **fiscal space** is unevenly distributed in the Euro area (but countries face common investment needs)
- There is a call for a **euro area-wide fiscal instrument** (powerful enough), to get closer to the optimal aggregate fiscal stance



SOURCE : *European Commission.*

NOTE: Fiscal space is computed as structural deficit – medium term objective