THE NEW ECONOMY: CHALLENGES FOR MONETARY POLICY

José Viñals

Banco de España and CEPR

Brussels Economic Forum

3 May, 2001

“…it is certainly true that we have a new economy. It is different. It is behaving differently and it requires a different type of monetary policy…”

Alan Greenspan, February 2000

KEY ISSUES

- Is there a new economy (NE) in the EU?
- What remains the same as far as monetary policy is concerned?
- What are the challenges for monetary policy?

IS THERE A NEW ECONOMY IN THE EU?

- In the EU, aggregate evidence for NE limited
  - Measurement problems
  - Smaller CIT producing sector
  - Traditional sectors have not yet significantly benefited

- But hope NE will progressively develop in EU, in an environment of
  - Macroeconomic stability
  - Competitive and efficient markets which create incentives for innovation

- Monetary policy can decisively contribute towards macroeconomic stability by preserving price stability
  - Better functioning price system
  - More efficient allocation of resources across new and old sectors

HOW IS MONETARY POLICY AFFECTED?

- Does the NE imply
  - Death of inflation? No
  - Death of business cycle? No

$\Rightarrow$ Monetary policy as necessary and important as ever to safeguard macroeconomic stability

WHAT SHOULD REMAIN THE SAME?

- Primary objective: price stability
    - Inflation ultimately a monetary phenomenon
- Policy decisions based on a comprehensive and flexible strategy

WHAT IS LIKELY TO CHANGE?

- NE creates a more complex environment for monetary policy

- Higher uncertainty about
  - the state of the economy: have the 'speed limits' increased and by how much?
  - the appropriate policy action to take
  - the consequences of policy actions

HIGHER UNCERTAINTY ABOUT THE STATE OF THE ECONOMY

- Traditional economic indicators may become less representative of overall economic conditions

- How does the NE affect potential output growth?

- Potential output key for monetary policy
  - When price stability and output stability objectives are on an equal footing
  - When price stability is the primary objective
- NE makes more difficult
  - To estimate potential output
  - And hence to forecast price and output developments

HIGHER UNCERTAINTY ABOUT THE APPROPRIATE POLICY STANCE

- Demand shocks

  - Appropriate policy response is to promptly and fully offset them

  - Increase interest rates after expansionary shock–regardless of its duration and specific origin–and viceversa

- Supply shocks of the NE type
  - ‘Speed limits’ may now be different
  - Need to assess how close the economy is to the new limits

- In practice, with NE, interest rate decisions need to carefully balance the following risks:

  - Overestimating the increase in potential output growth and running a monetary policy which is revealed ‘ex post’ as too accommodating

$\Rightarrow$Inflationary boom–strong tightening–recession

- Underestimating the increase in potential output growth and running a monetary policy which is revealed ‘ex post’ as too tight

⇒No inflation…but NE killed

TWO EXAMPLES OF TECHNOLOGY SHOCKS

- Technology shock **temporarily** increasing output growth
  - Long-run: interest rate unchanged
  - Short-run: interest rate decrease (increase) if supply effect larger (smaller) than demand effect

- Technology shock **permanently** increasing output growth

  - Long-run: interest rate should go up

  - Short-run: interest rates increase (decrease) insofar as demand effect is larger than supply effect

⇒Higher complexity of dynamic policy responses to NE requires

- More careful analysis

- Clear and transparent explanations to avoid confusion on the part of the public

- In practice, delays in the statistical measurement of productivity shocks leaves policymakers guessing for quite some time
  - Whether there has really been a technology shock
  - How big it is
  - The horizon over which it is likely to affect output growth

HIGHER UNCERTAINTY ABOUT THE MONETARY TRANSMISSION MECHANISM

- Immediate concern: uncertain behavioral response to policy
  - Faster arrival and processing of information
  - Possibly faster adjustments by firms
- Distant concern:
  - Impact of the e-revolution in banking on efficacy of monetary policy

CONCLUSIONS

- In spite of the NE
  - Neither inflation nor the business cycle are dead
  - Inflation ultimately remains a monetary phenomenon

  $\Rightarrow$ Monetary policy should continue to maintain price stability in the medium term

- Present monetary policy strategies—like those of ECB or Fed—are comprehensive and flexible enough to adequately respond to NE

- However, the task of monetary policy becomes more difficult since there is higher uncertainty about
  - Where the economy is (the new speed limits)
  - How should policy respond
  - What the policy consequences are

- In a NE environment, it becomes even more necessary
  - Exercise good judgement when performing the always difficult “art of central banking”
  - Explain clearly to the public the reasons behind policy actions to avoid confusion (Solow)