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Discussion of Dell'Arricia, Rabanal and Sandri (2018)

Angel Ubide
Head of Economic Research, Global Fixed Income

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Summary of Dell'Arricia, Rabanal and Sandri (2018)

- Unconventional policies have worked well
  - Effective in affecting financial conditions the desired way
    - Lower interest rates, lower corporate yields, higher stock prices, weaker exchange rate
  - Effective in affecting GDP and inflation, though less confidence in assessment.
- More effective if:
    - Financial distress
    - Central bank can credibly commit to provide accommodation
- Less effective if:
    - Deflationary pressures are entrenched
- Undesired side effects have not materialized
    - Stable inflation, little impact on bank profitability, not much search for yield
    - But political scrutiny has increased
- Unconventional policies should be used again. How?

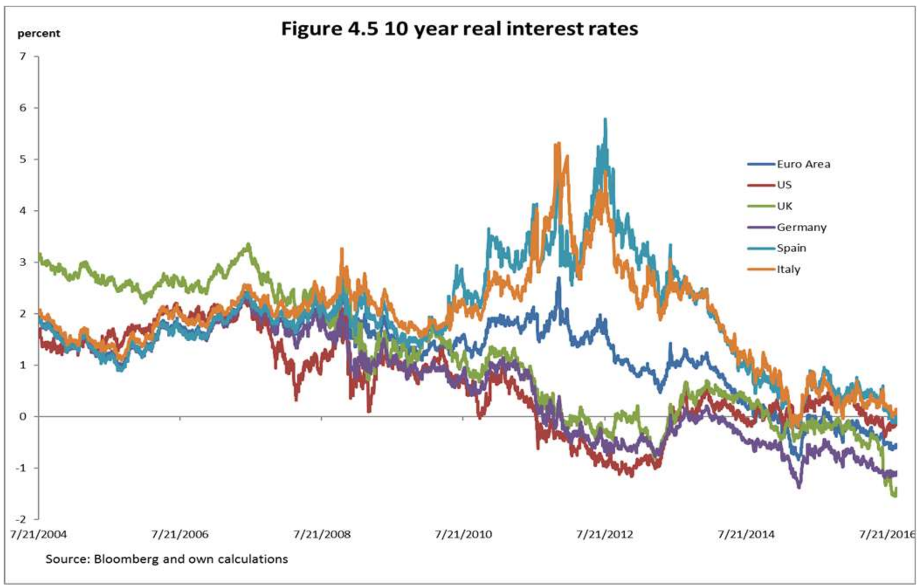
Some Additional Thoughts Based on Ubide (2017)*

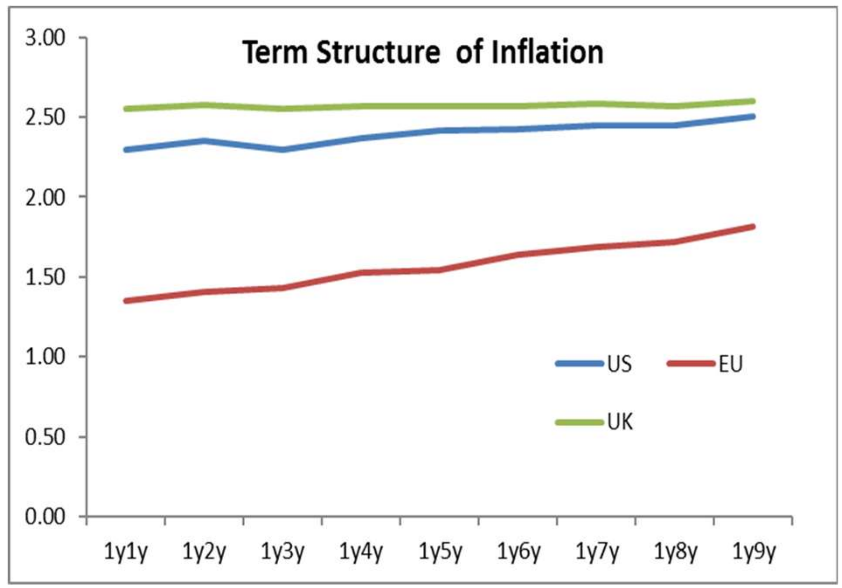
- Two phases of ECB policies – active vs passive easing
- The resetting of Abenomics – inflation is an economy policy phenomenon
- How did monetary policy really work? The insurance channel of policy
- How to do it next time. A monetary policy framework for all seasons

* Ubide, Angel, (2017), *The Paradox of Risk*, Peterson Institute for International Economics

ECB: Passive vs Active Easing

- Passive: euro area monetary policy didn’t really ease until mid 2012. Avoid tightening. Germany was different.
- Active: QE large and state contingent, but suboptimal – capital key, 33 percent.
- Inflation target still asymmetric – only central bank that hasn’t changed framework
- Are inflation expectations anchored at target?





Japan: Inflation Is a ~~monetary~~ ~~monetary policy~~ an Economic Policy Phenomenon

- Resetting of Abenomics -> a modern version of helicopter money
- At EZLB, fiscal policy in the lead, monetary policy explicitly supports
  - Focus on r<g to reduce debt overhang effect
- Explicit inflation overshooting
  - Make monetary policy support permanent -> insurance on the economic outlook
- Income policies to boost wage growth
- Yield Curve Control – when assets run out
  - A success?

Insurance Channel of Monetary Policy

- Monetary policy operates in (y,π) space and in (risk) space. Must close both gaps* -> stabilize (y,π)/risk
- In normal recessions, risk gap irrelevant.
  - Interest rates can credibly close (y,π) gap, economy self-equilibrating

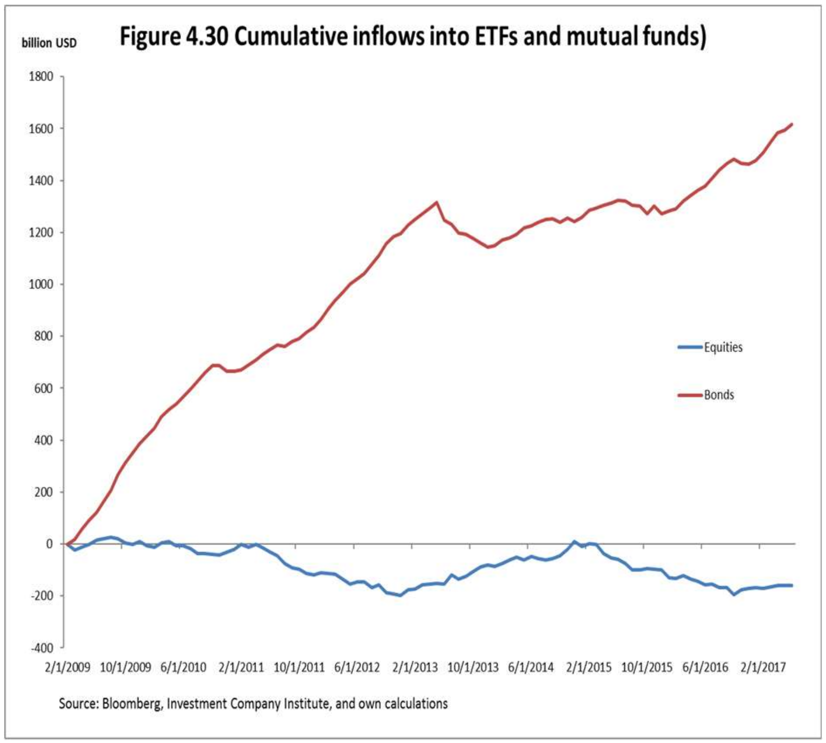
    -> markets can price assets and long term investment
- After larger crisis, at EZLB, or in deflation, risk gap dominates.
  - Economic agents don't know if/how QE works, economy may not be self-equilibrating

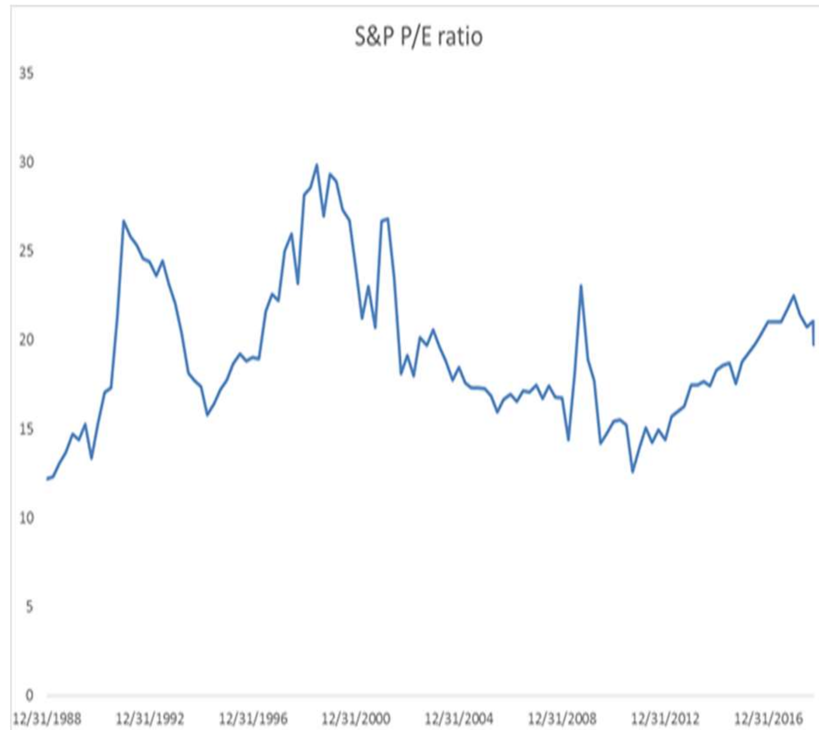
    -> difficult to price assets or make long term investment decisions.
- Solution: provide insurance on economic outlook via strong forward guidance and policy designed to close risk gap**
  - "Whatever it takes" commitment to restore equilibrium
  - Open ended, state contingent policy with explicit forward guidance

* One could think of it as stabilizing the Macro Value at Risk
**Caballero and Simsek (2017) focus on macro prudential policy to address the risk gap

Insurance Channel of Monetary Policy

- Main channel of transmission: risk aversion/taking, not flows





A Monetary Policy Framework for All Seasons

- Opportunistic reflation
  - Increase room to cut real rates – same concept as increasing banks' capital
- Maximize growth subject to price stability
  - Hysteresis + flat PC -> divine coincidence no longer works. Avoid weak demand trap.
  - Don't trust real time Nairu estimates when labor market is in flux
- Keep large balance sheets, be ready to buy all assets
  - Increase capital
- Use cyclically adjusted forward guidance to manage risk taking
  - Adjust degree of explicitness of guidance
- Stop calling it unconventional
  - There is nothing unconventional about buying assets or forward guidance
  - Creates stigma and political attention
  - Creates bias to exit -> policy tighter than optimal

Endnotes

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