BANK FOR INTERNATIONAL SETTLEMENTS

A possible way out from the "New Normal": Rebalancing fiscal-monetary policies by picking "Low-Hanging Fruits" to engineer more confidence

Remarks at the Eurofi High Level Seminar 2016

Amsterdam, 20–22 April

By Luiz Awazu Pereira da Silva[1]

There is a broad agreement that monetary policy (MP) is not sufficient to fundamentally change growth prospects under the "New Normal" in most advanced economies (AEs). Conversely there is a heated debate as to whether unconventional monetary policy (UMP) is still effective using Negative Interest Rate Policy (NIRP), especially in Europe and Japan. Moreover, without fully endorsing any of the explanations, many economists are wondering: why has the response to policies been so muted? Is it because of "debt deleveraging"? Or is it because of a fundamental shift such as the "secular stagnation" hypothesis? The answer is not easy, but perhaps one can try to propose an explanation and a possible alternative policy framework.

In these personal remarks, I will discuss one such possible alternative, a "way out" with all due respect to all. My main assumption is that the process of triggering the real sector "animal spirits" or "confidence" has been much more complex than we thought it would be. On the one hand, price incentives might not be enough to fully restore credit multipliers and might have created distortions. Hence, going further into NIRP with unknown results might produce more uncertainty that could itself undermine policy effectiveness. But on the other hand, "productivity-enhancing" stimulus directed to the real sector is needed in conjunction with structural reforms. The issue is how to achieve that with a rebalancing of policies that removes the excessive burden placed on MP. This rebalancing should be pro-growth without creating complacency and "free-riding".

So, here I will try to: (i) explain the muted response to policy, looking at the uncertainty and market scepticism, including doubts about NIRP; (ii) acknowledge that, despite the analytical reasons that might justify continuing UMP, there are also risks to financial stability that call for complementary policies; and hence (iii) propose a possible gradual "way out" with a rebalancing of our fiscal-monetary policy mix. My hope is that more confidence could be engineered and market expectations re-anchored if we use a pragmatic and more balanced policy framework.[2]

---

[1] Deputy General Manager, Bank for International Settlements. These remarks are personal and do not necessarily represent the views of the Bank for International Settlements (BIS). I am grateful without any implication for comments received from Pierre-Richard Agénor, Claudio Borio, Jaime Caruana, Dietrich Domanski, Leonardo Gambacorta, Giovanni Lombardo, Enisse Kharroubi, Robert McCauley, Hyun Song Shin and Fabrizio Zampolli.

[2] There is new accumulating empirical evidence showing that uncertainty about monetary and economic policy conditions contributes negatively to real loan growth and overall economic activity. See eg D Creal and C Wu, "Monetary policy uncertainty and economic fluctuations", *NBER Working Papers*, no 20554, October 2014; and M Bordo, J Duca and C Koch, "Economic policy uncertainty and the credit channel", *NBER Working Papers*, no 22021, February 2016.

1. Why is there increasing market anxiety about monetary policy effectiveness?

In my view, uncertainty is increasing market anxiety. It is about where the global economy is heading, it is about how the ongoing US business cycle with normalisation of its MP can be reconciled with developments in other systemic economies, and it is about policy divergence.

Uncertainty arises in part because of significant dispersion in growth projections[3] both in major AEs and in many emerging market economies (EMEs). Data seem finally to confirm the ongoing growth momentum in the US, but it is coming perhaps as the usual US business cycle reaches its peak. More worrisome, US growth does not seem to be supported by Europe or Japan as much as hoped for despite the fact that both are using very accommodative monetary policy (eg quantitative easing (QE) in Europe, quantitative and qualitative easing (QQE) in Japan) and now entering into NIRP. All this is playing out against the backdrop of a much anticipated growth regime rotation in China (whose real and financial consequences we do not fully know, even as we hope for the best), stress (albeit somehow idiosyncratic) in major systemic EMEs (eg Brazil, Russia and South Africa with the notable exception of India) and commodity price-led downturns in other related important economies (eg Canada, Saudi Arabia and the Middle East). To compound this picture, you could add odd events such as the Brexit debate, potential political crises in parts of Europe, severe geopolitical tensions (from Ukraine to Syria, Iraq and parts of North Africa and Nigeria), the unpredictable effect of the migrant crisis on the European political economy and, last but not least, the unresolved issue of (now) global confrontation with terrorist groups.

But there is also uncertainty over the policy front vis-à-vis the Global Financial Crisis (GFC). After having implemented and maintained unprecedented monetary stimuli for years with undeniable initial success, we might be facing decreasing returns from these bold interventions over time. In particular, NIRP has been implemented over and above many already exceptional and unprecedented policies after the zero lower bound (ZLB) was reached (eg asset purchase programmes as a form of QE and forward guidance). Academics and practitioners are debating whether the recourse to NIRP might have produced a rather unintended market reaction. Publicly expressed views from the private sector suggest that, instead of incentivising financial agents to provide more credit and positively influencing expectations and consumption demand, NIRP, if it persists for a long time, might have actually prompted more worries about financial stability,[4] tilting market sentiment towards a risk-off mindset resulting from NIRP's possible undesirable consequences for the profitability of banks, pension funds and insurance companies. Regarding the profits of banks, the concern is not necessarily profits per se, but the returns on lending activities, the impact on resilience and the uncertainty in the business models that NIRP might bring (eg distortions in the allocation of credit). In addition, the long-term effects on the behaviour of savers and financial institutions are difficult to foresee. Of course, there needs to be a more complete empirical investigation to better document and understand these consequences.[5] Some evidence, for example, suggests that volatility in early 2016 is an illustration that markets are now possibly viewing the current

3 Forecast dispersion has been used as a measure of uncertainty; see R Banerjee, J Kearns and M Lombardi, "(Why) Is investment weak?", *BIS Quarterly Review*, March 2015 (http://www.bis.org/publ/qtrpdf/r_qt1503g.htm).

4 The most important being the "negative" implications of NIRP for banking profitability, which is likely to weaken the credit channel of MP and possibly contribute to reduced MP effectiveness.

5 Even a prolonged period of low interest rates could impact negatively on bank net interest income and on overall bank profitability. For more detailed evidence on this point, see C Borio, L Gambacorta and B Hofmann, "The influence of monetary policy on bank profitability", *BIS Working Papers*, no 514, October 2015; and S Claessens, N Coleman and M Donnelly, "Low-for-long interest rates and net interest margins of banks in advanced foreign economies", *IFDP Notes*, Federal Reserve Board, April 2016.

valuation of assets as not supported by the foreseeable growth outcomes and future productivity prospects.

Overall, anxiety appears to be increasing somewhat on both data and policy fronts and prompting more market criticism. Even if many would claim that UMP has worked as intended in the US, the assessment vis-à-vis NIRP is more complex in Japan and Europe. On this front, evidence is obviously limited (the typical lag on economic activity is at least 12 months). At best, one should say that we don't yet know which is higher, costs or benefits. And even those that are very optimistic about the effectiveness of NIRP do recognise that it won't do the trick on its own: policymakers have to operate on other fronts.

2. Are there reasons that continue to justify UMP? Benefits and risks.

Despite the analytical justifications that can support using NIRP, as stated above, the real problem is "persistence" of ultra-low or negative rates for a long period of time that create distortions. If low rates or NIRP are only transitory, they might represent much less of a problem. In addition, we also know that UMP instruments are less effective when they are used in isolation. They have been helpful in preventing the financial meltdown, but their effects on "prices" are now showing decreasing marginal returns. And in the end, the negative side effects could more than offset the positive ones if not accompanied by other policies. In the presence of uncertainty, UMP "price incentives / interventions" can buy time but do not solve the problems if not accompanied by more active policies to foster growth and aggregate demand via "quantities", as I will explain shortly.

There are many documented disagreements among economists, including this one: theoretically, ultra-low interest rates are justified by the fundamentals of the "New Normal". Real interest rates might be and need to remain very low because the GFC has deeply affected our growth potential[6] and/or we are entering a long period of "secular stagnation". So there are both structural and cyclical analytical reasons that justify current policies. Under this reasoning, monetary policy has affected the real interest rate, but it is not necessarily UMP that has pushed interest rates too low, the new fundamentals have. The new neutral interest rate could be much lower than before the GFC.

Among other types of disagreements are the following: (i) whether or not to alter the composition of the asset purchase programmes (QE), ie consider buying riskier assets to lower spreads instead of acquiring mostly risk-free assets that lower yields;[7] (ii) whether or not to communicate the acceptance of an asymmetric policy response to inflation (ie tolerating higher-than-target inflation readings after inflation has hovered at much lower levels); and (iii) whether or not to use capital flow management policies to address the spillover effect on EMEs of unusually massive capital inflows.

---

6 See O Blanchard, "Slow growth is a fact of life in the post-crisis world", *Financial Times*, 13 April 2016. Output is persistently lower after a financial crisis; see V Cerra and S Saxena, "Growth dynamics: the myth of economic recovery", *American Economic Review*, vol 98(1), pp 439–57.

7 After the initial US programme, QE1, the subsequent ones did not seem to focus on reducing the equilibrium return on more risky assets. They shifted from lower spreads to lower the return on safe assets (eg sovereign bond yields fell into negative territory at unprecedented long maturities) and/or contain expectations of rises in short-term policy rates and/or work on flattening the long end of the yield curve, etc. Is this helping credit generation? Maybe not as much as intended, but more comprehensive empirical work is needed. If QE programmes indeed lower spreads of risky assets instead of lowering the returns on safe assets, which can create distortions, they could perhaps produce a more virtuous stimulation of credit as the central bank would be indeed shifting risk from the private sector to the public sector. Naturally, there are downsides to this as well: risk would also increase due to moral hazard, as the question remains whether central banks are really able to screen asset-backed securities.

There might also be practical justifications for maintaining ultra-low interest rates and even NIRP. In order to get out of this prolonged period of low growth due in part to the GFC, the alternative would be the much heralded and needed structural reforms in factor markets to increase efficiency and enhance productivity. But as we all know, these reforms are dependent on local political economy conditions and will (as they should) entail a social debate and hence take some time. Therefore, the view goes, MP still is and will remain "the only game in town" because of the absence of a practical alternative. And thus, pursuing NIRP seems to be the only practical option that is left.

The conclusion here seems discouraging. In theory, there could be a case for UMP at ZLB or even NIRP. But the way these policies are now perceived by markets (eg perhaps with a mixture of "addiction" and "scepticism") might not be helping to fully restore confidence. The theoretical and practical arguments listed above are generating competing and yet plausible narratives about future growth that are simply too distant from each other to be capable of reassuring the private sector and make it invest and consume. And ironically, using extreme versions of an already unconventional MP can be perceived as tantamount to sending the economy back to "intensive care", which is not a good sign.

Therefore, despite the very significant effort by central banks to use unprecedented price incentives to revive credit and hence real economy growth, they have produced more limited outcomes than markets thought they would. So if nine years into the GFC price incentives are not fully working, how can we bring back growth and productivity?

3. Rebalancing our policy mix by investing in total factor productivity (TFP), "low-hanging fruits" projects.

Markets themselves are now voicing a growing recognition for the need to rebalance policies, making more use of the public sector balance sheet and less of monetary policy. But rebalancing policy instruments is easier said than done. One needs to be careful about naive and/or "populist" approaches: some countries (usually those that want to apply fiscal stimulus) do not have enough fiscal space or have exhausted it; others (usually those that do not want to apply it) do have fiscal space but without the "political economy space" to activate it. So the rebalancing needs to be pro-growth, be accompanied by structural reforms, and avoid complacency and "free-riding".

Above all, it should be a matter of careful analysis and not "one size fits all". AEs and especially EMEs have spent decades trying precisely to build the set of institutions that would prevent the accommodation of excessive aggregate demand through the use of debt, inflation, taxation and other beggar-thy-neighbour policies that rely on some form of fiddling with the exchange rate, the tax structure, the capital account regime, banking regulations, etc. In many EMEs, this policy direction has already gone too far nine years into the GFC, and stabilising debt and reducing risk premia is the main task at present. At the same time, going back to a more direct fiscal or parafiscal impulse using the government's balance sheet should not mean forgetting old lessons of prudence. As has been extensively documented in the literature about macroeconomic populism and painfully felt in real life policy experiments, excessive usage of government resources has always led to crises. The GFC has shown that macro and credit populism is an equal opportunity menace for emerging and advanced economies alike, because somehow politicians tend always to think that "this time is different".

Rebalancing needs to combine reforms in some countries that need to be implemented with determination to trigger goodwill perhaps in countries where there is fiscal space. Then, all together, there could be a reassessment and a clear communication of how reforms plus a rebalancing of monetary and fiscal policy stimulus would help achieve a more pro-growth policy mix.

So what can be done? No sensible economist anywhere is today advocating a naive and simplistic approach involving the use of unproductive ("digging and filling holes") short-term fiscal policies. But we can continue – as some policymakers have already proposed and somehow done – reflecting on a rebalancing of fiscal-monetary policies that call more on ***profitable investments*** that improve medium- to long-term TFP; use a sustainable ***financing*** framework; and link these investments with ***structural reforms that might have a short-term cost*** but can also be absorbed in the medium to long term by producing higher growth. In a nutshell, the suggestion here implies identifying and investing in "low-hanging fruits" projects for a more prolonged, clearly defined period of time (five to six years) and making more extensive use not only of existing government plans but also of the multilateral public sector balance sheet. We could be more positive about investment in the short run if the overall policy package has a good narrative. In particular, as part of the reforms, there is a need to remove impediments to the reallocation of resources.

Profitable investment in "low-hanging fruits" projects. This is a convenient expression for investments that have high potential TFP returns and low "screening costs" and that increase potential GDP. There is a need for more public investment and infrastructure in several countries (but not in all). Public investment is typically one of the victims of financial crises, but let's also be careful. We are also observing, in several countries, a secular trend of rising fiscal transfers and declining public investment. The former may be crowding out the latter. In several cases, the transfers are biased towards the old, also intensifying the intergenerational conflict. If we control that problem, what might be our "low-hanging fruits"? It is certainly not the task of the monetary authorities or central banks to identify profitable investment projects. However, intuitively, one could point to a combination of physical infrastructure with projects to enhance human capital, for example in regions where there is skilled-youth unemployment.[8]

Sustainable financing framework for these projects. Taking the example of an imperfect fiscal union such as the euro zone, constructing automatic stabilisers and fiscal transfer and investment mechanisms that ensure efficiency and fairness will take time.[9] Local fiscal space might be very limited in countries that are in greater need of investment and/or where youth or general unemployment are high. Some of these countries might also have less institutional capacity to spend the money effectively. There may be, in other words, a significant governance deficiency that goes hand in hand with high debt, lack of investment, high transfers and lack of efficiency. However, while recognising the governance-efficiency issue, there might also be other ways to mobilise and adequately screen resources for investment through multilateral and/or national development financial institutions that foster public investment together with private capital through public-private partnerships.

Structural reforms typically have a short-term cost but they can be sustainable if we follow the route described above. It should be acknowledged upfront that the problems of financing TFP-enhancing projects and undertaking structural reforms are intertwined and run deeper than

---

8 For instance, one could improve professional training that targets the reduction of youth unemployment, which is running above 40–50% in many countries; such initiatives could focus especially on youth subgroups that have been discriminated against; human capital enhancing can also be strengthened by improving the fairness and quality of the education system and by better access to information through the various new networks and internet-related technologies. Moreover, the peripheries of large modern cities in many AEs could have their social services (and physical infrastructure) revamped. Given credit-constrained demand for services in those suburbs and peripheries, it is highly plausible to, with little work, identify projects that can generate positive externalities. The most obvious "low-hanging fruit" in a context of low oil prices, a search for higher headline inflation on target and public debt reduction was to institute a Pigovian tax on gas almost everywhere. Some countries are implementing that, but we know how difficult that is especially in the US. However, with the goal of combining new, rebalanced, post-GFC macroeconomic policies with an investment plan towards a more sustainable global order, one possible thought is to reflect on the way our societies will have to invest and spend to construct a lower-carbon economy. That will require innovation and changes in a number of production and consumption processes. This is perhaps too far-fetched now, although it can certainly be part of a G20-coordinated action plan.

9 See A Bénassy-Quéré, "Fixing a sovereign currency", Vox CEPR's Policy Portal, 8 April 2016.

economics: they are about institutions and the political economy of our societies. So, structural reforms need to be undertaken in a broad sense (beyond simply factor – labour and product – markets). They need to involve the fiscal system, redistribution of income and the sensible reform of institutions. Such reforms are paramount if governments are to adopt "long-term planning horizons", instead of persisting with their current quite myopic choices, dependent as they usually are on electoral cycles. That is necessary for them if they are to acquire the capacity to absorb the risk of projects whose fruits take a long time to ripen. Moreover, some of these structural reforms also have an important signalling effect for others. They can show the determination that is needed to unlock the goodwill of those that are sceptical, for good reasons, about engaging in financing even TFP-enhancing projects.

Will investment ignite growth? Here we are arguing for a policy sequence in which investment comes first, generating confidence and growth. The latter would then lower resistance to structural reforms. But engaging also in structural reforms is paramount to show determination and change perceptions of complacency and "free-riding". Moreover, if there are severe structural impediments to growth, then even TFP-enhancing investment may generate only a very limited short-term effect on demand. Removing these impediments would be a precondition for making the investment profitable, a "Catch 22" dilemma for our "low-hanging fruits" projects. Some structural reforms have a low or zero negative short-run aggregate economic impact (eg reforming the judicial system in some countries and/or removing red tape) but are necessary, albeit highly difficult, from a political economy perspective. Investing more money in professional training and education could bring some TFP, but it won't work unless those areas, through reforms, are made more competitive and efficient.

Therefore, there could be a fundamental time-inconsistency argument, and those concerns should be clearly in any sensible economist's mind. However, and conversely, the "do nothing" solution is a guarantee of failure too. And the time-inconsistency argument can also be reversed: undertaking any structural reform is also difficult because of the absence of any clear future growth perspective in the current gloomy context. Reforms have more chances of succeeding in an environment of positive sum games than of zero sum games.

It is not easy. Some countries need to carry out more structural reforms upfront to trigger a positive spin-off that will enable more financing of TFP-enhancing investments. High-level policy dialogue is more than ever necessary to escape from "corner" solution policies and rebalance instruments. But perhaps showing that policies combining investment with reforms can ignite some growth momentum is part of, and should lead to, more sustainable socioeconomic equilibria that could allow some constructive talk of reform. That, in turn, should help address some of our entrenched and widespread disputes about current and intergenerational resource allocation, our societies' "social contracts".

Thank you. I hope that these personal thoughts can help us think of our current challenges in a constructive and mutually beneficial way.

"Caminante no hay camino, se hace camino al andar"…. (Antonio Machado)[10]

[10] *"Wanderer, there is no path – the path is made by walking."*