

Monetary policy normalization: where do we stand?

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Outline

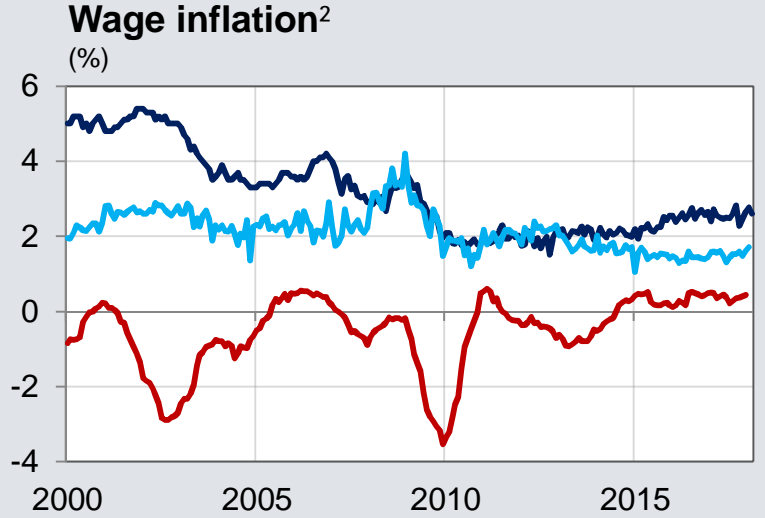
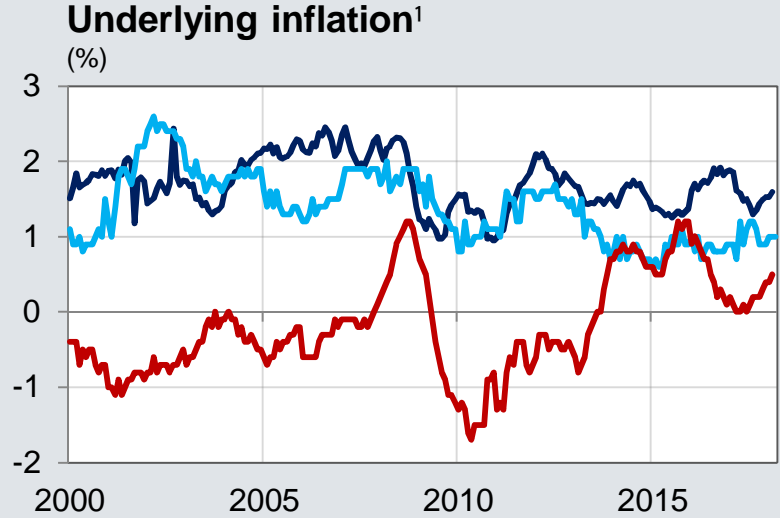
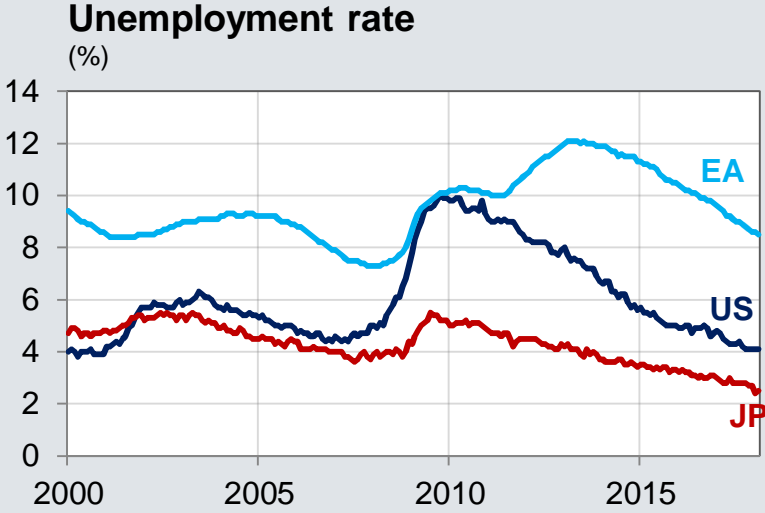
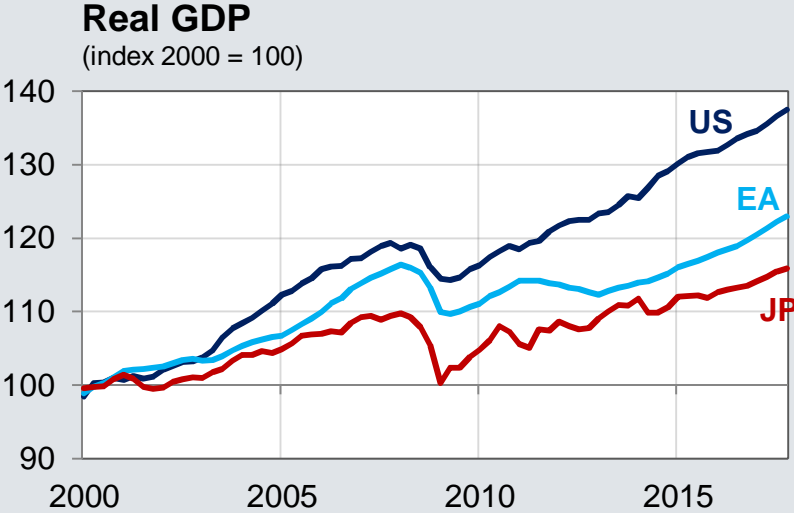
- ▶ **Advanced economies:** economic performance and monetary policy stance

- ▶ Focus on **euro area**
 - Remaining slack keeps inflation low
 - Importance of bringing inflation back to 2 %
 - Gradual monetary policy normalization
 - Exit principles

- ▶ Spillovers of euro area monetary policy to **Central, Eastern and Southeastern Europe?**



Advanced economies: a recovery with low inflation



Sources: Bureau of Labour Statistics, ECB, Thomson Reuters.

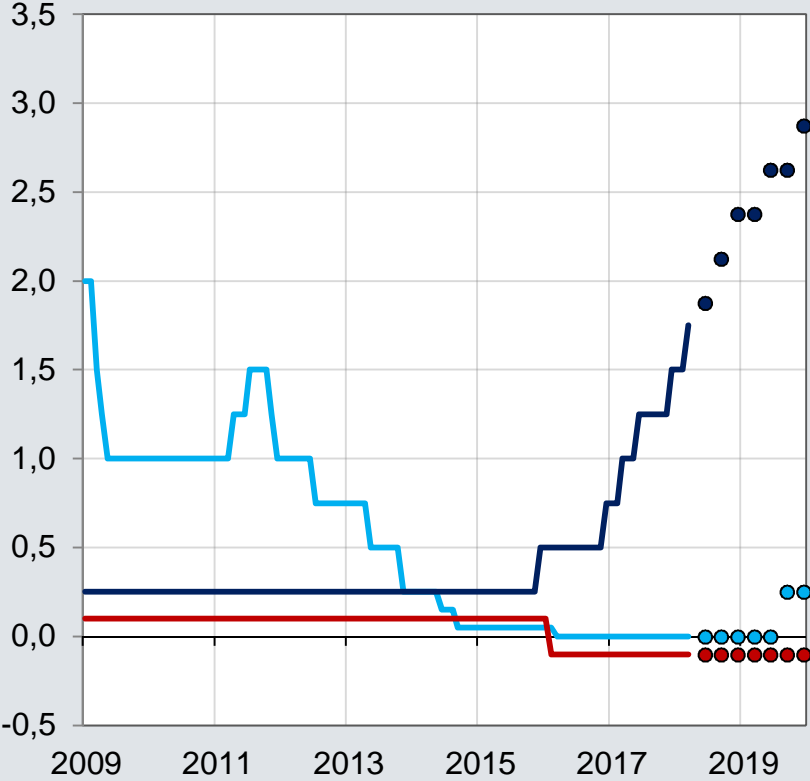
1 PCE for US, HICP for EA and CPI for JP. All measures exclude food and energy.

2 Hourly earnings inflation for US, negotiated wage inflation for EA and monthly cash earnings inflation (12-month moving average) for JP.

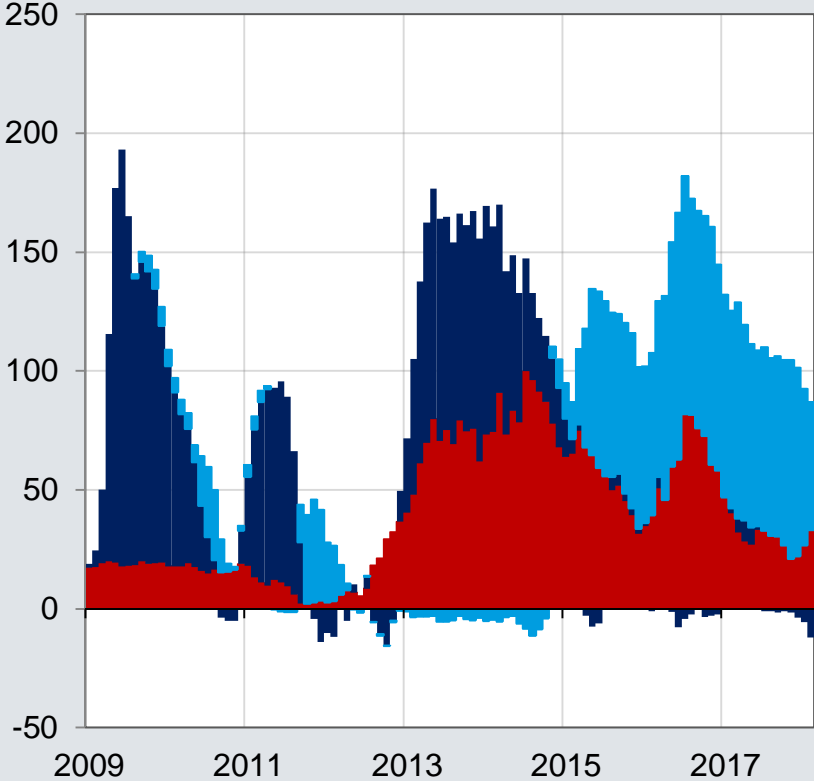


Advanced economies monetary policy stances differ

Key policy rates¹ and outlook²
(%)



Central bank net asset purchases
(bn USD; flows; 3mma)



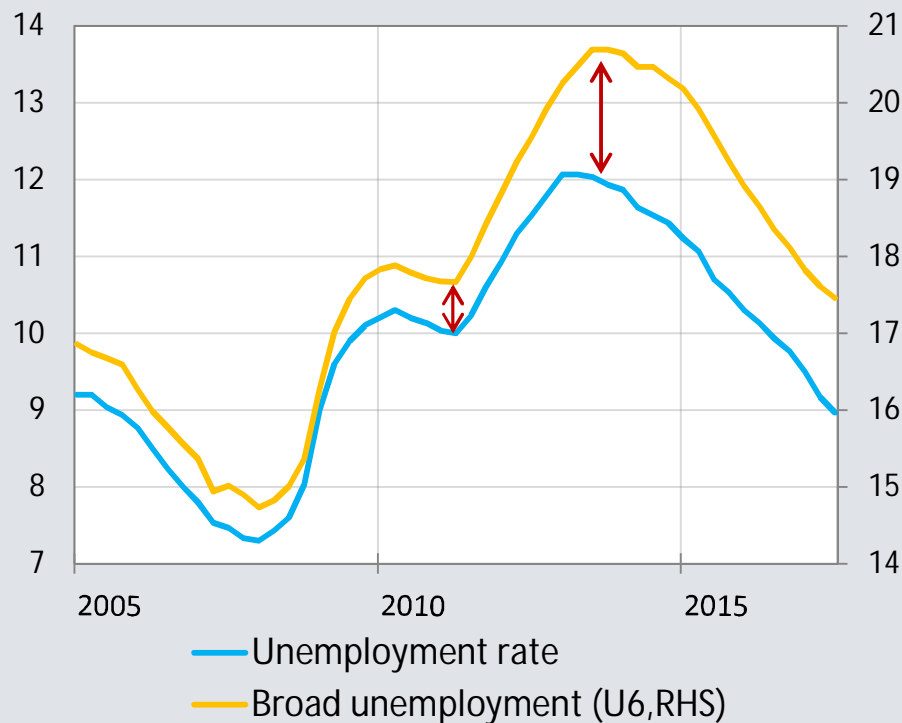
○ Reuters poll — Eurosystem — Federal Reserve — Bank of Japan

Source: Thomson Reuters.
 1 MRO rate for Eurosystem, federal funds rate for Fed and complementary deposit facility rate for BoJ.
 2 All polls were taken in March.



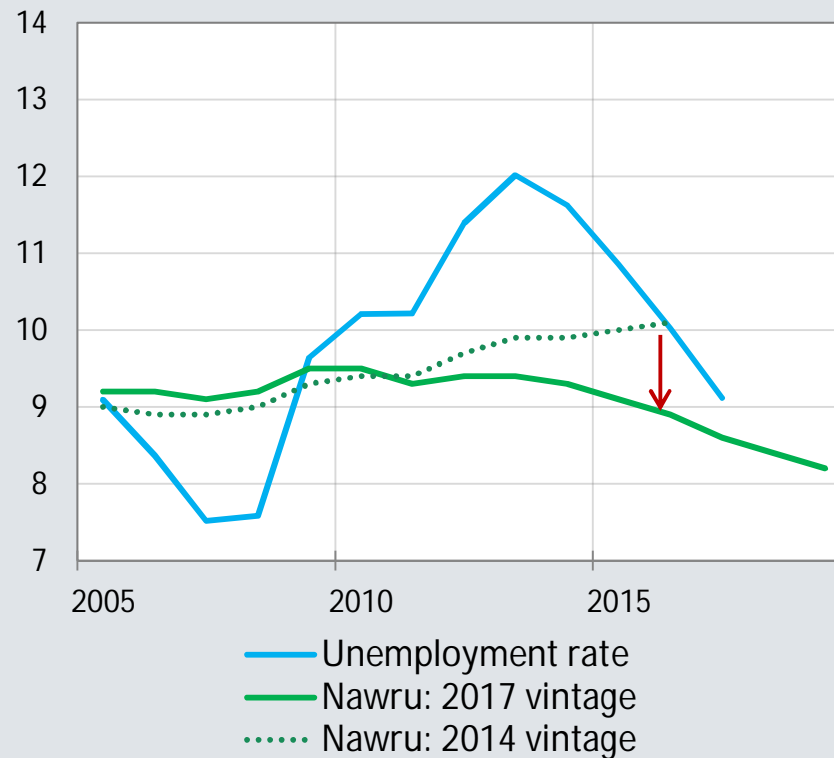
Despite strong growth, EA slack might be larger than presumed

Euro area unemployment measures



Unemployment rate and EC revisions of natural rate

(annual data)



- ▶ Still wide gap between broad and regular unemployment rates
- ▶ Systematic downward revisions of natural rate → more slack

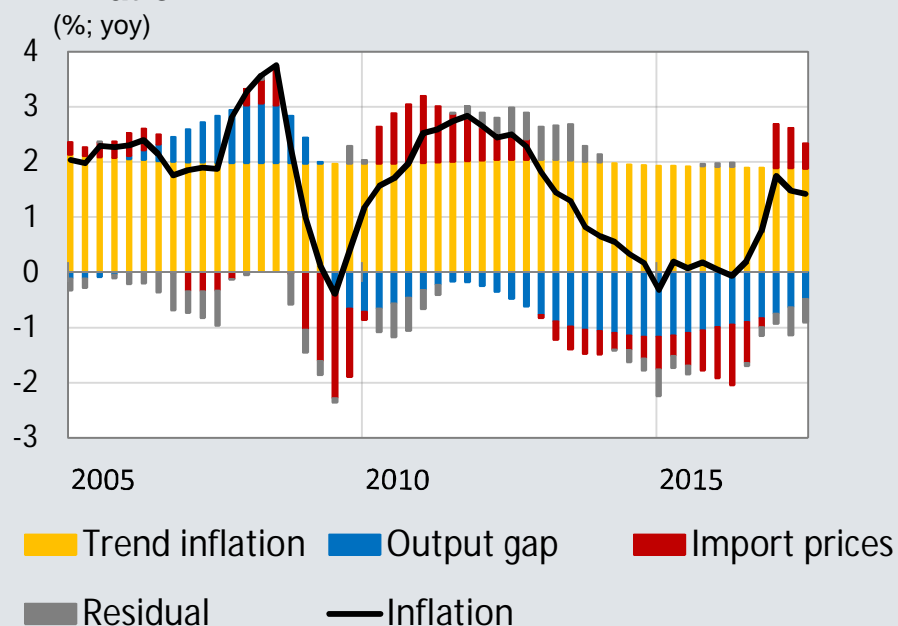


How to interpret the EA inflation-output disconnect?

A typical Phillips curve caters for many potential sources of low inflation:

$$\pi_t = \underbrace{\pi_t^* + \rho_t(\pi_{t-1} - \pi_{t-1}^*)}_{\text{Nominal factors}} + \underbrace{\lambda_t \text{slack}_t}_{\text{Real factors}} + \underbrace{\gamma_t \text{import price gap}_t + \epsilon_t}_{\text{External factors}}$$

Estimated contributions to EA headline inflation



Findings:

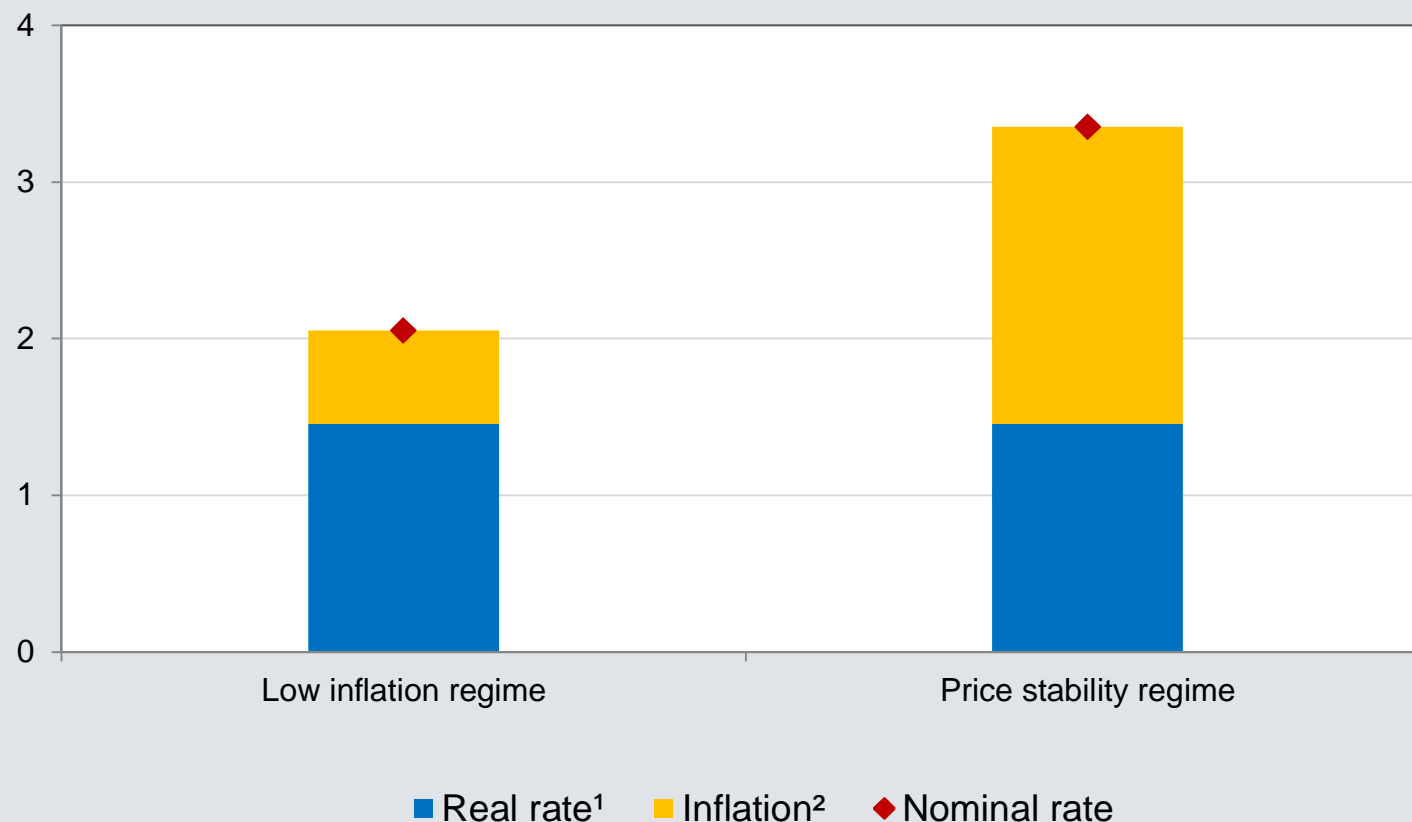
- ▶ Low inflation due to *cyclical factors* rather than low trend inflation
- ▶ The Phillips curve is alive:
 - Despite strong growth, economic slack dragged inflation down
 - But more inertia (higher ρ)

Source: Cordemans and Wauters "What explains the disconnect between real and nominal developments?", forthcoming in the June issue of the NBB Economic Review.

1 The estimated model is based on Chan, Koop and Potter (2016): "A bounded model of time variation in trend inflation, NAIU and the Phillips curve" to which extensions were added.



The importance of getting inflation back towards 2 %



- ▶ Low trend inflation would imply low nominal interest rates in steady state and limits the scope to use standard monetary policy measures

¹ The real rate equals the European Commission's potential growth rate estimate for the euro area for 2018.

² The inflation rate in the low inflation regime equals the average headline inflation since 2014. In the price stability regime, it stands at 1.9 %.



Monetary policy implications

- ▶ Monetary policy should continue to support the recovery:
 - Absorb slack
 - Bring inflation back to our objective

- ▶ Gradual approach:
 - Patience, prudence, persistence

- ▶ Condition: Sustained Adjustment in the Path of Inflation (SAPI) towards our aim
 - Convergence, confidence, resilience



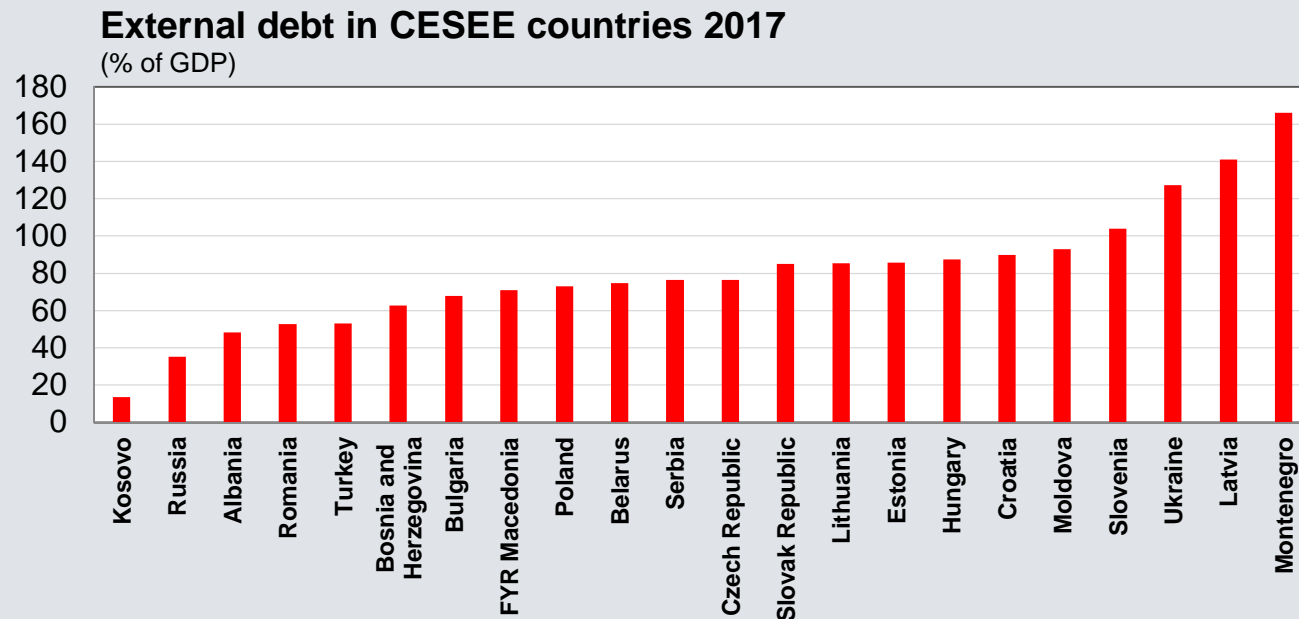
Principles of EA monetary policy normalization

- ▶ Sustained Adjustment in the Path of Inflation remains the guiding principle
- ▶ When purchases end, sizeable reinvestment policy will ensure that financial conditions remain appropriate
- ▶ Sequencing (policy rates are raised only after the net purchases of the APP will be halted) has been continuously confirmed in our forward guidance
- ▶ Looking forward, the main tool for shaping the stance, will become the path of our key policy rates and forward guidance about their likely evolution



Spillovers to Central, Eastern and Southeastern Europe?

- ▶ CESEE countries experienced sizeable capital outflows during 2013 *taper tantrum*, but have since reduced vulnerabilities
- ▶ CESEE countries vary in their exposure to global financial conditions, depending on level and structure of external liabilities



- ▶ CESEE countries should continue to build resilience through fiscal, financial and structural policies

Source: IMF.



Thank you for your attention

