Workshop on “Monetary Policy in the New Normal: Strategy, Instruments and Transmission”

Welcome address

by the Senior Deputy Governor of the Bank of Italy

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Rome, 11 October 2019

It is a pleasure to welcome all of you to Banca d'Italia for this workshop on "Monetary policy in the New Normal: Strategy, Instruments and Transmission". This event, which is organized by the Economic Outlook and Monetary Policy Directorate, has by now become an annual tradition, and brings together academics and central bankers to discuss relevant topics in the policy debate. The focus of this year's edition is on monetary policy in the so-called "New Normal".

What is the New Normal? Its meaning has changed somewhat over time. When the term was first used, it indicated generically the context in which monetary policy would have been operating after its "normalization", following a decade of extremely accommodative monetary conditions.

By now, the meaning of the term New Normal has become narrower, as it tends to refer specifically to the monetary policy framework that is appropriate to deal with a macroeconomic scenario in which low interest rates, low potential output growth and low inflation last for quite some time. A "low-for-long" environment, in a nutshell.

Indeed, since the early 1980s, real interest rates in the advanced economies have been following a declining trend. The estimated natural rates of interest also decreased. These estimates are surrounded by a large degree of uncertainty, but there is by now ample consensus on natural rates being currently lower than they used to be. Several reasons account for this widespread trend, such as demographic changes, productivity developments, the global saving glut and the increased appetite for scarce safe assets. Banca d'Italia economists have tackled this issue in the last couple of years.

As we all know, in this low interest rate environment, monetary policy has less space for addressing economic slowdowns, recessions and low inflation. The times of the so-called Great Moderation, when interest rate changes sufficed to steer the economy around, are now over. Monetary policy had to adapt, and it did, in a profound and at times even spectacular and creative way. Central banks have shown great determination and inventiveness in responding first to the global financial crisis and, more recently in the euro area, to risks of deflationary spirals.

After more than a decade since the outbreak of the crisis, the time has come to reflect upon how the "art" of central banking has evolved and to draw some lessons for a framework that can serve us well in the future. Having, and communicating to the public, a well-defined framework, as opposed to what Ben Bernanke called the Marcel Marceau communication strategy – that is: watch what I do, not what I say – is particularly helpful whenever one sails into uncharted waters, i.e., when the public does not have enough examples of the central bank's past behaviour and hence the information vacuum looms unusually large. A review of central banks' monetary policy strategies could serve this purpose; many central banks are currently involved in doing precisely that.

I am sure that this workshop will provide important insights on all these issues. Among the many ways in which the term "New Normal" may be analysed, I am happy to see that today's papers tackle three questions that are of the utmost relevance in my view.

The first concerns the optimal inflation target in a low rates environment. I am sure that the keynote speech by Professor Galí as well as the papers that will be presented in the opening session will help us deepen our understanding of the implications of a low interest rates and low inflation environment for monetary policy.

A second issue is about the strategies that central banks should follow: should bygones be bygones? Or should policymakers seek instead to undo past deviations of inflation from the target, adopting what are known as "make-up" strategies? This is one of the most momentous questions that is being discussed within the broad ongoing review of the monetary policy strategy by the Federal Reserve. I am delighted to have with us, as keynote speaker, Paolo Pesenti from the Federal Reserve Bank of New York, and I am eager to hear his insight on these questions.

The final issue is the new tools used after the outbreak of the global financial and sovereign debt crises. How do they influence the real economy? Are there limits to their effectiveness? Although the literature is flourishing with studies on unconventional monetary policies, little is known about the transmission mechanism of these tools to the economy. The papers that will be presented in this afternoon's session will shed further light on these issues.

Let me conclude by saying that the New Normal is already with us: returning to the pre-crisis status quo is not only unlikely, it is probably unfeasible. To deal successfully with this New Normal, central banks must keep developing analytical tools and robust models. A continuous interaction between academics and central bankers is the best way to prepare for the challenges ahead. Therefore, I would very much like to thank all the speakers and discussants for taking part in the workshop. I wish you all a fruitful and very productive day.

Designed by the Printing and Publishing Division of the Bank of Italy