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# What do low inflation and low interest rates mean for monetary policy?

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At the farewell seminar for ABN Amro's chief economist Han de Jong, Klaas Knot was one of the speakers. In his speech, Klaas Knot outlined the main challenges that constitute a point of departure for the review of the ECB's strategy that is anticipated to start formally in the new year.

It is a pleasure to say a few words in honor of Han De Jong. Han has written a great deal about macroeconomic policy issues. The topics range from the peculiarities of the Dutch pension system and housing market. To worldwide economic trends and the impact of statements of politicians like Johnson and Trump. I would like to thank Han for his valuable and thought-provoking views over the years.

As Han has been the chief economist of ABN AMRO for 14 years, he has covered a considerable part of the lifespan of the euro. Here I have to inform you that Han and I share a special interest in the magic number 14. Not because my own term is maximized by law to 14 years in total. But because of our predilection for the legendary number 14: Johan Cruijff of Amsterdam's football club Ajax. The football team where Han and I both attend the occasional home matches.

Apart from his impact on the game, Han and I know that Cruijff's legacy also carries lessons for chief economists and central bank governors. Han for instance already covered the link between football and economics in 2000, when he, provokingly for a Dutch economist, stated that a German victory during the European Championship would be best for the euro area economy.

As Cruijff did in his days, economists have an inclination to speak in a language that can leave an audience confused at a higher level. Or, as Johan Cruijff once proclaimed: “If I wanted you to understand, I would have explained it better.” Well, Han's work shows the importance of explaining better, to improve all of our understanding of the economic challenges that policymakers face. I very much hope that you will find my contribution reflects this philosophy.

For this afternoon, I was asked to talk about the implications for monetary policy of persistently low inflation. When preparing this speech, I remembered some advice Han gave on monetary policy some five years ago: “The ECB should not follow the example of the Fed and embark on QE”. I wonder how Han reflects on this quote today, looking at the current calibration of monetary policy on both sides of the Atlantic. Whereas by now the Fed has unwound the bulk of its QE-portfolio, the ECB restarted net purchases under its QE-program as recently as in September.
But today, I will not dwell on the merits of the policy package that was adopted in September and has been discussed extensively afterwards. Instead, I will focus on longer-term challenges for monetary policy. In my view, these challenges constitute a point of departure for the review of the ECB's strategy that is anticipated to start formally in the new year. Earlier this week, Han remarked in the Dutch newspaper

Het Financieele Dagblad that a new captain is in charge of developing a new strategy for his team.[1] Well, this is also the case for the ECB.

I will focus on three challenges affecting central banks worldwide. I will also discuss two challenges related to the specific context in which the ECB operates. I will argue that these challenges warrant a discussion in the upcoming review of the monetary policy strategy on the merits of increased flexibility with respect to our inflation aim.

**Three challenges for central banks worldwide**

Let me start by outlining three challenges that are not unique to the ECB, but apply more broadly to central banks worldwide.

The first challenge, of course, is the fact that in the current environment, inflation is persistently low, and no one knows exactly why… Different possible explanations for this phenomenon have been put forward, of which I would like to mention four:

1. We now see a weaker relationship between real economic activity and inflation than in the past.
2. Inflation may be subject to more negative shocks than in the past.
3. Inflation expectations are increasingly backward-looking.
4. And, finally, inflation may be subject to a declining trend in some of its underlying components. This explanation has been confirmed by recent DNB research.[2]

To be more precise, I am not talking here about a secular declining trend that will inherently go on forever. Some of the underlying drivers of this trend, like globalization or ageing, might fade away or reverse, as was also stipulated by Carl Tannenbaum. The process of globalization of the past decades for example might reverse due to an ongoing escalation in protectionism.

The various explanations for persistently low inflation are interrelated and may to some extent co-exist. In terms of their implications, they share two important lessons:

1. The uncertainty surrounding the drivers of inflation has increased over the years.
2. Inflation is subject to incomplete control by central bankers.[3]

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[1] https://fd.nl/economie-politiek/1326407/economen-zijn-niet-de-meest-moedige-mensen

[2] See Hindrayanto, I., Samarina, A. and I. Stanga (2019). Is the Phillips curve still alive? Evidence from the euro area. Economics Letters 174, 149-152.

[3] See also "The quest for policy scope: Implications for monetary policy strategies", speech at The fourth annual high-level conference Racing for Economic Leadership: EU-US Perspectives, New York, 16 October 2019.

The second challenge relates to the reduced room for maneuver central bankers have. When trying to address persistently low inflation, at some point monetary policy will hit the effective lower bound on short-term interest rates. Beyond that point, increasing side-effects start to outweigh the marginal returns of taking the policy rate deeper into negative territory.

This lower bound is more relevant today than it was in the past. Interest rates, for a variety of reasons mostly outside the realm of monetary policy, have declined substantially since the 1980s.[4] This implies that central banks have less conventional policy space when confronted with a recession. In order to provide additional accommodation with policy rates at the effective lower bound, central banks have developed and employed unconventional monetary policy instruments.

And with unconventional monetary policy instruments comes the third challenge. Despite the experiences gained in recent years, our understanding of unconventional tools like forward guidance, asset purchases and long-term credit operations is still less developed than our understanding of conventional tools. Hence, the impact of these instruments remains subject to considerably more uncertainty than that of conventional instruments.

Moreover, the effect of unconventional instruments on financial conditions, and ultimately inflation, depends very much on the specific conditions under which they are implemented. And, therefore, can also differ over time. More specifically, the impact of balance sheet instruments crucially depends on the existence of financial frictions. Because these frictions are what shape the impact of such central bank interventions on financial conditions. A central bank can for instance effectively suppress risk premia by increasing its role as an intermediary.[5]

There is, however, an important catch: relevant frictions may not only reflect temporary market disfunctioning, they could also reflect more structural underlying problems that monetary policy measures cannot resolve. If the central bank were to respond to the latter, it would intervene in areas where other players have a responsibility to act. The key challenge is therefore to assess which circumstances apply, before deciding on the most appropriate instrument or set of instruments to activate.

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[4] For a discussion of these results in a broader context, see Bonam, D., Galati, G., Hindrayanto, I., Hoeberichts, M., Samarina, A. and I. Stanga (2019). Inflation in the euro area since the Global Financial Crisis. DNB Occasional Study No.3.
[5] See for instance Gertler and Karadi (2015), Monetary policy surprises, credit costs, and economic activity, American Economic Journal, 7(1), 44-76.

It is important to note that, next to the higher level of uncertainty, employing unconventional tools will also likely carry larger risks, for instance in terms of longer-run side–effects. I have therefore argued before that policymakers should consider exercising more caution in deploying unconventional instruments.[6] In times of severe market stress with equally severe frictions, however, the advantages of more aggressive action might outweigh the disadvantages of higher uncertainty and larger risks.

**Specific challenges for the ECB**

Against this backdrop, let me focus on two additional challenges related to the institutional context within which the ECB operates.

The first challenge here is provided by the observation that the ECB has to operate in an incomplete monetary union with a more convoluted process of policy coordination. The design of our Economic and Monetary Union remains a compromise between limited risk-sharing and a large degree of national liability and control. This confronts the ECB with more institutional restrictions than other central banks. It has to deal with 19 different fiscal counterparts, for instance, all of which face different sovereign risk premia. This makes the purchase of government bonds more fraught than in other jurisdictions. To what extent further steps toward fiscal risk-sharing should be taken, is very much a political question. From my perspective, I can only note that more effective fiscal stabilization would have the potential to make the ECB's job significantly easier.

The second challenge specifically faced by the ECB relates to the euro area's financial architecture. Within the euro area, banks play a dominant role. Pervasive banking sector weaknesses like non-performing loans and the bank-sovereign nexus, have plagued the euro area for a long time. Given the importance of banks for credit provision to the real economy, the ECB employed a wide variety of unconventional instruments to address impairments in monetary transmission. At the same time, deposit insurance schemes and macro-prudential policies are still a national responsibility and the banking sector remains fragmented along national lines. Financial frictions may therefore also emerge along national lines. This creates additional uncertainties and interdependencies for the ECB.

Before I conclude, let me say some more words about the design of EMU in light of these ECB-specific challenges I just mentioned. In the aftermath of the crisis, EMU's functioning has been enhanced, for instance, by the establishment of the European

[6] "Knows and unknowns of monetary policy instruments: implications for monetary policy strategies", speech at the European Banking Institute's policy conference, Frankfurt, 14 November 2019.

Stability Mechanism and the steps towards a European Banking Union. Such enhancements help align the incentives for policy action by other players with those of us, monetary policymakers. This is helpful for monetary policy in two ways. First, it reduces the likelihood of adverse shocks hitting the economy to which monetary policy would need to respond. And where monetary policy would need to respond to risks to price stability, the risk of undesirable side-effects is reduced.

There is however no room for complacency. Future steps to complete the EMU could provide further comfort to the ECB that monetary policy will not be the only game in town. Fostering more risk-sharing, would for instance entail developing a Capital Markets Union and completing the Banking Union by means of a European Deposit Insurance Scheme. This, by the way, was already foreseen by Han de Jong as early as in 1980, when he joined the European Commission to work on proposals for harmonizing deposit insurance schemes in Europe!

**Conclusion**

So let me conclude. Today I discussed what I see as the main challenges for central banks worldwide and the ECB in particular. These challenges underline the need for a review of the monetary policy strategy under the new ECB-presidency. And, as I have also tried to illustrate, some of these challenges imply that elements and lessons from other central banks cannot always be transposed onto the ECB.

A discussion is therefore warranted on the merits of increased flexibility. The ECB has to navigate its policy in a world characterised by:

1. Elevated uncertainties surrounding the inflation process.
2. Inherent uncertainties surrounding the employment of unconventional instruments at the effective lower bound.
3. Pervasive uncertainties as to the degree of alignment with other policymaker's actions and its impact on financial fragmentation.

Some of the challenges, like those created by the effective lower bound, are only relevant when inflation is below our aim. But flexibility could, in principle, be applied in either direction: both when inflation is below or above our aim.

One way to increase the flexibility of our monetary policy strategy would be to introduce a symmetric band around the inflation aim. Another way would be to lengthen the time horizon over which inflation should return toward its aim. Both approaches would buy us time and flexibility in responding to forces we simply cannot control. In doing so, it would help us communicate our commitment to price stability in a more appropriate fashion, by being humble about our limited control over short-run inflation and about the inherent uncertainties surrounding unconventional instrument applicability.

Let me then conclude with one more quote by our shared hero Johan Cruijff:
"You'll only see it, once you get it."

Han, thanks for helping us at least to see it, over these last 14 years.