Economic Viewpoint

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# Monetary policies after the crisis

## Part one: Refocusing on the medium term

Monetary policies in advanced countries are still heavily influenced by the 2008-2009 financial crisis even ten years out. Central banks seem to have stayed in crisis management mode. Negative consequences of these new approaches are however starting to be more apparent. In this first part, we will mainly discuss the fact that central banks now seem to base their decisions much more on short-term factors, which seems to go against their desire to signal their decisions far in advance. To maintain their credibility and break out of the continuous monetary easing cycle, central banks should go back to working on a medium-term horizon and make sure to adopt monetary policies that are appropriate for the economic situation.

### A NEW NORMAL YET TO BE DEFINED

We have written a lot in recent years on the significant changes that have affected monetary policy in advanced countries.[1] Facing one of the worst financial crises in history and a disappointing recovery, central banks showed great boldness in proceeding with massive financial asset purchases and reducing key rates to historic lows, even into negative territory. The fact that monetary financing[2], the famous helicopter money, is seriously considered by certain experts clearly demonstrates that the central bank regime that prevailed before the 2008-2009 crisis—which was conservative to the point of sometimes being a bit dull—is truly behind us.

In recent years, central banks' main objective seems to have been doing everything they can to prevent a new financial crisis or an economic relapse that could lead to deflation. As such, they seem to have stayed in crisis management mode for nearly a decade. Negative consequences of this new approach to monetary policy are now starting to be more apparent. Among other things, several central bank leaders begin to worry about the effects, particularly on financial markets, of holding interest rates extremely low for a long period. Several countries, including Canada, are also dealing with a worrisome spike in real estate prices and household debt.

[1] For instance: Desjardins, Economic Studies, *Economic Viewpoint*, ''The central banks still have some ammo left'', May 21, 2015, https://www.desjardins.com/ressources/pdf/pv150521-e.pdf?resVer=1432212456000

[2] Desjardins, Economic Studies, *Economic Viewpoint*, ''The helicopter money'', October 6, 2016, https://www.desjardins.com/ressources/pdf/pv161006-e.pdf?resVer=1475767240000

### DURING THE 2008-2009 CRISIS, IT WAS NORMAL TO FOCUS ON THE SHORT TERM

Current monetary policy and the behaviour adopted by central banks stem directly from the financial crisis and great recession. After the fall of Lehman Brothers, the central banks' main worry was to rebuild investor confidence to prevent a veritable international financial system meltdown. In such a context, it was totally justify that central banks would concentrate their efforts on the short term and be on top of all financial market fluctuations.

These efforts and those of governments succeeded in ending the financial crisis in 2009, and the global economy was able to start growing again. A financial crisis will nevertheless leave scars, and fears of a relapse have continued to plague central banks in recent years. The sovereign debt crisis in Europe and its impact on the banking system also contributed to keeping them in ultra-interventionist mode, in a context where economic growth and inflation remained weak.

### A STRUGGLE TO RAISE RATES IN THE UNITED STATES

While several central banks in advanced countries continue to announce monetary easing measures, the Federal Reserve (Fed) is in a different situation. Even though U.S. growth is steel modest, the labour market improved to the extent that the Fed now believes it is appropriate to start gradually raising its key rates. An initial increase of 0.25% took place in December 2015, and Fed leaders signalled, at that time, that there could be an additional 1.00% increase in 2016.

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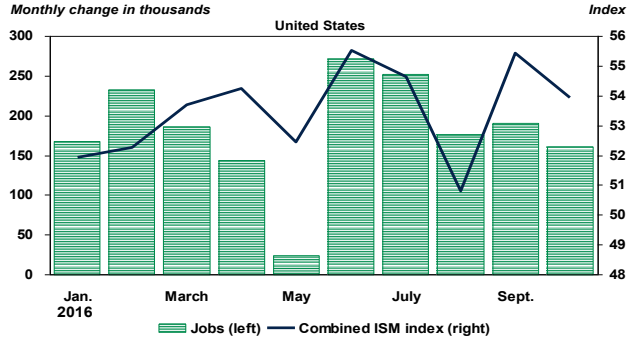
However, things did not go as expected this year, and we are still waiting for the second key rate increase. A stock market drop at the start of the year, poor employment numbers in early June combined with uncertainty around the referendum on Brexit, and a temporary decrease in ISM indexes before the September meeting convinced, at each turn, Fed leaders to stay with the status quo a little longer.

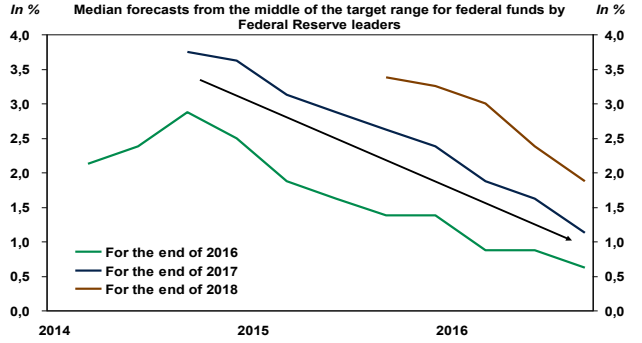
The events that had worried the Fed however quickly turned around (graph 1) and the surprise victory for Brexit ultimately had no major impact on financial markets or the U.S. economic outlook. In fact, Fed leaders did not stop downgrading their forecasts on future interest rate movement in recent years (graph 2), despite a more than acceptable job market performance. Even some Fed leaders worry about this situation, and James Bullard, President of the St. Louis Fed said last summer, "The Fed's actual pace of rate increases has been much slower than what was mapped out by the committee in the past. This mismatch between what we are saying and what we are doing is arguably causing distortions in global financial markets, causing unnecessary confusion over future Fed policy, and eroding credibility."

**Graph 1 Weak employment in May and ISM indexes in August amounted only to volatility**




Sources: Bureau of Labor Statistics, Institute for Supply Management and Desjardins, Economic Studies

**Graph 2 Federal Reserve leaders continue to downgrade their forecasts for key rates**




Sources: Bloomberg, Federal Reserve and Desjardins, Economic Studies

## IT'S TIME TO START FOCUSING ON THE MEDIUM TERM

In our opinion, the primary mistake that Fed leaders are making is to react to all the fluctuations in economic statistics and financial markets. That kind of attitude is reasonable in a crisis, but counterproductive in calmer times, especially since it usually takes several quarters before monetary policy affects the economy and inflation. It is normal that central banks very closely monitor economic statistics, but statistics should only influence their decisions when they change medium-term economic outlooks. Data on job creation for the last 12 months should therefore have a much greater impact on the Fed's next monetary policy decision than should the monthly data released just before a meeting.

It is even more problematic to see that financial market fluctuations now have a major influence on monetary policy decisions. This creates a vicious circle where investors react to any signal from Fed leaders and the Fed reacts to investor reactions. In addition, the perception that a decline in the value of the stock market will trigger a reaction by central banks to support markets creates enormous moral hazard, which could boost asset prices. If we concede that central banks can play a certain role in avoiding serious financial crises, the way to do it is certainly not by trying to limit short-term market fluctuations.

## A SUGGESTION FOR THE FED TO REGAIN CREDIBILITY AND PREDICTABILITY

A clear lesson from recent years is that it is totally counterproductive for the Fed to try to prepare markets well in advance before raising rates only to then allow its decision be influenced by volatile statistics released a few days before a meeting. Under current conditions, it seems to be a good idea to prepare financial markets before an increase. The Fed should however be willing to sacrifice some of its flexibility.

Last September, the Fed signalled that U.S. key rates could go up 0.25% by the end of 2016 and by 0.50% to 0.75% in the following years. Such rate hikes appear perfectly appropriate, but the Fed should now impress upon markets that it would take a major change in the U.S. economic outlook for it to deviate from this path. It would therefore be much less data dependant than it has been in recent years. To make it very clear that the exact moment rates are increased is of little importance, it could even decide that, until further notice, key rates will be changed only

during meetings in December, March, June and September, as a former president of the Minneapolis Fed recently suggested.[3]

Next, the most important move would be to actually increase key rates on a regular basis in the coming quarters, even if bad data is released or the markets go through a rough patch. Such an approach would be an important step toward a credible and predictable monetary policy that would let investors focus their attention on other things. In the event of moderate deteriorations to the outlook for the economy or inflation before a meeting when an increase was signalled, the best strategy would be to go ahead with the increase, but to signal an even slower rate increase thereafter. Of course, if there was a major shock, the Fed could justify quickly adjusting its monetary policy because of changes to the U.S. economic outlook.

## FOCUS ON KEY RATE LEVELS RATHER THAN THEIR MOVEMENT

The Fed would not be the only central bank to benefit from refocusing on the medium term. In other advanced countries where the economic recovery is often less advanced and more fragile than in the United States, the question that central banks seem to be asking at each of their meetings is, **is it time to further soften our monetary policy?** As inflation in most countries remains below central banks' target level (graph 3), the answer is often yes. Since each central bank's act of easing tends to exert upside pressure on other countries' currencies, it turns into a vicious circle of continuous monetary policy easing. This is what led to negative rates and even greater purchases of financial securities in several countries.

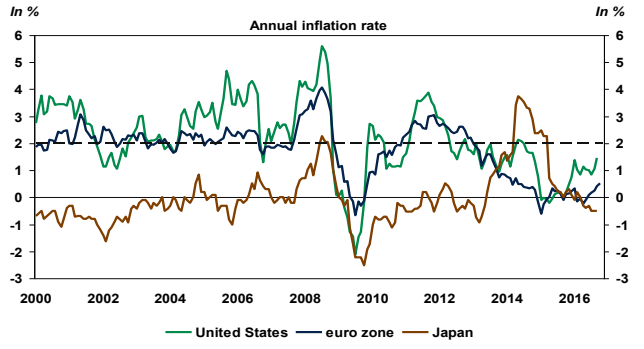
This approach to always adjusting monetary policy at the margin is not desirable in our opinion. When they meet, central banks should ask this: **is the current level of key rates and other monetary policy interventions still appropriate in light of the outlook for the economy and inflation?** This question acknowledges that it is the level of key rates that influences the economy in the medium term, not its changes. Short-term movements in key rates instead impact financial markets, which should not be the main concern for central banks.

## A WIDE DICHOTOMY BETWEEN MONETARY POLICY AND THE ECONOMY

Continuous adjustment of monetary policy at the margin brought us to a situation where we see increasingly extreme monetary policy despite a more acceptable economic and financial environment. With output gaps not widening anymore, weak inflation is essentially the cause of this dichotomy.

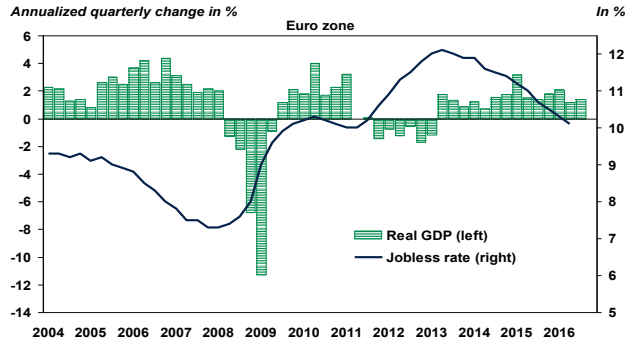
The example of the European Central Bank (ECB) is striking on this point. The sovereign debt crisis in Europe and particularly difficult economic recovery marked by a second recession starting at the end of 2011 could well justify the ECB's further softening of monetary policy in the years following the crisis. However, financial markets seem more solid today and the European economy has returned to growth for 14 quarters now (graph 4). Inflation remains too weak, however, and the ECB still feels bound to do more, as everything points to it announcing an extension of its bond purchase program soon.

**Graph 3 Central banks worry about inflation staying low**




Sources: Datastream and Desjardins, Economic Studies

**Graph 4 The economic situation in the euro zone is more favourable today than in 2009 and 2012**




Sources: Datastream and Desjardins, Economic Studies

[3] Narayana Kocherlakota, Bring the Fed's Dead Meetings to Life, Bloomberg View, October 12, 2016.

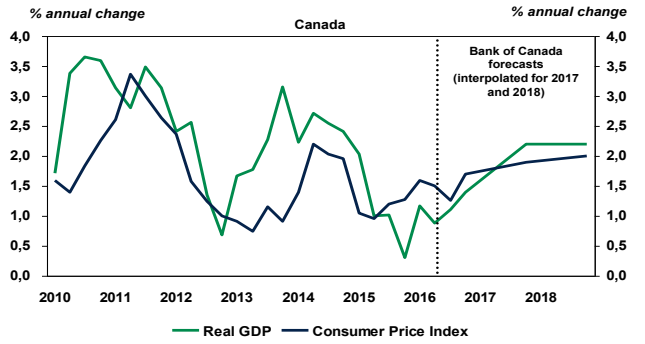
## HOW TO REACT TO INFLATION STAYING UNDER THE TARGET FOR A LONG PERIOD?

One of the problems for the ECB and several other central banks is that monetary policy seems to have less of an impact on the economy and inflation than it was previously thought to have. The world has changed greatly since the financial crisis, and major structural changes, including an aging demographic, are making the future uncertain. The macroeconomic models on which central banks based their decision before the crisis seem not to work as well today[4], forcing monetary authorities to practically feel their way in the dark. In this context, central banks should accept that situations may arise where inflation will spend some time sitting uncomfortably far from the target level. The fact that monetary easing seems less effective to raise inflation should not be a reason to use more these tools, which also have negative consequences.

To protect their credibility and make sure that inflation expectations do not drop to much, central banks should continue to assert their determination to bring inflation close to the target level in the medium term. They need however to clearly convey the message that maintaining key rates very low is already a major step in that direction. Recent years have caused people to forget that in normal conditions, key rate should be close to the neutral rate, which is the rate at which inflation stays at its target when the economy chugs along at its full potential. For different reasons, particularly demographic factors, this rate has fallen in recent years, but remains clearly above zero, like in Canada where it is around 3.25%.

Holding key rates significantly below the neutral rate would seem to us a totally appropriate monetary policy in a situation where the outlook for inflation is too low, like in the euro zone. Additional monetary policy softening would be justified only if the inflation outlook deteriorated more. In contrast, lower deflation risk should translate into higher key rates, which would give central banks some flexibility to react to another outlook downgrade. Had central banks adopted such an approach, the situation would be very different today.

**Graph 5 Bank of Canada forecasts draw a fairly encouraging portrait**




Sources: Datastream, Desjardins, Economic Studies

## THE BANK OF CANADA SHOULD ALSO FOCUS ON THE LEVEL OF ITS INTERVENTION

The two key rate decreases announced by the Bank of Canada (BoC) in 2015 could be justified by the desire to help the Canadian economy adjust following the spectacular plummet in oil prices. Now that the worst of the shock is behind us and the risk of recession and deflation are lower, it would be logical to begin reversing this preventive rate decreases. The BoC's outlook, which suggests growth will soon be above its potential pace and inflation will be close to the 2% target (graph 5), would even support, in theory, gradually raising rates to close to their neutral level. Nonetheless, the BoC is considering further softening its monetary policy, to bring key rates to the same level as during the financial crisis. This clearly shows that it has also fallen into the trap of making monetary policy at the margin, in part to influence the Canadian dollar. The BoC should take a step back and question if the level of its interventions is appropriate to the medium-term economic outlook for the Canadian economy.

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[4] For instance: Stephen S. Poloz, Integrating Uncertainty and Monetary Policy-Making: A Practitioner's Perspective, Discussion Paper, Bank of Canada, October 2014.