A new normal or a temporary phenomenon?

Let me begin my presentation with the question from which its title is derived, a question that is not simply interesting as a nice title but is one to which an answer must be sought: 'Is monetary policy facing a 'new normal' or is the current situation merely a temporary phenomenon?' This seminar provides an ideal setting in which to explore an answer.

Recent years have presented central bankers with a raft of challenges and, I may venture to say, a number of unprecedented precedents, too. Uncharted horizons are appearing before us, and we must steer a course that takes us to our objective. We have for longer time begun falling away from our inflation target, or at least we have not moved towards it as fast as we would like. Therefore, may be, it is being asked whether the target is correct, whether the time is not ripe for a reassessment. There are various proposals. Some say that increasing the target could raise inflation expectations. Others argue that reducing the target would be reflective of a long-term low inflation environment, or what is sometimes referred to as a 'new normal'. Such proposals may reckon on an explicit and symmetric inflation target, such as the range 1.5% to 2.5%. They may also reckon on a change in mandate by opting for price level targeting, in which case the central bank would be implicitly stating its acceptance of higher-than-target inflation. In my view, such discussions are still at the academic level, and there needs to be research into whether changes to inflation targets in other countries have had favourable and clear effects on expectations and on the transmission of monetary policy to the economy.

Despite a continuous and substantial easing of monetary policy conditions, the inflation target is plainly being missed. This is due to strengthening headwinds. I mean the impact of sudden and unexpected shocks in oil prices, *an environment of extended period of high unemployment and of very low inflation (even turning into deflation), which may be putting downward pressure on inflation expectations.*

How is monetary policy supposed to react? As we have heard in the lead speech, the coordination and some impulse from fiscal policy is recently considered to be fine. I strongly agree that “monetary policy cannot deliver without sustainable” and I will add responsible fiscal policy. However as the life shows us it far from being ideal.

Should or could monetary policy be still more aggressive?

The scope for deploying standard instruments is almost exhausted. We have even shown that interest rates are not zero lower bound; they can be lower still, and we are now testing how low they can go. Given the costs of holding large volumes of cash (including costs of transportation, storage, insurance and security), the effective lower bound on nominal interest rates is negative. Looking more closely at interest rates, it is clear, and logical, that policy interest rate transmission has had a greater impact on lending activity than on the deposit-taking business. The resulting narrowing of margins has had still manageable, and not too significant, impact on banking sector profits. If this tool must continue to be used, then it must be with caution, so as not to bring about a totally counterproductive threat to financial stability. I myself do not see much room for manoeuvre here, but it may be worth considering the introduction of a two-tiered system. Relief of this kind could minimise the potential adverse effects on margins and profits, while maintaining interbank rate levels and expanding the set of eligible securities to include lower-priced assets.

Could monetary policy still be accommodative in other respects, when unprecedented and substantial non-standard measures have almost been deployed? Unconventional instruments were introduced on the assumption that they were temporary, short-terms measures. Now, however, the situation has changed. The original temporary duration has been considerably extended and we should therefore get used to a 'new normal' in the monetary policy arsenal. In the academic debate there is room to explore the potential for using other, new non-standard instruments as the need arises. Liquidity is excessive, bond yields and interest rates are at all-time lows, and the ECB's balance sheet it is as large as it has ever been, yet inflation remains muted.

In the case of the euro area, it is not necessary at this point to consider further accommodation, since the recently introduced non-standard measures have not had time to do what they were intended to do. The question is whether they will be as effective as earlier measures. Our models indicate that they will be, and so does the evidence from monetary policy implementation in the United States. On the other hand the potential growth is much lower. Is it facing a 'new normal'? Before the ECB expanded its asset purchase programme there were, as I recall, some voices warning about the potential for excessive inflation. From today's perspective, that risk seems very distant indeed. If, however, there were an upward oil price shock (ideally on the demand side) and energy commodity prices were again to approach triple digits, the central bank has many standard instruments with which to tighten monetary conditions, should that be necessary.

Are we facing a 'new normal' environment at the global level as well? Can emerging-market economies be expected to enjoy double-digit growth over the long term? Has their growth, especially that of China, been sound and based on strong fundamentals? Lending growth, unproductive investment financing, and high debt indicate that one of the engines of the global economy is more likely to slow than to create and exacerbate imbalances. And what are the prospects for global trade? Its decreasing correlation to global GDP suggests it will not be returning to pre-crisis levels any time soon. We must rely on the recovery of domestic consumption of goods and services.

The effectiveness of monetary policy, as we have been tought, is heavily dependent on the environment in which it is implemented. While monetary policy has tools to stimulate demand, it cannot influence the performance of the supply side of the economy, which is crucial for sustainable growth. Although the scope for fiscal policy is limited, we should not take that as a 'new normal'; we should not see fiscal policy as some kind of sleeping beauty. At the time when monetary policy targets and the ECB mandate were being formulated, it was assumed that responsible policy (in particular fiscal policy) and responses of (product and labour) markets to imbalances would be sufficiently strong and flexible to prevent extended deviations from the equilibrium. That assumption turned out not to be valid everywhere. Because fiscal policy was often not conducted responsibly in the good times, it has been unable to help monetary policy in the bad times, in easing conditions and supporting economic growth. But despite the lack of fiscal leeway, it is incumbent on governments not only to consolidate public finances, but, through reforms, to lay the ground for stimulating the supply side of economic growth. In the short-term, governments must pursue growth-friendly consolidation by making efficiency savings in the public sector, where the potential for productivity gains is significant.