

# EE432 Monetary Theory and Policy

## Lecture 14 Modern monetary policy and the challenges

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# Outline

- The Challenges Modern Monetary Policymakers Face
- Booms and Busts in Property and Equity Prices
- Deflation and the Effective Lower Interest-Rate Bound

# Chapter 23

## Modern Monetary Policy and the Challenges Facing Central Bankers

# The Challenges Modern Monetary Policymakers Face

# The Challenges Modern Monetary Policymakers Face

- **Stock prices and property values** have a *tendency* to go through **boom and bust cycles**.
- Policymakers' *options* are limited
- The *nominal interest rate* cannot *fall below* the *effective lower bound*.

*Booms and Busts in Property  
and Equity Prices*

# Booms and Busts in Property and Equity Prices

- **Bubbles** are damaging because the wealth effects they create *cause consumption to surge* and *then contract* just as rapidly.
  - Bubbles are identified after the fact by a **sharp rise** then a **sharp decline** in *prices*.
- The **collapse of the Internet bubble** in the **1990s** had a relatively minor impact because intermediaries faced *limited credit exposure* and *remained well capitalized*.
- While the *loss of capital* in the financial system *in 2007-2009* could have *led to catastrophe* without extraordinary government actions.

# Booms and Busts in Property and Equity Prices

- Proponents of a *policy of “leaning against bubbles”* say that ***stabilizing inflation and real growth*** means **raising interest rates to discourage bubbles** from developing.
- ***Opponents of this interventionist*** view claim that **bubbles are too difficult to identify when they are developing**.
  - Central banks should **wait until the bubble bursts** and **only then react aggressively to limit the fallout** on the economy by cleaning up the mess.

# Booms and Busts in Property and Equity Prices

- Today, the *proper policy toolkit* for addressing bubbles is not interest rates but the **macroprudential regulatory** approach
- According to this view, **bubbles** are a *major threat*.
  - The best result would be to *adjust regulatory rules* to **inhibit intermediaries** from extending such *risky credit* in economic booms.

# Booms and Busts in Property and Equity Prices

- This approach *still depends on* the **foresight and judgment of regulators** to limit the *buildup of an asset price bubble*.
- Using **interest rates to combat *asset price bubbles*** now is *more likely* to be viewed as a *backup* approach for *extreme circumstances*.

*Deflation and the Effective  
Lower Interest-Rate Bound*

# Deflation and the Effective Lower Interest-Rate Bound

- **Nominal interest rates can not be *deeply negative*.**
  - There is an ***effective lower bound (ELB)*** that is **below zero** due to transactions costs
  - Investors can ***always hold cash***, so ***bonds must have yields*** above the ELB to attract bondholders.
- Such risk which policymakers have ***no scope to lower rates further***, has concerned central banks since Japan's experience in the 1990s.

# Deflation and the Effective Lower Interest-Rate Bound

- Think about the *consequences of a shock that depresses aggregate expenditure*.
  - The dynamic aggregate demand curve shifts to the *left*.
  - Real output *falls below* potential - a *recessionary output gap* putting *downward pressure* on inflation.
  - Monetary policymakers would normally react by cutting interest rates.
  - This would *increase spending*, *raise* real output, and *eliminate* the output gap.

# Deflation and the Effective Lower Interest-Rate Bound

- What if, when the shock occurs, inflation is zero and the policy interest rate that central bankers control is ***at the ELB***?
  - The **decline in aggregate demand** still *drives real output below potential output*.
  - There is *downward pressure on inflation*.
  - But when **inflation falls**, it drops below zero so that, on average, *prices are falling*.
- This result is **deflation**.

# Deflation and the Effective Lower Interest-Rate Bound

- When there is a recessionary output gap, **current inflation** is *below expected inflation* and **expected inflation falls**, which drives deflation down even more.
- Because the **nominal interest rate** is at the ELB, policymakers cannot counter the *worsening deflation* by *lowering* it.

# Deflation and the Effective Lower Interest-Rate Bound

- The interest rate stays near zero and could ***not* be negative**.
- Inflation *keeps falling*, real interest rate *thus increases*
- The *effects of the shock* could be ***amplified through a deterioration in confidence and expectations of declining prices, exacerbating the initial deflationary impulse and recessionary output gap.***
- The result is ***deflationary spiral*** in which *deflation grows worse and worse.*

# Deflation and the Effective Lower Interest-Rate Bound

- **Deflation** makes it *more difficult* for businesses to *obtain financing for new projects*.
  - Without investment there is *no growth*.
- **Deflation**, therefore, **increases** the *real value* of a firm's **liabilities** without *affecting the real value of its assets*.

# Deflation and the Effective Lower Interest-Rate Bound

Policymakers can minimize the chances of this sort of catastrophe:

1. They can ***set*** their inflation objective with the ***perils of deflation in mind***
2. They can ***act boldly*** when there is ***even an indication of deflation***
3. They can ***utilize*** unconventional policy tools

# Deflation and the Effective Lower Interest-Rate Bound

- ***Reducing*** the interest rate ***significantly*** and ***rapidly*** when faced with the ***possibility of hitting the ELB*** is “***acting preemptively***”
- Central bankers can use ***unconventional policy tools*** that ***include***:
  - Forward guidance
  - Quantitative easing
  - Targeted asset purchases

# Deflation and the Effective Lower Interest-Rate Bound

- Central bankers are *very reluctant to use unconventional policy tools*
  - Continued uncertainty about *how and why they work* and *how to apply them effectively*
  - *Policy exit* may be difficult

End of lecture