Recommended reading

Monetary tightening: Doomed if you do, doomed if you don't?

■ Monetary policy normalisation is a balancing act: tighten too early could trigger a recession, hike too late could mean an inflation overshoot and a need to raise rates more aggressively ■ The reaction of financial markets adds to the complexity of the balancing act ■ Different factors have made the job of central banks more difficult in recent years

Monetary policy normalisation, which in the current environment consists of adopting a less expansionary policy stance, confronts central banks with challenging questions: when to start, what should be the pace, which guidance should be provided?

The answers are important for households, companies and in particular for financial markets, all the more so because the reaction of the latter can weaken or, more likely, reinforce a given impulse coming from the central bank. Weakening would occur if e.g. equity markets would rally because they see a monetary tightening as a signal that according to the central bank the economy is in good shape or because the central bank tightens policy less than expected. Reinforcement would occur if equities would drop and/or credit spreads widen because the required risk premium rises as investors become more risk averse because of increased concern about the economic outlook.

Wage dynamics have changed

These reactions could in turn impact the real economy via spending, hiring and corporate investment decisions. The different outcomes lead to the obvious conclusion that it's important to do the right thing. This also applies when looking at it from the perspective of the real economy. Too slow a pace of tightening would mean that the central bank ends up "being behind the curve": rates are too low considering the output gap and the amount of slack in the labour market. Hike rates too fast and one runs the risk of killing the upswing.

On this matter, the past two weeks have seen two important contributions to a debate which has become very intense. **Chapter 4 of the 87th annual report of the Bank for International Settlements**[1] discusses how monetary policy is *"inching towards normalisation"*. Wage dynamics play a key role: labour market bottlenecks should eventually cause wages to grow faster than productivity forcing companies to increase their prices (unless their competitive positioning would force them to accept a decline in profit margins). However, despite the decline in the unemployment rate in e.g. the US or the UK, wage growth has been more subdued than in previous cycles. According to the BIS this reflects a long-term trend of "labour's declining pricing power" due to the huge expansion of the global labour force (increased globalisation, changes in global value chains) and industrial automation.

Wage growth and inflation should eventually accelerate

In addition, the relationship between unit labour costs and inflation has become weaker. However, even a weak relationship would still imply that reduced slack would eventually lead to a pick-up in inflation, possibly in a non-linear way. Central banks are faced with a balancing act: tighten early under the belief that inflation will rise could, via higher real rates of interest, act as a big headwind for growth if inflation does not pick up. Financial markets would also suffer, which in turn could have second-round effects on the real economy. Acting late implies low rates for longer which could lead to higher asset prices and an abrupt correction when it turns out that the central bank should have hiked rates earlier. This in turn would weigh on economic growth.

The BIS eloquently discusses the issues but does not provide a policy recommendation in terms of hiking rates or not, probably because this is out of its remit. At most it emphasizes the need of enhanced central bank cooperation, which is a valid point considering the international spillover effects of monetary policy conducted by the major central banks. **Kristin Forbes**, external member of the monetary policy committee of the Bank of England, on the other hand, does at least for the UK express a clear opinion. In her recent, particularly rich speech[2] on *"Failure to launch"* she starts from the observation that although global growth has been above 3% for seven years in a row and that global inflation is picking up, no central bank of an advanced economy[3], except the US, has tightened policy since 2011.

What explains the reluctance to tighten?

Several explanations are provided for this reluctance to tighten. Lingering concern about the fundamental weakness of the economy is one but in her view this argument has lost much of its power. A second explanation concerns the role of central banks. Their toolkit has broadened and now also includes using the balance sheet (QE) and applying forward guidance in addition to setting interest rates. Many central banks also have a macroprudential policy role. The

[1] BIS, 87th annual report 2016-2017, Building, https://www.bis.org/publ/arpdf/ar2017e.htm

[2] Kristin Forbes, Failure to launch, Bank of England, 22 June 2017, http://www.bankofengland.co.uk/publications/Pages/speeches/2017/985.aspx

[3] The sample excludes Denmark, Hong Kong, Singapore and Iceland.

simultaneous use of several tools would allow for fewer or at least a slower pace of rate hikes. In addition, central bank action has also become much more visible and subject to public scrutiny, which may influence the policy stance, e.g. by paying more attention to the short rather than the longer horizon. A third explanation is about constraints on central bank policy. With still very low interest rates, the case can be made that the cost of tightening too much is bigger than ending up behind the curve. The former would mean a significant growth slowdown or even a recession, which would be hard to address given the limited leeway, if any, to cut rates. Forbes doesn't buy this "out of ammunition" argument because the balance sheet could always be increased. A more important constraint is the exchange rate: currency appreciation on the back on rate hikes expectations would imply a tightening of financial and monetary conditions, weigh on the growth outlook via exports, and reduce the need for traditional rate hikes. Against this background and focusing on the fundamentals of the British economy, she argues that *"the lift-off of UK interest rates should not be delayed any longer"*, all the more considering that sterling weakness will have a persistent upward influence on inflation.

William De Vijlder

Monetary policy and different adjustment speeds of the real economy vs asset prices

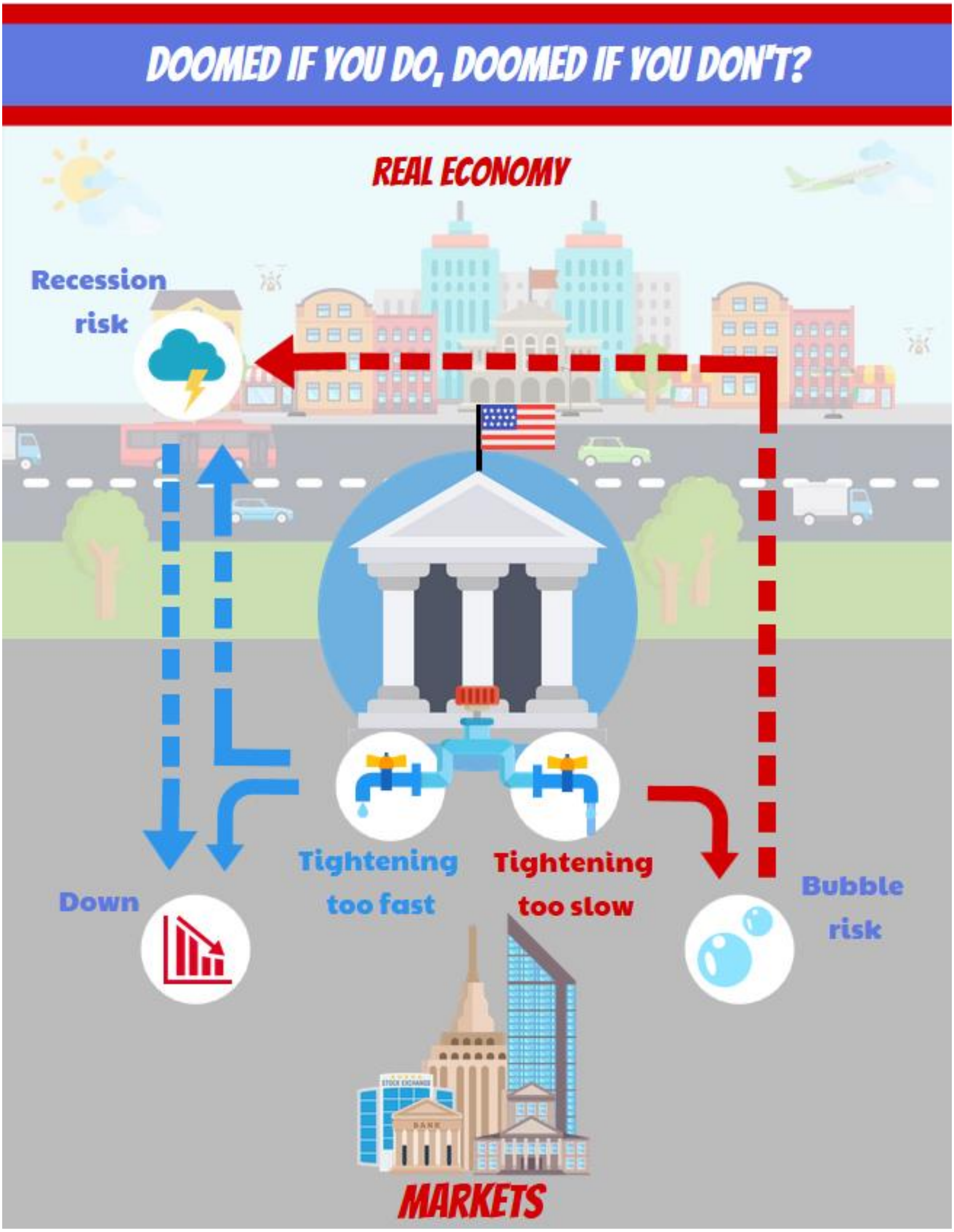
Back in 1976, **Rudiger Dornbusch** published his seminal article on exchange rate overshooting[4]. A monetary easing weakens the currency in the long run but because of different adjustment speeds between foreign exchange markets and the real economy, the exchange rate overshoots: an excessive depreciation in the short run is followed by a gradual appreciation. The bigger the monetary easing, the bigger the depreciation of the exchange rate in the long run and the bigger the overshooting in the short run.

It is tempting to transpose this framework to the relationship between monetary policy, asset markets and the real economy when analysing central bank policy. Asset prices are a key variable in the conduct of monetary policy. Not only do they reflect expectations about the economy as well as the risk appetite of market participants thereby providing useful information to the central bank (signalling role) but they also are a key transmission channel for monetary policy. Interest rate cuts and QE can support asset prices via higher growth expectations and a lower required risk premium.

If the adjustment speed of the real economy is very slow, i.e. if it takes considerable time for inflation to pick up, a central bank which is following an inflation-targeting policy may very well decide to keep rates low for longer and to continue with QE. Quite likely this could squeeze risk premia further to levels well below historical reference points. The longer the expansionary stance would be maintained, the bigger the squeeze on risk premia.

There is concern that this *gradual* overshooting would eventually be followed by a market correction: when the real economy at long last reacts to years of expansionary policy, the increase in wage growth and inflation would force the central bank to react more strongly, which would increase the required risk premium and weigh on asset prices. Via wealth and confidence effects this could turn into a headwind for the real economy.

[4] Rudiger Dornbusch, *Expectations and exchange rate dynamics*, Journal of Political Economy, 1976, vol. 84 nr 6, http://www.journals.uchicago.edu/doi/pdfplus/10.1086/260506


DOOMED IF YOU DO, DOOMED IF YOU DON'T?
REAL ECONOMY
Recession risk
Tightening too fast
Tightening too slow
Down
Bubble risk
MARKETS