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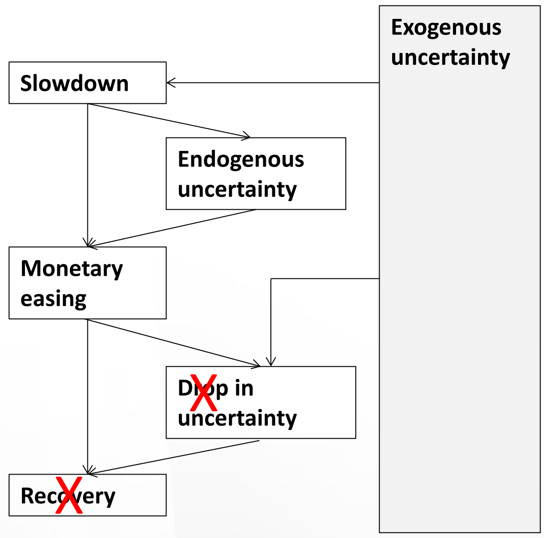
Exogenous versus endogenous uncertainty and monetary policy

■A high level of uncertainty can act as a drag on growth ■Whether monetary easing will succeed in boosting growth will depend on the nature of uncertainty. Endogenous uncertainty follows from the normal development of the business cycle and rate cuts should succeed in reducing this uncertainty by boosting confidence of economic agents ■Exogenous uncertainty is not driven by the business cycle but is triggered by other factors, such as, in the current environment, ongoing trade disputes. In this case, monetary policy effectiveness suffers and, despite rate cuts, the growth slowdown should continue until its root cause (exogenous uncertainty) is addressed.

Both on theoretical and empirical grounds, it can be argued that a persistently high level of uncertainty can act as a drag on economic growth. In such a case, monetary policy can be called upon to stop the slowdown so as to avoid that it would develop into a recession. However, the effectiveness of monetary accommodation will depend on the nature of the uncertainty. A first type of uncertainty is endogenous. It results from the normal development of the business cycle: slower growth raises concern about what is causing it, how long it will last, what will be the amplitude of the drop in growth, how it will influence household income and corporate profits, etc. A credible central bank can, by means of sufficient policy easing, reduce the level of uncertainty because economic agents expect that in due course, the monetary transmission channels will work. It is this expectation which boosts confidence, encourages cash-rich households to increase their spending, entices companies to invest more, raises the demand for bank credit, etc. As a consequence, endogenous uncertainty drops, stimulating spending even more.

EXOGENOUS UNCERTAINTY AND MONETARY POLICY



Source: BNP Paribas

A second type of uncertainty is exogenous. It doesn't follow from the normal course of the business cycle but is triggered by other factors such as geopolitics or economic policy. An example of the latter are trade disputes, such as those we have experienced since last year between the US and China. Exogenous uncertainty has its own drivers (e g negotiation tactics in matters of international trade) which are hardly influenced by cyclical developments. This has important implications for monetary policy. The effects of rate cuts, which are supposed to support confidence and trigger an increase in spending, are neutralised by ongoing high levels of uncertainty. After all, what difference does a 25bp cut in the policy rate make when companies and households have no idea whether, going forward, import tariffs will be hiked further or will be lowered, because an agreement has been reached? The same line of thinking can be extended to other instances of exogenous uncertainty, such as Brexit. Given the debilitating effect of exogenous uncertainty on monetary policy effectiveness, policy decisions are required to address it in order to stop the growth slowdown.

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