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Monetary easing at full employment: how effective?

■ Fed Chairman Powell, in his address to Congress this week, has confirmed that easing is coming ■ In June, ECB President Draghi provided similar hints ■ This comes on the back of growing concerns regarding global growth and ultimately facing too low a level of inflation ■ Risks may be mounting, but, on the other hand, the unemployment rate is close to the natural rate ■ There are reasons to assume that monetary easing under full employment would be less effective than when the economy is marred in recession. Monetary easing could also raise concerns about financial stability, which, if unaddressed, could weigh on the ability of monetary policy to successfully boost inflation.

Speaking in Sintra last month, Mario Draghi has hinted at an easing of monetary policy: inflation is too low compared to target, which is an issue, all the more so considering that risks to growth are tilted to the downside. Jerome Powell, in his testimony to Congress this week, has done the same: uncertainties about trade tensions and concerns about global economic prospects weigh on the outlook for the US and could lead—on a more enduring basis—to weaker than expected inflation. Yet, the prevailing level of activity compared to potential remains high: in the US, the unemployment gap (the difference between the unemployment and NAIRU, the non-accelerating inflation rate of unemployment) is negative and in the eurozone unemployment is in line with NAIRU. This complicates one's assessment of the likely ramifications associated with a new cycle of monetary easing.

Traditionally, policy accommodation starts when an economy slows down significantly. It tends (i) to gather pace during a recession and (ii) to continue well into a recovery, until it becomes clear that the economy is capable of "standing on its own two feet" so to speak. During these phases, several stylised facts can be observed: mounting recession fears cause a decline in equity markets and a rise in corporate bond yields. It also makes access to financing, both via capital markets and banks, more difficult. Inevitably, confidence and activity both drop. Interest rate cuts then seek to restore confidence which in turn boosts risk appetite. Subsequently, equity and corporate bond markets rebound and access to credit improves. Growth ultimately picks up, signalling the start of a recovery.

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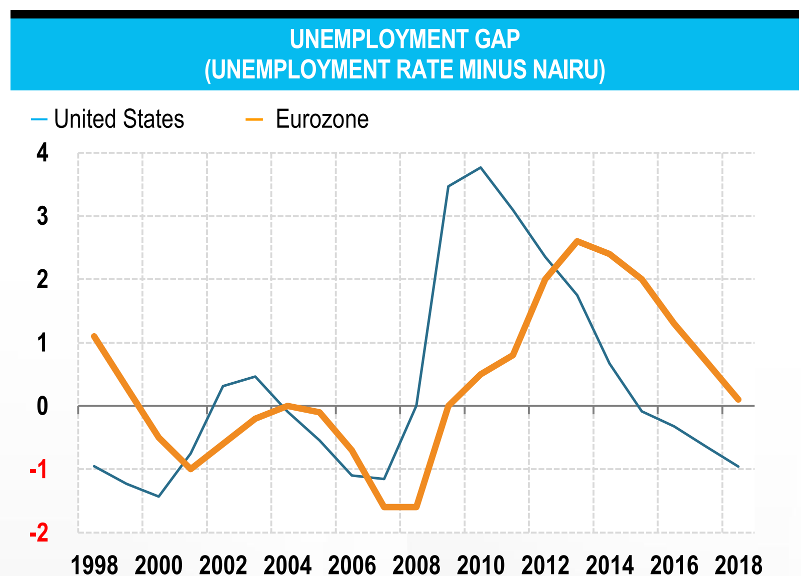

Source: Ameco, national sources, BNP Paribas

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At the current juncture, these transmission channels will likely be less strong, which would imply less of a boost to growth and inflation: equity indices are at a high level, corporate bond spreads are rather tight, bank lending surveys point towards a normal credit environment. When liquidity is abundant, adding more of it will have less of an effect on the real economy than if access to credit is severely constrained, like in a recession. Clearly, the prospect of more easing has supported the stock market (the S&P500 has set a new record) and the property market should benefit from ever lower interest rates.

However, easing policy in a full employment economy so as to chase the inflation target, raises questions about financial stability. The recently published annual report of the Bank for International Settlements summarises the dilemma very neatly: *"the price stability mandate sets the stage. This naturally induces central banks to maintain policy accommodation, or to ease further, when inflation is below target, even when the economy appears to be close to estimates of potential."*[1] But *"it constrains the policy options when such a policy could have unwelcome effects on the financial side of the economy longer-term, such as by encouraging excessive risk-taking."* The latest Financial Stability Review of the ECB[2] makes similar points. Although household indebtedness has stabilised for the euro area as a whole at 58% of GDP, which is slightly below the debt overhang threshold, it remains a source of concern in certain areas. Moreover, *"in some countries, the combination of house price rises and strong new lending and/or household indebtedness warrants closer monitoring"*, although *"macroprudential policy actions, such as extra capital buffer requirements or controls on loosening borrower terms, can help mitigate possible risks to financial stability at the country level."* This means that, at least in certain countries and sectors, tighter macroprudential rules might very well neutralise the impact of more policy easing, thereby complicating the convergence of inflation to the ECB's target.

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[1] Bank for International Settlements, Annual Report, June 2019
[2] ECB, Financial Stability Review, May 2019