

CAUSES, CHALLENGES AND CONSEQUENCES OF THE LOW INTEREST RATE ENVIRONMENT

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THE PAPERS

Paul Tucker

- ▶ 'Fiscal, Monetary and Macroprudential Regimes: Incentives-Values Compatibility in Constitutional Democracies'

Marco del Negro

- ▶ ' r^* : Definition, Uses, Measurement, and Drivers'

REVIEW OF RBA MONETARY POLICY

General international concerns

- ▶ Failure to generate inflation after the financial crisis
- ▶ Long-run secular decline in growth and real interest rates
- ▶ What are the appropriate objectives for central banks?
- ▶ What are the appropriate instruments?

Specific domestic concerns

- ▶ Democratic accountability
- ▶ Important to assess world's best practice
- ▶ Ensure institutional design and framework appropriate for future challenges

REVIEW OF RBA MONETARY POLICY

Under the Reserve Bank Act 1959

- ▶ Stability of the currency
- ▶ Maintenance of full employment
- ▶ Ensuring the economic prosperity of the welfare of the Australian people

Statement on the Conduct of Monetary Policy

- ▶ Documents the operational understanding of the Act between the Governor and Government
- ▶ Consumer price inflation between 2 and 3 per cent, on average, over the cycle
- ▶ Government endorses the inflation objective and emphasises the role that disciplined fiscal policy must play in achieving medium-term price stability

TWO PAPERS: TUCKER AND DEL NEGRO

Constraints from institutional design

- ▶ What are central banks responsible for?
- ▶ What can central banks do?
- ▶ What can't central banks do?

Constraints from the economy

- ▶ Consequences of private sector behaviour
- ▶ Cyclical versus trend

DEL NEGRO: DETAILS

Results

- ▶ State of the art reduced-form and structural modelling
- ▶ Both adduce evidence of a fall in r^*
- ▶ Largely a story about liquidity (+ safety)
- ▶ To a lesser degree about growth

Implications

- ▶ Central objective in models for policy evaluation
- ▶ Provides a gauge of the stance of monetary policy
- ▶ Twist: r^{**} distinction between "real" and "financial" stabilization
- ▶ Looking forward: demographics, inequality, productivity, ...

DEL NEGRO: DETAILS II

Consider a neo-Wicksellian model with

$$x_t = E_t x_{t+1} - \sigma(i_t - E_t \pi_{t+1} - r_t^*)$$

Solving forward provides

$$x_t = -\sigma E_t \sum_{T=t}^{\infty} (i_T - \pi_{T+1} - r_T^*)$$

- ▶ Effective 'nominal space' determined by r^*
- ▶ Actual and neutral nominal rate gap determines stimulus
- ▶ At the ELB monetary policy must be more aggressive
- ▶ Generates a search for instruments. Central banks need to be seen to be doing something—to wit forward guidance and QE
- ▶ Unclear these challenges won't soon reassert themselves

TUCKER: DETAILS

Weak claims

- ▶ Principle-agent problem
- ▶ How do we hold unelected power accountable?
- ▶ What are the general principles of delegation to experts?

Strong claims

- ▶ How these principles translate to central banking
- ▶ Many uncontroversial: measurable objectives, clear focused mandates, provision of data consistent with transparency and accountability, avoidance of distributional judgments
- ▶ Some less so

TUCKER: DETAILS II

The eye of the beholder

- ▶ Alternative objectives: 'monetary Rood screen'
- ▶ Forward guidance undesirable—even though clarifying reaction function is desirable

The myth of independence

- ▶ Central banks are complex entities with a range of responsibilities—many require explicit coordination
- ▶ Acknowledged in the discussion of financial stability: 'frictionless flow of information' with prudential authorities
- ▶ But what about fiscal policy? Tucker's over-riding concern is to not blur the distinction between monetary and fiscal policy—but inextricably linked
- ▶ Economic theory and evidence makes clear central bank instrument independence is not enough
- ▶ This is not simply a matter of restricting instruments and appropriate accounting—i.e. to avoid money financed deficits