Policy Spillovers and Synergies in a Monetary Union

by Arce, Hurtado and Thomas

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Challenges for macroeconomic policy in a low inflation environment

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The usual disclaimer applies

BANCA D'ITALIA
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Outline

1. Summary and policy implications
2. Comments and suggestions
3. Conclusions

The three presidents’ arrows

↗ Structural reforms

↗ Fiscal policy

↗ Monetary policy

<u>Joint implementation in euro area</u>

↓

positive synergies

Forward guidance <u>reinforces</u> expansionary effects of countries’ policies; these measures <u>improve</u> effectiveness of forward guidance

The three presidents' arrows (cont'd)

↗ Structural reforms ➡ Increase competition in goods and labour markets

↗ Fiscal policy ➡ Increase government spending in "core" economies

↗ Monetary policy ➡ ECB commits to keeping policy rates low (fwd guidance)

Objective: expand economic activity in a deleveraging phase with policy rates @ ZLB

Key role of forward guidance

- Structural reforms raise potential output
- Intertemporal substitution prevented by deleveraging
- At ZLB forward-guidance reduces real rates, raising present-discounted value of future higher income and wealth (*discounting effect*)
- Recall yesterday papers on quantitative effects of forward guidance and role of intertemporal substitution

“ [….] *Given continued high structural unemployment and low potential output growth in the euro area, the ongoing cyclical recovery should be supported by effective* ***structural policies****. In particular, actions to* […] *raise productivity. The swift and effective implementation of structural reforms, in an environment of* ***accommodative monetary policy****, will* […] *raise expectations of permanently higher incomes and accelerate the benefits of reforms* […]. ***Fiscal policies*** *should support the economic recovery, while remaining in compliance with the EU’s fiscal rules*. […] *At the same time, all countries should strive for a growth-friendly composition of fiscal policies.*”
Mario Draghi, Introductory statement, Malta, 22 October 2015

All in all, well done policy paper, clear message to policy-makers

Model

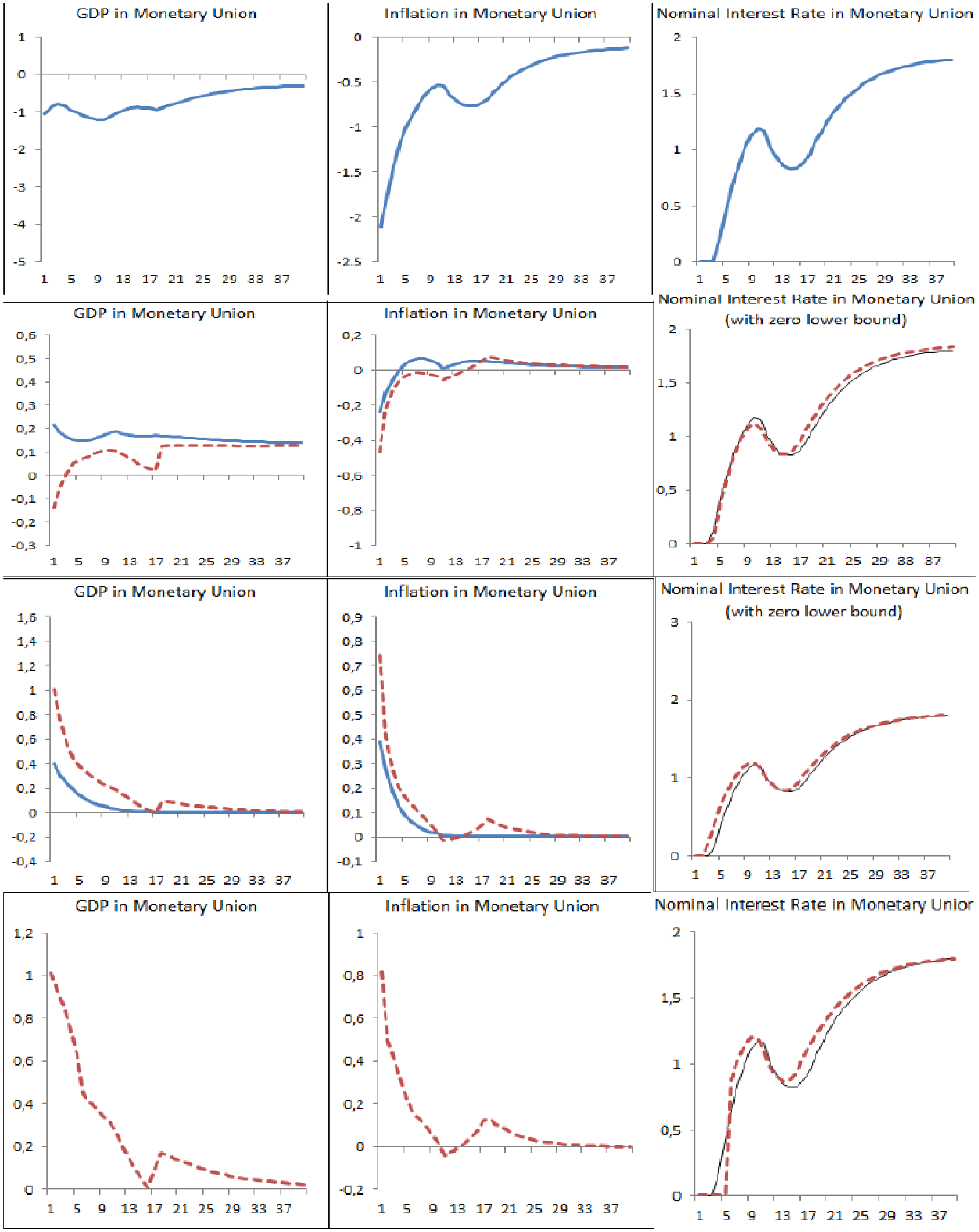
- Two-country (closed) monetary union
- Monopolistic competition + sticky prices/wages
- Investment adjustment costs
- Borrowing-constrained agents (new vs. old debt!)
- Long-term debt contracts (Woodford, 2001)
- No role for banks
- Fiscal policy: balanced budget
- Simulation method: perfect foresight

See Andrés, Arce and Thomas (2015)

1. Presentations of results

Current presentation not easy for reader, focus on marginal effect of each measure

One chart with all simulations, in order to better understand role of each policy?



Baseline

1. Deleveraging in periphery

2. Area-wide demand shock (π and R ↓)

Baseline + structural reforms in periphery (red lines)

Baseline + fiscal expansion in core (red lines)

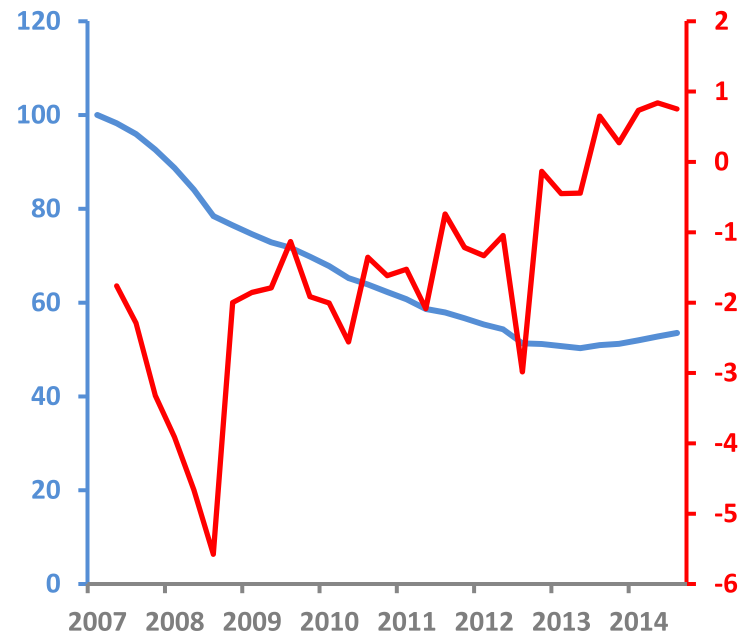
Baseline + forward guidance (red lines)

2. Calibration of model

Investment adj. cost parameter chosen to match sharp contraction in construction and equipment investment in 2007:Q4-2009:Q4

Key issue: speed of contraction is same as speed of recovery. Realistic?

Propensity to invest may have become structurally lower after global financial crisis. *Shock to investment equation*? *Other ways*?



3. Role of banking sector

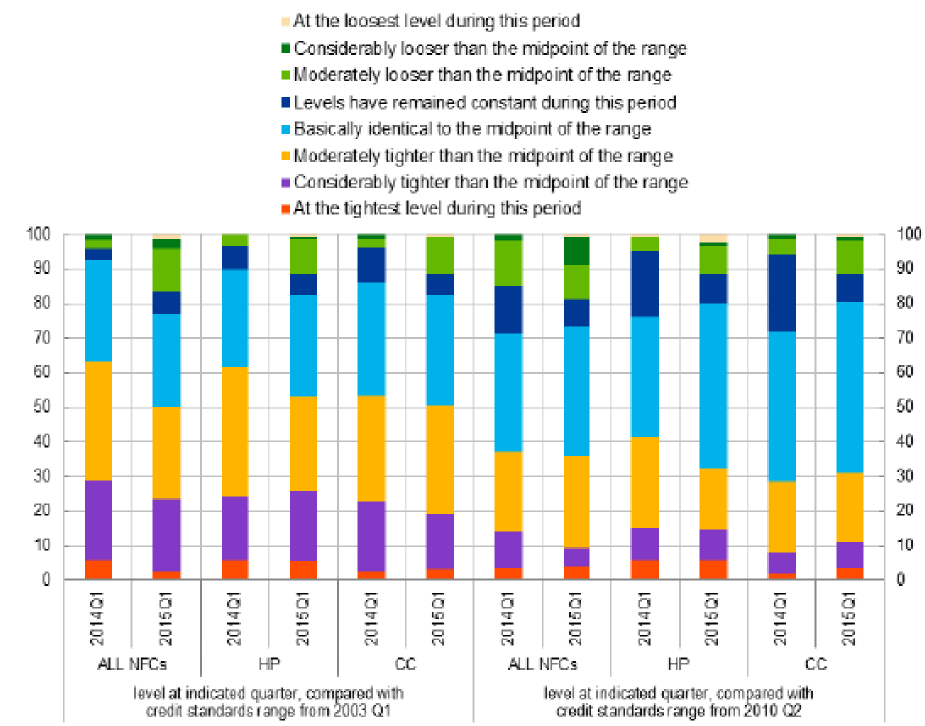
- Credit supply conditions may have become tighter after crisis hit
- Credit standards still tight
- During crisis pressure on bank *K,* higher lending rates
- Change in regulation may have also caused tightening of lending conditions

Why not including a banking sector?

Chart 14

Current level of credit standards for loans to enterprises and households, relative to the level of credit standards in the past

(percentages of banks)



Notes: The "midpoint of the range" of credit standards is defined as the midpoint between the maximum and the minimum level of credit standards during this time period. "All NFCs" indicates loans to all non-financial corporations, "HP" indicates loans to households for house purchase, and "CC" indicates consumer credit and other lending to households.

4. Monetary policy/exchange rate

- Forward guidance extremely powerful
- Currently asset purchase programme (APP) main instrument
- *"Asset purchases* [...] *are intended to run until* [...] *we see a sustained adjustment in the path of inflation* [...] *consistent with our aim of achieving inflation rates below, but close to 2%*"
- Forward guidance and APP may reinforce each other
- Exchange rate key in transmission of APP, model is closed-econ
- Burlon, Gerali, Notarpietro and Pisani (2015) evaluate effects of purchases of APP in monetary union open-econ model
- *Assess role of asset purchases*? *Open up monetary union*?

- Very useful paper, clear message to policy-makers
- Countries more hit by global financial and sovereign debt crisis have done/are doing their part
- ECB took extraordinary steps to avoid deflationary spiral and de-anchoring of expectations
- Other players can do their part
- Structural reforms/fiscal policies key for raising potential output and natural rate of interest