EUROFI VIEWS MAGAZINE - BERLIN SEPTEMBER 2020

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Hand that rocks the cradle: limits of unconventional monetary policy

A debate on side effects of unconventional monetary policies has gained a lot of traction over the past decade. Issues like governance of central banks or interaction of monetary policy with income and wealth inequality made their way into the mainstream. And then central banks reacted to the Covid-19 crisis with unprecedented speed, scale and scope. As recovery gradually advances, there will be ample time to contemplate potential effects and possible adjustments to the monetary policy. With no ambition to exhaust the topic, I will raise only a few points on overreliance on unconventional monetary policy.

First of all, we should not forget that monetary policy alone is far from sufficient to lift growth and inflation. Low interest rates are a real phenomenon rather than simply a reflection of monetary conditions. The "natural interest rate" has been on a declining trend for at least a few decades due to the combination of secular and cyclical factors. This trend has coincided with a slowdown in productivity and with falling investment levels. Adjusting dials on monetary policy instruments to reflect this underlying economic reality will not resolve the dearth of investment opportunities. Fostering perception that unconventional monetary policies will simply take away the savings glut is risking inaction on more relevant policy-front.

The real issues for economic policy are how to improve business environment, remove structural impediments for investments, foster competition, boost investments in R&D and encourage new businesses to start and grow. Long period of exceptionally loose monetary policy may provide a headwind as it softens the debt sustainability constraints and can reduce both government and corporate dynamism, capturing economic resources in inefficient uses. In communism something like that was called soft budget constraint, and the central bank was in charge of enabling it.

The impact of unconventional policies on financial system is another popular topic. We rely on a healthy financial system in order to pass-on our monetary policy actions to the wider economy, and the financial system relies on maturity transformation with upward sloping yield curve to function properly. Sure, loose monetary policy is supporting banks' loan books and banks can improve on their cost effectiveness in order to dampen the effects of low interest rates. However, as we push our unconventional policies further, we may be nearing the "reversal rate" where damaging effect of persistently low interest rates and flattened yield curve overwhelms their positive effects.

Finally, one way in which unconventional monetary policy operates is the risk-taking channel. Encouraging "search for yield" type of behaviour should support investments. But it is also fuelling asset price rally and a boom in real estate markets. In theory, macroprudential policy should deal with growing imbalances and excesses in the financial markets. In practice, our macroprudential toolkit still lacks instruments to cover non-bank intermediaries in a comprehensive manner and cross-border activities may circumvent even the best policies. Also, significantly stepping-up macroprudential policies may exacerbate legitimacy issues. Monetary policy should not shun the financial stability concerns.

Monetary policy is like most medicines – it can speed-up recovery, but it is up to the immune system to restore health to its normal state. Undesired side effects expand if the medicine is administered for longer periods and if the dosage is increased. The primary goal for our economic policies should be to foster creation of profitable business opportunities, inject more dynamism and increase long-term growth potential. Excessive reliance on unconventional monetary policies may divert attention from needed policies and even work in the opposite direction – reduce government and corporate dynamism by creating the soft budget constraint and permeate our financial systems with risks. ●