A Prolonged Period of Low Interest Rates: Unintended Consequences

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Discussion by Diana Bonfim

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Summary of the paper

Research question:

Monetary policy rates have been (too?) low for (too?) long.

Which are the unintended consequences?

- Excessive credit growth and leverage
- Mispriced risk
- Excessive maturity mismatch and market illiquidity
- Misaligned incentives and moral hazard
- High interconnectedness and exposure concentration

The discussion

My comments

1. What if interest rates had not been low?

2. The role of macroprudential policy

3. What did we learn from the ECB's Strategy Review?

4. Are negative (nominal) rates special?

5. Minor issues

1. What if interest rates had not been low?

- *"It is important to stress that there is **a significant number of studies supporting the need for, and the effectiveness of**, both the conventional and unconventional monetary policy tools deployed in the recent decade."*

- I'm not sure about this **balance**. There is possibly more research on the unintended effects than on the intended (publication bias?).

- Do we really know how would the world look like if monetary policy had been **tighter** in the last decade?

- How would that have affected **financial stability**?

1. What if interest rates had not been low?

- *"On the one hand, such an environment may **improve the current financial conditions**, but on the other hand it may create and **increase future financial vulnerabilities**."*

- What if tighter monetary policy had jeopardized **current** financial conditions in the last decade. Would future financial vulnerabilities look better?

  (weaker recovery, disanchoring of inflation expectations, higher funding costs, NPLs…)

- Can we live in a world without financial vulnerabilities?

2. The role of macroprudential policy

- The paper shows that **business cycles** are more synchronized than **financial cycles**.
- Is **monetary policy** designed to deal with (long) financial cycles?
- Now that most countries have a well established **macroprudential toolkit**, aren't these instruments better suited to address financial risks?
- Monetary policy "gets in all the cracks", but it is often **too blunt**. Can't macroprudential policy be much better targeted at addressing risks (especially when cycles are not synchronized).

  If targeted macroprudential measures are not effective, would blunt monetary policy be?

2. The role of macroprudential policy

- Could monetary policy alone have avoided these risks? Are they ultimately created by monetary policy?

- Excessive credit growth and leverage
- Mispriced risk
- Excessive maturity mismatch and market illiquidity
- Misaligned incentives and moral hazard
- High interconnectedness and exposure concentration

3. What did we learn from the ECB's Strategy Review?

- The role of **non-banks**:

  *"Low profitability and increasingly stringent banking regulation can also motivate banks to search for **less regulated environments**"*

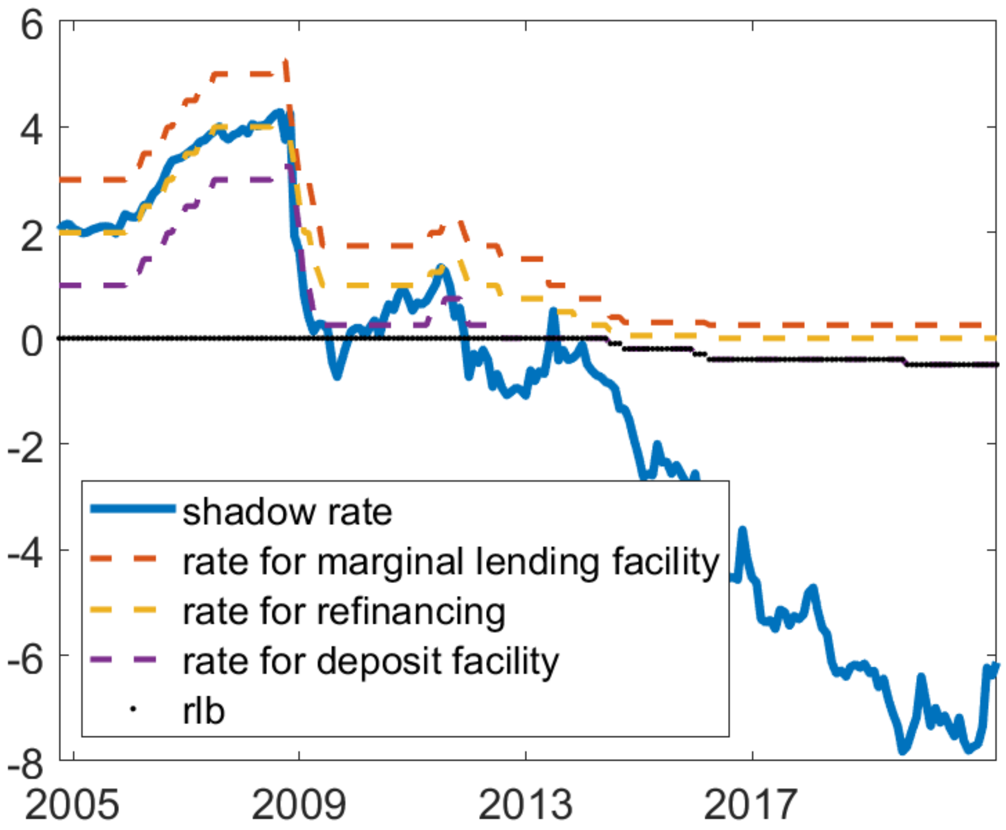
  *"Low interest rates may undermine the solvency of **insurance** companies and **pension funds**."*

  Macroprudential policy is less equipped to deal with non-banks and the Strategy Review acknowledges this.

- *"Monetary policy should act **symmetrically** over the medium to long term".*

4. Are negative (nominal) rates special?

- What does the nominal policy rate mean when unconventional monetary policy is at work?



Note: downloaded from https://sites.google.com/view/jingcynthiawu/shadow-rates

4. Are negative (nominal) rates special?

- *"Some central banks are most likely at their lower bound according to the literature."*

If this was true, how can we explain the importance of monetary policy decisions in stabilizing markets and the economy during the **pandemic**?

4. Are negative (nominal) rates special?

Negative **real** rates do not seem to be:

Table 1: Percent of the Time Central Bank Policy Rates Have Been Zero or Negative (%)

	Nominal CB policy rate			Real CB policy rate		
	Total	Before 2008	2008+	Total	Before 2008	2008+
Euro area	8	0.0	31.5	39.8	28.7	71.6
Other European countr.	4.5	0.0	16	32.7	25.2	50.9
Asia	2.3	2.2	2.5	30.4	25.7	37.8
US	0.0	0.0	0.0	31.7	20.7	81.1
Canada	0.0	0.0	0.0	27.2	13.3	83.1
Japan	10.9	7.8	27.3	38.8	34.3	61.3

5. Minor issues

1) Risk-taking is not an undesirable feature of monetary policy. The problem lies in *excessive* risk-taking (not always clear in the existing literature).

Great paper:

- Exhaustive and well-executed revision of the literature.
- Own analysis on tightness of monetary policy (natural rates with and without financial factors).
- Please read it!

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