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PRESS RELEASE

Normalisation of monetary policy: prospects and divergences
(Article for the December 2014 Economic Review)

The world's leading central banks are currently still pursuing a decidedly expansionary monetary policy. The five-year real interest rates remain very negative and the five-year real interest rates five years ahead are well below their long-term average. However, in the most recent period the central banks of the advanced economies have adopted a clearly divergent course. While monetary policy in the euro area continued to be eased, the Federal Reserve opted for a partial tightening. This divergence is in line with the differing macro-economic situations and prospects. This macro-economic divergence will also lead to non-synchronous normalisation of monetary policy, as is already clearly reflected in interest rate expectations on the financial markets.

The Federal Reserve's preparations for the exit from its very accommodative monetary policy are now well under way: determining the exact timing and communication of the first monetary policy tightening is a serious challenge, because in the past any surprise in the timing of the US exit often triggered volatility on the global financial markets. In line with its dual mandate, the FOMC therefore made it clear that estimating the degree to which the labour market has excess capacity and the impact of that on wages and prices will be crucial for the pace of the exit. In addition, in September 2014 the FOMC announced the Policy normalisation principles, from which it emerged that monetary policy is likely to be tightened by use of the interest rate instrument, rather than by active intervention in the size or composition of the central bank balance sheet. In the euro area the monetary policy stance is expected to remain very accommodative in a climate of very low inflation that seems to be weakening the anchoring of inflation expectations to some extent.

A challenge for the monetary exit is the implementation of a more restrictive monetary policy by means of higher interest rates, while the central bank reserves still contain a substantial liquidity surplus. Thus, it may be desirable to maintain the liquidity surplus or to reduce it only gradually, for the sake of financial stability, whereas the outlook for economic activity and inflation requires a more restrictive monetary policy. Central banks can then opt to tighten monetary policy via an interest rate corridor system by raising the interest rate floor. In order to ensure the effectiveness of this interest rate floor system – in other words, a proper transmission of the policy rates to market interest rates – the Federal Reserve has now felt the need to expand its operational framework with a supplementary interest rate floor, namely the overnight reverse repo rate, which is accessible to a broader range of counterparties.

Asynchronous normalisation of monetary policy in the main advanced economies implies risks of undesirable spillover effects. For instance, in May and June 2013 the mere announcement of a possible reduction in asset purchases by the Federal Reserve had sparked a strong reaction on the global bond markets. The observed increased synchronisation in government bond yield movements suggested that the euro area could well feel the impact of any potential turmoil associated with the normalisation of monetary policy in the United States. However, it is evident that, since the end of 2013, the Eurosystem has been successful in clearly establishing the independence of its monetary policy and is managing to devise a monetary policy course in line with the euro area's fundamentals. That is also apparent from the movement in the exchange rate since mid-2014.

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