# Macroeconomic trends and challenges 2015

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*Insurance: Globally under Pressure?*
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1. Central bank strategy: „Lower for longer“
2. Extreme behavior of long rates and asset prices
3. Secular stagnation to negative equilibrium rates?
4. Eurozone heterogeneity supports structural reform

5. The insurance sector: Risks and responses

# 1. Central bank strategy: „Lower for longer“

… aims to fight deflation but brings substantial risks.

Central banks mostly react systematically to macroeconomic developments.

Policy rate = equilibrium rate

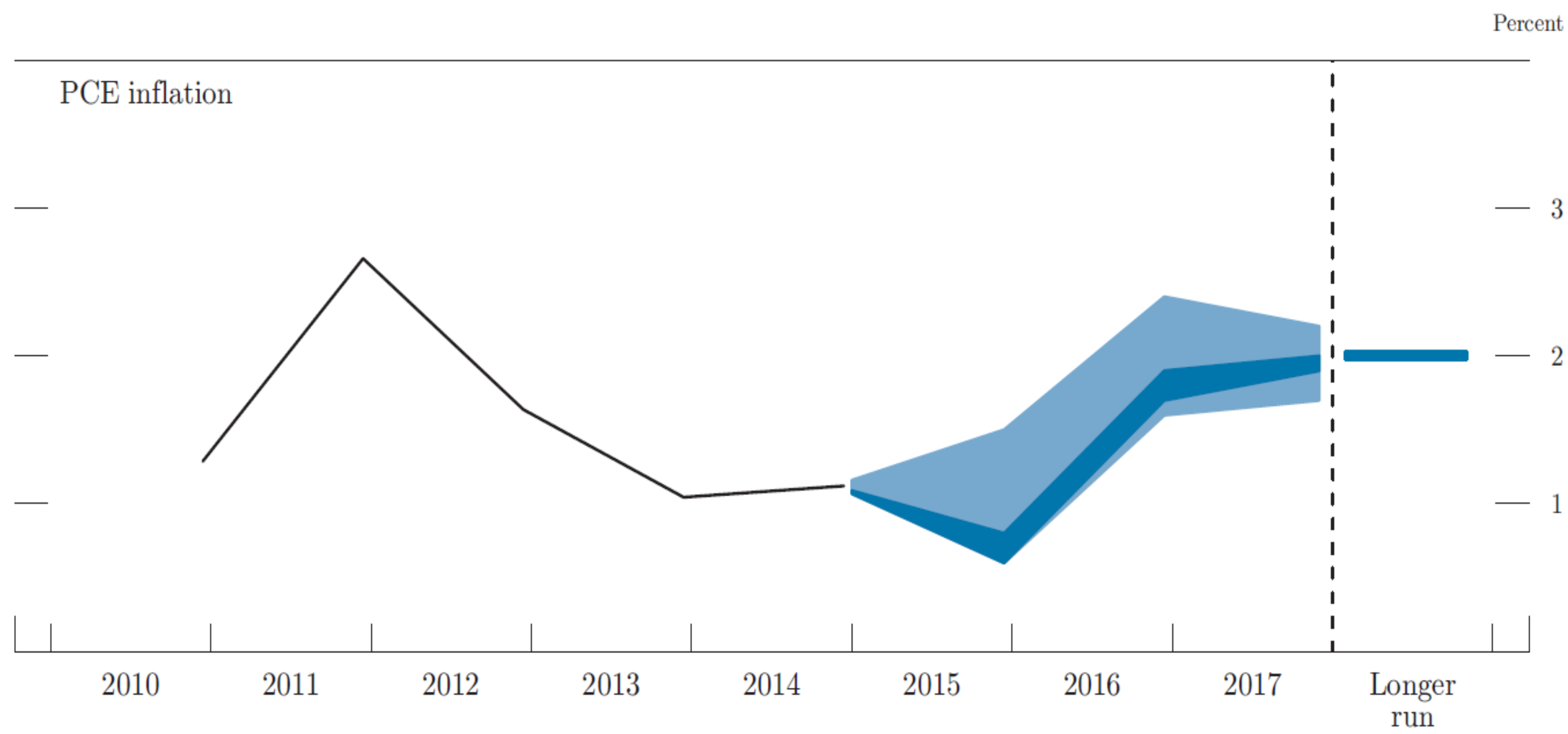
+ reaction to inflation forecast relative to target

+ reaction to real activity relative to potential

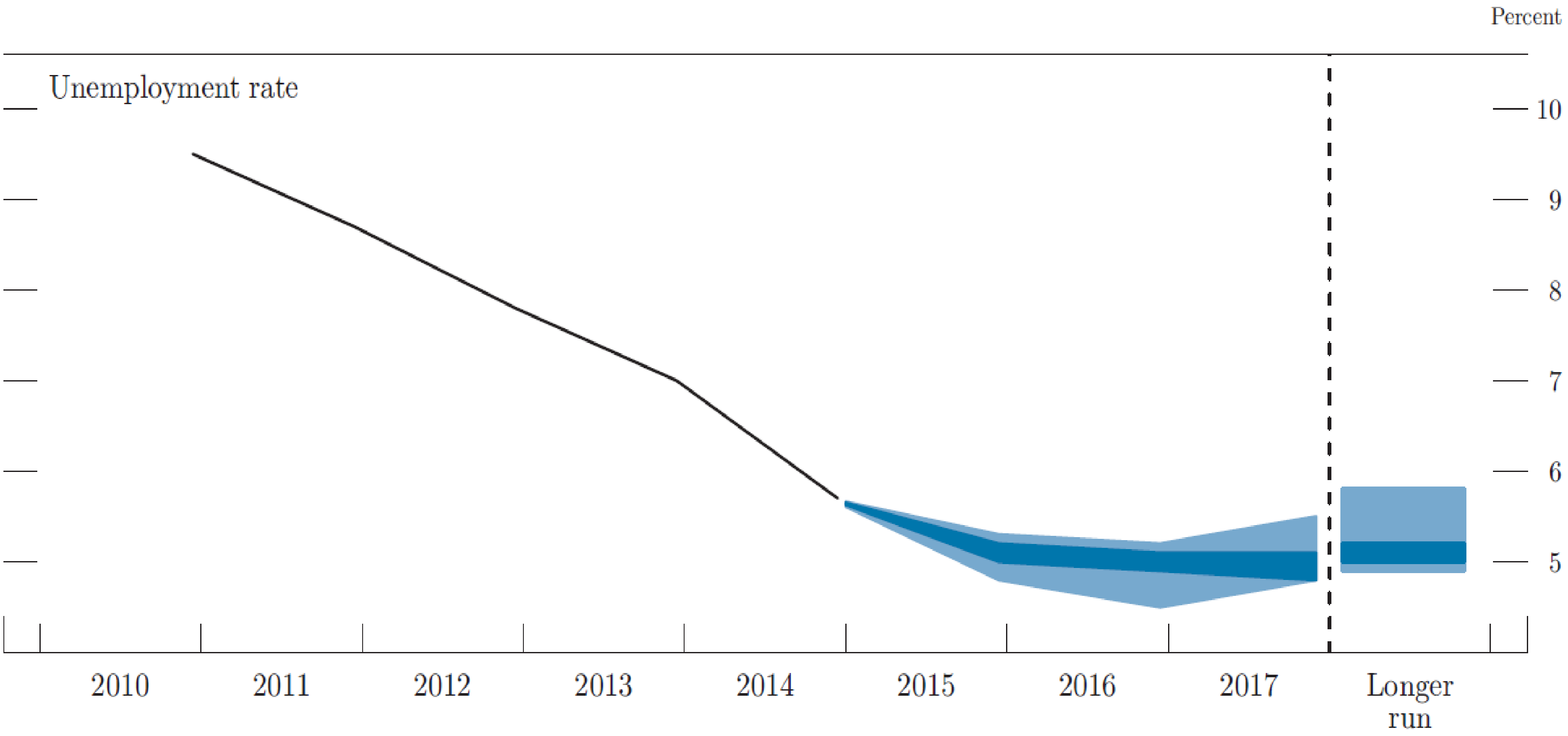
In response to global crisis, they kept rates „lower for longer" than historical reaction fns would imply.

To fight danger of deflation/recession spirals.

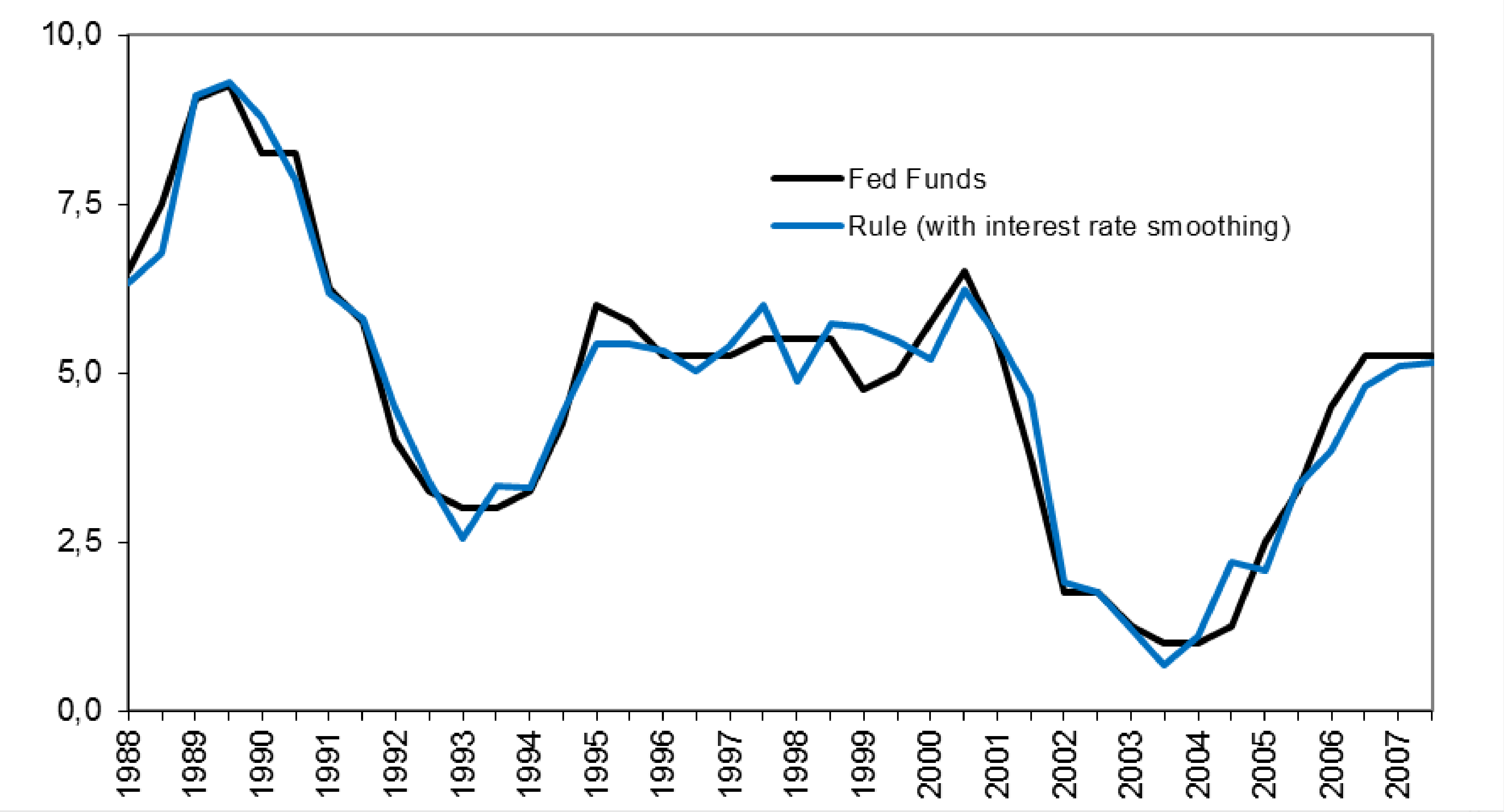
# Example of U.S. FOMC: Inflation projections by its members (June 2015)

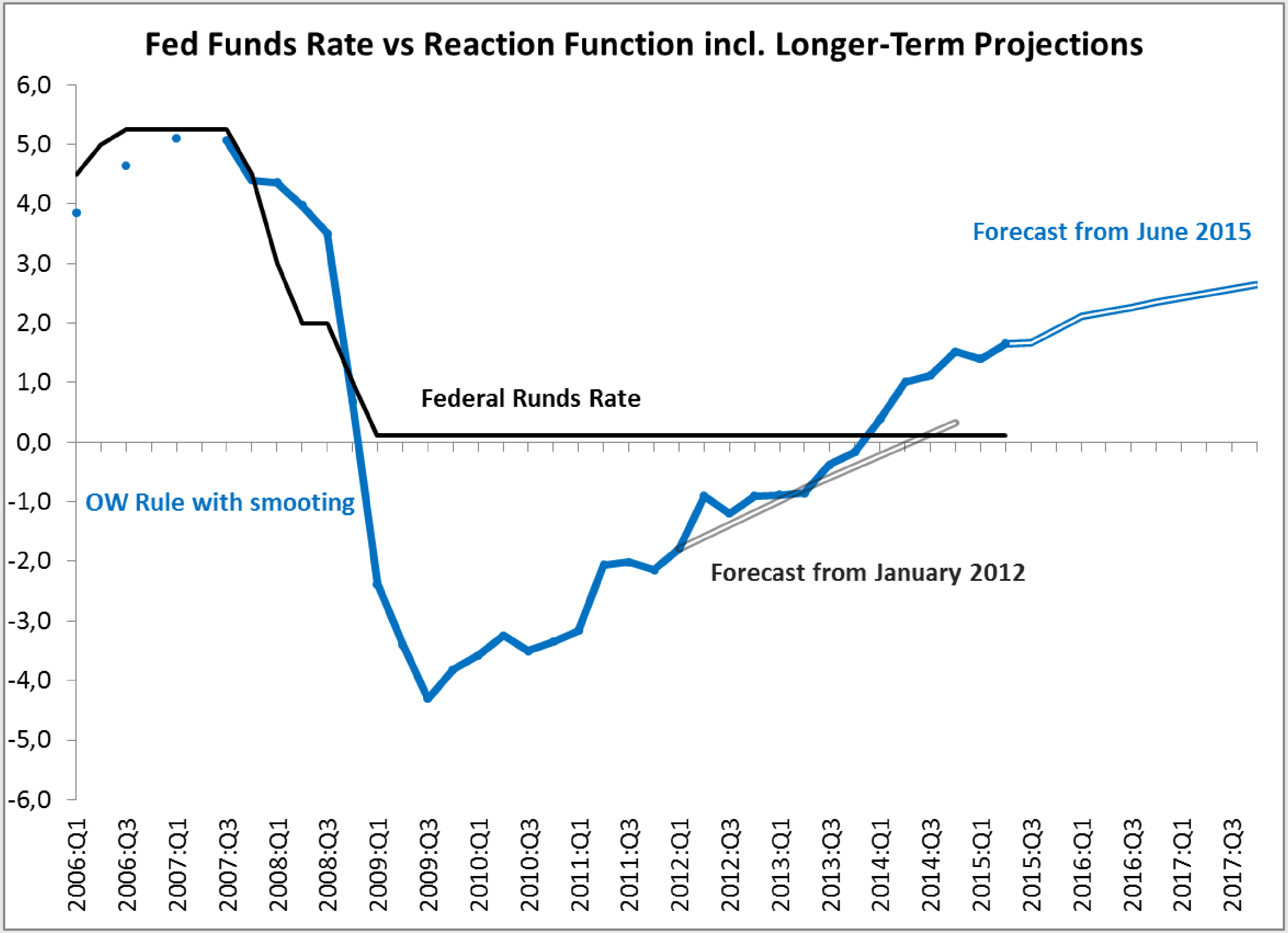


# FOMC members unemployment projections (June 2015).



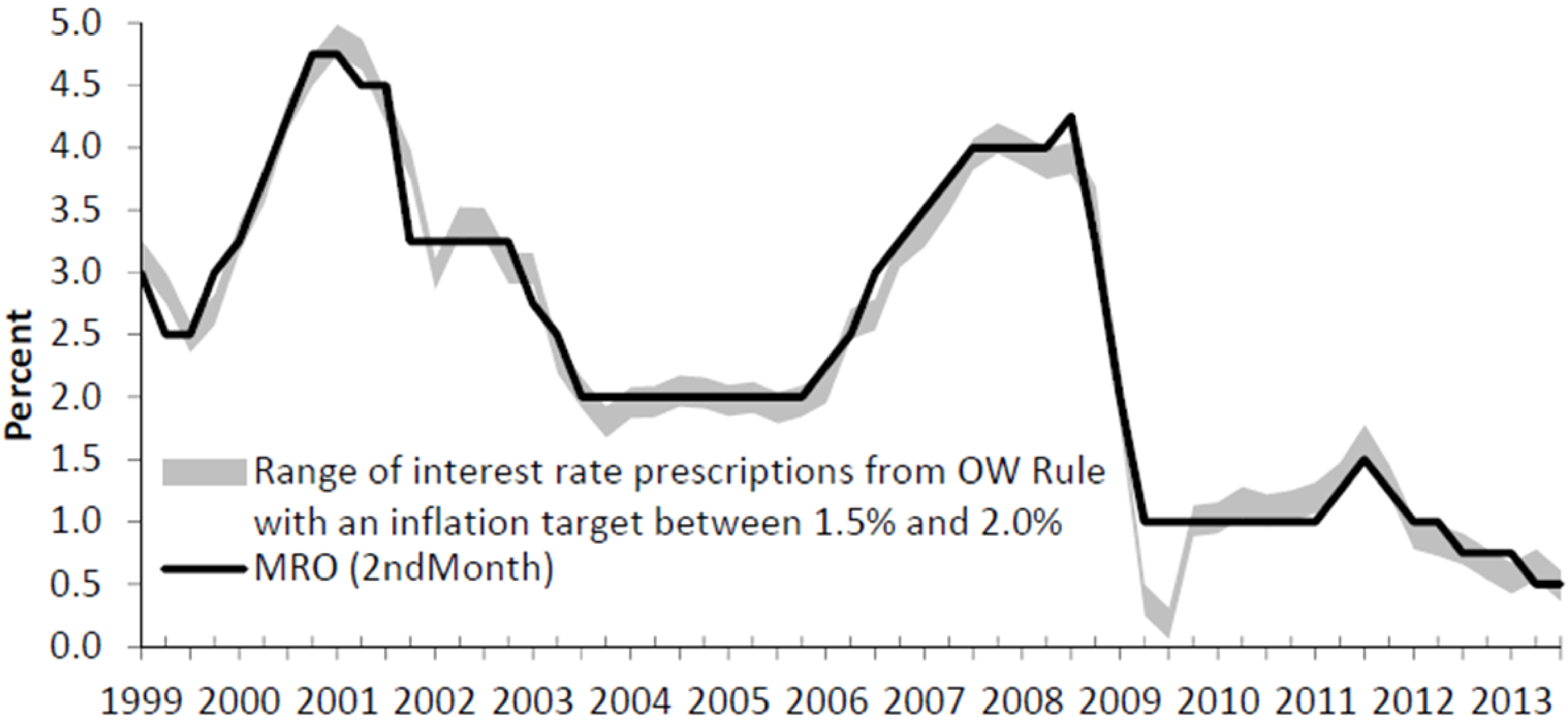
# Reaction to FOMC forecasts explains past FOMC decisions (Orphanides-Wieland 2008).



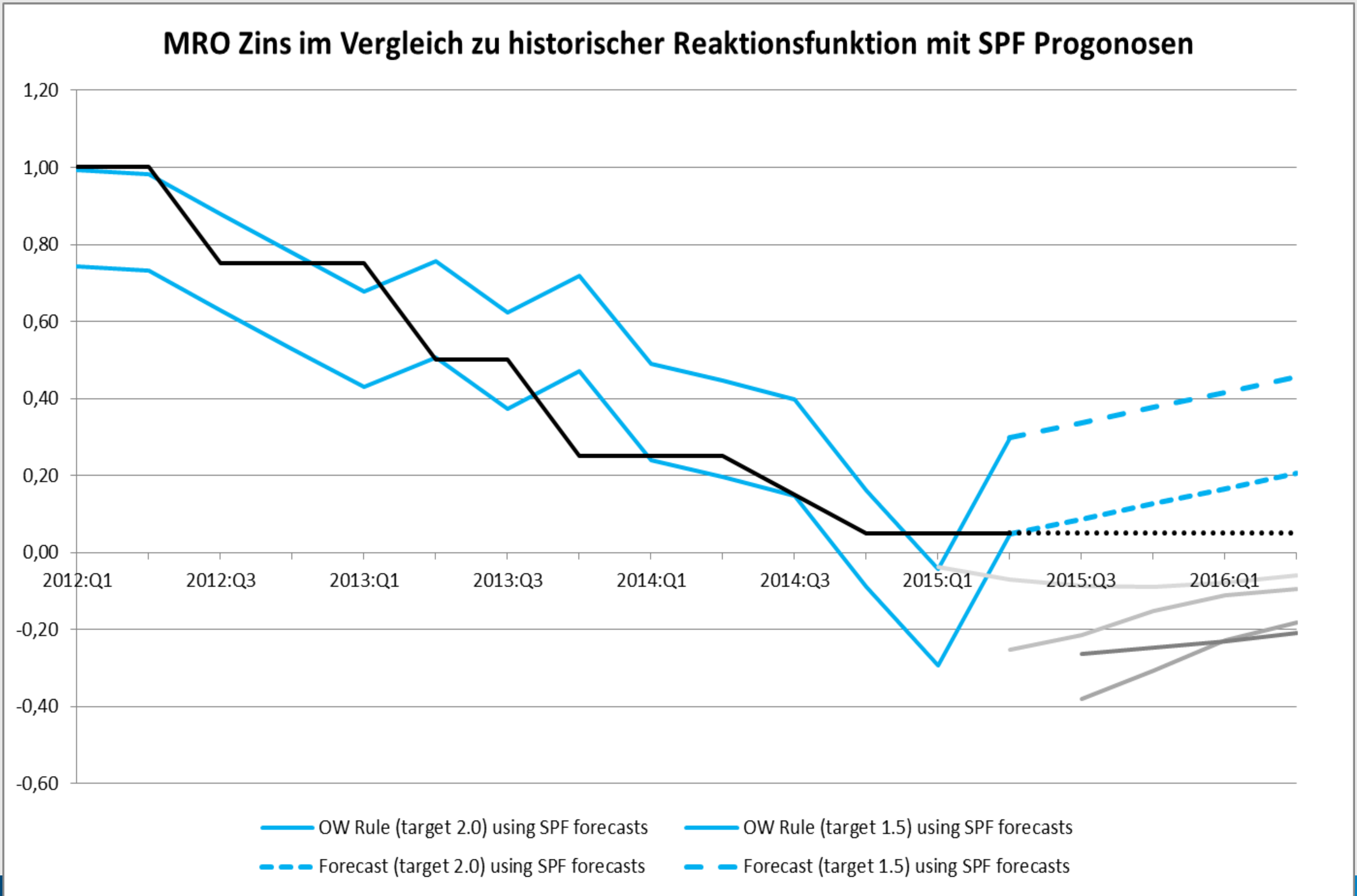

Fed Funds Rate vs Reaction Function incl. Longer-Term Projections
6,0
5,0
4,0
3,0
2,0
1,0
0,0
-1,0
-2,0
-3,0
-4,0
-5,0
-6,0
Forecast from June 2015
Federal Runds Rate
OW Rule with smooting
Forecast from January 2012
2006:Q1
2006:Q3
2007:Q1
2007:Q3
2008:Q1
2008:Q3
2009:Q1
2009:Q3
2010:Q1
2010:Q3
2011:Q1
2011:Q3
2012:Q1
2012:Q3
2013:Q1
2013:Q3
2014:Q1
2014:Q3
2015:Q1
2015:Q3
2016:Q1
2016:Q3
2017:Q1
2017:Q3

# ECB empirical reaction function with SPF forecasts of inflation and growth (change rule, no equilibrium rate)

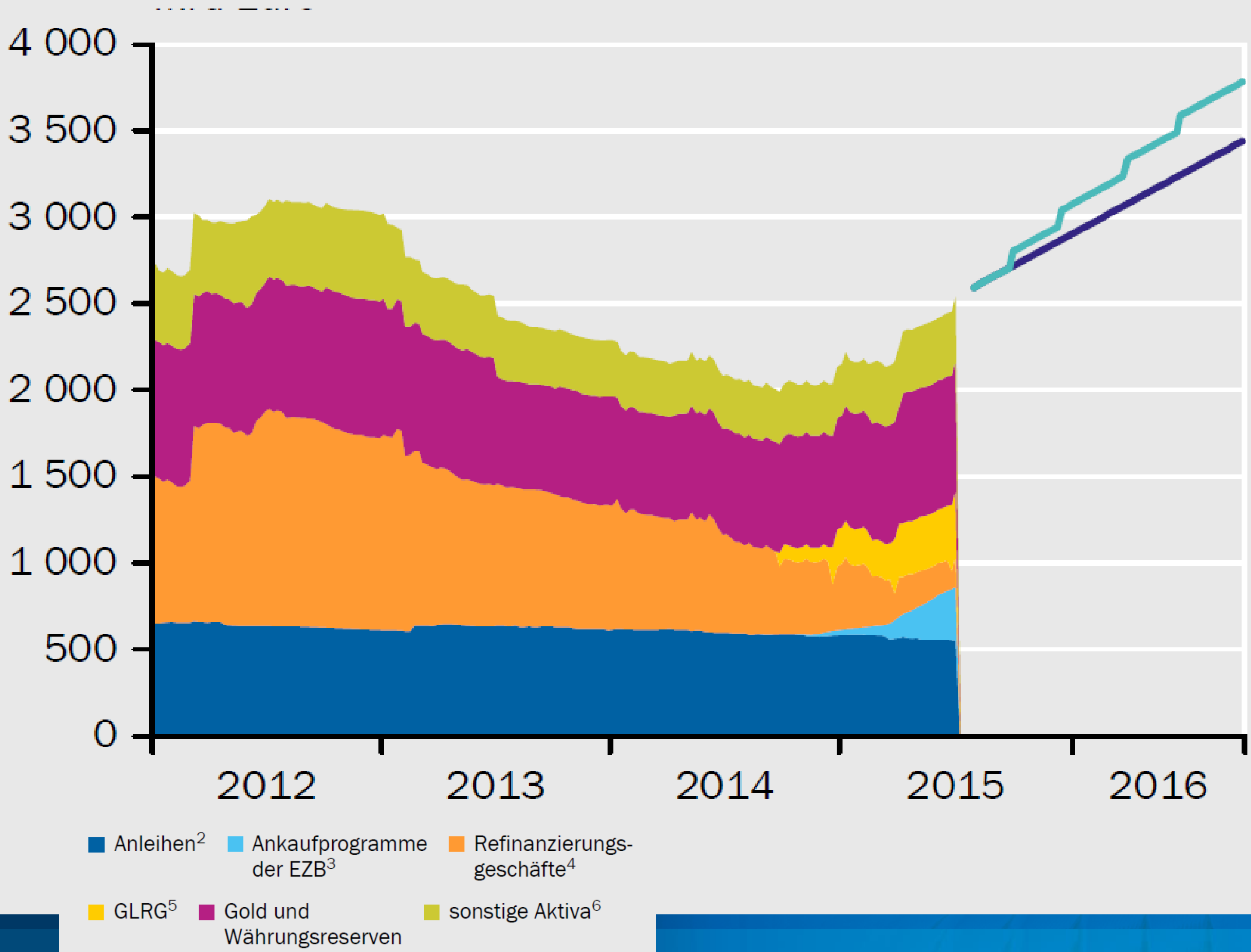
**Figure 1: MRO Rate versus Orphanides and Wieland (2013) Rule with SPF Forecasts**



- ECB: „Lower for longer!“



# ECB Balance sheet expansion with public sector debt purchases (60 bln/month) and TLTRO‘s.




**Other**
**Gold/Foreign Currency**
**TLTRO**
**Refi**
**APP**
**Bonds**

# 2. Extreme behavior of long rates and asset prices

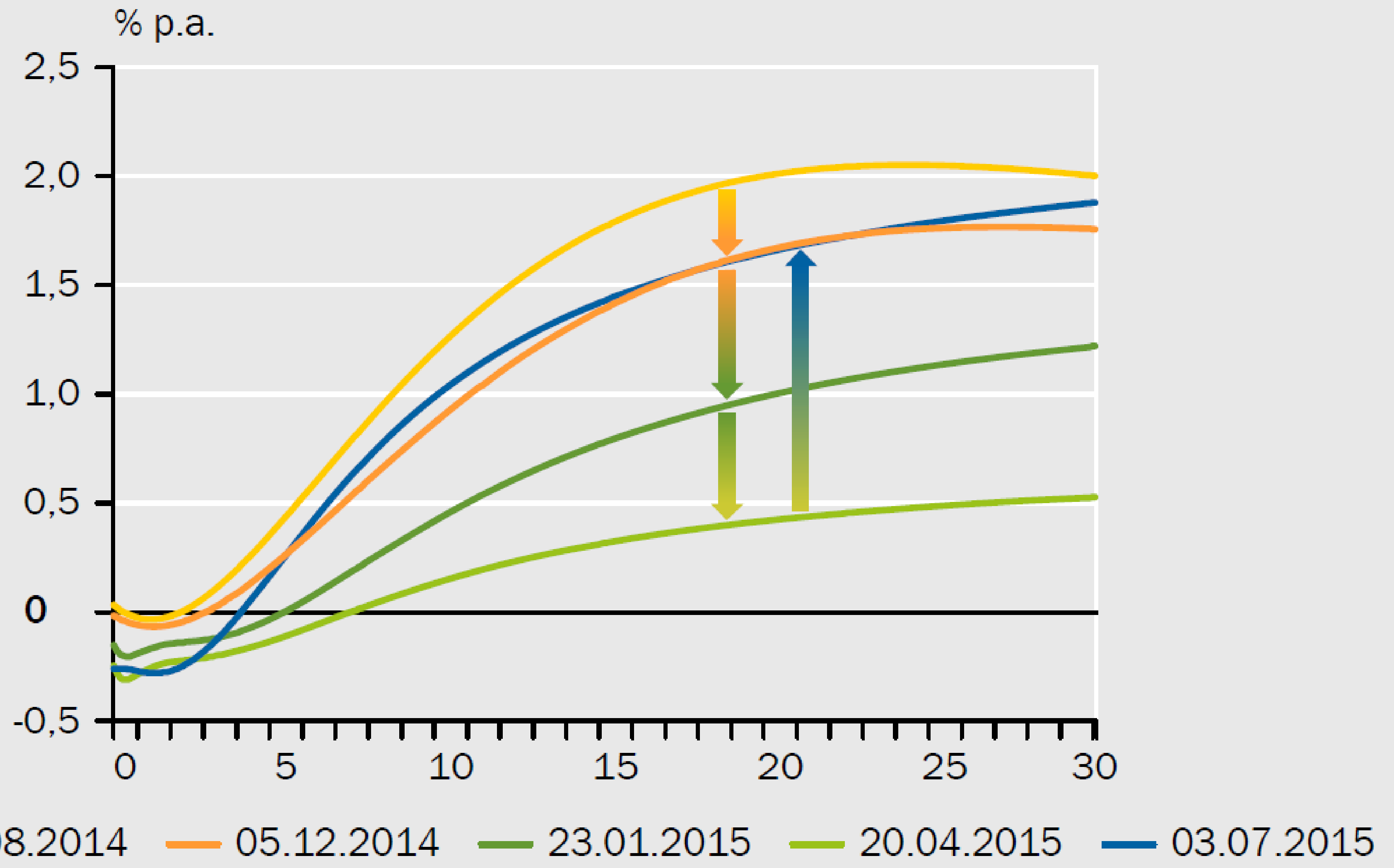
…. is related to policy and regulation.

- „QE and lower for longer“ strategy developed in 1998-2003 in light of Japanese experience.
  - Fed Studies: Reifschneider & Williams 2000, Orphanides & Wieland 2000, Ahearne et al 2002.
- Transmission to economy via anticipated future rates, term premia, long-term rates, higher asset prices, exchange rate depreciation.
- Greater risk-taking and potential for new boom-bust cycles in finance.
- Governments may postpone needed fiscal consolidation and structural reform.

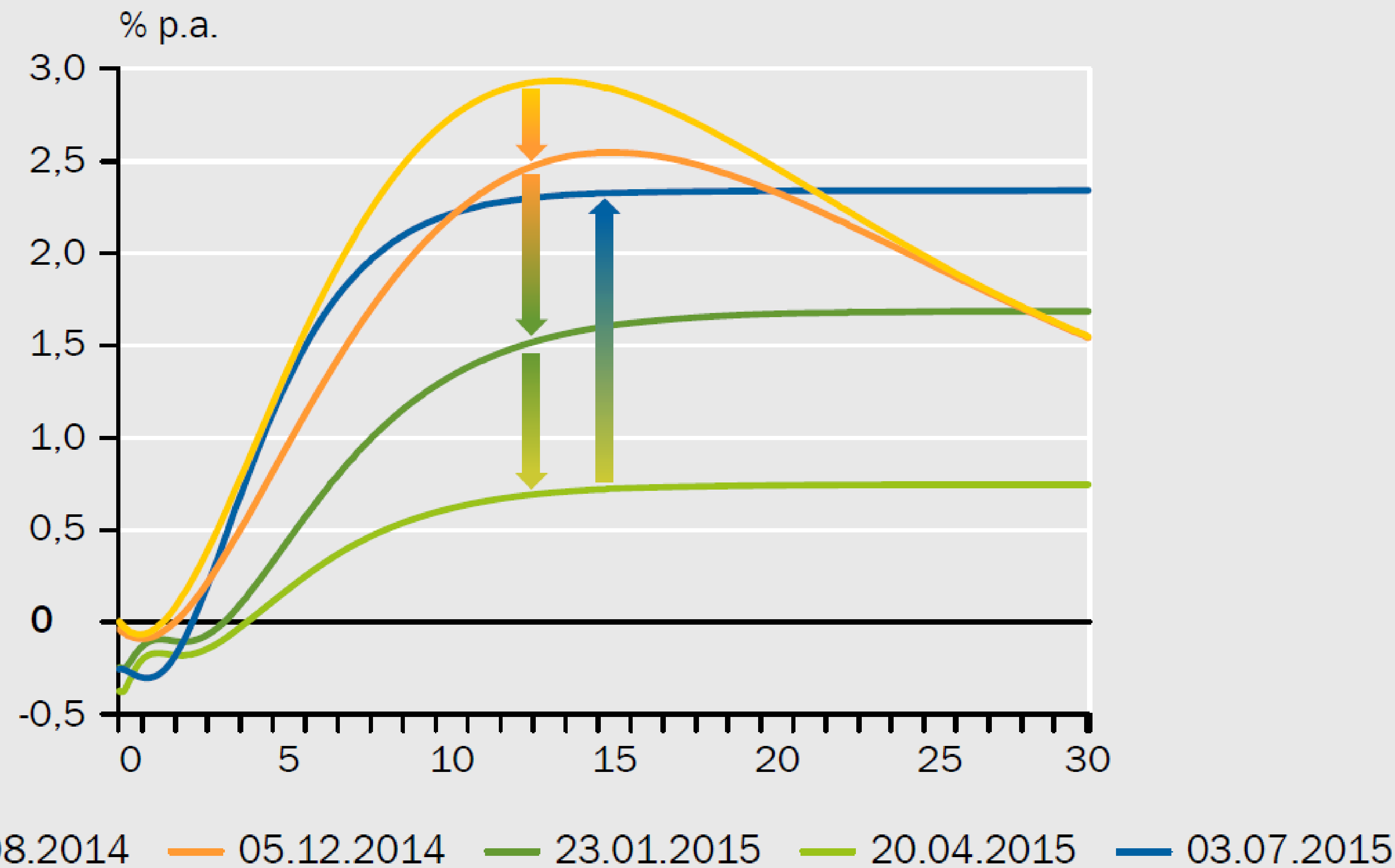
SACHVERSTÄNDIGENRAT
zur Begutachtung der
gesamtwirtschaftlichen Entwicklung

1963–2013 50 JAHRE

# Term structure of euro area AAA government bonds.



# Implicit anticipated future short-term rates.



# Exchange rate drop and stock price boom.

At the same time, ECB projects growth reaching 2% soon and inflation edging back towards 2%.

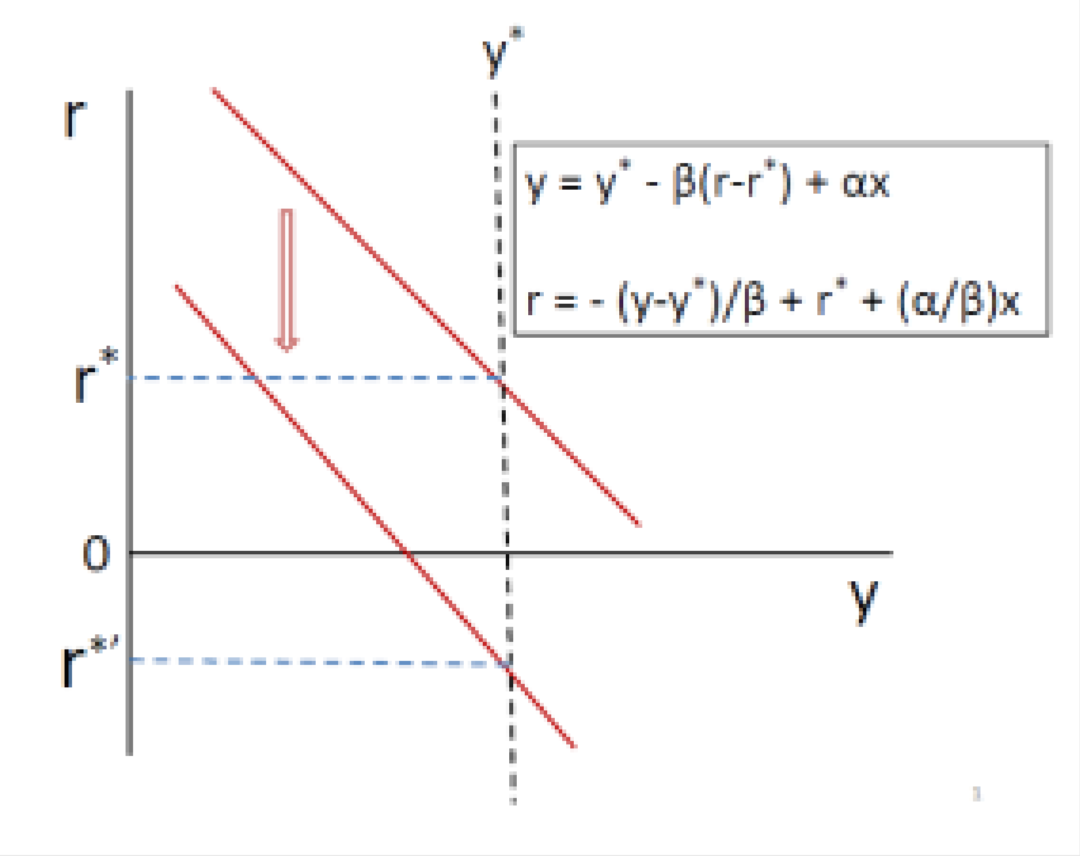
- Inconsistency of low long-term interest rates with inflation and growth projections.
- Low liquidity due to increased regulation.

➔ High uncertainty & volatility is the consequence.

# 3. Secular stagnation view and negative equilibrium rates

…. not supported by empirical evidence.

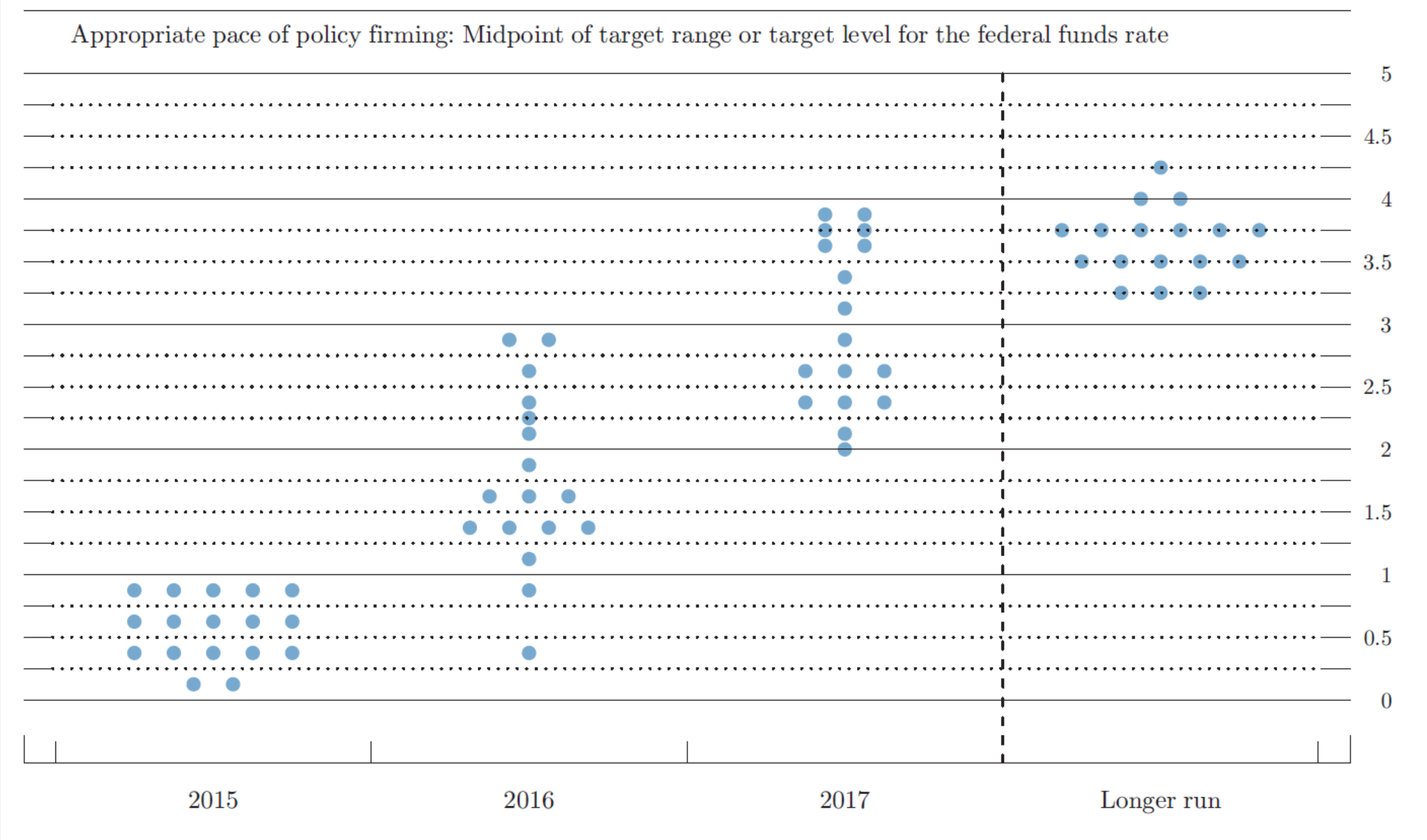
# Some commentators fear very low potential growth and negative real equilibrium rates due to excess supply of savings (secular stagnation).



Need to distinguish **short-** , **medium-** and **long-run equilibrium** rates.

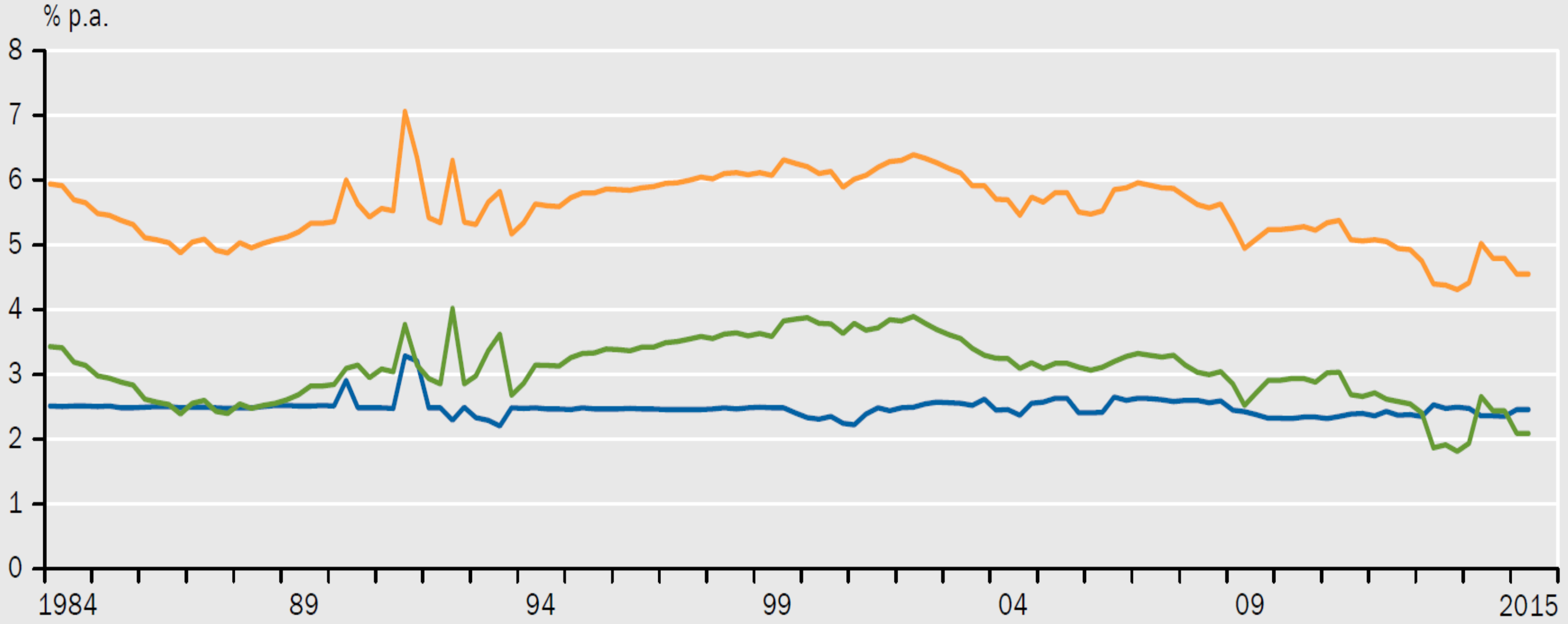
1. **Short-run equilibrium** interest rates may well have been negative.
2. **Medium-run equilibrium** rates may be low due to „headwinds“ (Yellen, Bernanke) such as high debt of households and fiscal consolidation.
3. Secular stagnation theorists fear low or negative **long-run equilibrium** rate (Summers, Weizsäcker). They believe the only solution is a massive increase in government spending and government debt.

- FOMC members anticipate positive long-run equilibrium real rate a bit below 2%.



# **Structural estimation of long-run** equilibrium interest rate with Smets-Wouters (2007) model of U.S. economy.

(recursive real-time estimation. 20-year windows).



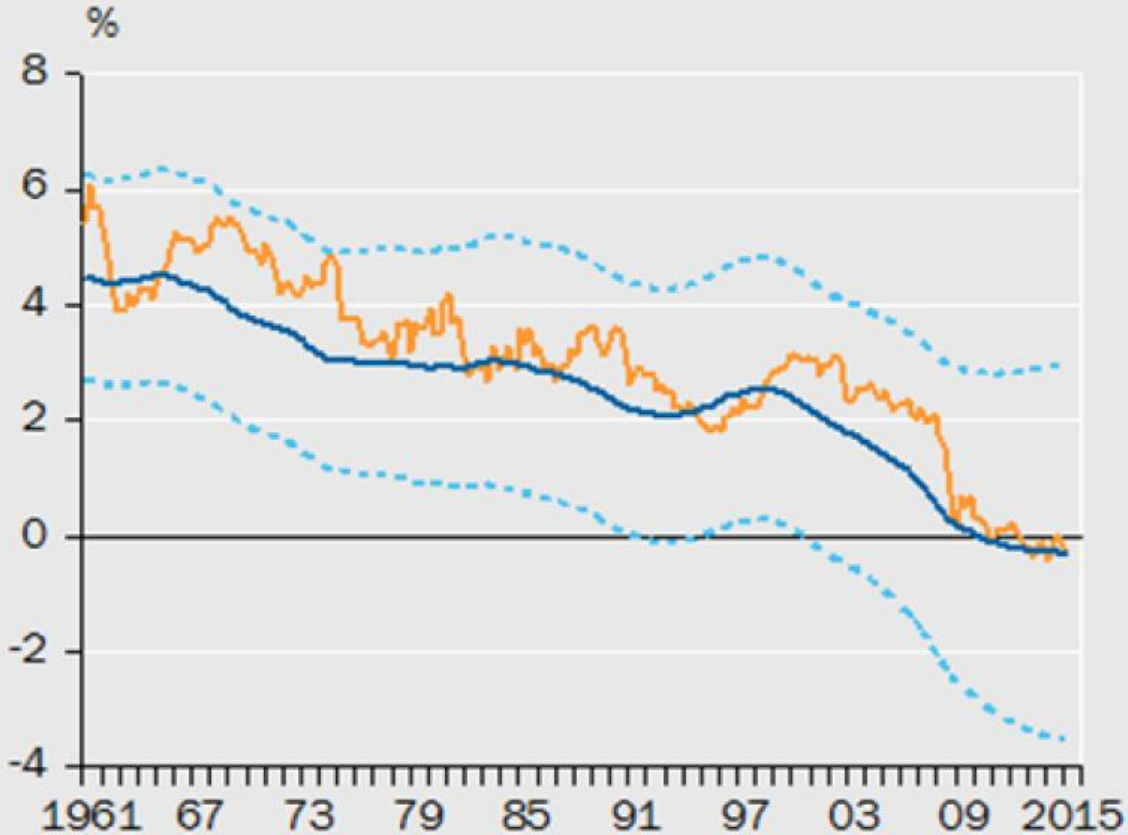

**Nominal long-run-equilibrium rate, Inflation objective, real long-run-equilibrium rate**

# Laubach-Williams AD/Phillips curve model estimates of **time-varying medium-run** equilibrium rate for U.S..

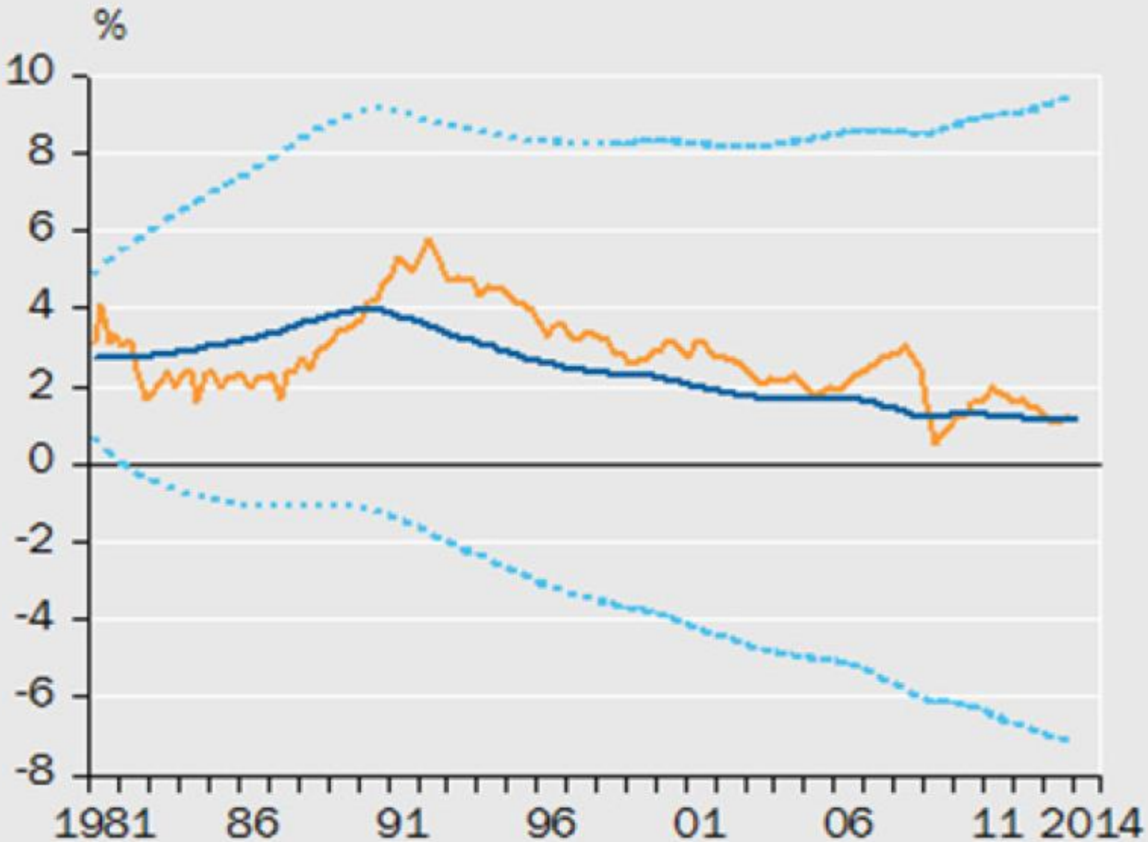
Declined but

highly unertain.

**One-sided estimate,**
**Two-sided smoothed estimate,**
**Standard error bands**



# Medium-run equilibrium rates with Laubach-Williams method for Germany.




**One-sided estimate, Two-sided smoothed estimate, Standard error bands**

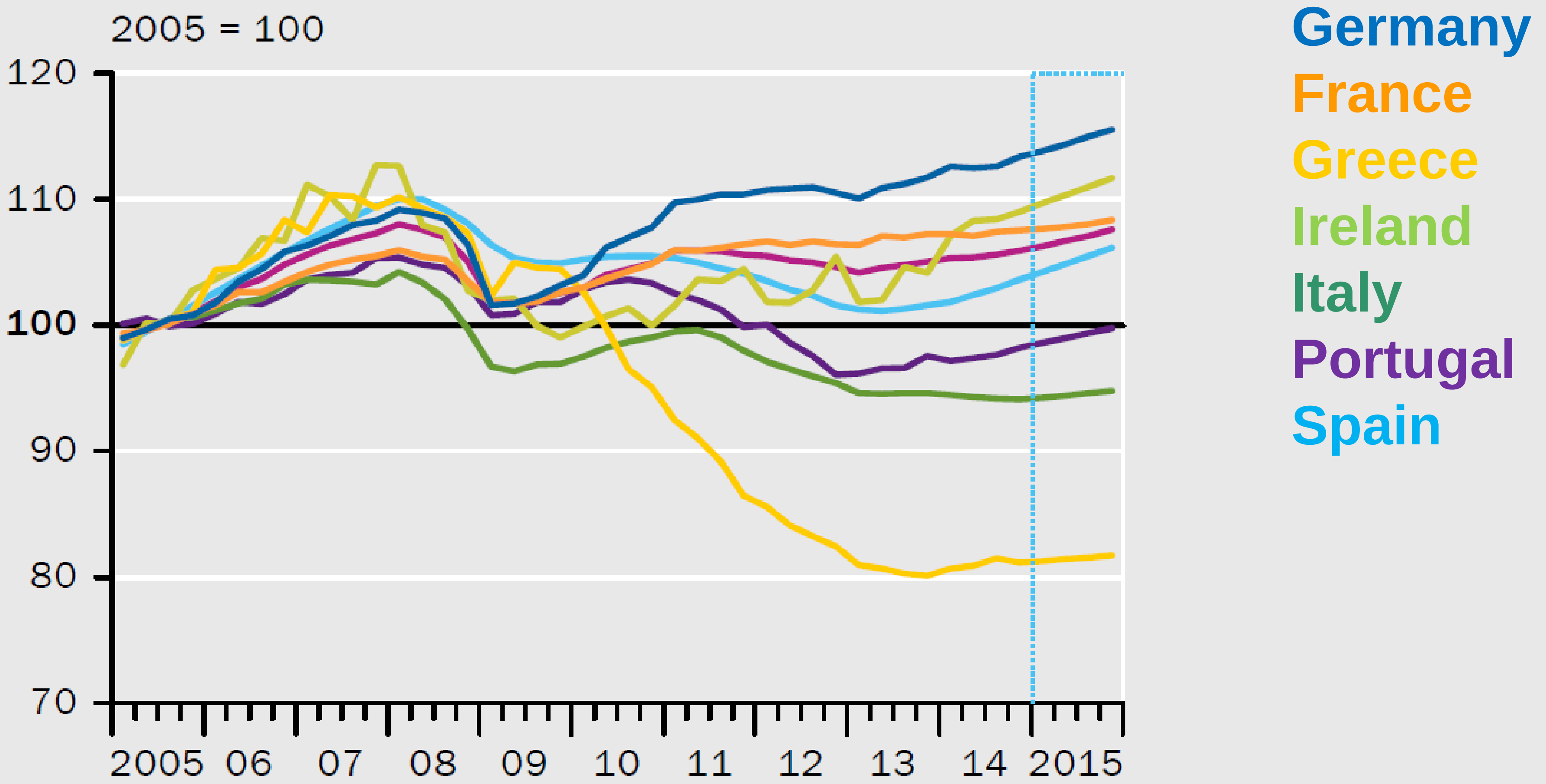
No empirical support for negative long-run equilibrium interest rates.

- Medium-run equilibrium rates estimated with Laubach-Williams (2003) method have declined.
- Should monetary policy hence be much lower? No, because they imply positive output gaps.
- Furthermore, the medium-run estimates are highly uncertain and very sensitive to estimation assumptions.

# 4. Euro-zone heterogeneity supports case for structural reform

…. rather than secular stagnation.

# GDP 2005-15: Turn-around in program countries except Greece. Early reformers grow faster.



# Competitiveness: Effective real exchange rate vs euro-zone on unit-labor cost basis.


**Germany**
**France**
**Italy**
**Spain**

# 5. Insurance

…. Prepare for possible long period of low rates and quick reversal.

Nominal and real rates may remain low for quite some time because of central bank policy. More rapid reversal may become necessary, the longer this lasts.

1. Business models of certain banks and insurance companies threatened. Low profitability of new business.
2. Particular challenge for life insurance contracts with guaranteed rates.
3. Substantial build-up of interest rate risk in savings banks and insurance business.
4. At the moment, asset price boom helps. Yet high volatility. Future rate reversals could trigger declines.

# Possible policy responses.

1. Regulating banks: More explicit and additional regulation of interest rate risk. Capital requirements. Debt-to-income ratios.
2. Regulating insurance: Solvency II covers interest rate risk. Systemic relevance of life insurance?

If monetary policy insists, macro-pru regulation will not help.

If risks emanate from monetary policy, reconsider if policy is justified from macro-perspective.