CFA Annual Dinner Netherlands

Economic recovery and macroeconomic policies

Presentation by
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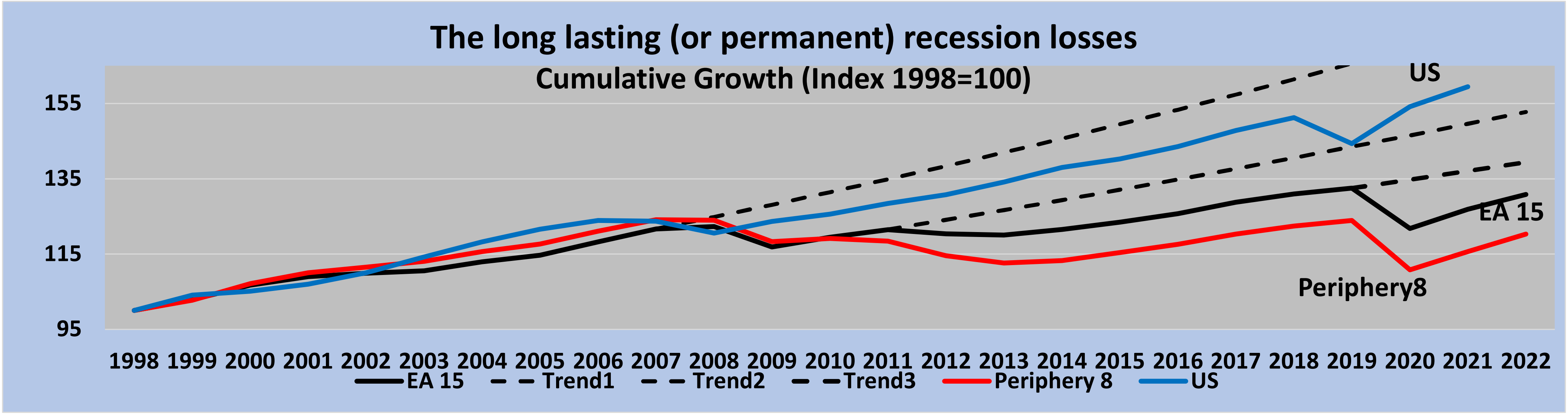
GROWTH PROSPECTS

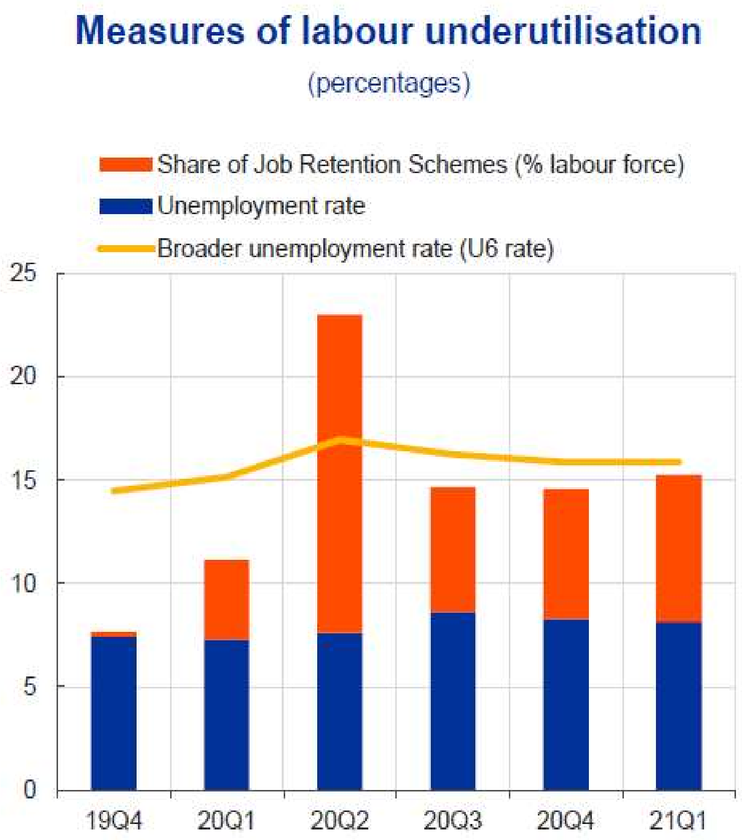


After a recession, the difficulty of economies getting back to their previous trend implies a lasting or a permanent loss of output. There is a decrease in potential output driven by supply damage and need of restructuring. It is also associated to what is called "scarring" or hysteresis, i.e. losses during the recession of the quality/quantity of labour and installed capital. After a recovery in 21/22, growth is predicted to decline from 2023 onwards approaching potential growth (1.2% to 1.5%).

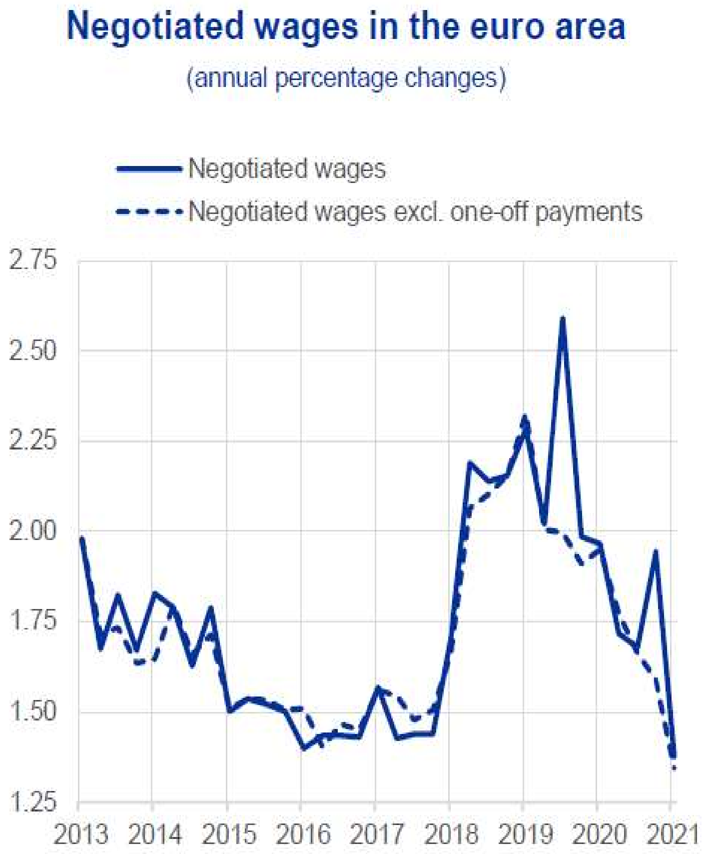
This justifies running a "moderately high pressure " economy after recessions to overcome those effects. <u>The present foreseen fiscal policy will not be enough. Last April the IMF recommended an additional 3% GDP stimulus for the EA to reach the trend growth previous to Covid by the end 2023</u>. The US will attain it before the end of this year.

Source: Eurostat AMECO Database and author´s calculations. 2021 and 2022 are forecasts. Core countries (7): DE, FR, NL, AT, BE, FI, LX.
Peripheral countries (8): IT, ES, PT, GR, CY, SK, SI, MT

A SIGNIFICANT ECONOMIC SLACK



Sources: Eurostat, BMPE questionnaire and ECB calculations.
Notes: The U7 rate is the sum of the blue (unemployment) and red (job retention schemes) bar. The U6 rate is defined as the sum of (a) unemployment, (b) underemployment), (c) discouraged and (d) marginally attached workers as a percent of the extended (by c. and d.) labour force. Latest observations: 2021 Q1.



Sources: Eurostat and ECB staff calculations.
Latest observation: 2021 Q1.

The left-hand chart shows how a broader measure of unemployment, U6 (yellow line) is still slightly above 15% . It also points to the uncertain future of the persons declared as employed because their wages have been supported by public policies (red bars). Both these points, plus the fact that the number of persons now employed is still almost 3 million below the number in Feb 2020, illustrate that there is still a lot of slack in the economy.
This is also reflected in the sharp deceleration of wage growth

Source: Isabel Schnabel speech (July 2021) " Escaping low inflation?" available at https://www.ecb.europa.eu/press/key/date/2021/html/ecb.sp210703~f221554ff2.en.html

ANNUAL FISCAL IMPULSE AND DISCRETIONARY FISCAL STANCE

All numbers in % of GDP	2019	2020	2021	2022	2023
A. Overall Budget balance annual change	-0.1	-6.7	0.2	3.7	0.8
B. Fiscal impulse = -(A)= B1+B2	+0.1	+6.7	-0.2	-3.7	-0.8
of which:					
B1. Discretionary impulse or fiscal stance = change in CAPB(1)	+1	+4.2	+1	-2.1	-0.1
B2. Automatic stabilizers + +change in interest payments	-0.9	+2,5	-1.2	-1.6	-0.7
C. Gross Public Debt	83.9	98.0	99.4	96.3	95.2

Note (1): This row is equal to (-) the variation of the cyclically-adjusted primary balance (CAPB). **The forecast includes the NGEU grants foreseen for those years**
Source: ECB Macroeconomic projections, June 2021 and author calculations
For concepts see ECB Occasional Paper n. 109 pp 23-34.

Existent forecasts point to a future restrictive fiscal policy, measured either by the annual fiscal impulse and or by the discretionary fiscal stance. Naturally, the budget deficit could not continue to increase after 2020, but the table shows that the discretionary policy decisions would contribute to the restrictiveness of budgets impact on the economy.
Given the big increase in covid related debt, restrictiveness can even become worse if from 2023 onwards there will be an enforcement of the SGP rules about the debt criteria (reduction each year of 5% of the deviation between the actual debt to GDP ratio from 60%, an obsolete threshold)

THE PUBLIC DEBT PROBLEM

In the context of a more active fiscal policy what to do about public debt levels?

In a regime of low interest rates where interest rate < growth rate there is no explosion of the debt ratio with higher deficits and there is usually a decline. Market interest rates have been declining for 35 years.The situation of r < g has been common in the last ten years and many other periods in the past. The present regime of low rates will prolong that.

In the new low rates regime, it makes no economic sense to use a 60% limit for the debt-to-GDP ratio. There is no theory about this type of rule. The two rationales for the Maastricht Treaty adopting such a threshold were: a) 60% was the average of the ratio among countries (it was 86% in 2019); and b) in the worst scenario of countries always having a 3% deficit, considering a nominal GDP growth of 5% , then seen as normal, (3% real plus 2% inflation), it can be shown from the equation of the debt dynamics that the debt ratio stabilises at 3/5 or 60%. Applying the same rationale today and using a realist nominal growth of 3.25% (1.25% potential growth plus 2 % inflation), the limit would come at 92%.

Additionally, the SGP went beyond the Treaty and imposed that the debt ratio had to go to zero in the long term, denying the crucial role that the public debt benchmark plays

FISCAL RULES REFORM

In order to have a fiscal policy appropriate for the present challenges, beginning with the very demanding greening objectives, requires the revision of the EU fiscal rules, particularly in what regards the debt criterium. In case of being impossible to change the Protocol annexed to the Treaty where the 60% limit is defined, then the convergence to it cannot be subject to a mechanical formula but must be left to the discretionary decisions of the EU Commission/Council, taking into account the country specific situation and the expected relation between r and g. If no SGP revision occurs the EA may face another double dip recession down the road.

In the past few years, there has been a convergence of opinions in Academia and some official Institutions to adopt an expenditure rule. In an expenditure rule, public spending is guided by the country´s growth potential and the need to converge towards debt sustainability. A change in the debt criterium would pave the way for that possibility. Otherwise, given the debt increase in all countries with the pandemic, keeping the existent formulas and parameters would make the expenditure rule impossibly restrictive. In the present context, an expenditure rule could foresee the exclusion of some expenditures linked to investments that crowd-in essencial private green investments that may not happen on a sole commercial base.

A fiscal rule usually does not properly consider the cases of bigger shocks and deeper recessions. Additionally, it cannot impose that countries fully use their allowed fiscal space. Consequently, in order to respond to deeper recessions, there is a good case for a permanent European Stabilisation Fund to be used only in cases of significant recessionary shocks, asymmetric or symmetric.

MONETARY POLICY PROSPECTS

The ECB has maintained an expansionary policy to ensure favourable financing conditions and continues to promise an accommodative policy as indicated by its forward guidance decision about future policy interest rates. However, financial conditions have recently become slightly more restrictive.

Potentially, there are two reasons that could justify or lead to a more restrictive monetary policy:

1) **a sustained increase in inflation ;**
2) **an uncompensated termination of large scale purchases under PEPP.**

Before addressing these two questions it is useful to analyse the main features of the recently approved ECB´s Monetary Framework to assess how this change may impact the conduct of monetary policy going forward.

PROSPECTS FOR MONETARY POLICY AND THE NEW ECB STRATEGY

It is more difficult to foresee monetary policy developments despite the clarifying adoption by the ECB of a new policy framework that has the following main features:

1- The medium-term inflation target is now a fixed 2%, instead of "below but close to 2%" which is a more demanding target than before.

2- The target is symmetric in the sense that some deviations from the target are admitted;

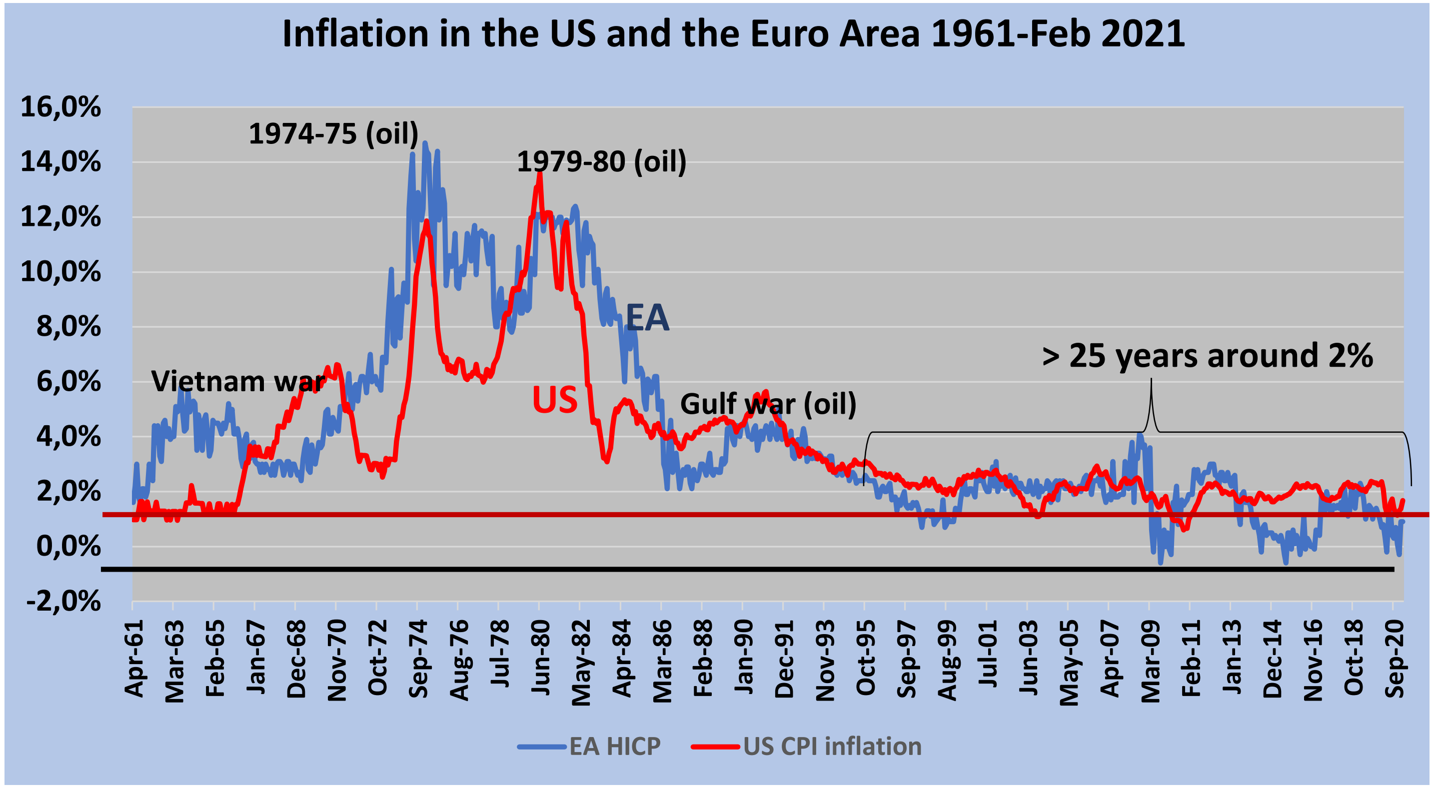
"The symmetric two per cent inflation target provides a clear anchor for longer-term inflation expectations, which is essential for maintaining price stability."

.. "when the economy is close to the lower bound, this requires especially forceful or persistent monetary policy measures to avoid negative deviations from the inflation target becoming entrenched. This may also imply a transitory period in which inflation is moderately above target."

"The flexibility of the medium-term orientation takes into account that the appropriate monetary policy response to a deviation of inflation from the target is context-specific and depends on the origin, magnitude and persistence of the deviation. "

3. Recognition of all former "unconventional instruments: "The primary monetary policy instrument is the set of ECB policy rates…the Governing Council will also employ in particular forward guidance, asset purchases and longer-term refinancing operations, as appropriate

THE DRIVERS OF LONG WAVES OF INFLATION

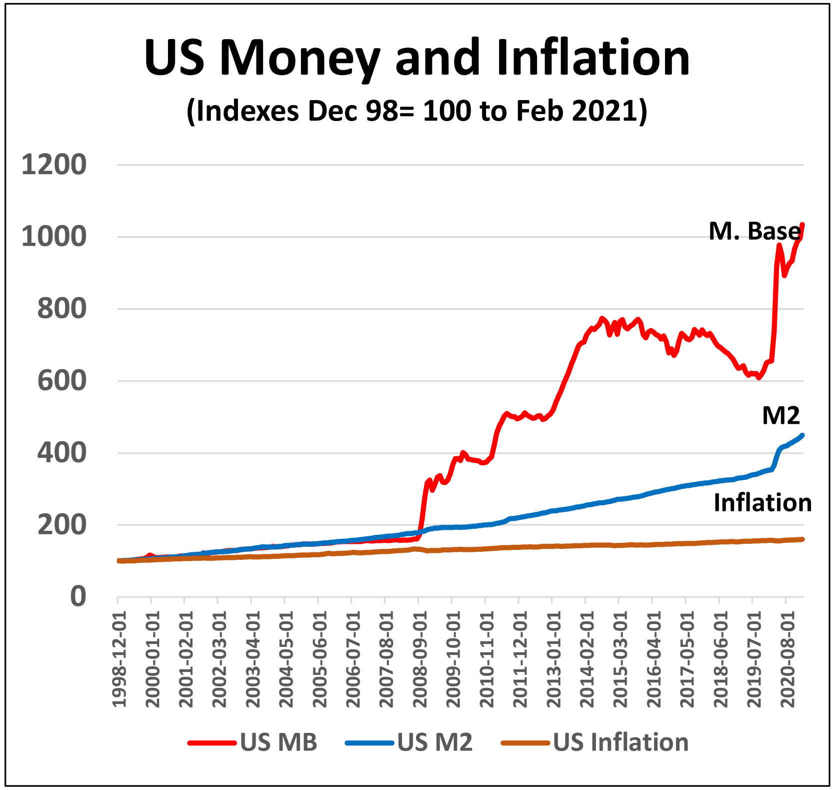


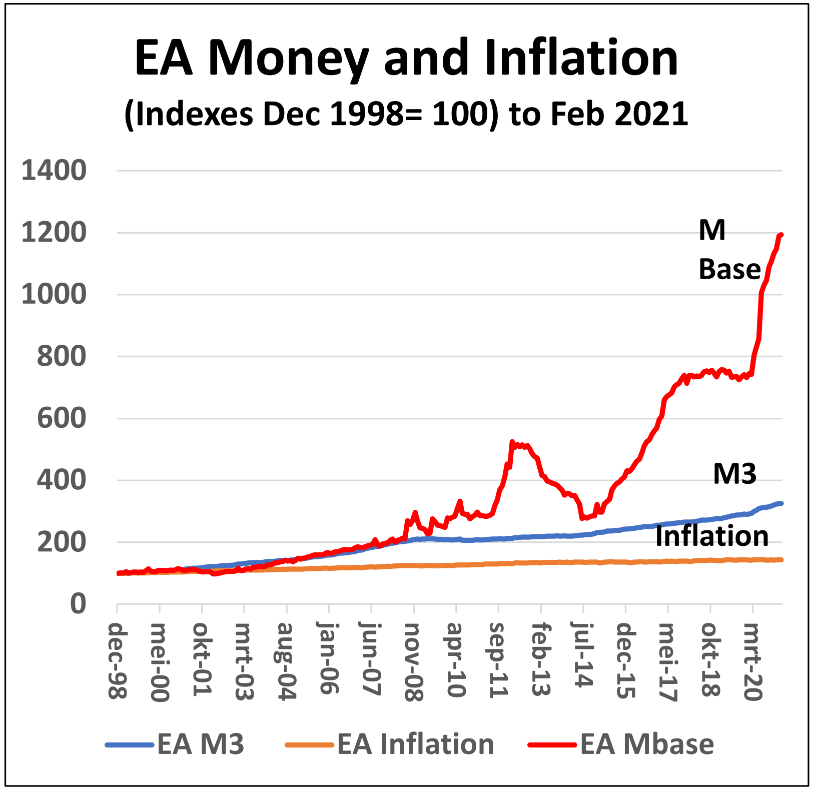
Turning to first reason that would justify a more restrictive policy, what are the prospects about inflation ?. Sustained phases of high inflation have been linked to wars or big oil price shocks and in the last 25 years EA and the US had inflation around 2%. **It is difficult to imagine credible shocks that could lead to a new sustained phase of high inflation**. The June ECB forecasts inflation for 2021-23 at 1.9%, 1.5% & 1.4%.

For the future, wars cannot be predicted and other **high inflation causes seem unlikely, like large oil shocks or wage shocks resulting in a significant wage-price spiral.**

Source: ECB SDW and FRED Database, St.Louis FED. Author caçculations

INFLATION AND MONETARY AGGREGATES





The demise of Monetarism. No reliable relation between M. Base and Total Money (M2 or M3). Second, for 20 years there has been no reliable relation between Money and Inflation in the US and the EA

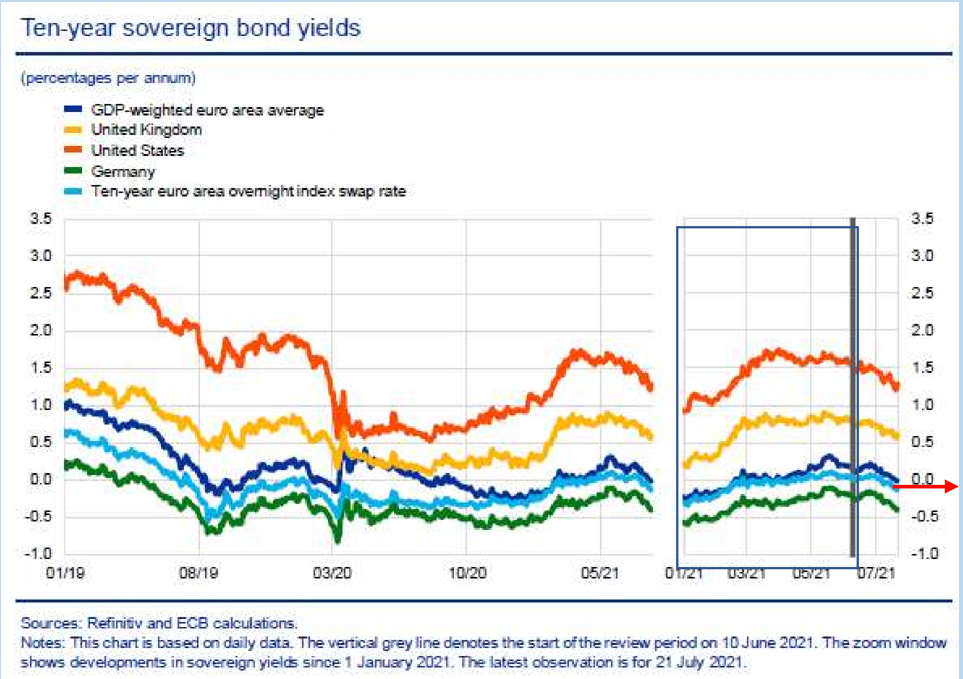
US Money and Inflation (from Dec 98 to Feb 2021)		
US M. Base	US M2	US Inflation
934.74%	349.50%	60.07%

EA Money and Inflation Dec 1998 to Feb 2021		
M Base	M3	Inflation
1093.00%	225.20%	43.60%

AND LOW RATES FOR LONG TERM

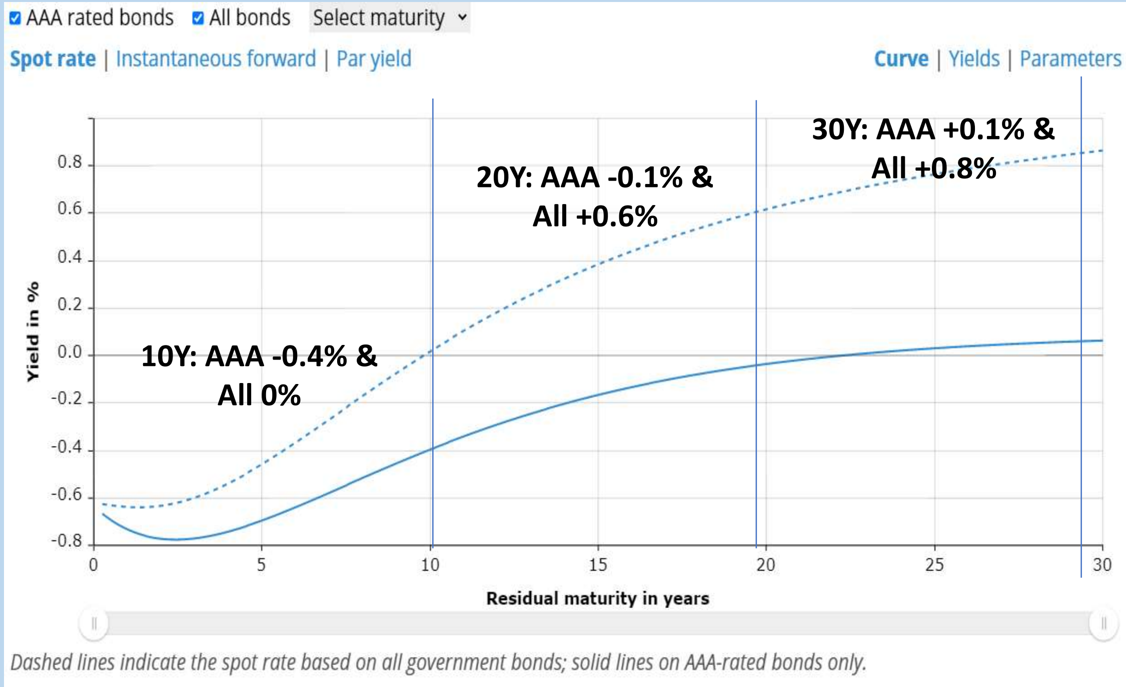
Monetary and financial markets continue to expect future low interest rates. The Overnight Index Swap (OIS) rate for 10Years is only slightly above zero, indicating that the fixed rate leg of the 10 Year Swap at e.g 0.2% is willingly exchanged for the accumulated income of daily overnight rates during 10 years. <u>The inflation linked swaps 5 year 5 years ahead are also below 2%. Markets do not believe that high inflation is coming.</u>

Triple-A EA countries: Government bond yields for 10 years maturity from 09/2004 to 19/05/2021,

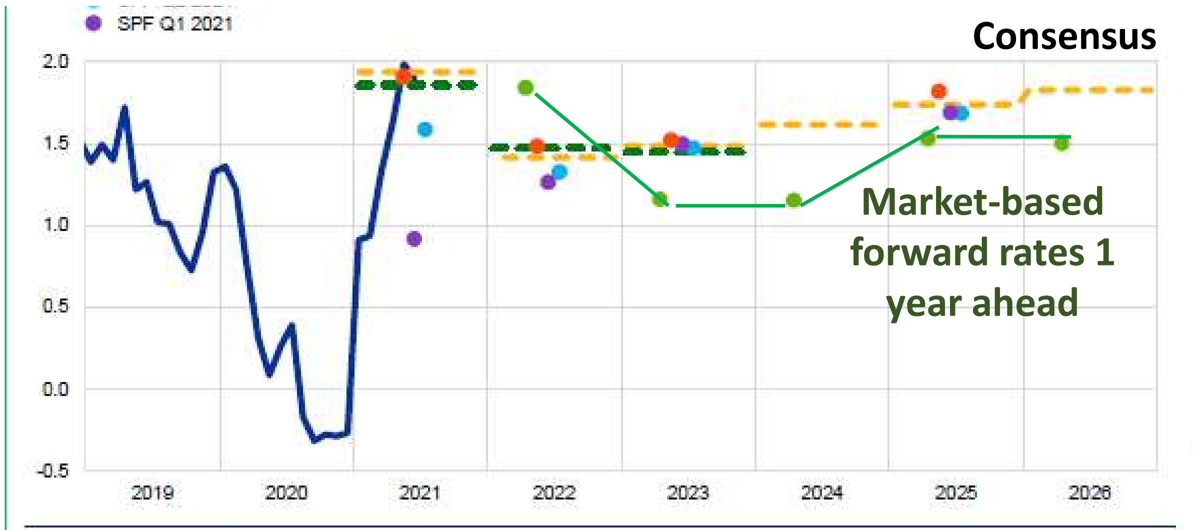


Source: ECB Economic Bulletin, July 2021

Daily spot yield curve for EA triple A countries (solid line) and for all countries (dotted line) (27 August 2021



Source: ECB SDW



Sources: Eurostat, Thomson Reuters, Consensus Economics, ECB (SPF) and ECB calculations.
Notes: The market-based indicators of inflation compensation series is based on the one-year spot inflation rate and the one-year forward rate one year ahead, the one-year forward rate two years ahead, the one-year forward rate three years ahead and the one-year forward rate four years ahead. The latest observations relating to market-based indicators of inflation compensation are for 21 July 2021.

1.0
0.5
0.0
-0.5

predict inflation below 2% until 2026. On the other hand, the Consensus forecast by specialists (the yellow dotted levels), while slightly above, also does not point to inflation attaining 2% in 2026. On a quarterly basis, we must be aware that in the last quarter inflation in the EA will be around 2.6% but that is due to a base statistical effect as inflation last year declined by 0.3% in every month of the last quarter. Inflation will sharply decline from January 2022 onwards.

Source: ECB Economic Bulletin, July 2021

MONETARY POLICY PROSPECTS

The second of the two reasons that could lead to a slightly more restrictive monetary policy would be an uncompensated termination of large scale purchases under PEPP. PEPP has an approved total €1850 billion (1272 bn already used) with the ECB commitment for it to last "until at least the end of March 2022 and, in any case, until it judges that the coronavirus crisis phase is over " So, its termination will be determined by the end of the crisis if it is considered to last beyond March. It is reasonable to admit that the crisis period will end some time next year but any announcement to the markets must come months before this year´s end.

It is also reasonable to expect that the ECB will avoid cliff effects by a sudden stop. With inflation forecasts that put it below 2% until 2023 (2021-1.9%; 2022-1.5%;2023-1.4%) and a new Monetary Framework with a fixed 2% target, the ECB is expected to increase purchases under the old APP programmes well beyond the present 20 bn a month to partially (or totally?) offset the winding down of PEEP.

In any case, this transition will be very difficult to manage as it hinges on what will be the market´s reaction to a possible significant reduction of overall purchase, possibly increasing yields of sovereign bonds, and therefore of other market interest rates and wider financing conditions.

THE NEW MONETARY POLICY FRAMEWORK AND THE NEW FORWARD GUIDANCE FOR RATES

Immediately after approving the new framework the ECB took a bold and consequential decision, keeping for quite a long time the present expansionary stance of interest rate policy:

“.. the Governing Council expects the key ECB interest rates to remain at their present or lower levels until (1) it sees inflation reaching two per cent well ahead of the end of its projection horizon and (2) durably for the rest of the projection horizon, and (3) it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term. This may also imply a transitory period in which inflation is moderately above target. “

Given the present inflation forecasts, even if the September projections slightly increase them, it seems unlikely that the three criteria will be met any time soon, implying that the present level of negative policy rates could stay unchanged possibly until 2025/6, depending on inflation.

However, as this rates level has been in place for so many years there are clear diminishing returns in its impact on the real economy and inflation. It cannot be considered a new expansionary tool that could, for instance, offset any significant tapering in the use of the asset purchase tool.

MONETARY POLICY PROSPECTS

Monetary policy has to continue to be accommodative while inflation is still distant from its new inflation target. If anything, the new more demanding target could justify a "*especially forceful" policy".* Especially if inflation forecasts continue to show target undershooting.

In the present economic environment and its challenges, monetary policy should reflect the medium-term nature of the policy on the symmetry commitment. As Mario Draghi said in 2016:"*...our mandate is defined as reaching an inflation rate which is close to 2% but below 2% in the medium term. Which means that we'll have to define the medium term in a way that, if the inflation rate was for a long time below 2%, it will be above 2% for some time. The key point is that the Governing Council is symmetric in the definition of the objective of price stability over the medium term.(1).*

There are other reasons for symmetry, condoning inflation moderately above target and not just the proximity of the policy rates effective lower bound (e.g. supply-shocks).

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(1) Mario Draghi during the Q&A of the Press Conference on 10th March 2016

MONETARY POLICY PROSPECTS

The ECB must avoid cliff-effects in managing its purchase programmes.
Hopefully, that seems to be the sense of the recent statement by the ECB's chief economist Philip Lane:
"Asset purchases will continue after PEPP …, as conditions to end APP are not there. That's why we still have time. If we were in a pure taper situation, going from supporting the market to finishing net purchases, then preparing the market is an issue. But that is not the situation here. Regardless of when PEPP might end, that's not the end of the ECB's role in terms of QE."(1)
Like the FED, the ECB also committed with low rates for longer with its new forward guidance.
Indeed, in this still challenging situation, monetary policy should use all its instruments in the pursuit of its goals and should continue to independently accompany fiscal policy in ensuring for a little while longer a "high pressure economy" that a full European recovery requires, particularly when high inflation is not in the medium-term horizon

(1) Philip Lane Interview on 25 August 2021 at https://www.ecb.europa.eu/press/inter/date/2021/html/ecb.in210825~db23a29fa6.en.html

THANK YOU FOR YOUR ATTENTION