

Challenges and conditions for a normalisation of EU monetary policy

1. It is time to discuss policy normalisation and unwinding the asset-purchase programme

1.1 QE has contributed to economic growth and deflation risk has disappeared

An official stated that the time has come to talk about policy normalisation. Europe is in completely different situation today than a couple of years ago. In terms of what the asset-purchase programme and the ultra-accommodative monetary policy of the ECB have contributed to, there are four areas where there has been great progress. First, looking at overall financial conditions in the euro area, it is fair to say that borrowing costs in the euro area are no longer an impediment. Financial conditions are as easy as they get for households, companies, banks and sovereigns. North to south and east to west in the Eurozone, every interest rate is essentially at about zero. That is something that was done deliberately by the ECB, but the ECB has been very competent in getting the financial conditions to where it thought they were appropriate.

Second, financial fragmentation has been an issue since the onset of the crisis. Not all fragmentation issues have been resolved today, but there is a much greater degree of homogeneity in terms of the monetary-transmission process today than there has been for a long time.

Third, in terms of the economy, the recovery in the Eurozone has sometimes been undersold. The second-quarter growth number, which was very favourable, was the 17th consecutive quarter of positive growth in the euro area. Since the third quarter of 2014, so the last 12 of those 17 quarters, growth has consistently been above potential. The recovery has been in its reflationary phase or growth trajectory for 12 consecutive quarters. It is, then, fair to say that Europe may be at the peak of the current cycle. There is reason to believe that momentum can be continued, but this is still a significant achievement, where monetary policy, among other things, has played a role.

Fourthly, the main rationale for starting asset purchases was a fear in 2015 that the eurozone was sliding into deflation – a 1930s type of negative spiral of falling prices, postponement of spending and a further fall in prices. That deflation risk has completely gone. All indicators of how the market prices deflation risk have also completely gone.

Given those four factors, now is the time to talk about unwinding and about policy normalisation.

An official explained that there is a highly expansionary monetary-policy stand, not only with regard to the standard measures but also non-standard measures. This official considered that there was a need to talk about the exit from the APP as some of the unconventional measures were discussed under the headline deflationary risk, which is no longer there.

Another official agreed that it is relevant discuss what is meant by 'normalisation.' He added that he fully shares the previous views: the ECB and other central banks have been completely successful in preventing a period of disinflation spiralling into one of deflation. This is a clear success.

1.2 The strength of the euro is not a reason to postpone normalisation

An official stated that on the exchange rate, there is no denying that the euro has gained strength over the last few weeks. That is not yet a matter for concern. First of all, the exchange rate appreciates in anticipation of policy normalisation, but that is no reason to postpone policy normalisation.

Second, the strength of the exchange rate is, for the most part, endogenous. It is a reflection of the strength of the eurozone economy, which is a completely different strength of the exchange rate if it were to be due only to factors exogenous to the eurozone. If it were only weakness of the US or of the rest of the world, it might be more problematic, but at least the bulk of the exchange-rate strength is endogenous, which means that there is less reason to worry about exchange rate developments than there would otherwise be.

Of course, there has to be gradualism in the winding-down process, so the exchange rate is not allowed to overshoot or unnecessary exchange-rate volatility and overshooting is not created. That is something to be very aware of but it is not so existential that it should change the path outlined.

1.3 Sustainable adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to 2% over the medium term should guide the withdrawal of the asset purchase programme (APP)

An official stated that one should be aware that this success rested on the use of both conventional and unconventional measures, although the discussion now is primarily about unconventional and QE. It would be a mistake to discuss normalisation in only an instrumental way; it is also important to discuss the economic basis and to look at the inflation rate and its long-term development. Here, the ECB is in a different situation as compared to the Federal Reserve, which has a dual mandate. The ECB has a single mandate only with regard to the inflation rate. There is a discussion worldwide about downward trends in the inflation rate, which is called the natural rate of inflation. There may be different reasons for that, such as Ben Bernanke's point about a savings glut and the effects of changes in income distribution. This situation is something that will also have effects on central banks.

The official did not think that the basic mandate of central banks should be changed. Their basic mandate is to avoid deflation and to avoid inflation that is too high. That is quite clear, but it is not so easy to translate this mandate into numbers. There are different approaches here. For instance, the Swiss central bank has an upper limit but no lower limit. There are discussions among other central banks about a range.

As regards the ECB definition of price stability, the official saw no need to change it, as it had proven its worth in the past and had to be seen as a medium term goal.

One also has to be aware that, especially in times like these, it is also necessary to look at core inflation, which does not include energy prices. No central bank in the world is able to control energy prices.

In the months to come, it may be quite interesting and important to remember to distinguish between stability in the core inflation and a trend in the right direction, while the overall inflation rate fluctuates according to energy prices.

1.4 The longer the ultra-loose monetary policy conditions persist, the more the risks increase

An official stated that prolonged monetary easing comes with diminishing returns, especially in a situation of very low interest rates. Additional monetary easing becomes less effective in this situation. Moreover, growth and inflation is also influenced by structural factors. By itself, loose monetary policy is not enough to achieve sustainable economic growth. Lack of structural reforms can limit the effectiveness of the policy measures over time.

Moreover, the risk parameter relates to the unintended side-effects of unconventional monetary policy measures. The longer the ultra-loose monetary conditions persist, the larger this risk. Since loose monetary policy has stimulated risk-taking in financial markets, asset prices can grow out of synch with real economic developments. This can create imbalances, which might become unsustainable once monetary conditions are normalised. Furthermore, market discipline has been reduced by the abundant availability of liquidity. This can distort the risk compass of investors and can contribute to a misallocation of resources and so undermine potential economic growth.

Another official stated that an expansionary monetary policy stance does not come without costs.. As time passes, the costs of these measures are increasing, as are the vulnerabilities, while the benefits or the impacts of those measures are decreasing. When deciding on monetary-policy measures, this always has to be taken into account. What a central bank cannot take into account when fighting deflation is the consequences of its measures on the distribution of wealth. As the risk for financial stability grows the longer the Central Bank has to implement a loose monetary policy, it would be even more important to identify and implement appropriate macro-prudential policies in order to react to a potential bubble in some asset classes. Another official pointed out that asset-price bubbles in Europe are not a general problem. This is different from the US, where they are. In the QE process, the ECB decided to buy corporate bonds. This was the right decision at that time. However today, though, the central banker stressed that distortion effects outweigh the positive effects of stabilisation. Indeed corporate bonds are bought from big companies. While that is a positive market effect for these bonds, it is increasingly difficult to explain why big companies are being supported rather than small or medium ones. This is the distortion effect. Every action taken by a central bank has a certain distortion effect, so it is necessary to always think about costs and benefits. In this case, however, the economic-policy costs outweigh the benefits.

2. The challenges to deal with in normalising ECB monetary policy

2.1 What does normalisation mean?

An official stated that policy normalisation is not the end of the world. The Central Bank is concretely talking about winding down its programme of asset purchases. That is not the only instrument in its toolbox. But nobody is talking yet about raising interest rates. As a matter of fact, everyone in the Council agreed that interest rates would not be touched well beyond the moment at which asset purchases are effectively wound down. Interest-rate hikes are not on the horizon, and the market has correctly identified that.

An official felt that if there is a discussion about normalisation in the field of unconventional policies, there is a discussion about timing, volumes and structure. Another official thought it would take too long to go into detail of what is an on-going discussion. A third official stated that it is mainly a question of timing: when to react. It is not a discussion about putting the brakes on expansionary monetary policy but rather about slowing down the acceleration.

2.2 The stock of assets on the balance sheets of the ECB will remain elevated for a significant period of time

An official said that the reinvestment policy, i.e. the stock of asset purchases residing on the balance sheet, will be maintained at the same level after phasing out monthly net purchases. That also means that there will be a continued presence in the markets, because that reinvestment policy will gain importance over time, and more and more transactions will have to be conducted in the spirit of reinvesting the current stock.

There is a lot of literature about whether stocks or flows matter more in terms of asset purchases. In the market generally, attention is mostly on flows, because flows mean trading opportunities. The official argued that it should be on stock. Indeed, he thought that the bit of empirical evidence available particularly for the quantitative easing (QE) programmes in the US – there is no empirical evidence available yet for the eurozone – also indicates that it is more about stocks than flows. Flows, of course, matter because they are additions to the stock, but ultimately it is about stocks. The stock of assets residing on balance sheet will remain elevated for a significant period of time.

Another official agreed that it is necessary to look at the stock. There is a huge amount of stock, which will stay on the balance sheet and which will have an impact and influence on prices in the market. When talking about timing, all underlying facts for a sustainable inflation path can be seen coming back: a growth rate higher than expected, employment rates increasing and unemployment decreasing. There is buoyant internal demand, and sentiment factors have been very positive for many quarters now. It is a very clear message that the ECB will reach its goal in the medium term.

Accommodation in such a buoyant environment is even more expansionary than in an environment where there is still very moderate recovery. Therefore it is not a problem to slow down the acceleration. The exit from the unconventional measures has to be gradual and not drastic. And there will still be the expansionary conventional measures and the stock will keep growing or stabilize, which will put quite a lot of accommodation into the market to support growth and price stability goals over the medium term.

2.3 The precautions to be taken and the way forward

Answering to the question of how to normalise, an official said it should be with caution. It is not about stopping but about reducing speed. This is the general topic that will go on over the coming weeks and months.

2.3.1 Europe should keep an eye on monetary developments in the US. Whatever the US does will affect financial conditions in Europe

An industry representative explained that normally in advanced economies, monetary conditions in one particular area of the world are affected by what happens in the rest of the world. This is even more so in the presence, as in recent years, in the presence of unconventional monetary policies, with huge increases in central-bank balance sheets. The evolution of exchange rates reacts to the short-term state of the economy and, in the long run, to the prospects of productivity. However, monetary affairs also play a role and could explain short-term evolutions. The evolution of the euro exchange rate in recent years, in particular relative to the dollar, has very much been a reaction to the evolution of unconventional policies on both sides of the Atlantic.

The comments about normalisation of monetary policies fundamentally apply, first and foremost, to the US, according to the industry representative. It is critical that the ECB does not lose sight of that, and that it introduces potential normalisation only after the US has done so; otherwise, Europe will find itself in a situation where the financial conditions will be indirectly affected by what has been done in the US.

2.3.2 Two mistakes to be avoided: acting excessively on the precautionary side on the one hand, doing too little too late on the other

The second point the industry representative wanted to develop cannot be understood without the first. The decision to unwind the QE that monetary authorities in the US, Europe, Japan and the UK are confronting can be put in the context of confronting two possible mistakes that the authorities might make.

The first mistake is a well-known one: acting excessively on the precautionary side. The consequences of this mistake are known. The second mistake is doing too little, too late. These two mistakes can be judged on the basis of the potential damage done. If action is taken too soon, mistakes can be dangerous because they lead to recession and deflation, and QE may be needed again, making it addictive because it is the only tool to react with. It is a mistake with costs that are revealed clearly in the short term. In contrast, the costs of doing too little, too late come in the distant future. As the dominant concern, tends to rest in the near term, the winning paradigm is the excessively precautionary one. However if action is taken too late, bubbles are created, resources misallocated and debt is built. This hurts long-term growth.

Polymakers around the world, however, are careful to avoid the first mistake of acting too soon. In terms of these two potential mistakes, policymakers should also think in terms not only of damage but also of the probability that the mistakes will be made. Assessing probabilities means that there should be a very good diagnosis of what is going on and the extent to which that diagnosis is reliable. The dominant view in the world is the secular-stagnation hypothesis. This is the idea that we now live in a world of very low interest rates and, therefore, policy should not be normalised because there needs to be a very lax monetary policy to support very low real interest rates. The industry representative stated that he was not sure about that. The estimates he had seen of the natural interest rate are very unprecise. Inflation is low but even Stanley Fischer said a few weeks ago that he did not understand why inflation is low.

There is, then, a lot of imprecision and uncertainty about the real state of the economy and, therefore, the possibility of the mistake of staying lax for a long time is high. On the contrary, especially in the US, there is evidence that lax monetary policy has created huge increases in debt, huge asset-price bubbles, and distortions in the risk premium, in the bond premium and in high-yield markets. There is evidence in several indicators of financial conditions that may be stressed for certain non-financial corporates when interest rates start to go up.

Concluding, the industry representative stated that he favoured the view that the second mistake, of acting too little and too late, is a significant risk. However, he stressed that it is US that should be acting first, because the EU is in a less mature phase of the economic cycle and there is no clear indication of excessive debt and bubbles; secondly, and very importantly, the EU is still not a full economic and monetary union. It is still a fragmented market. Therefore, normalisation brings an additional problem compared to the US.

The moderator asked whether the industry representative is broadly happy with the direction of ECB policy or whether he thought the ECB should be doing other things. The representative replied that he is broadly happy, summarising his key point that Europe should keep a very close eye on developments in the US. Whatever the US does will affect financial conditions in Europe.

2.3.3 The risks of being behind the curve as being bigger at the moment than being ahead of the curve.

An official noted a general level of agreement on the panel. He thought the industry representative's points reinforce the fact that he gauges the risks of being behind the curve as being bigger at the moment than being ahead of the curve. Making a comparison to the US, the decision that the ECB is about to take is one that the

US took at the end of 2013, when it started to wind down its asset-purchase programme in the first half of 2014. Europe is roughly four years later than the US.

Looking at where the output gap in the US was in 2013 and where it is in the eurozone today, and looking at where inflation was, it is fair to say that the eurozone is further in achieving its goals at the moment than the US was in 2013-14. Another way to gauge the question around the first type of error versus the second is to look at Taylor rules and to try to sketch an objective measure of whether policy is too easy or too tight. There are various methodological issues around Taylor rules, such as what rates to take, but looking at the development of Taylor rules, in 2015-16 they were significantly below Europe's policy rates. Therefore, that gap was filled by the asset-purchase programme, which has a shadow interest rate and, therefore, a further rate reduction that is not measured but which is there. Today, Taylor rules are no longer below the main policy rate, which also leads to the conclusion that the rationale for asset purchases to complement conventional policy has gone.

2.3.4 Although the international context is important, do not be dependent on the actions of a different central bank

An official asked whether the industry's representative thought that the Fed is a little too late and wants Europe to make the same mistake.

On the point that Europe is four years behind, with different underlying economic factors, the official stated that a central bank would and should not want to be dependent on the actions of a different central bank. In monetary policy, global economic factors and their impact in the euro area have to be taken into account, but in the end it was about whether price stability was achieved or not. If the ECB were dependent on the actions of somebody else, it would not be complying with its mandate.

Another official agreed that the international context was important because many basic developments are international ones. One main difference between the Fed and the ECB, however, is the mandate. The Fed has a dual mandate, which means that whether the economy is improving is something of great relevance. One could argue that the Fed perhaps should have moved more quickly. The ECB has a single mandate. It is not so easy to reconcile this, which is why the official sought a more encompassing interpretation of this mandate; otherwise, there could result a difficult situation of possibly having negative financial stability effects.

In the long run, negative financial-stability effects may also have negative inflationary effects. If this is seen in a more encompassing way, it can be reconciled. This is one of the main points of the discussion that has to be had within decision-making bodies. It is also a good argument for the well-proven maxim for central banks: always move with a steady hand, with no abrupt changes. In that regard, the official agreed that one should not be behind the curve, but central bank credibility is also very much based on a certain amount of stability, which may not mean changing policy but that there can be gradual changes. ■