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Do not dream of new normal, but prepare for gradual normalization

WHAT ARE THE POSITIVES AND NEGATIVES REGARDING THE ON-GOING ULTRA-ACCOMMODATIVE MONETARY POLICY OF THE ECB?

We are in the middle of the largest global policy experiment in the history of central banking. Policy measures that are globally undertaken by central bankers are unprecedented. One of the major benefits of the accommodative policy stance applied by the eurosystem is the gradual increase in economic activity and inflation. In addition, low rates have delivered significant ease to the debt refinancing of governments which may have contributed to short-run political stability in some countries. Thereby besides serving our commitment to price stability, the low interest rate environment has provided additional space for fiscal policy. Our presence in bond markets has avoided the most turbulent developments.

However, large scale monetary stimulus also comes with significant risks. Interventions in the government bond markets have partially removed the market pressure on governments. Our bond purchases have put governments to certain extent into the comfort zone, which has, at least in some cases, led to less ambitious agenda for reforms.

The dynamics of asset prices must be carefully monitored. There is a potential tradeoff between financial stability and price stability. The mandate of the central banks is related to price stability as defined by consumer prices. The link between the short term dynamics of asset markets and consumer price inflation has weakened. Therefore, additional measures against unsustainable dynamics of asset prices along with crisis resolution mechanisms have the key role in mitigating the possible risks of low rates. This means that various preemptive measures in macroprudential policy are inevitable; despite the fact such measures are often unpopular.

TO WHAT EXTENT CAN LIQUIDITY CREATION BE A SOLUTION FOR RELAUNCHING CONSUMPTION, INVESTMENT AND SUSTAINABLE GROWTH IN EUROZONE COUNTRIES CHARACTERIZED BY STRUCTURAL DEFICIENCIES AND RIGIDITIES?

Every additional quarter of incoming data has confirmed that albeit very gradually, we are witnessing improved performance of consumption and investments in the euro area. The recovery in economic activity has been slower due to the high uncertainty surrounding the global and domestic economic outlook. For years, the risk assessment of the euro area's growth outlook has been tilted to the downside. It was only this June when we reached a balanced risk assessment for economic growth. Looking forward, the link between interest rates and economic activity is expected to strengthen again due to higher confidence among investors and consumers. What we have not seen yet is the pick-up in inflation. After the global crisis, the link between the performance of the real economy and inflation has been weak in almost every western country. Despite its current dormant state, the link between inflation and economic activity has not fundamentally changed.

One must carefully look at the reasons behind low wage and price pressures. First, the recovery in economic activity has been only very gradual. This implies that the lags between the increase in economic activity and inflation are also longer than usual. Second, we have seen at least some progress in the structural reforms. It is inevitable that some labor and product market reforms are somewhat disinflationary in the short term. The horizon of structural policies is longer than the medium term. Therefore one should not expect that the agenda for structural reforms is fine-tuned for monetary policy. Thirdly, the recovery of employment has been faster than expected. This also implies that some wage pressures have not built up yet as the byproducts of the limited downward flexibility of wages of the recession episode are not fully undone yet. And lastly, this crisis has proven that despite the low mobility of labor, the stakeholders in wage bargaining have perhaps perceived the potential for mobility of jobs being more acute than ever. An elevated focus on cost optimization has made employers seek alternative locations with lower wage levels. This can explain why despite cyclical recovery in output, the wage pressures are somewhat lower.

More serious issues are related to the low potential output growth in many countries. Lost competitiveness due to postponed reforms and populist policies has led to the deterioration of the potential growth. This cannot be improved by cyclical policies like monetary policy. For promoting the sustainability of growth, many labor and product market reforms are necessary. Monetary policy cannot substitute the supply side reforms.

ARE MEMBER STATES, NOTABLY THOSE RUNNING A PRIMARY FISCAL DEFICIT, SUFFICIENTLY PREPARED FOR A PROGRESSIVE NORMALIZATION OF MONETARY POLICY AND SHOULD THEY ADAPT THEIR FISCAL POLICIES CONSEQUENTLY? WHAT ARE THE EXPECTED IMPLICATIONS OF THIS CHANGE FOR CAPITAL MARKETS, BANKS AND INSURANCE COMPANIES?

It must be clear that at the end of the current cycle, the gradual normalisation of rates should be priced in. The combination of relatively promising economic variables and still very low interest rates which we see in the projections for 2019 is a snapshot of the ongoing economic recovery and do not represent the set of new equilibrium values. Going beyond, the recovery in inflation will be reflected also in interest rates. Too much emphasis has been put on the fears of policy normalisation. The potential risks of recovery include the excessive leverage developed during the low rates period and unsustainable fiscal policy. Those risks can be mitigated by the macroprudential measures and structural reforms which elevate the potential growth and address fiscal sustainability. To reduce the fear of cliff effects of policy normalisation, one must understand that the process of normalisation of policy stance is very gradual and in fact, it has been already started. Inflation rates have been gradually increasing and it has enabled us to lower the amounts of our monthly purchases. Looking at monetary policy, too much emphasis has been put to the volumes of the asset purchases and other changes in the stance. During the extensive application of non-standard policy measures, the central bank balance sheet and excess liquidity have increased significantly. This means that not the change in the balance sheet, but the absolute level of excess liquidity is the main contributor to the accommodative policy stance in the medium term. Given the duration of government debt and the expected dynamics of longer term interest rates, at least for some time, governments will continue to enjoy the refinancing of its earlier bonds at significantly lower rates than in the previous cycle.

But in many respects, the normalisation delivers an ease for the industry. The normalisation of the yield curve may even support the business of universal banking and the escape from the negative money market rates would significantly improve the performance of insurance companies and absolute return providers.

In case of significant deviations from the baseline inflation path Eurosystem stands ready to act. It must be noted that ECB has a wide range of policy instruments available, which can be used in case of necessity. ●