SESSION SUMMARY - BERLIN SEPTEMBER 2020

Is current monetary policy doing more harm than good and are there alternatives?

Monetary policy responses to the crisis were necessary and effective. Financial markets have stabilised, and credit continues to flow. With their pandemic responses, central banks have contributed to avoid an even deeper recession and shown that they can overcome the limits posed by very low interest rates and provide additional stimulus through innovative balance sheet policies.

However, it is essential to recognise the limits of monetary policy. Prolonged monetary policy easing has side effects, can increase financial vulnerabilities, and cannot alone deliver higher sustainable growth. Once the economy has recovered from the crisis, the challenge will be to rebuild monetary and fiscal buffers. The ECB's review of monetary policy strategy should also consider whether the 2% inflation target should be revisited.

1. Monetary policy responses to the COVID crisis were successful

1.1 The extended monetary policy measures implemented since March were necessary to support monetary transmission and to help the economy establish a foothold during lockdown, and this has contributed to avoiding worst case scenarios and the threat of deflation

A Central Bank official opined that the ECB has done what it had to do since the outbreak of COVID 19. In early March there was a real threat of another destructive development in the markets comparable to 2011 2012, when the markets 'had a go' at the debt sustainability of euro membership countries. Europe learned its lesson from the previous crisis: if these dynamics start to take hold in markets, it is essential to take action in a big and decisive way. There is an acknowledgment that in the whole European Institutional Setting, the ECB is probably the only institution with both the balance sheet and the swiftness of decision making to perform this backstopping function for the markets.

1.2 The monetary policy responses to the COVID crisis have clearly been effective

A Central Bank official summarised the effectiveness of the ECB's actions as 'so far, so good'. Any assessment of effectiveness requires an understanding of policy objectives, however. The Pandemic Emergency Purchase Programme's first objective was to restore monetary transmission, i.e. to avoid destructive spirals and reduce fragmentation. Bond spreads are now more or less back at pre COVID levels, which means the policy has been highly effective. In restoring monetary transmission and avoiding these catastrophic scenarios, Europe has also averted deflation risk. In terms of market based indicators of inflation expectations, at one point the market was pricing in more deflationary scenarios, but these have returned to their pre COVID levels. Additionally, the ECB's TLTROs have ensured the continuation of bank lending to the economy.

Another Central Bank official described how the hit to the euro area economy from the pandemic has been extraordinary, noting that the strong response from governments and the ECB was certainly warranted. It cannot be disputed that the monetary policy intervention has been effective so far. Without central bank purchases, bond yields would have risen, tightening financial conditions amid the pandemic. The ECB's response was instrumental in avoiding a financial meltdown.

1.3 Easy monetary policy and fiscal expansion reinforce each other and make the overall response more effective and efficient

An industry representative agreed that Europe needed this kind of swift and decisive monetary policy reaction. However, there is also a need for a strong reaction on the fiscal side. This happened at the national level, and it also happened in a coordinated way at EU level with the Next Generation EU package. An industry representative agreed on the need for the extraordinary monetary support at the start of the pandemic, noting that it has proved effective. Combined with the fiscal response, monetary policy helped preserve economic capital and social cohesion.

2. Prolonged monetary policy easing creates financial vulnerabilities and has long term side effects

A Central Bank official wondered how long Europe could continue with its debt build up and the already very long period of loose monetary policy. The Central Bank official asked whether central banks are risking a loss of independence and fiscal dominance in the future.

2.1 If central bank support continues for a prolonged period of time, debts accumulate and asset prices are further stimulated, which poses risks to financial stability

A Central Bank official explained the importance of side effects. The longer these policies continue, the more there will be an explicit trade off against the side effects. These include the build up of bubbles in financial markets and asset prices, and the ratcheting up of debt. Additionally, there is a more general point about the misallocation of resources in the economy, which also increases in the 'low forever' environment.

2.1.1 The origins of any trouble in the market might be the spill over from corporate bankruptcies rather sovereign debt

An industry representative stated that the corporate sector was hit first and hardest by the COVID -led recession, as the pandemic put entire parts of the economy 'on pause'. More than 20% of S&P's global corporate ratings have been downgraded as a result of the stress on the economy, and most of these downgrades took place at the lower end of that scale and in sectors most exposed to social distancing measures and a collapse in demand. A third of the corporates rated by S&P are rated 'B' and below, which means they are vulnerable to changes in economic and business cycles. S&P forecasts the

corporate default rate in Europe for speculative grade credit to increase to 8% in the next 12 months. and estimates that credit losses for banks in Western Europe will more than double this year and next. While preprovision earnings should cover most of those, some banks will unavoidably report net losses.

The next 6-12 months will be a critical transition period where we will see if private demand comes back to sufficiently strong levels, while the extraordinary fiscal support gradually phases out. This unprecedent fiscal support to businesses and individuals will inevitably lead to a sharp increase in government debt, although part will depend on the degree to which indirect support will be drawn on, in particular the guarantees. The speed and strength of the economic recovery will be key to determine how much the crisis impacts governments' balance sheets.

2.1.2 Lasting low interest rates enable corporates with weaker credit profiles to access Liquidity, but solvency risks remain high for low rated corporates

An industry representative described how it is important to look beneath headline debt numbers when trying to understand why increased debt levels at near zero costs can be problematic. Since the outbreak of the pandemic, there has been an increase in corporate debt. The idea of a K shaped recovery is helpful here. Essentially, there are major differences between the situation for corporates at the higher end of the ratings scale – i.e. investment grade corporates – and those at the lower end. A large part of the debt borrowed by investment grade corporates since the onset of the crisis has remained on balance sheets as precautionary cash or was used for refinancing purposes. This generally pauses limited concern from a credit risk standpoint, although the situation varies across industries.

The story is very different for companies at the lower end of the ratings scale, however, and a large proportion of SMEs. Here, a substantial amount of the debt incurred has been used to fund working capital. This is a question of survival, and it is a cause of concern. The industry representative considers it critical to remember that Europe started the year with a record number of companies at the lower end of the scale, including some companies which may not generate sufficient earnings to cover the interest on their debt. These companies are undergoing a massive shock particularly in the industries most exposed to social distancing and a drop in global demand such as transportation, automotive, media and entertainment, retail. The gradual phasing-out of extraordinary support programs, while the pandemic is still weighing on private demand is expected to lead in an increase in defaults. Policymakers will have to manage the delicate balance between preserving the economic and social fabric by preventing the rise in bankruptcies and the long term cost of greater government intervention. Preserving employment is important in the short term, but the survival of companies with unsustainable capital structures or obsolete business models could hinder long term productivity.

2.1.3 If short term relief continues for too long, it could 'plant the seeds' of the next crisis

A Central Bank official emphasised the need to be flexible in monetary policy, but it is essential to do this in both directions. A central bank must be able to react forcefully when required and to dial back this accommodation whenever possible. The longer the policy stays very accommodative, the more its side effects will build up. There is a risk, for example, of central bank interventions weakening the role of markets in adequately pricing credit risk and holding back favourable structural changes in the private sector and necessary reforms in the public sector, both of which lead to lower productivity.

2.2 Lasting low interest rates reduce economic dynamism, increase adverse distributional effects and sap the resilience of financial intermediaries

An industry representative emphasised that, as investors, they do not seek to place blame but rather to observe that the current economic and monetary environment makes it difficult to invest. In terms of negative side effects, there are some general economic considerations. There is an over indebtedness of sovereigns and companies, and a question about debt sustainability. This under pricing of credit risk leads to capital misallocation and asset bubbles, and it increases the risk and magnitude of an eventual market dislocation. Economically, it prevents the Schumpeterian cycle of destruction and creation, and supports 'zombie' firms. This makes things difficult for asset managers and institutional investors and promotes an undesirable 'search for yield' behaviours.

The industry representative highlighted the fact that the side effects do not affect all people equally, noting that a Central Bank official had outlined the divergence between Northern and Southern countries on a previous panel. This point connects to the idea of the K shaped recovery. While some sectors are benefiting from the pandemic, many industries are suffering, such as retail, airlines and hospitality. However, there are other important distributional effects. The low interest rate and very depressing return on savings create a distributional or intergenerational effect between the young and the old. There is also an effect on access to the housing market for first time buyers in some countries. If Europe is not alive to these effects, there could be further social backlash.

Responding to a query on negative interest rates from a Central Bank official, an industry representative opined that QE would be preferable to negative interest rates, because the side effects of extra negative interest rates are worse. In particular, negative interest rates lead to a structural weakness in the banking industry and a squeeze on margins. The ECB's intervention has been well designed, however. They provided an incentive for additional lending, which was needed. Europe emerged from the financial crisis with a huge debt overhang. At some stage, government interventions must support equity injections to ensure the system does not develop an even greater debt overhang.

2.3 Monetary dominance or fiscal dominance?

2.3.1 ECB policies do not constitute 'financial repression'

Turning to monetary and fiscal interactions, a Central Bank official stressed that Europe is going to face the issue of rising government debt. There was a first push after the Global Financial Crisis, and due to the COVID crisis there has been another rise in public debt. In some euro area countries public debt will increase to levels beyond 100%. It has been suggested that this could jeopardise central banks' independence. Additionally, some commentators have even argued that the ECB's asset purchase programmes effectively monetise sovereign debt, which is explicitly prohibited by the treaty.

The Central Bank official highlighted the potential for using counterfactual analysis in addition to considerations of raw data. Counterfactual analysis suggests that the public debt ratio would indeed have been notably higher without the ECB's measures. This is driven mainly by better growth performance and to a lesser degree by lower interest rate expenses for governments. The ECB's monetary policy is not guided by the wish to lower public debt but by its mandate of price stability. There is certainly no feedback loop from sovereign

debt developments to monetary policy decisions. For example, there is no systematic relationship between government bond issuance and the amount of bonds purchased by the ECB in the secondary market. Additionally, the surge in debt after the Global Financial Crisis appears not to have led to a structural break in the ECB's reaction function, including in the current COVID crisis. Finally, in terms of fiscal dominance, if the ECB was monetising public debt, there would likely be a spike in medium to long term inflation expectations, as was observed in the 1970s. What is happening now is quite far away from that.

A Central Bank official suggested that the big question for Europe was how to lift inflation to the 2% target. One difference compared with the last crisis is that fiscal policy is now playing a more constructive role. If Europe does not bring up inflation relatively quickly, there is a risk that these policies will have to be in place for a long time. There are already quips in the markets about 'QE forever' and 'negative rates forever'.

2.3.2 The spectre of fiscal dominance

An industry representative observed that there is a huge and worrying build up of public debt. Fiscal policy and monetary policy reinforce each other, and it is necessary for there to be a joint reaction. However, it is also true that monetary policy, in particular unconventional monetary policy, has fiscal consequences. The fiscal-monetary nexus has been strengthened. Therefore, it is important that the decisions taken by different actors are taken by independent institutions and that monetary policy does not react to the fiscal needs of governments. Europe could end up with monetary policy geared towards the sustainability of public debt and 'zombie governments' to the extent that monetary policy interventions create moral hazard and reforms are delayed in member states.

The industry representative agreed that the eurozone has strong institutional arrangements and that Europe does not have to fear debt monetisation. However, the environment in Europe means these unconventional monetary policies are likely to remain in place for a long time. If they last too long, there will be a situation in which these policies become a permanent expansion of the monetary base. While Europe has a strong and independent central bank, it also has 19 sovereigns, which is indeed quite different from any other major monetary area. This robust institutional setting is fundamental, but it will come under substantial pressure for at least two different reasons. First, if other monetary areas engage in a degree of monetisation, this will cause an appreciation of the euro and a tightening of financial conditions in the eurozone. Second, there could be trouble if different euro area states have different preferences regarding the possibility of using debt monetisation to solve the huge problem of debt build up in the EU.

3. The way forward is challenging

The economy will require support for quite a long time. Fiscal policy can now stabilise economies more effectively due to changes in the interaction between fiscal and monetary policy. However, when and how Europe can exit its accommodative policy is a key question. Indeed, it is important not to take for granted that current financial conditions will continue indefinitely. In this context, boosting growth is the key priority. When conditions allow, there will be another challenge concerning rebuilding monetary and fiscal buffers.

3.1 'Fixing the roof when the house is on fire': the economy will require support for a very long time

A Central Bank official noted that current forecasts suggest that the recovery of the euro area to pre crisis levels will take at least two years. It is clear that monetary policy should remain accommodative and support the recovery. At the same time, however, this does not have to mean that emergency measures will stay in place until there is a full recovery.

3.2 Fiscal policy is now more effective at stabilising economies, but it is essential not to take for granted that current financial conditions will continue indefinitely

3.2.1 Secular trends have changed the interaction between fiscal and monetary policy

A Central Bank official stated that the interaction between fiscal policy and monetary policy has changed in recent years. Slowly moving structural factors – such as lower trend productivity growth, an ageing society and global excess savings – have led to long term decline in the real equilibrium interest rate. Therefore, conventional monetary policy now has much less space to stabilise the economy. As a result, years of weak aggregate demand have forced central banks to introduce a wide range of non standard monetary policy tools. These tools have proven quite effective at stimulating the economy, but they also have side effects. The longer these tools are employed, the larger these side effects tend to become.

A Central Bank official underlined the potential consequences of non standard monetary policy. First, a more accommodative fiscal policy is required to lift the economy out of a low growth and low inflation trap. In times of low interest rates, monetary policy alone may be insufficient to stabilise the economy. Fiscal expansion is indispensable to sustain demand and mitigate the long term costs of the crisis. Second, fiscal policy has not only become more important but also more effective. Fiscal spending seems to be more effective at or close to the effective lower bound. This could be because fiscal stimulus normally triggers expectations of a tightening of monetary policy, while at the lower bound investors anticipate a prolonged period of low interest rates and accommodate the fiscal response. Thirdly, the cost of debt has fallen. The extent of this drop has been such that countries may no longer need to run primary budget surpluses to stabilise or reduce their debt burden over time, provided interest rates are lower than nominal growth rates.

3.2.2 When the crisis has been overcome, monetary policy should step back

A Central Bank official highlighted the importance of the interest rate growth differential. Taking a longer perspective, it is possible to observe that this differential is currently negative, which implies two things. First, governments should strive to foster potential growth, i.e. work on the 'g' part of the interest rate growth differential. For Europe, this means the money from Next Generation EU must be spent wisely. Second, governments will have to regain fiscal space once the economy has recovered. If debt levels are too high for too long, it will hurt growth and make the euro area more vulnerable. Moreover, when inflation is on a sustained path towards levels consistent with price stability, central banks will have to exit their loose monetary policy. The ECB will ensure this does not happen too early and thereby choke the incipient recovery.

3.3 Boosting potential growth should be the priority

3.3.1 Monetary policy cannot be 'the only game in town'

A Central Bank official stressed that monetary policy cannot be 'the only game in town'. This was clearly the case in the aftermath of the previous crisis. Here, it is vital that fiscal authorities and economic authorities also do their part. Without sufficient sustainable and productive investment on both the public and private sides to put the economy on a

permanently higher growth path, it is difficult for sustainable growth to take hold. If the ECB is again left to act alone, Europe will remain in this environment for a very long time, and the side effects will also manifest themselves. Another Central Bank official agreed that the ECB will not be able to ensure Europe's recovery alone. There is a need for fiscal authorities to step in by directing spending towards productive investment. If capital markets union (CMU) were fully operational, it would help with the transmission of monetary policy.

3.3.2 After COVID 19, productivity growth will be paramount to cope with higher debt

An industry representative underlined how a lower cost of debt helps governments. Taking the example of Italy, S&P forecasts the ratio of general government debt to GDP to increase to 160% of GDP at the end of 2020 from 132% in 2018. At the same time, the cost of debt, which is the interest revenue ratio, should remain just slightly above its 2018 level of 8% of revenues. While low interest rates are providing short-term relief for almost all sovereigns, higher government debt is not without posing risks. Ultimately, the effect of the COVID shock on government's balance sheets will depend on the timing and strength of the economic recovery and how these large amounts of new debt will fund productive activity and help boost national income and government revenues on the medium to long term.

3.3.3 Next Generation EU – funded by common debt issuance and including grants – is welcome

An industry representative expressed strong support for the Next Generation EU package. This is a huge contribution to the stabilisation effort needed. It can increase the structural resilience and growth potential of the EU and will lead to the initial creation of a safe asset, which will certainly help the implementation of monetary policy within the eurozone. It is a very welcome step, which ideally should be strengthened further. There are still changes needed within the eurozone regarding fiscal rules, which are excessively complex and based on estimates of data. This package will also help drive the advances Europe needs in the projects of the Banking Union and the CMU.

3.3.4 When the economy has recovered, governments will have to commit to regaining fiscal space

A Central Bank official emphasised that governments will have to make a credible commitment to regain fiscal space once the economy has recovered. In the past, many countries failed to take advantage of the good times to create a sufficient amount of policy space. There are two broad and complementary ways to address high debt – boosting potential growth and cutting budget deficits – and both have a role to play.

However, there is a clear hierarchy in the sequence: governments must give clear priority to boosting potential growth by directing spending towards productive investment. Public investment in the euro area has been too low for too long, which has held back economic growth. ECB research demonstrates the beneficial effects of higher potential growth on debt dynamics: an increase in the potential growth rate of one percentage point would reduce public debt as a share of output by more than 10 percentage points in some economies. Fiscal consolidation should follow once the recovery has matured. It must reflect the lessons learned from previous crises and should maximise the use of growth friendly measures. Similarly, it should be accompanied by an overhaul of the euro area's fiscal framework, now more than ever. Fiscal rules are still too complicated, too politicised and too pro cyclical.

4. Should the 2% inflation target be revisited?

A Central Bank official turned to the topic of the 2% inflation target, wondering whether this should be revisited. The monetary strategy of the ECB is now under revision. The Central Bank official described the idea that, if inflation does not reappear, it might be possible to 'throw all of the textbooks out of the window' and allow central banks to print as much money as they want. The Central Bank official queried whether there could be other unintended consequences of monetary policy if inflation does not reappear or undershoots the 2% target. A disincentive to the efficient allocation of resources could be created both on the government side and the corporate side, which is linked to the suggestion that inflation still exists in asset prices and creates inequalities.

4.1 Monetary policy has contributed to the low level of interest rates

An industry representative stated that the issue around monetary policy is whether the market environment is attributable to the central bank and its monetary policy or whether it is due to insuperable forces. When there are negative interest rates or depressed rates, the risk free rate is very low or negative, but the risky rate – i.e. the corporate rate – is very low. Monetary policy contributes to this through QE and through the policy of negative interest rates, but this is also due to insuperable forces such as demographics, the reduction in the working population of the eurozone and reduced productivity growth.

4.2 Inflation performance would have been much worse without unconventional instruments

Emphasising that they could not pre empt the ECB's strategy review, a Central Bank official reiterated the relevance of counterfactual analysis. It is important to ask how inflation would have evolved in the absence of the measures taken by the ECB. According to the models, inflation performance would have been much worse. Even though inflation is still well below the target level, current forecasts at least demonstrate that the numbers are moving in the right direction, though very slowly. Additionally, other institutions have a role to play here. The lack of conventional monetary policy space is related to the evolution of the natural rate of interest, and central banks can do very little about this. At the moment, there is extremely low inflation, but it will not always be so low. While some people have suggested that inflation could rise soon due to supply side constraints, this is not currently occurring. Current projections suggest that demand side factors are so strong that this will not happen any time soon. Of course, the supply side factors are indeed there, and it is not possible to exclude the return of inflation.

4.3 There should be sufficient flexibility in the way inflation targets are set

A Central Bank official suggested that a deflationary episode would be very low on their list of risks. The word 'deflation' is used too often in the context of a 1% inflation rate. 'Deflation' usually means 1930s style deflation, which is probably the only deflationary episode in history with negative spirals of postponed consumption and investment thereby exacerbating the downturn and lowering inflation even further. By far, most episodes of 'deflation' in history have been benign deflation.

A Central Bank official described how, for a central bank like the ECB, monetary policy always takes place in a global context. There seems to be an emerging consensus around the 2% inflation rate, which is a global standard for central banks. It is hard to argue, as an individual central bank, for a deviation from that standard. For example, any structural deviation will have costs in terms of exchange rate consequences.

Despite the neat convergence towards 2% in the ECB models, the Central Bank official prefers seeing inflation in data instead of models. There have been many predictions of rising inflation which did not materialise. This should make central bankers more modest about their ability to control inflation. The financial industry should acknowledge this limited degree of control: when it comes to inflation, there are relevant factors outside the realm of central banks. This demonstrates a need for sufficient flexibility in the way targets are set. In terms of the international dimension, the Central Bank official highlighted the fact that what is happening in Europe bears similarities with what has happened in Japan. In terms of demographic distribution, Europe lags behind Japan by roughly 15 years. This should make Europe more modest in terms of its ability to deliver 2.0% inflation in an environment with a structural savings glut, an ageing population and the maturation of much of the productive apparatus.

A Central Bank official agreed on the need for flexibility. Of course, there is already some flexibility. Depending on the side effects, it is possible to adjust the speed of the ECB's measures, which provides a degree of flexibility. There is a problem, of course. If Europe deviates from 2% for too long, there could be a de anchoring of inflation expectations.

4.4 Ultra loose monetary policy has not been able to control inflation

A Central Bank official stressed that there are forces putting downward pressure on inflation such as demographics and international trade. However, it is important to be modest and recognise that it is impossible to fine tune inflation with monetary policy. In terms of the 2% target, Europe is dealing with monetary policy as a single entity despite being composed of 19 different economies. There must be a single policy for the entire euro area, but the fact that different countries can be at different points in the cycle in terms of growth argues in favour of having a buffer in the inflation target.

A Central Bank official noted the lingering question of below target inflation, which is a challenge not strictly related to the COVID crisis. This has already been a challenge since 2014 2015. Despite the employment of a 'full arsenal' of monetary instruments, inflation seems to have anchored closer to 1% than 2%. There are different issues at play here such as supply side factors. When markets have stabilised, this will be the challenge. Europe will again have an output gap and an inflation gap, and any measures it takes will again have to prove themselves to be effective.

An industry representative suggested that, given Europe's track record of being generally stuck at around 1%, the most Europe can do is to move to the symmetric target of 2%. The embedded assumption in models and counterfactuals is that the inflation process is linked to the decline in the natural interest rate and the savings glut, but an alternative way to understand could be the debt overhang and the money glut. It is vital to consider the data, which shows that Europe has not been able to control the inflation process. Additionally, inflation has appeared in the prices of assets, which has produced tremendous harm and tremendous dislocations.

4.5 Financial stability should be considered when designing monetary policy

An industry representative agreed that Europe should consider financial stability when designing monetary policy, but this is easier said than done. There are two contradictory impulses here. First, one way to make over indebtedness more manageable is to overshoot the 2% target and use higher inflation to bring down the real value of the debt over time. Second, if inflation has been 1% for a very long time, it is possible to say that this is what the financial industry was seeking all along. The ECB's strategic review should consider this. A way of making this possible would be to tackle the bank sovereign loop. When Europe established the SSM, one of the objectives was to ensure the bank sovereign loop would be broken and this has not been achieved.

5. How will the development of a vaccine affect the markets?

A Central Bank official invited panellists to comment on what effect the development of a COVID 19 vaccine would have on the markets, noting that this might imply the end of stimulus from central banks. Another Central Bank official disagreed, suggesting that the single most decisive factor for future economic development will be the management of the health crisis.

A Central Bank official stated that the markets 'absolutely' would rally and there would be a general bout of optimism. The upside of a vaccine would clearly dominate the more moderate response that central bankers would take. Europe is in an environment of unprecedented uncertainty, but it is important to remember that uncertainty also sometimes works positively. An industry representative agreed that the market would go up. An industry representative offered a different view. Although a significant step forward, this is not a 'black and white' question. Multiple challenges would remain: the manufacturing of billions of doses; the cost of widespread distribution; ensuring availability to both developed and emerging markets; people's willingness (or lack thereof) to be inoculated; and the likelihood that efficacy will be less than 100%. An industry representative stressed the importance of managing expectations here. There is a considerable amount of pent up demand, so there could be substantial upside. However, news about a vaccine and its adoption will be changeable from positive to negative. There will be a bumpy road towards a strong recovery. ■