# NORMALISING MONETARY POLICY: WHEN AND HOW?

An industry representative stated that this is an appropriate time to think about the monetary policy mix and the present stance of monetary policies. Fiscal and monetary policies have played a major role in Europe to help to overcome the crisis. The pandemic is not over, but Europe is slowly getting out of it and confidence in the recovery is growing. The eurozone may not be 'out of the woods' yet, but it is very much on its way.

An industry representative added that inflation is back, as increased demand and supply bottlenecks have raised food, commodity and shipping costs. There are also risks of much more persistent pressures on inflation in the future.

The session discussed views of when the pandemic will be over, if the return of inflation is a temporary or lasting phenomenon, and what consequences for monetary policy this will have. An expert explained that central banks should move towards a monetary normalisation event if inflation remains low, in order to avoid a possible financial crisis.

## 1. Consequences of the end of the pandemic and the return of inflation on the normalisation of monetary policy

The panel began by discussing views of when the pandemic will be over and what consequences it should have on the policy mix in the euro area. The most important question is whether the current higher inflation rate is temporary or something that should be worried about over the longer term.

### 1.1 When the pandemic is over is a medical, economic, social, and political issue

An industry representative stated that the question around the pandemic ending is three questions rolled into one. It is a medical question, and it cannot be answered. Throughout the world and in the EU there are different patterns and waves in different countries, which are not synchronised. COVID may never end entirely, but could instead turn into something endemic, like Middle East Respiratory Syndrome (MERS). A second question is a public economic question. The pandemic ends when it cannot be seen in the economy. When looking at job creation, gross national product (GDP) and the Purchasing Managers' Index (PMI), if the effect of the pandemic cannot be seen except for the rebound then it is economically over. For society, the pandemic stops when society says it does.

In the first year of the pandemic, without vaccines or masks, France had 100,000 deaths from COVID-19. There are 600,000 deaths per year in France, and roughly 100,000 of those are due to air pollution, 100,000 are due to smoking, and 100,000 are due to alcohol consumption. From now on there will be 20,000 to 50,000 deaths from COVID every year and it will be a new normal.

### 1.2 Economically, it is time to exit from urgent COVID measures

A Central Bank official explained that there may be a fourth or fifth COVID-19 wave, but Europe has made a good progress with respect to vaccinations that only little impact on the economy is expected. The virus will be with Europe for years to come, but the economic implications have become very small. The latest projections which have just been published at the European Central Bank (ECB) show that the outlook for 2021 and 2022 is better than expected. By the end of this quarter Europe will have jointly reached the GDP level of 2019. Inflation is projected at well over 2%, and at 3% in some countries, although perhaps beginning to decline in 2022. It is important to think about moving out of the current urgency mechanism.

### 1.3 The return of inflation is not a surprise, but is it a lasting or transitory phenomenon?

An industry representative noted that a range of factors are currently pushing up inflation. The most important question is whether the current higher inflation rate is temporary or will be more persistent and therefore something that central banks should be worried about over the longer term.

#### *1.3.1 Arguments for the temporary nature of inflation*

An industry representative listed several arguments that supported the notion that higher inflation was transitory. There were base effects related to the decline in activity and prices in Q2 2020. A year later, the year-on-year numbers look very high, but it is partly a statistical artifact. Second, idiosyncratic factors such as used car prices and auto rental rates are having disproportionate effects. Those prices have moved, but they impact a relatively small number of people. Third, there are supply chain disruptions and shipping delays, which have prevented goods from getting from A to B. Those matters are expected to work themselves out as the pandemic recedes if it ends quickly. Finally, since the 2008 crisis, there have been many warnings that there would be higher inflation and all the money printing was going to result in inflation, or even hyperinflation. Those have all been proved wrong. Many view the current warnings as similarly overdone.

A Central Bank official stated that the euro area has learnt from the past decade that it should not move too early. It should move when it is sure that inflation is where the target is. Raising rates will have some repercussions, but it is no excuse not to move when inflation is close to its target. It is extremely important to point to the difference as to the ECB's monetary policy strategy and the Fed's strategy – ECB is not to compensate for past inflation shortfalls. Regarding the recent inflation dynamics, overall macro news is very good. There is growth, recovery has strengthened, and inflationary expectations are increasing. The current inflation dynamics forecast is 'hump shaped' and the current increase in inflation is largely transitory, i.e., it is not a binary thing that is either fully transitory or fully permanent. The ECB's latest inflation forecast for 2022 and 2023 is significantly lower than 2%, but it has been pushed up to 1.7% and 1.5% respectively.

A Central Bank official added that he is optimistic that inflation is going to be somewhat higher than the current forecast. It will not yet be at 2%, but it will be significantly above the current forecast. There are a number of factors possibly pushing up the forecast. The new strategy and guidance is very clear and much stronger than in the past, removing the past asymmetry due to "close to but below 2%". Supply chain bottleneck problems are likely to last longer, which will provide more time for these pressures to be built up and priced in. Wage negotiations is – there is some anecdotal evidence of growing pressures but has not yet been seen in data. Another important factor that might increase inflation by increasing demand is household savings behaviour. There has been a recent decrease in savings rates, but surveys show that households do not plan to tap into the savings that they have accumulated during the crisis. If the risk of COVID can be removed it is quite likely that people will start dipping into their accumulated savings as well. That is going to increase demand.

A Central Bank official summarised that inflation going forward is likely to be 'hump shaped'. Inflationary expectations are climbing up, with a very clear target of 2%. When these higher inflationary expectations will start to be priced into the wage negotiation, second round effects will root in and there will be a much more robust story for the inflation outlook.

#### *1.3.2 Arguments in favour of a lasting phenomenon*

An industry representative stressed that there are arguments against the transitory nature of the higher inflation rate. During the pandemic there has been a massive fiscal stimulus in the United States and elsewhere that increased income. That increase in income has increased demand so that the aggregate demand curve has increased at a time while the aggregate supply curve has stayed flat, or even decreased, because of the supply chain limitations. Demand for housing in the US is very strong, but there is a shortage of skilled labour and materials to build these houses to meet that demand. There is also a migration of inflationary forces into wages and compensation. In both skilled and unskilled labour there is a bidding up of compensation rates.

An industry representative summarised that the risk is that we observe a migration of one-off factors in prices into compensation, which then becomes a self-reinforcing process. The Fed is not in a hurry to dial back the amount of stimulus that it is putting into the system. In the past few years warnings of inflation have not materialized and that seems to have made the Fed hesitant to act pre-emptively. Over the last five years the worry has been that inflation has been too low rather than too high. The new approach, which it calls flexible average inflation targeting, is about getting the inflation rate above target to compensate for previous undershooting. Whereas previously central banks wanted to act before inflation began to rise, now they want to wait until after it has risen. This framework has a new set of risks,

#### *1.3.3 Inflation is likely to stay elevated*

An industry representative concluded by noting that in the near term it seems that inflation is likely to stay elevated. Measures of compensation are rising, suggesting that inflation pressures are not only a "goods" phenomenon. Markets will hope the Fed's outlook is correct, because there are a lot of long-duration assets that the market is holding, whether they are bonds or equities. If the Fed and other central banks have to tighten then these assets will be at risk. The risk is that the inflation process takes hold, and the central banks have to move much more aggressively later on.

### 1.4 The moment to wind down approaches

A Central Bank official underlined the importance of inflation estimates. At the moment, the increase in inflation looks like transitory. The macro models show that inflation will most likely go back below 2% in 2022 or 2023. The financial markets also show that inflation is not expected to increase. A recent poll in Austria amongst 1,000 individuals showed that inflation expectations are increasing from below 2% to above 2%.

Besides the macro modelling it is important to stay alert and to follow a cautious approach.

An industry representative agreed with much of what has been said, as nobody knows if the 'inflation genie' is out of the bottle or not. There are a lot of accumulated savings. Their company's life insurance business premium volume has increased by close to 50% this year, which has come from all the accumulated savings. There is a lot of 'dry powder' that can go into life insurance, but it can also go into consumption. One of the main markets to look at is the labour market. Labour costs are growing, and both unskilled and skilled wages are growing. Younger people hired to replace people going into retirement are better paid. If the collective choice is to address climate change and move towards more expensive energy sources such as renewables, that will feed inflation.

An industry representative concluded that the ECB needs to remember history, as it had one episode where it moved too early. However, to go back in history before the creation of the ECB, it is clear that US monetary authorities in the 1970s took a very long time to accept that inflation was here to stay, was taking hold and was entrenched. Inflation can be missed for quite a long time before a mandatory authority acts.

## 2. Central Banks should move towards a monetary normalisation event if inflation remains low to avoid a possible financial crisis

### 2.1 There must be awareness of the dangers of two low interest rates, on financial stability and on the accumulation of purely liquid savings, that deter from long-term, productive investment

An expert explained that monetary policy was already at an impasse before COVID-19 struck. The system had been swamped with liquidity through the highly accommodative monetary stance of the past decade, which pushed global debt to 355% of world GDP. Huge leverage has weakened the financial system and endangered stability. Consumer price inflation has remained subdued, but prices of financial assets and real estate have skyrocketed. The continuation of very low interest rates for a couple of more years would intensify already negative consequences for growth and employment. A huge boost in monetary policy has been enacted in order to address the COVID problems. Since the pandemic is reducing in Europe and elsewhere, it would seem logical to normalise monetary policy and significantly reduce the pandemic-related emergency purchase programme.

As far as inflation is concerned, the structural dampening factors at play over recent decades related to demography and globalisation could potentially keep inflation relatively moderate in the longer-term after the immediate bubble and inflationary forces. However, that does not mean that monetary policy should continue its accommodative stance. Care should be taken not to push leverage beyond its boundaries, and there must be awareness of the dangers of two low interest rates, on financial stability and on the accumulation of purely liquid savings, that deter from long-term, productive investment.

He added that structural causes of low inflation cannot be adequately addressed by conjunctural creation of liquidity. Structural deficiencies call for structural measures, not for systematic money creation. House prices are increasing because of a strong demand for houses and because very low interest rates are now granted for people who want to buy a house on credit. More monetary policy facilities will not solve the housing supply problem; they will only increase house prices, which is what is currently happening.

He concluded that it is important to realise the dangers of continuing the present monetary stance without looking at the conditions of supply. Society is living in a world of extremely high leverage, which is always a cause of future financial crisis. Lasting low or negative interest rates are deterring long-term investment, which has declined over the last 20 years in a dramatic fashion.

### 2.2 The normalisation process should be sufficiently gradual to avoid motor market tensions

An expert stated that the normalisation process should be sufficiently gradual to avoid market tensions. It should be firm enough and its orientation should be understood by the markets. This normalisation must be as a result of collaboration between central banks. To avoid exchange rate 'beggar thy neighbour' practices as well as trade and currency war and protectionism, there needs to be a common understanding of what monetary policy should be. A common misconception is that fiscal policy should be privileged and should take the lead while monetary policy is normalising and abating. Fiscal policies have been slipping in the most advanced countries for the last three or four decades to a point that is indescribable. A normalisation of both monetary and fiscal policy is needed.

He noted that continuing to live under the illusion that fiscal stimulus can replace monetary stimulus will lead to two negative results. The first will be fiscal dominance. If more fiscal stimulus is done it cannot be done with high interest rates, so the central bank needs to keep interest rates low. Secondly, a fiscal crisis will come onto the horizon because that is what excessive leverage always leads to. Extremely extended debt calls for low interest rates because, if interest rates are high, the indebted parties cannot pay, but low interest rates are not compatible with monetary normalisation. The world needs more public and private productive investment in order to improve productivity and potential growth on the supply side.

### 2.3 Ultra-loose monetary policy and a delayed withdrawal of monetary policy accommodation carry risks

A Central Bank official stated that it is necessary to make sure that monetary policy does not interfere with the issues that an expert has outlined before. It is important not to misuse instruments in order to make sure that inflation stays in place. Central banks will have difficulties to normalise monetary policy if the equilibrium interest rate stays as low as it is now. Central banks could promote an economic situation – with their monetary policy and responsibility for financial stability – with a new wave of social entrepreneurism and new enterprises entering the market, which could drive productivity in areas such as climate and digitalisation.

### 2.4 Structural problems need to be addressed by structural policies

A Central Bank official agreed with many points that an expert made. Normalisation will happen, inflation permitting. One must distinguish between (i) pandemic emergency support and (ii) monetary stance vis-à-vis medium to longer-term inflation. The pandemic emergency purchase programme (PEPP) is a measure designed specifically to deal with COVID-19. PEPP should end with pandemic fading. ECB's quantitative easing (QE) will not end with the end of the PEPP, which is why it is very important to draw the difference between the discussions at the Fed and the ECB.

A Central Bank official added that the strategy review that has just been published clearly states 2% symmetric inflation over the medium term, as well as taking forceful and persistent action when necessary. Every decision will be taken while considering proportionality. Negative side effects will also be assessed. The monetary policy mix and set of instruments can only be effective if monetary policy is politically independent of fiscal policy. That is one of the reasons why fiscal dominance should not be allowed. The ECB will do everything necessary to avoid fiscal dominance. Normalisation will be done, and it will be done very cautiously. Clear and timely communication is very important. Monetary policy should not be overstretched, as it cannot solve structural problems.

An industry representative summarised that recovery from the pandemic is well underway. It is unclear how inflation will play out, so central banks have to be vigilant, careful, and not act too early or too late. Regarding normalisation, everybody wants to keep flexible. Everybody has the clear goal of avoiding fiscal dominance. Normalisation is needed, and strategies that may force excessive monetary reactions somewhere down the road should be avoided.