ECB's new challenges

Presentation July 19th 2022

I. Introduction

I want to organize my presentation into 4 sections. The first two sections deal with more long term and background issues, namely the unprecedented macroeconomic uncertainty hitting the €-area and the doubts about the precision of inflation control by the central bank. The last two sections will deal with more topical issues, what are the prospects of monetary tightening in the €-area and the risk of problems with its periphery.

II. Unprecedented macroeconomic uncertainty

With a colleague at Bruegel, Monika Grzegorczyk, we have recently written a paper, published by Bruegel, in which we document that currently, under the double hit of COVID and Ukraine, macroeconomic uncertainty is higher than it has ever been since the launch of the €.

Figure 1: Changes in the ECB, IMF and SPF forecasts averaged over the different time horizons (inflation and GDP growth, percentage points difference)

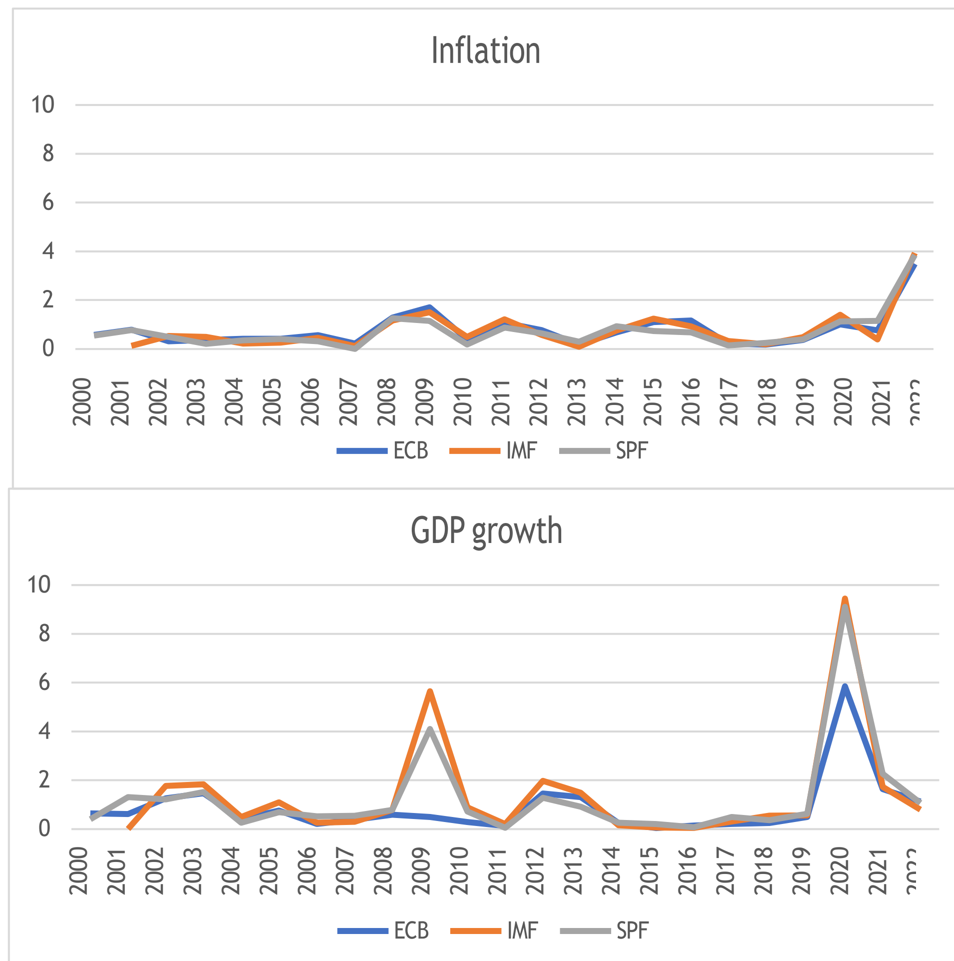


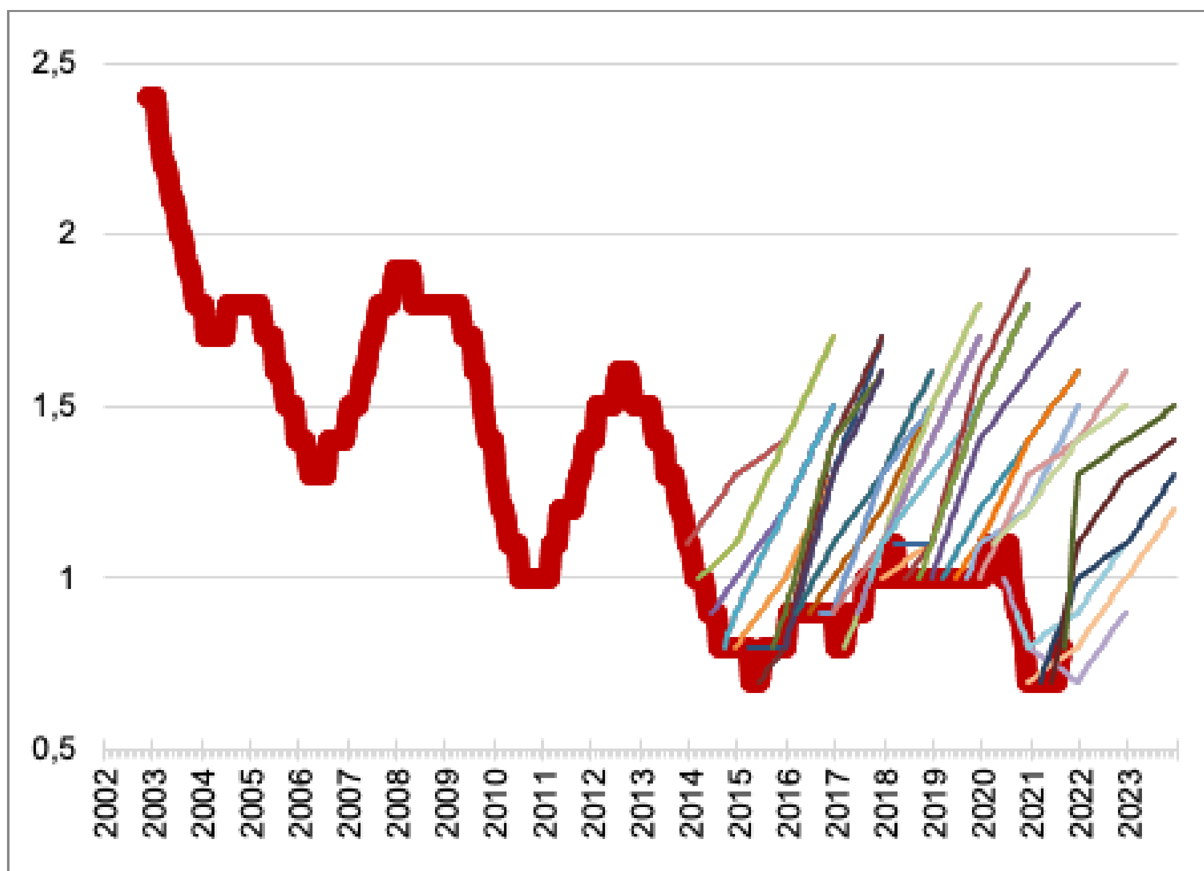
Figure 1 shows how the IMF, the ECB and Professional forecasters have changed their forecasts of inflation and real growth for a given year. This is a measure of uncertainty,

assuming that forecasts at a given point of time are a transformation of then current economic conditions and thus changes in forecasts mean changes in economic conditions. The further step is that the more intense the changes are the more uncertainty there is in the economy. Indeed, you see that in 2020 for growth and in 2022 for inflation, uncertainty is higher than in any previous period, including being about twice as high as during the Great Financial Crisis. This result is confirmed by looking at forecast errors of the three institutions as well as the dispersion of forecasts among professional forecasters. So, while it is something of a cliché to lament extraordinary uncertainty, this is justified now: the ECB is conducting monetary policy in extremely uncertain conditions.

III. Against the background of faulty inflation control

Unfortunately, this exceptional uncertainty is prevailing at a time when we have cumulated doubts about the precision of inflation control by central banks, including the ECB.

Figure 2 Inflation and ECB inflationary projections. 2002-2022.



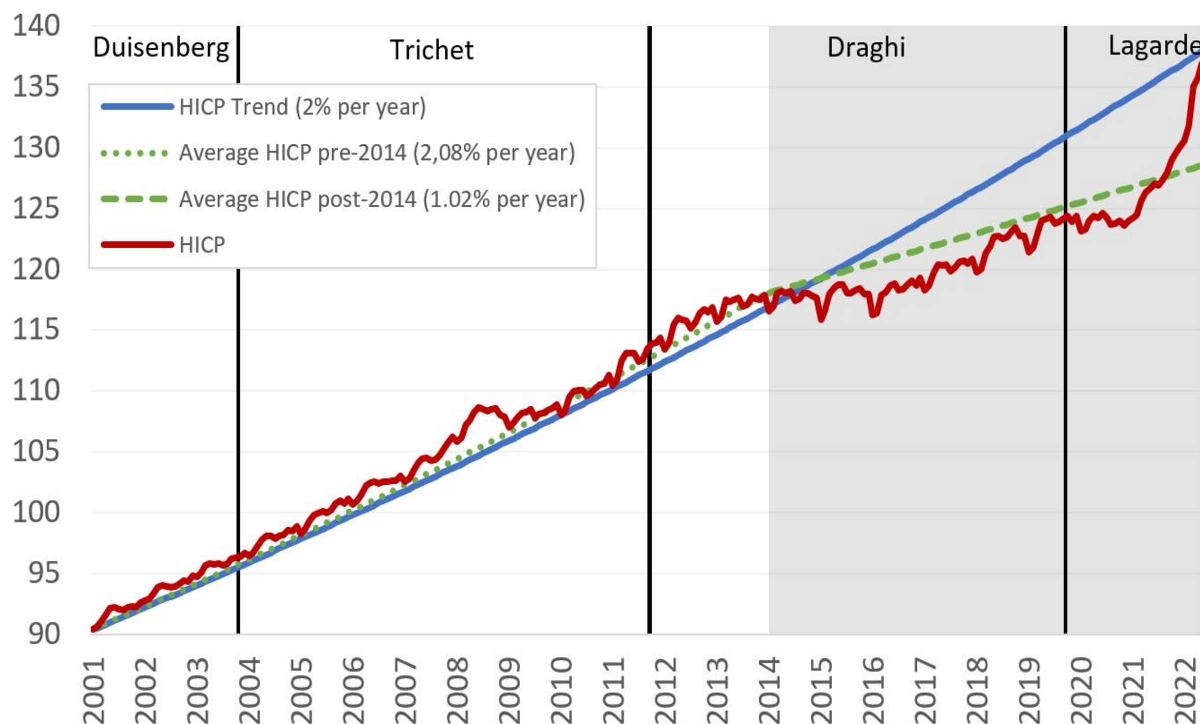
Source: Zsolt Darvas, Z. (2018). Forecast errors and Monetary Policy Normalisation in the Euro Area, Bruegel Policy Contribution, Issue nº 24, December.https://www.bruegel.org/2018/12/forecast-errors-and-monetary-policy-normalisation-in-the-euro-area/.

The figure shows actual inflation, in the thick line, and ECB inflation projections, in the thin lines that depart from it. The inevitable conclusion from the figure is that not only the ECB for a very long period could not reach its objective of 2% (the red line was below the target), but also that it systematically overestimated inflation (thin lines), projecting that it would move towards its objective.

In sum, the ECB systematically overestimated the "potency" of its policy to reach its inflation objective.

The problem of lack of precision in the control of inflation is further illustrated by the following figure with the price level in the €-area since its founding in 1999.

Figure 3. Consumer price level, 2% trend increase of the price level. 1999-2022



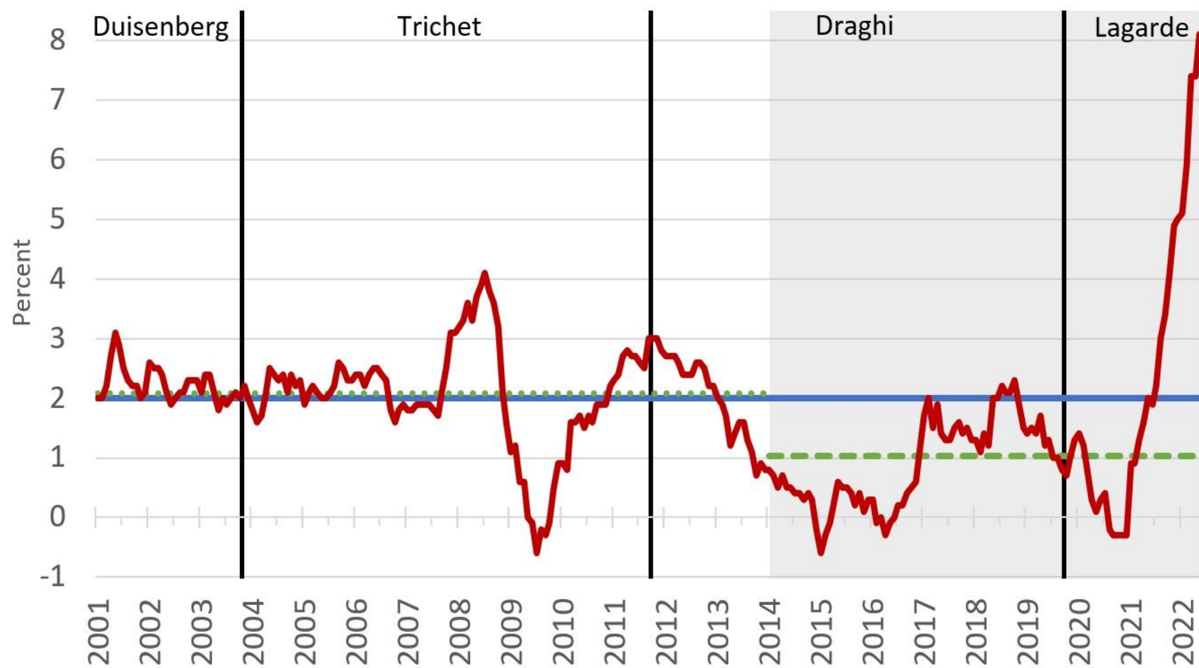
Source: Eurostat.

In the figure you see what the price level should have done if it had grown at a constant 2% (blue line), what it did on average between 1999 and 2014 (green dotted line) what it has done on average since 2014 (green broken line) and what it has actually done (orange line). Comparing the different lines, you see that, while inflation was close to target between 1999 and 2014, it was too low for the subsequent 7 years and then much too high now. So, you should conclude that for 8 years, i.e. more than one third of its existence, the ECB was incapable of reaching its 2% objective, remaining for many years short of it and recently much above it.

Inevitably, a naïve observer would say that the ECB has been much more successful in the first, non-shaded period in the figure, ending around the beginning of 2014, than in the following period, in which inflation was either too low or too high.

Partitioning the life of the ECB so far along the tenure of its 4 presidents, as in figure 2 below, would lead the naïve observer to assess that the first two presidents were more successful than the second two.

Figure 4. Rate of consumer inflation during the tenure of the first four ECB Presidents



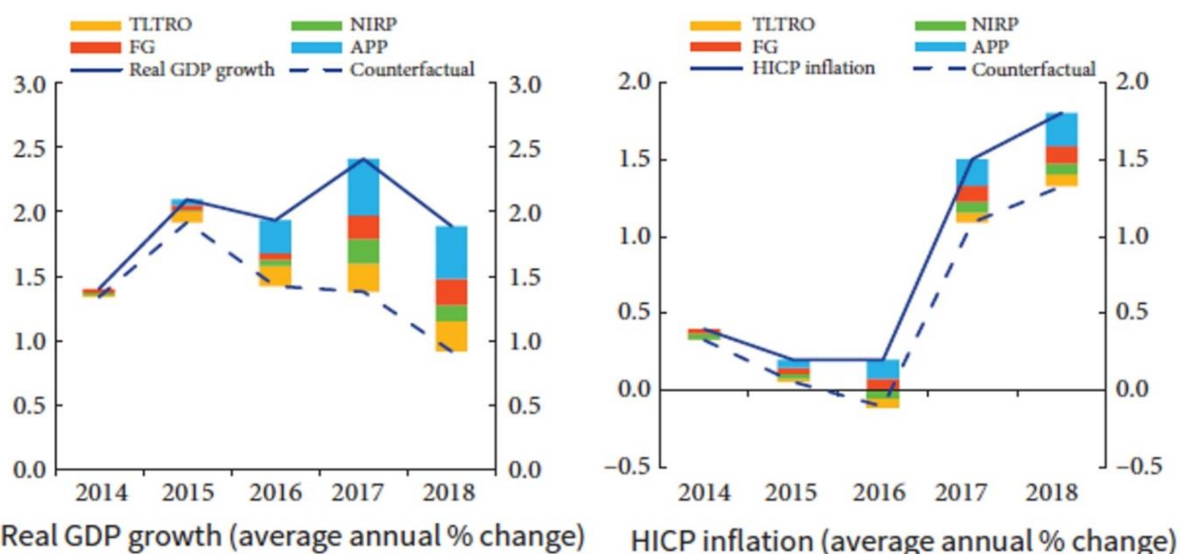
Source: Eurostat.

But the point about uncertainty mentioned above is relevant here: uncertainty has, overall, been much lower in the years before the Great Financial Crisis and it is not surprising that inflation control was more precise.

Of course, one possible conclusion from the evidence considered so far is that the ECB did not try hard enough to achieve its objective, especially during the long years in which inflation was below the objective. This is not correct. The ECB displayed a forceful monetary policy, innovating in its panoply of instruments and using them to a very large extent, just think of the enormous amount of securities it bought and the negative interest rates, as shown by Rostagno and others (Monetary Policy in Times of Crisis: A Tale of Two Decades of the European Central Bank. OUP 2021).

Yet the results were modest, as documented in figure 5 taken from that book.

Figure 5. Cumulated effect of unconventional monetary policy. (2014-2018)



Actual real GDP growth and HICP inflation, and counterfactual paths in absence of ECB's non-standard measures

Source: ECB Calculations. Notes: The distance between the actual data (solid line) and the counterfactual path in absence of ECB's policy measures is the estimated impact of those measures (dashed line). The impact is disaggregated into the contribution of the individual measures (coloured bars). The results are based on a BVAR.

There is clearly a dispiriting bang for the buck: critically, on the inflation issue, the forceful policies for 5 years have raised inflation by 30 bps, precious but not enough to reach 2.00%.

Let me be clear: I am not criticizing the ECB. I think it has done what it needed to do, all through its 23 years of existence. Of course, one can criticize one or the other decision or its timing, but overall, it has proved a competent, courageous, well directed and well-staffed institution. The problem I see is more profound and has to do with the ability of central banks, in the EU but also globally, to really control inflation as precisely as we thought they could before the Great Financial Recession.

Given this lingering doubt, it is with a degree of skepticism that I regard the prevailing view that the economy, in the EU but also in other advanced economies, will return to the 2-2 paradigm, 2 for growth and 2 for inflation, as documented in table 1.

Table 1: Medium term scenarios, growth and inflation for the euro area

	Growth		Inflation	
	2021	2022	2021	2022
	December	April	December	April
			Core inflation	
IMF	2022: 4.2%	2022: 2.8%	2022: 2.5%	2022: 5.8%
	2023: 2.0%	2023: 2.4%	2023: 2.2%	2023: 2.9%
		2024: 2.1%		2024: 2.0%
	December	June	December	June
ECB	2022: 4.6%	2022: 2.8%	2022: 1.7%	2022: 6.8%
	2023: 2.1%	2023: 2.1%	2023: 1.5%	2023: 3.5%
		2024: 2.1%		2024: 2.1%
	December	April	December	April
			HICP	HICP
			2022: 2.7%	2022: 7.0%
OECD	2022: 4.3%	2022: 2.6%		2023: 4.5%
	2023: 2.1%	2023: 1.6%	Core inflation	Core inflation
		2024: 1.5%	2022: 1.5%	2022: 3.8%
				2023: 2.4%
	December	April	December	April
Goldman Sachs	2022: 4.4%	2022: 2.5%	2022: 2.0%	2022: 6.8%
	2023: 2.4%	2023: 2.0%	2023: 1.3%	2023: 2.5%
	2024: 1.6%	2024: 1.6%	2024: 1.4%	2024: 2.2%
	December	April	December	April
			2022: 2.0%	2022: 7.1%
CITI	2022: 3.9%	2022: 2.3%	2023: 1.3%	2023: 3.4%
	2023: 2.4%	2023: 1.8%	2024: 1.4%	2024: 2.4%
				2025: 2.1%

Source: Bruegel based on Bloomberg.

Table 1 updates the table in Grzegorczyk et al (2021), which showed a convergence of forecasts towards a return to the pre-COVID-19 pattern. Table 1 seems to confirm this, showing an expected return to normal both for inflation and growth between 2023 and 2024.

This is somewhat surprising considering that the de-globalisation, or reshoring, phenomenon, which COVID-19 and then the Ukraine war is causing, is often assumed to reduce productivity, and hence growth, on a persistent basis. The forecasts for 2023 and 2024 in the table conform instead with a pattern according to which the economy is hit by a shock that gradually dissipates and returns to the equilibrium prevailing before the crisis. This is possible but is contrary to the fear that the two crises will leave persistent scars on the economy.

The same type of expectation prevails for inflation, with forecasts for 2024-2025, pretty close to 2.00%.

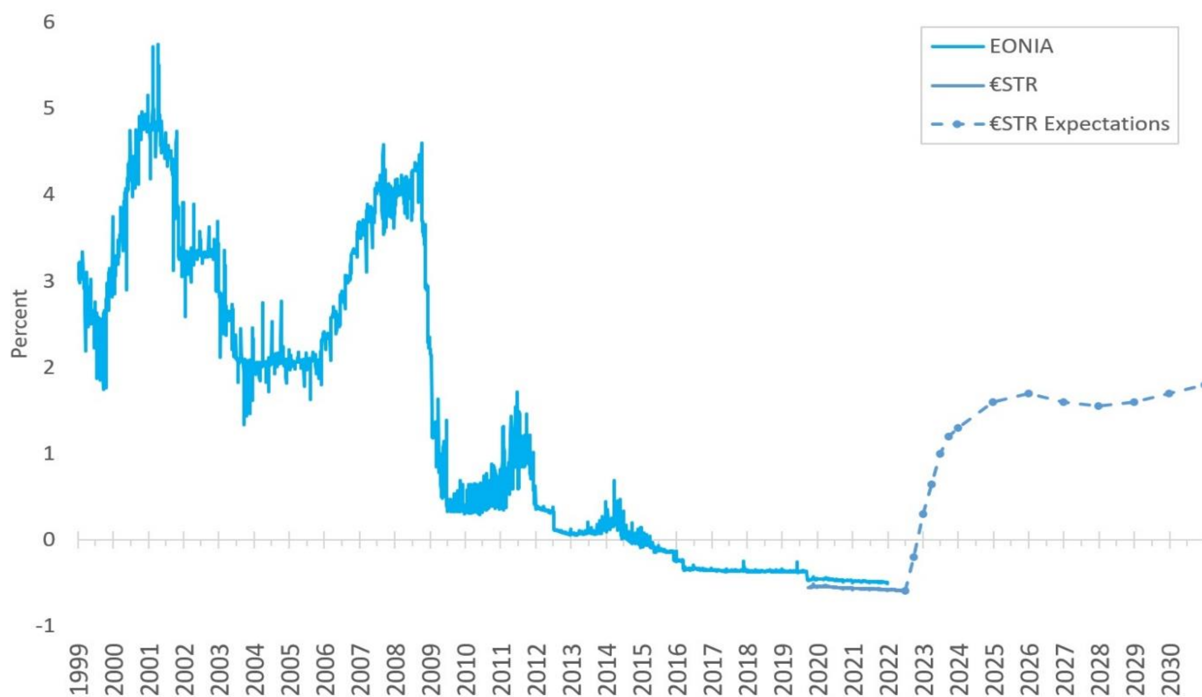
The forecasts in Table 1, however, do not illustrate sufficiently the conditions on which the euro-area economy is forecast to converge. What is missing is the fact that, confronted with exceptional uncertainty, forecasters have moved to a methodology in which, instead of a central forecast, different scenarios are produced, without specifying their probability.

The ECB introduced a systematic release of scenarios in March 2020.

However, also looking at the different scenarios, forecasts still gravitate towards the pattern prevailing before the COVID-19-Ukraine crisis, with both inflation and growth at around 2% over the medium-term horizon.

IV. Monetary tightening to regain price stability

Figure 6. Overnight interest rate in the €-area



Source: ECB Statistical Data Warehouse and OECD Database

Figure 6 shows the recent path of the overnight rate in the € area as well as its expectation going forward. The overnight rate should reach close to 1.3 % around the end of 2023 and 1.6 at the end of 2024, moving further in the following years towards 2.0%, without quite reaching it. These kinds of level could be reached with the sequence of increases in table 2.

Table 2. Possible sequence of ECB rate increases

Date	bp increase
July 2022	25
September 2022	50
October 2022	25
December 2022	25
2023	50
2024	25

I doubt this sequence of rate increases will be enough to get back to the ECB objective of 2% for inflation in 2024. My doubt rests on two reasons:

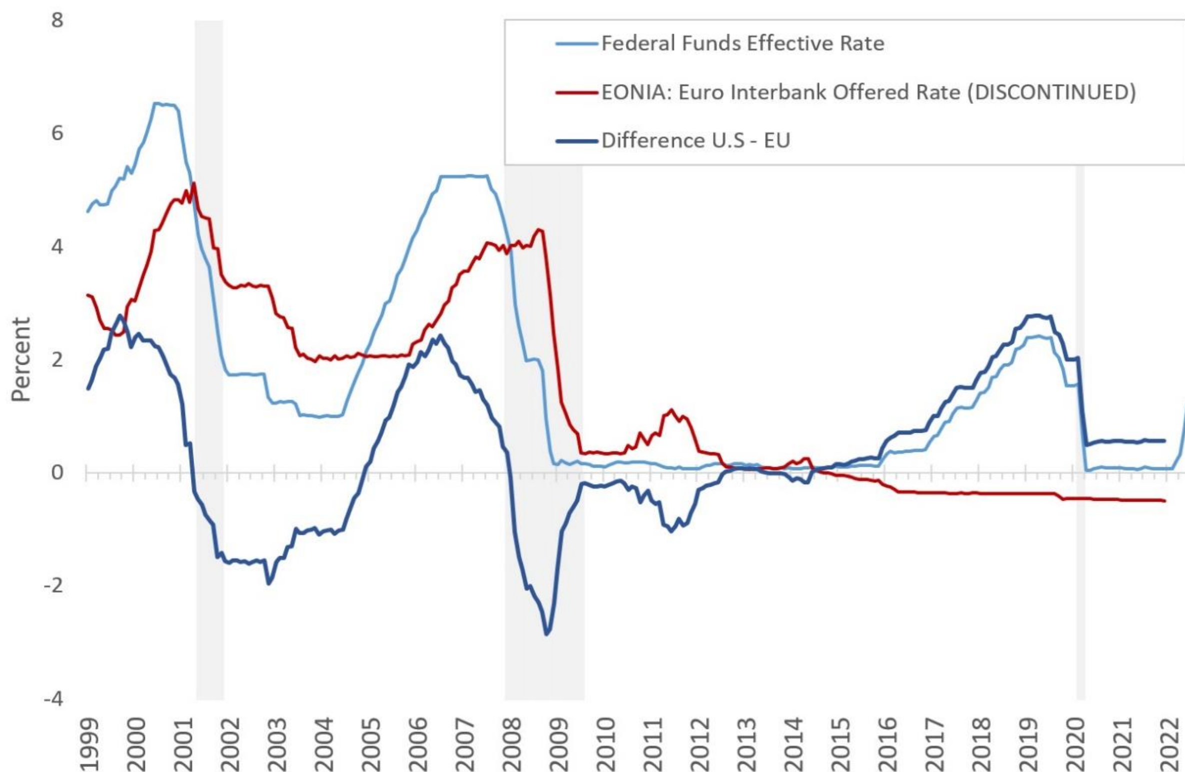
First, interest rates are expected, according to the FOMC dot plot, to be quite higher in the US, as in table 3.

Table 3. Expected interest rates in the FED dot plot

Date	EFFR level
End 2022	3.4
End 2023	3.7
End 2024	3.4
Longer term	2.5

This would imply a difference of 1.5-2.00% between interest rates in the US and the €-area, which is possible, but unusual, as it can be seen in figure 7, especially for a sustained period of time.

Figure 7. Overnight interest rates in the US and the €-area.



Source: FRED Dataset: FED Board of Governors and ECB

Second, a terminal level of 2% for the interest rate, with both inflation and growth stable at 2%, would mean that the Wicksellian real natural rate remains extremely low (around 0), thus the secular stagnation hypothesis should continue to prevail. This could be, but if we think we

lived over the last years in an exceptional situation, there is no special reason for it to continue. Recent statements by central bank presidents of the US, the €-area and the UK hint at a basically new macroeconomic configuration going forward, especially as regards inflation. This new situation is, in my view, difficult to reconcile with an interest rate settling below 2% in the €-area.

Of course, I do not know what the level of rates in the €-area will be. I recognize the big uncertainty, which has affected interest rate expectations recently, about a possible recession which would affect both inflation and monetary policy. And the cause of the recession could be a total gas embargo by Russia, which could have dramatic effects in the EU and, in particular, in Germany and Italy. While recognizing these big uncertainties, I would not be surprised if rates were higher going forward than built in the OIS curve, consistent with the increases sequenced in table 2.

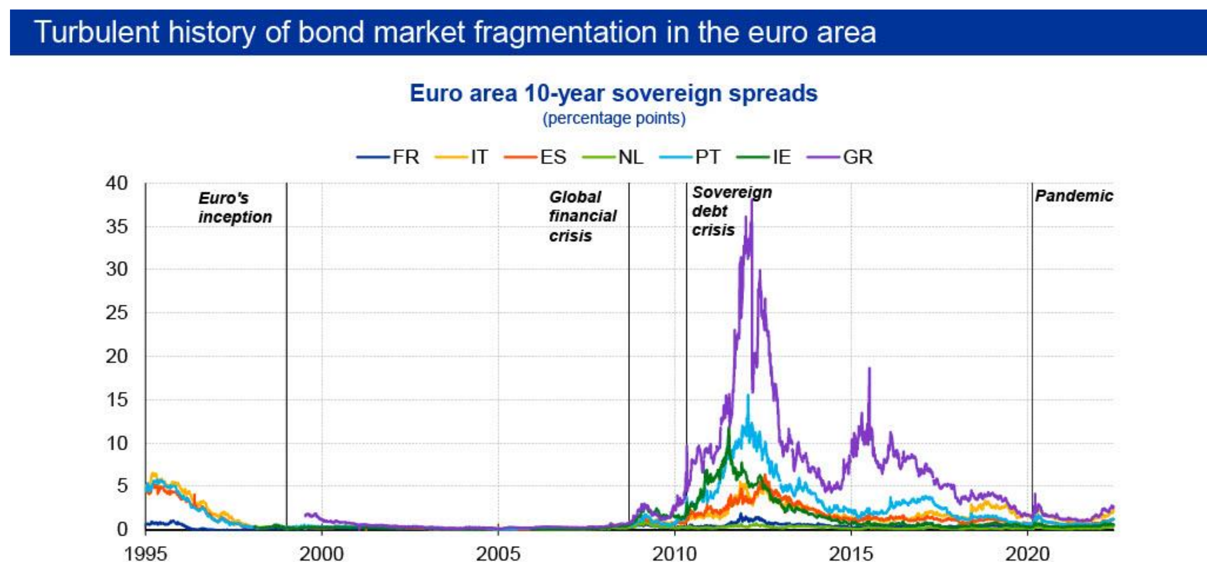
Let me anticipate a point about the periphery, on which I will expand in a moment. Heavily indebted countries should, in my view, be the strongest supporters of decisive action to control inflation: this would allow enjoying the reduction of the real burden of debt caused by a jump in the price level without paying for a persistent higher cost of debt brought about by persistent inflation

V. Problems with the periphery of the €-area

Let me first give you my understanding of why the ECB, about one week after its normal Governing Council meeting in June had to call an exceptional one to react to increasing spreads on peripheral bonds and committed to communicate about the transmission protection mechanism I n two days time.

The issue was not the level of the spread, as this figure drawn by a presentation of Isabel Schnabel shows.

Figure 8. 10-year sovereign spread.



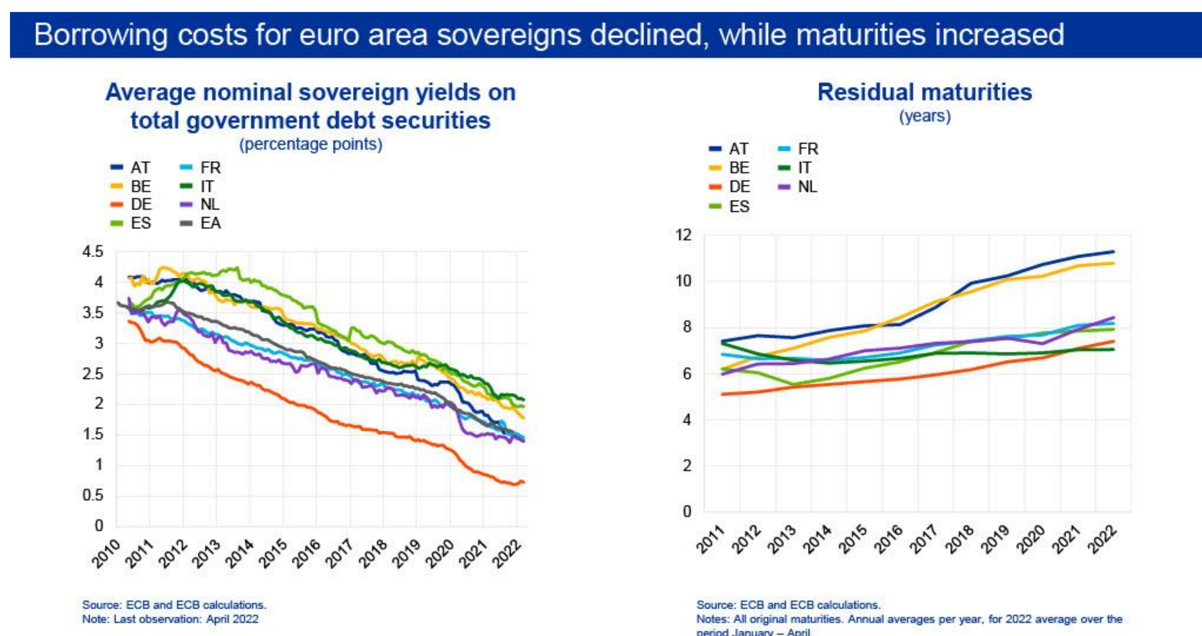
Source: Schnabel, United in Diversity – Challenges for monetary policy in a currency union. June 14th 2022. Haver. Notes: 10-years sovereign bond yields over 10-years German Bund. The vertical lines mark the beginning of each phase. Latest observation: 10 June 2022.

Current levels are not exceptionally high in historical perspectives, even excluding the extreme levels of the Greek spread during the €-area crisis. The issue was more one of speed of increase of the spreads and the desire to break their dynamic before it went out of hand: kill it in the bud, as Lagarde said at the European Parliament.

The point is reinforced by looking at this other figure showing the effective cost of debt, which is for most countries about a half of what it was some 10 years ago, while maturities have substantially lengthened.

For those who remember their microeconomics, it could be useful to define the cost in the left panel as average cost of debt, while the day-to-day yield on government securities can be defined as marginal cost, which affects the average cost depending on the debt maturity. The maturity, as seen in the right panel of figure 9, has substantially gone up in the last decade, making the average cost of debt less sensitive to the marginal cost.

Figure 9. Borrowing costs and maturities of selected government bonds.

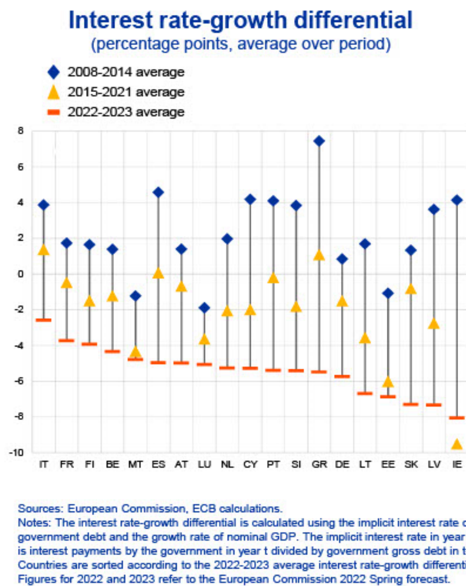


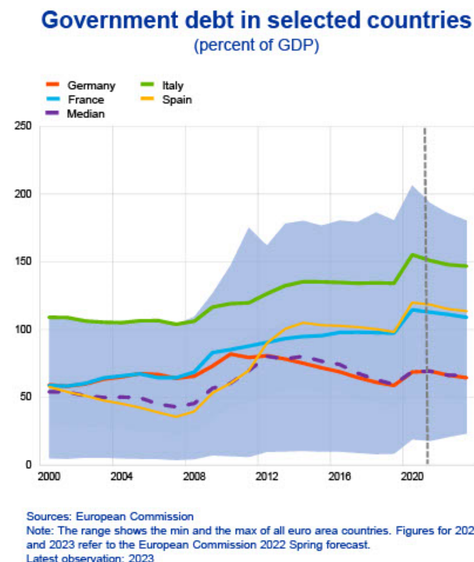
Source: Schnabel, United in Diversity – Challenges for monetary policy in a currency union. June 14th 2022.

Let me further reinforce my argument with yet another figure, also taken from the Schnabel speech, on the effect of the rate-growth differential on the debt to GDP ratio.

Figure 10. Interest rate growth differential and debt/GDP ratio.

Given favourable interest rate-growth differentials, public debt ratios likely to decline





Source: Schnabel, United in Diversity – Challenges for monetary policy in a currency union. June 14th 2022.

In all countries the differential is favourable, meaning that also with a zero primary deficit the debt/GDP ratio goes down. And the positive effect on the debt/GDP ratio can be reinforced by a primary surplus. For instance, Italy ran primary surpluses of 1-2% in 2011-2019. But Italy's situation remains delicate, already in the panel on the left you see that it has the smallest margin between the average cost of debt (interest rate) and GDP nominal growth, on which more below.

We will know in two days which form the ECB's anti-fragmentation tool (the so called Transmission Protection Mechanism) will take. Let me give you my expectations in this regard.

Before using any anti-fragmentation tool, the ECB will want to use the room given by the maturing bonds under the PEPP, which they said they want to reinvest until the end of 2024. These are estimated at around 200 bn by Claeys over the next 12 months and the ECB has said that it wants to use this room freely as regards time, asset classes and jurisdictions.

I am not sure what time flexibility precisely means. Could the ECB say that, given they expect maturing bonds over the next 12 months for 200 billion, they could purchase freely within that envelope, even before the bonds mature? If that was the case the flexibility would indeed be very large. Alternatively, it could just mean that they don't need to reinvest as soon as a bond matures, but could let some purchasing space accumulate, to be used when needed. I am genuinely uncertain about this, even if the first interpretation looks less likely to me.

I have no doubt, instead, that, building on the experience of the SMP, the OMT, the APP and the PEPP, the ECB services, mandated to come up with an anti-fragmentation tool, will design an operationally effective tool. This would resemble more the OMT and the SMP than the APP and the PEPP, especially because assorted with more flexibility as regards the jurisdictions into which to buy. I don't think the new tool will have a predetermined envelope, but rather be open and used when needed and concentrated on the countries where the risk of fragmentation (spreads) is higher. Recent press information about the division of the €-area countries in 3 groups, depending on their need/ability to help, goes into this same direction. As a very

personal note as Italian, I am somewhat frustrated that, once more, Italy will likely be in the group needing help instead of in the group able to offer help. This has happened much too often during my professional life.

A trickier issue is conditionality. I exclude that the ECB, both for substantive and legal reasons, may have a tool without conditionality. On the other hand, the OMT`s heavy conditionality (an ESM program), under whatever guise, would not be appropriate for a situation that would not be as serious as one requiring the use of the OMT. The obvious candidate for conditionality would be the engagements taken by countries in the National Recovery and Resilience Plans of the Recovery and Resilience Facility (Next Generation EU), including those related to the European Semester[1]. This is currently respected, so the conditionality could limit itself to the respect of it going forward. As I will tell you this condition may be less innocent for Italy than for some other countries.

Recently there has been talk about liquidity sterilization of the purchases under the new tool. Let me say clearly that I regard this issue, from a substantive point of view, as close to irrelevant. There is so much liquidity into the system, now and going forward, that a few hundred billion more or less would not make a significant difference: in any case the weight of existing liquidity will keep the overnight rate close to the floor of the interest rate corridor, thus maintaining the rate on the deposit facility as the most important one. From a presentation point of view, however, the liquidity created under the new program could be reabsorbed to stress the point that its effects on the overall stance of monetary policy are offset. This is what was indeed decided under the “separation principle” when the SMP was implemented. Sterilization could also help reassure that the new tool is consistent with the ECB statute and thus make it stronger from a legal point of view.

One possibility to sterilize the liquidity created under the new tool is that the APP reinvestments, and in particular those in public bonds, estimated at 242 bn for the next 12 months, would be reduced to make room, without increasing liquidity, for purchases under the new tool. This should not be difficult since the ECB did not take a firm engagement of the date until when to carry out reinvestment of the maturing bonds.

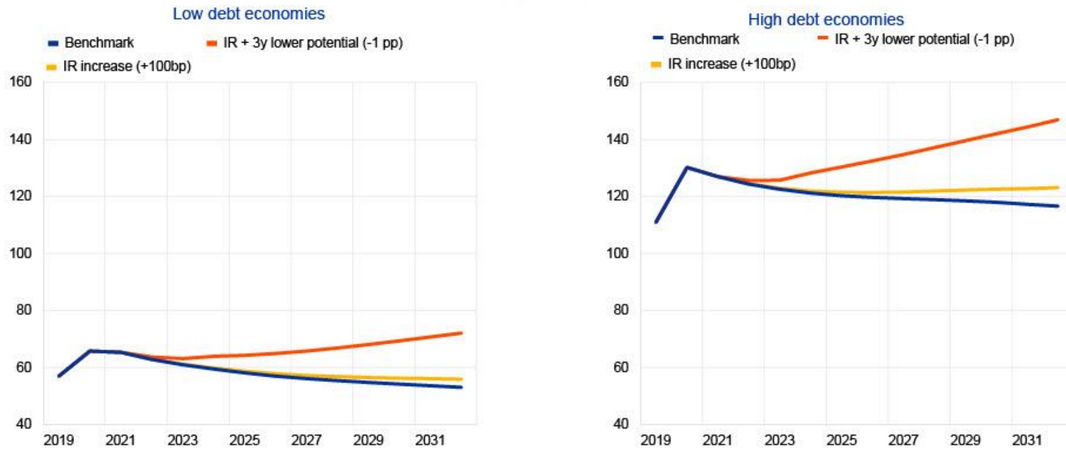
Another possibility would be to issue term deposits, open to banks, with one week maturity, as it was done when conducting the SMP.

As a final point about the possible anti-fragmentation tool, let me say that I see full complementarity between it and the tightening of monetary policy by means of rate increases. The latter serve to control inflation raising the general rate level, which basically correspond to German yields and OIS, while avoiding a disproportionate increase in peripheral countries, as it happened during the European phase of the financial crisis.

The most important point I want to make about the debt sustainability of peripheral countries is that growth is the critical variable. And assuring debt sustainability is a necessary condition to keep the cost of credit in these countries close to that chosen by the ECB as consistent with price stability. This point is graphically made in another figure drawn from Schnabel’s presentation, reproduced as figure 11.

Figure 11 growth and interest rate changes on gross financing needs.

1 For Italy, e.g. Council recommendation on the 2022 National Reform Programme of Italy and delivering a Council opinion on the 20°22 stability Programme for Italy.



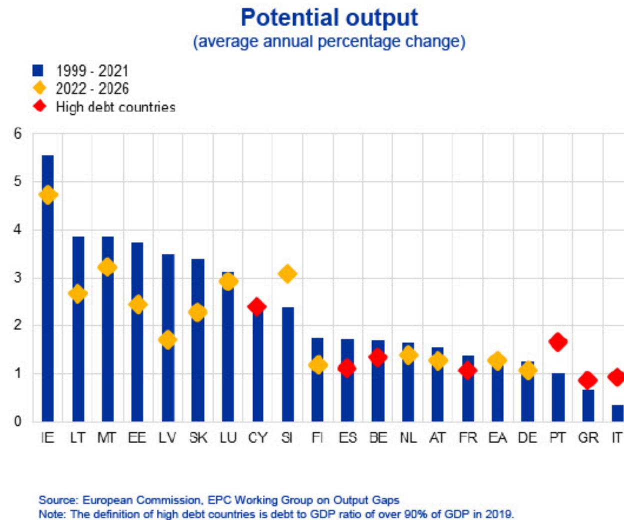
Source: Schnabel, United in Diversity – Challenges for monetary policy in a currency union. June 14th 2022.

The figure shows that the negative effect of a 1.0% interest rate increase is much less damaging to debt sustainability than 1.0%. lower potential growth. On the optimistic side of the medal, this means that increasing growth is more important than keeping interest rates low. This conclusion goes against the quasi-exclusive emphasis that is put on ECB purchases for the spread of individual countries, stressing again that the first line of defense against disproportionate spreads is sustainable growth, in addition of course to sound fiscal policies.

There is some, admittedly tentative, evidence in figure 7 that peripheral countries (in particular PT, GR and IT) with high debt and low growth, where the two are of course interconnected, can have, going forward, somewhat higher growth. This is expected to be brought about also by the reforms to which countries have committed under the National Recovery and Resilience Plans of Recovery and Resilience Facility (Next Generation EU).

Figure 12 Potential output growth.

Potential growth outlook above historical average for some high-debt countries



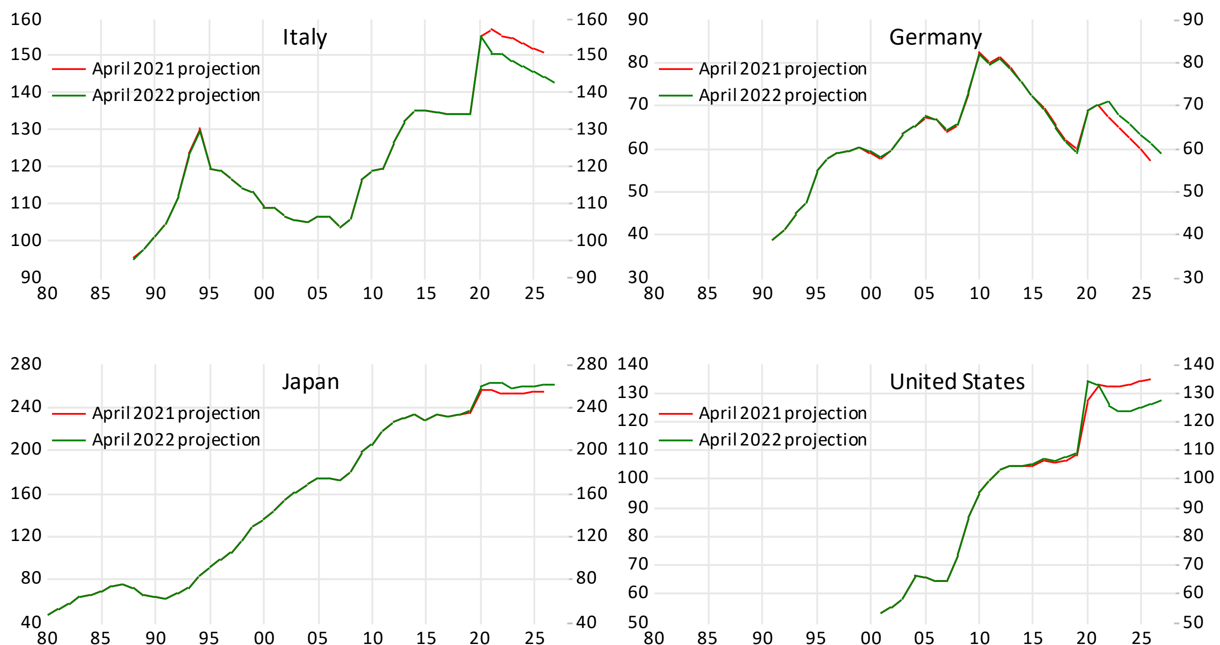
8

Source: Schnabel, United in Diversity – Challenges for monetary policy in a currency union. June 14th 2022.

All these favourable considerations do not mean that the situation of peripheral countries is without concerns. The situation is particularly delicate in Italy. I think Spain has lower debt and quite satisfactory growth. Portugal is increasing its growth and has a stable political situation. A stable political situation is also likely prevailing in Greece and the debt situation is made much more sustainable there by the extremely long duration and low cost of its debt. Unfortunately, my beloved country has high debt, still low growth and a political rendez-vous in the spring of 2023 that could bring bad news. This pessimistic note has been aggravated by recent political tremors, putting in doubt the continuation of the Draghi government.

I believe that Italian debt is sustainable, that the most likely development is that it will decrease, as in Figure 8, drawn from a blog just published on the Bruegel website by my colleague Zsolt Darvas.

Figure 13. Gross public debt to GDP ratio, comparing the April 2022 and April 2021 IMF World Economic Outlook projections (% of GDP)



Source Zsolt Darvas:

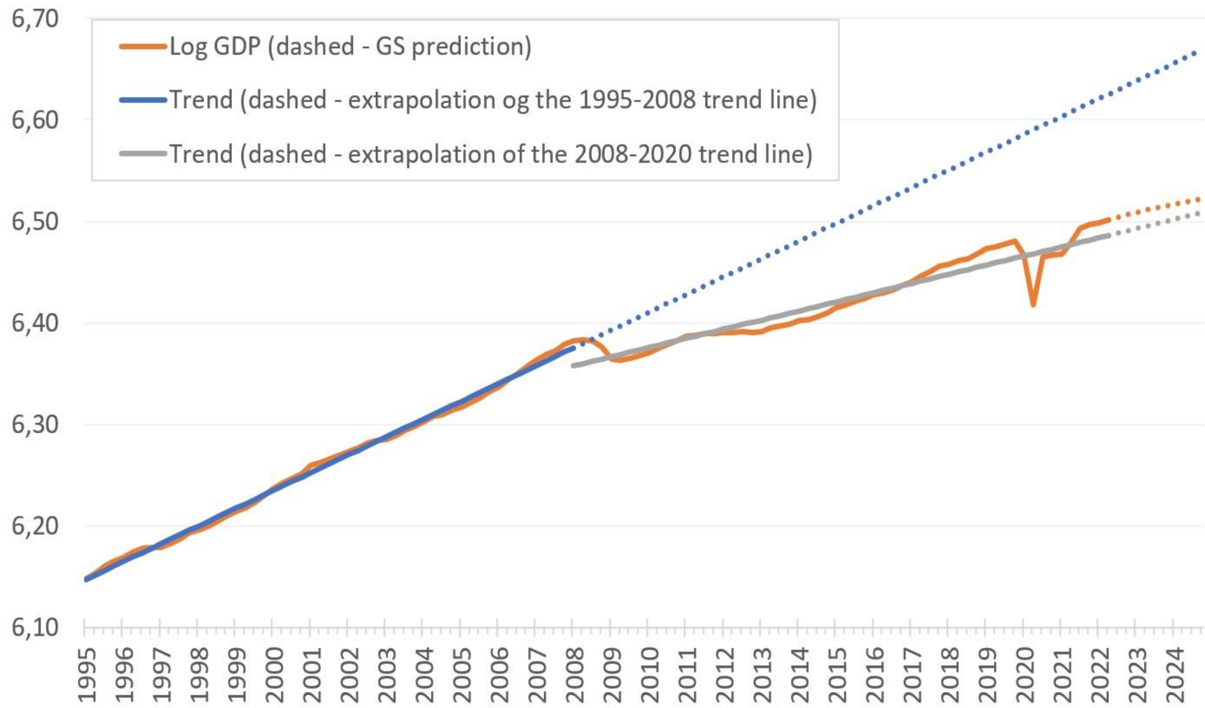
I cannot exclude, however, that a new government could embark into policies that could put in doubt debt sustainability.

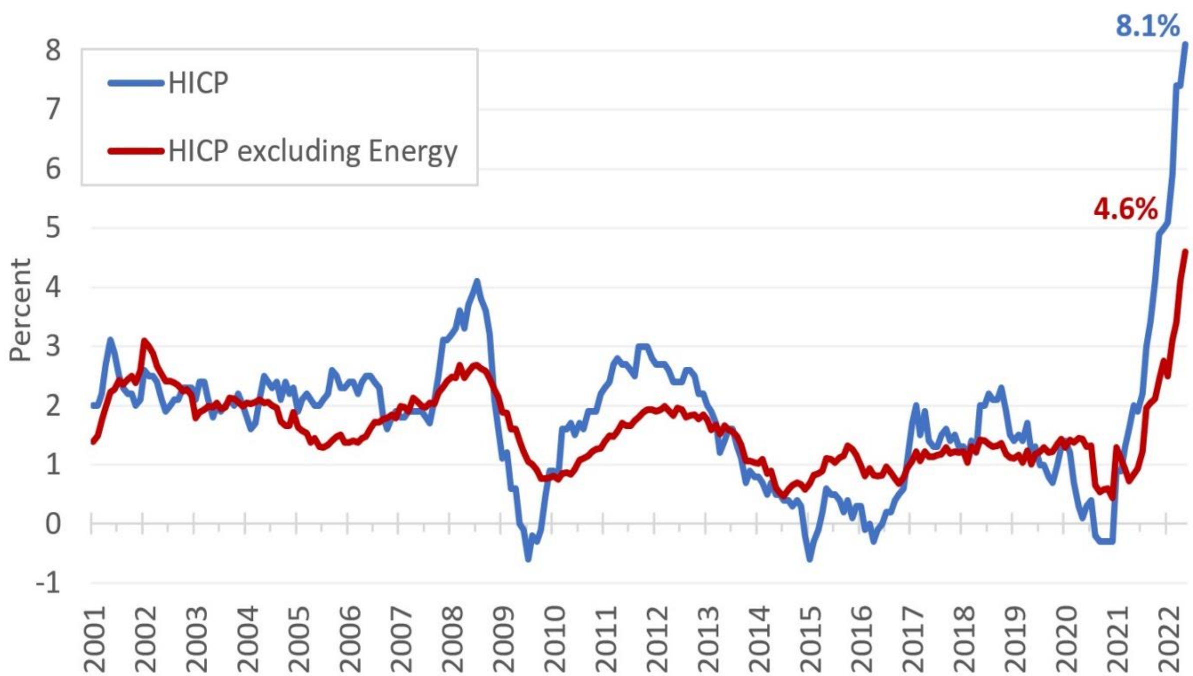
I can see the reasons that, rationally, should avoid this turn of event:

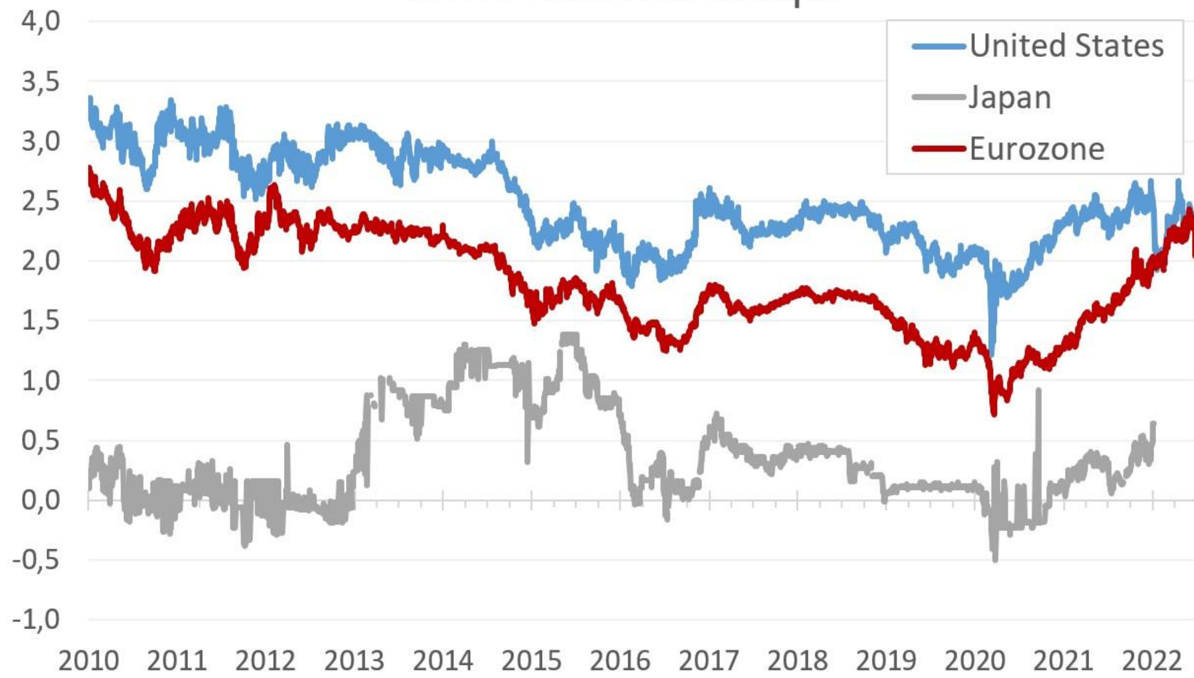
- Italy is the biggest beneficiary of Next generation EU funds, which are conditional on fulfilling the commitments taken in this framework
- Any support by the ECB will also be, in my view, conditional on complying with respecting those commitments
- Bond vigilantes would be very active again in signaling their active displeasure with unsound policies
- More deeply, a heavily indebted entity should do all it can to reassure its creditors about the safety of their investment, to reduce the cost of its debt.

Whether the incentives established by these reasons will be enough and whether they will push policies in the right direction I cannot say. I would just advise you to remain alert to political developments in Italy.

Additional figures

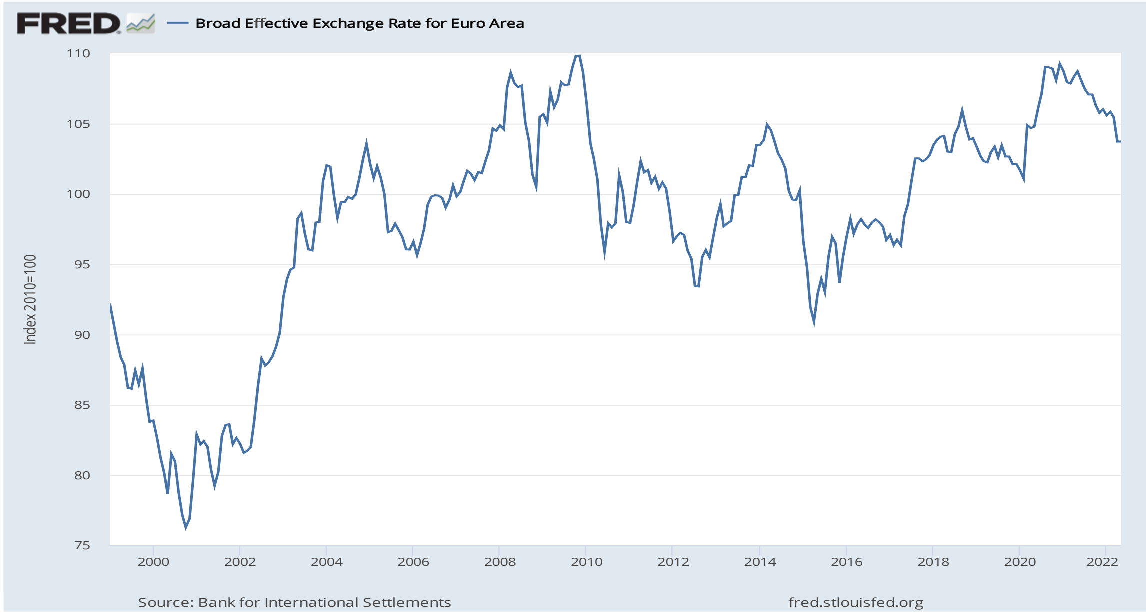


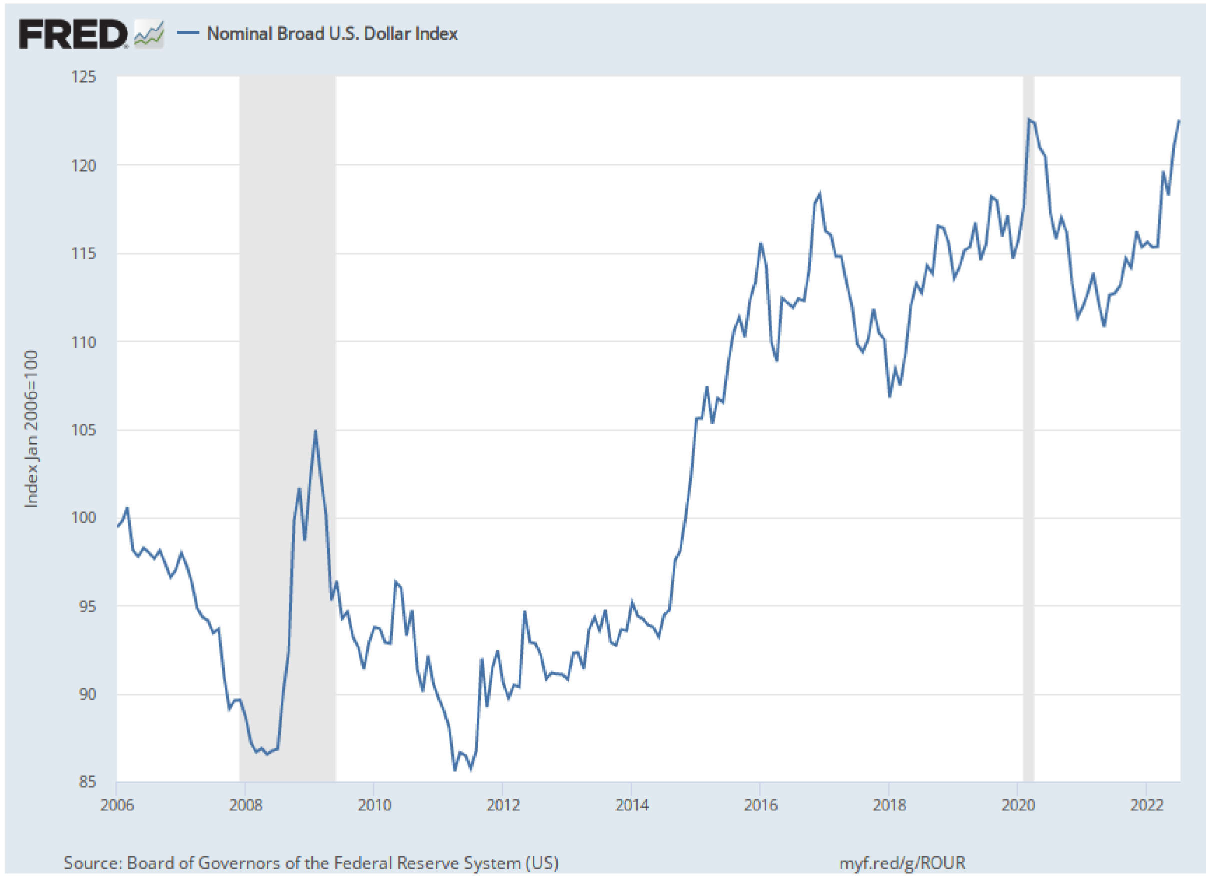




Saved from:
https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=120.EXR.M.USD.EUR.SP00.A

ECB reference exchange rat...->


FRED
Broad Effective Exchange Rate for Euro Area
Index 2010=100
110
105
100
95
90
85
80
75
2000
2002
2004
2006
2008
2010
2012
2014
2016
2018
2020
2022
Source: Bank for International Settlements
fred.stlouisfed.org


FRED
Nominal Broad U.S. Dollar Index
Index Jan 2006=100
125
120
115
110
105
100
95
90
85
2006
2008
2010
2012
2014
2016
2018
2020
2022
Source: Board of Governors of the Federal Reserve System (US)
myf.red/g/ROUR