Event with investors on January 20th 2022

Presentation of Francesco Papadia

I will cover 3 issues, moving from the longer to the medium and then the short term

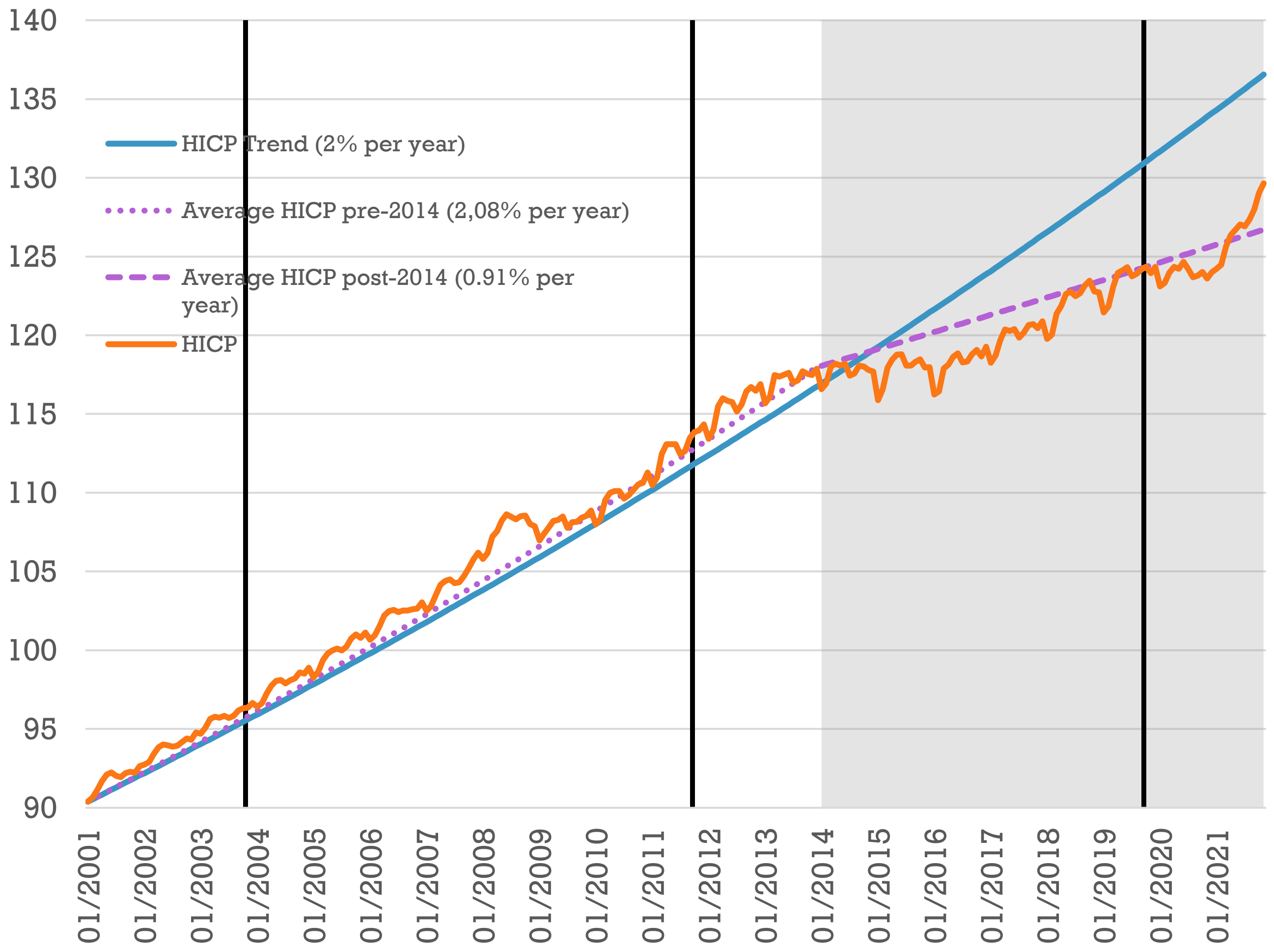
1. Do we have to revise our view about the ability of central banks, including the ECB, to control inflation?
2. What are the medium-term macroeconomic scenarios that could prevail after the impact of COVID will have dissipated?
3. What are the next likely policy moves of the ECB?

The longer-term issue

- Is the medium-term inflation path determined by the central bank?
- While exogenous shocks cause short term deviations around that path?
- I have been harbouring for some time doubts about this view, which I find difficult to reconcile with three pieces of evidence.

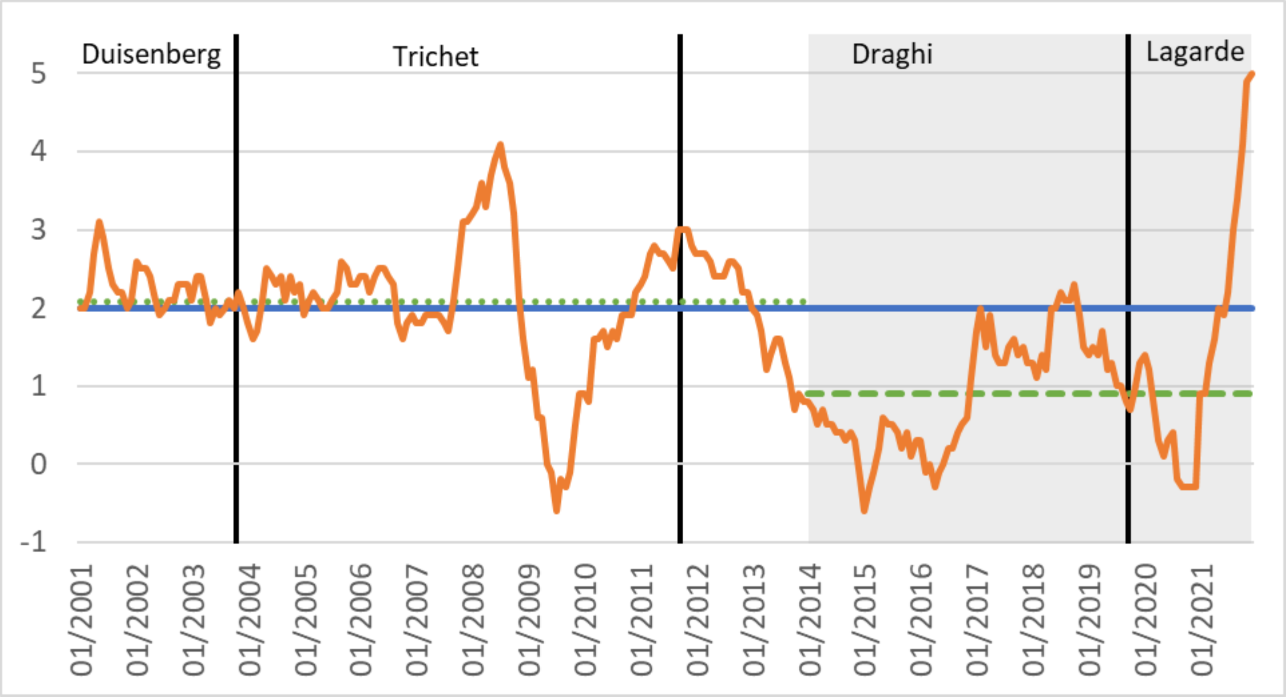
First piece of evidence

Figure 1. HICP price level and two trends



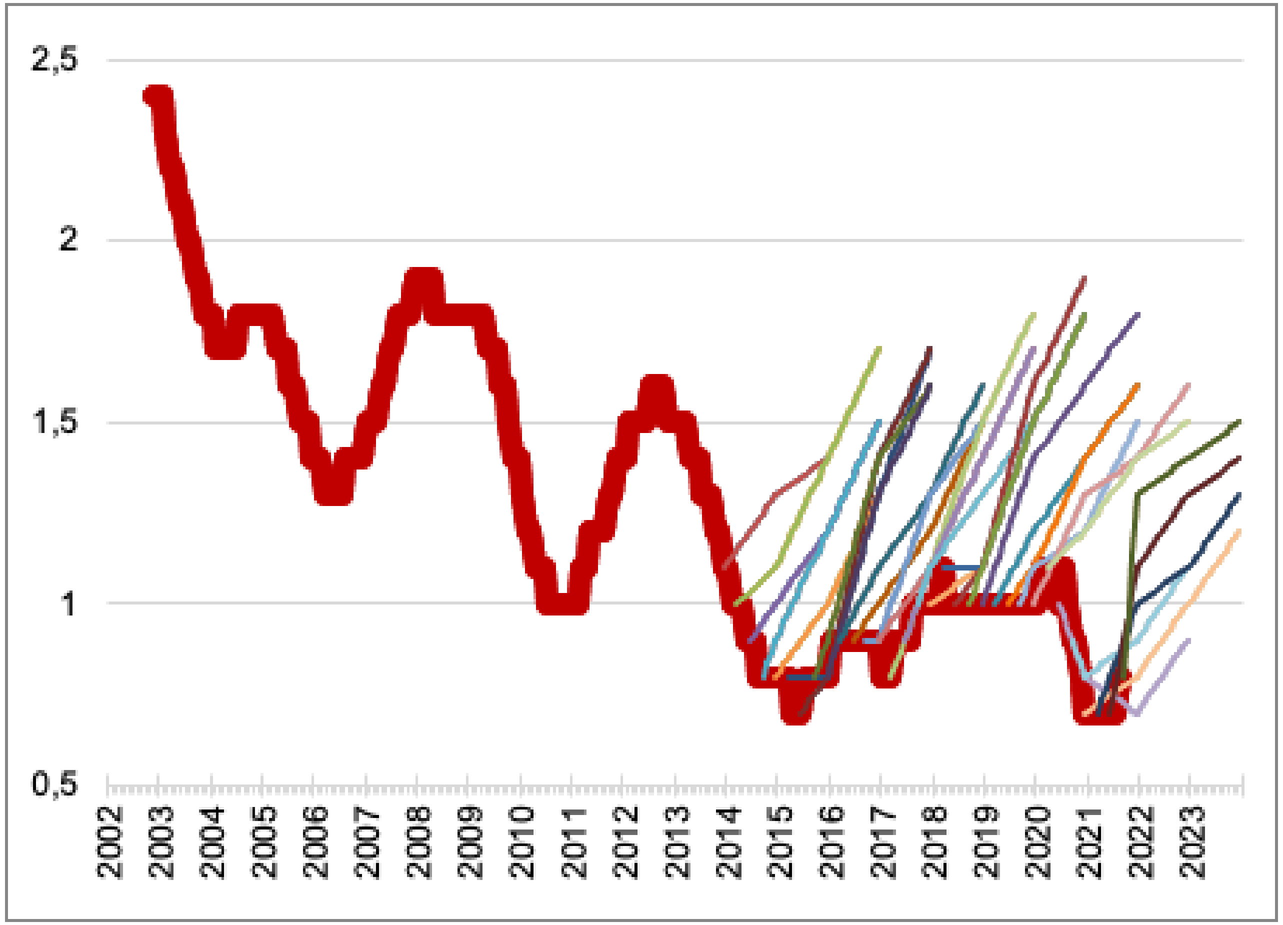
Still on the first piece of evidence

Figure 2. Inflation during the tenure of the first four ECB Presidents



Second piece of evidence

FIGURE 3. Actual core inflation and ECB inflation projections.



Source: updated from Z. Darvas, Forecast errors and Monetary Policy Normalisation in the Euro Area, Bruegel Policy Contribution, Issue nº 24, December.

Third piece of evidence

Figure 4. Estimated effects of extraordinary monetary policy on real GDP growth and inflation, 2014-2018.

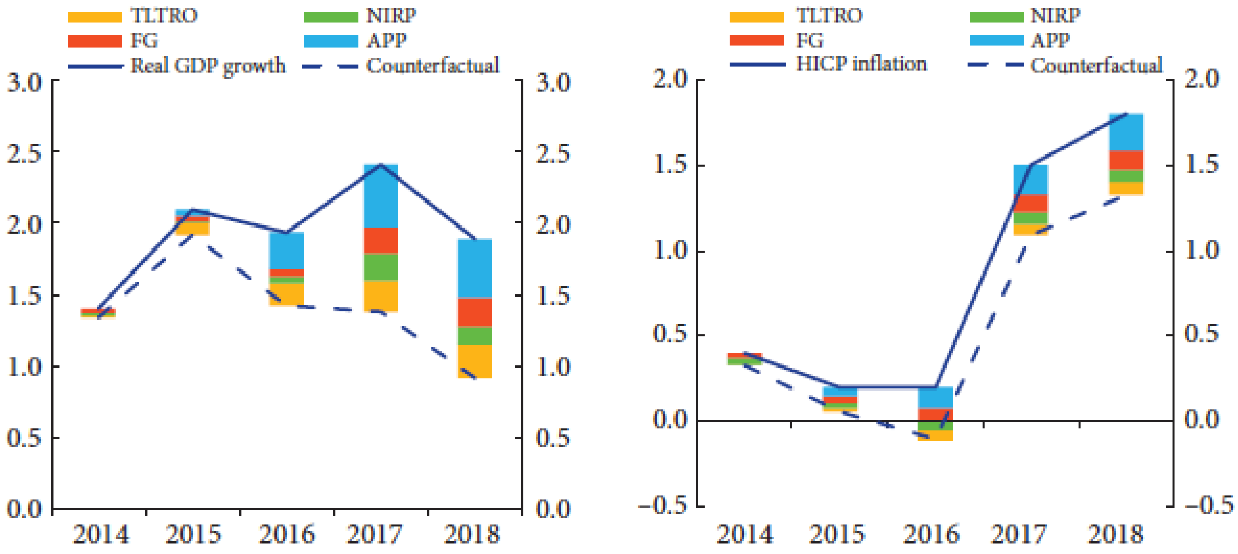


Figure 6.22 Actual real GDP growth and HICP inflation, and counterfactual paths in absence of ECB's non-standard measures

Real GDP growth (average annual % change)

HICP inflation (average annual % change)

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.

Medium-term issue

What are the medium-term macroeconomic scenarios that could prevail after the impact of COVID will have dissipated?

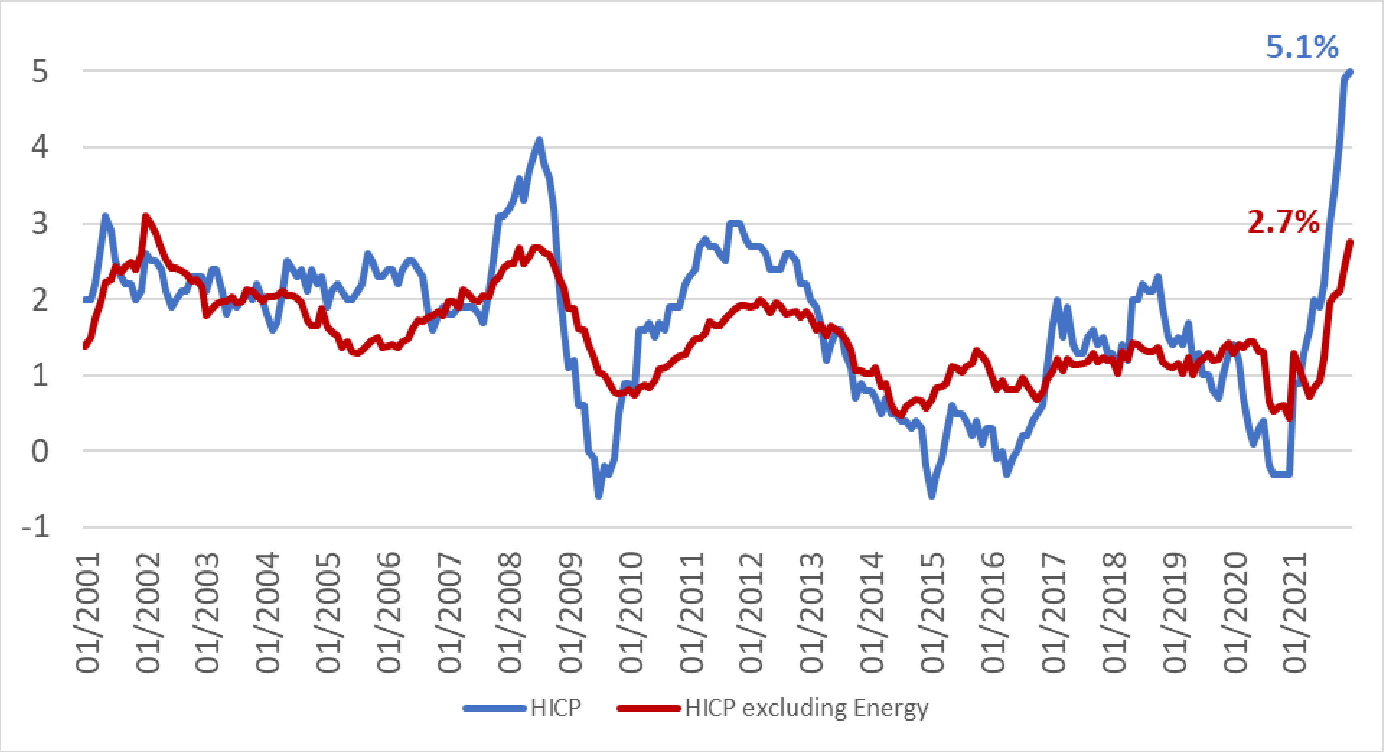
1. Move to a higher growth and inflation path, say 2.0-3.0%
2. A return to the pre-Covid situation, with both EU growth and inflation at 1.0-2.0%
3. A move to stagflation, where growth and inflation move in opposite direction, say with inflation > 3.0% and growth < 1.0%

My central scenario

- Is a variant of the second one (return to pre-Covid), where growth is between 1 and 2 per cent, while inflation is somewhat higher than 2 per cent. Indeed, I believe that there is justification for the concern on the inflation front, but not for a contemporaneous stagnation.

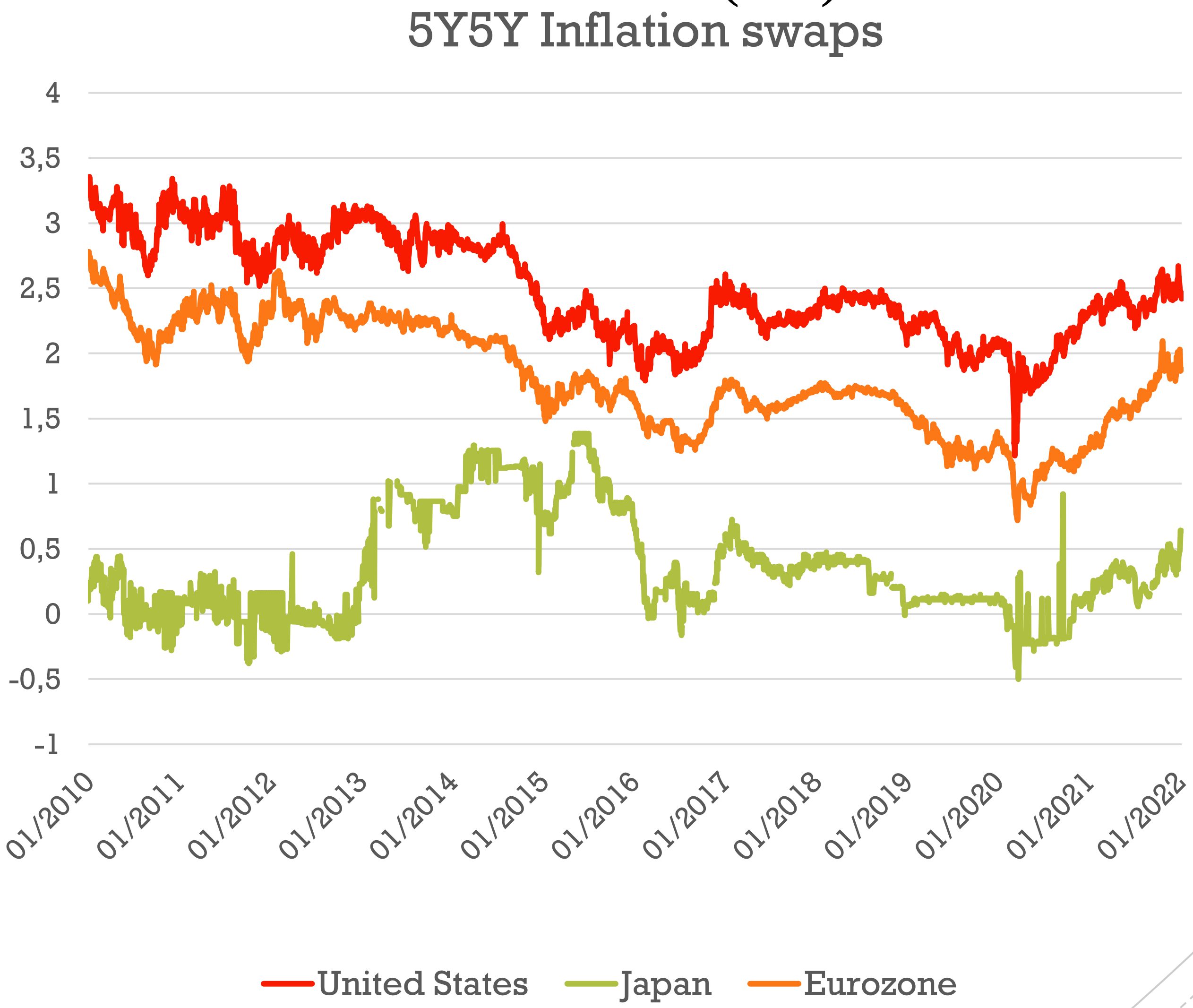
Inflation in the €-area

Figure 5: Consumer prices in the euro area 2000-2021 (Not Seasonally Adjusted)



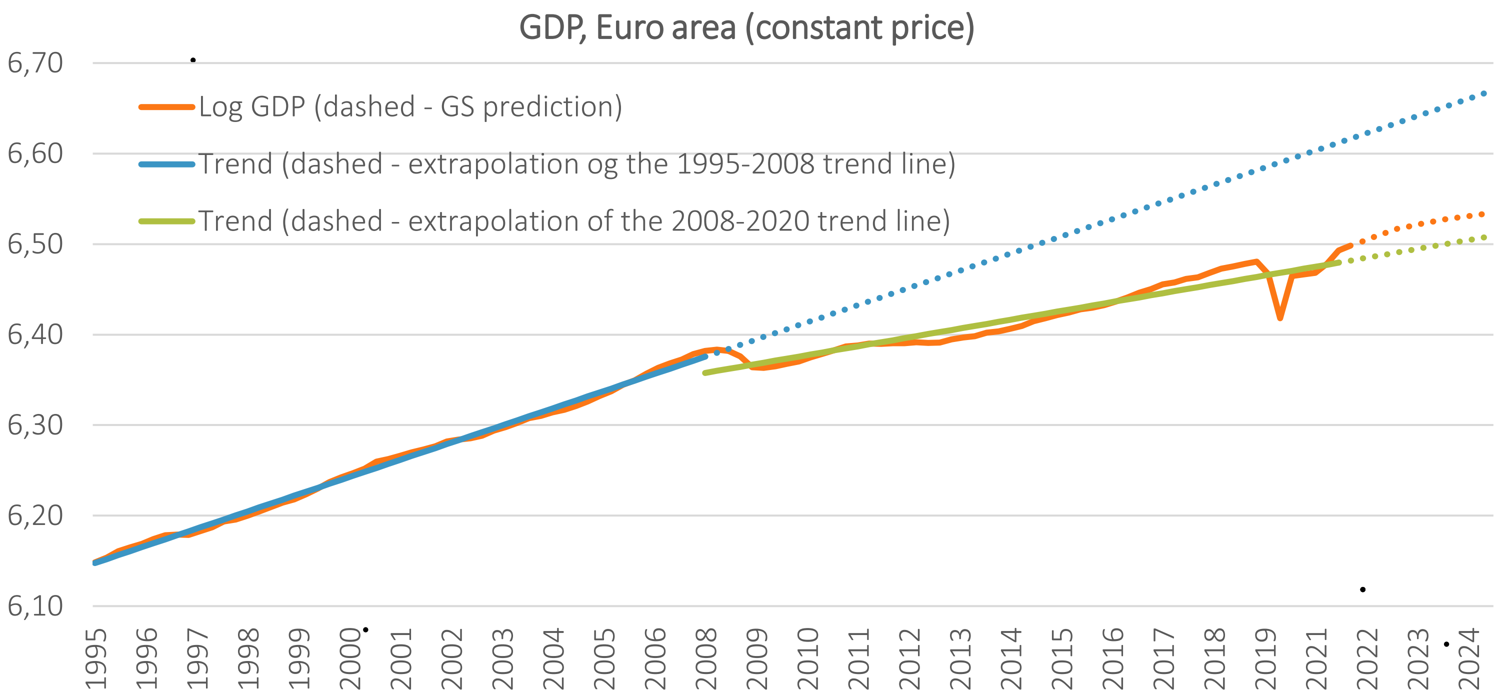
Inflationary expectations in the €-area

Figure 5: Consumer prices in the euro area 2000-2021 (nsa)



Hysteresis and super-hysteresis in the €-area?

Figure 7. GDP, Euro area (constant prices)



The market and official and private forecasters converge to the pre-Covid scenario

	Growth		Inflation	
	[Past observation]	[Current]	[Past observation]	[Current]
IMF	(April 2021) 2021: 4.6% 2022: 4.3%	2021: 5.1% 2022: 4.0% 2023: 2.0% 2024: 1.4%	(April 2021) 2021: 1.8% 2022: 1.3%	2021: 3.0% 2022: 2.5% 2023: 2.2% 2024: 2.0%
ECB	(June 2021) 2021: 4.6% 2022: 4.7% 2023: 2.1%	2021: 5.1% 2022: 4.2% 2023: 2.9% 2024: 1.6%	2021: 1.9% 2022: 1.5% 2023: 1.4%	2021: 5.1% 2022: 3.2% 2023: 1.8% 2024: 1.8%
OECD	(May EO) 2021: 4.3% 2022: 4.4%	(December Preliminary OECD Economic Outlook) 2021: 5.2% 2022: 4.3% 2023: 2.5%	(HICP) 2021: 1.7% 2022: 1.2% (Core inflation) 2021: 1.3% 2022: 1.1%	(HICP) 2021: 2.4% 2022: 2.7% (Core inflation) 2021: 1.4% 2022: 1.5%
Goldman Sachs	(July 2021) 2021: 5.2% 2022: 4.5%	2021: 5.2% 2022: 4.4% 2023: 2.4% 2024: 1.6%	2021: 2.0% 2022: 1.4%	2021: 2.3% 2022: 2.0% 2023: 1.3% 2024: 1.4%
CITI	(July 2021) 2021: 4.6% 2022: 4.5%	(December 2021) 2021: 5.2% 2022: 3.9%	2021: 2.0% 2022: 1.4%	2021: 2.3% 2022: 2.0% 2023: 1.3% 2024: 1.4%
Market Price	N.A.	N.A.	(April 2021) 1.54 (monthly average)	(December 2021) 1.80 (monthly average)

To repeat, my own scenario

- I agree on the little likelihood of stagflation and on the growth part, while I see inflation somewhat higher.

Short-term issue

- What are the next likely policy moves of the ECB?

The next ECB policy moves depend on inflation developments

If the expectation of my central scenario consolidates, I expect:

- End of APP net purchases towards the end of 2022
- Small change in official rates (deposit in particular) before the end of 2022 is likely
- Moving forward guidance towards YCC a la BoJ
- Rate increases continuing in 2023, finally moving away from negative domain

Overall a somewhat tighter scenario than put forward by the ECB, Lane in particular

Will not the Italian debt situation be an obstacle to policy normalization?

I have no definitive answer, but I have 3 points:

- It`s unlikely that the ECB would not do what is needed to control inflation because of the fiscal situation of a country
- There are 2 strong incentives for Italy to maintain debt sustainability and market access, bond vigilantes and the control by the Commission on the reform engagements taken in the Next Generation EU program
- Italy`s fiscal situation is protected by the combination of fairly long debt maturity and the very low level of yields from which any increase could start

What if more or less inflation?

- With more inflation:
  - Earlier end of APP purchases in 2022
  - Prospect of an interest rate increase in 2022 more likely
- With less inflation:
  - Lagarde and Lane insistence of no rate increase in 2022 would be confirmed
  - Net purchases could continue until the end of 2022 and possibly for a few months more.