MONETARY POLICY IN THE EURO AREA

END OF EASING, EXIT, RE-ENTRY AND END-STATE

ONE PROBLEM AT A TIME.....

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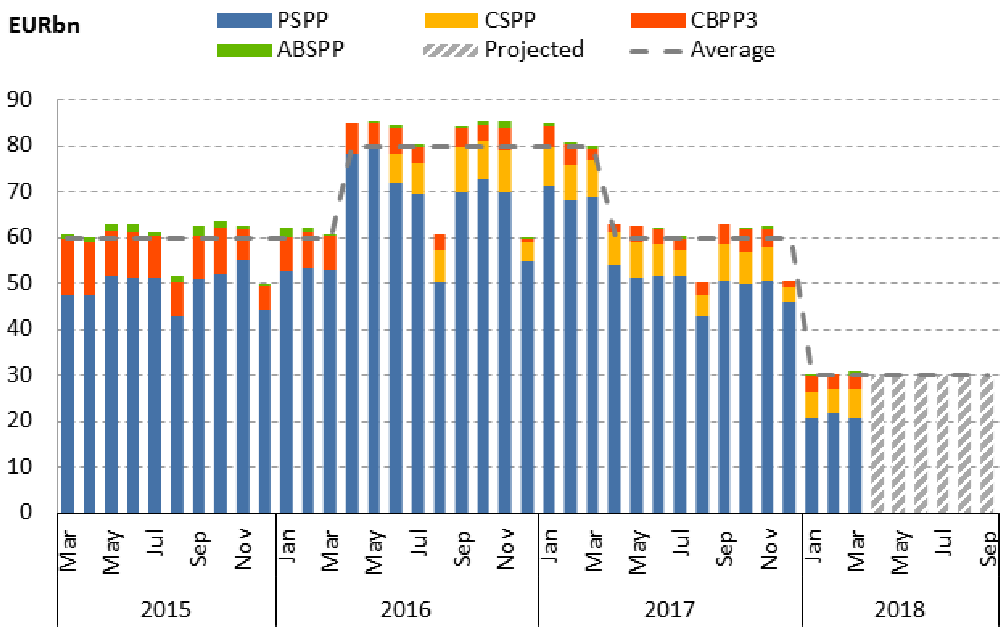
The asset manager for a changing world

Introduction | The challenges ahead

Monthly net purchases under ECB APP



Source: ECB.

- There is a tendency to talk about ECB policy as if it is already in the exit phase. **It isn't.**
- Net purchases likely to continue throughout 2018; first hike may be more than a year away
- Want to discuss the four phases of ECB monetary policy:
  - **end of easing, exit, re-entry and end state**

End of easing | Odysseus in disguise & Operation

- ECB is close to being in a bind twice over – from below on rates and from above on bond purchases given the quasi-legal issue limits on sovereign bond purchases
- Most economists agree that it makes sense to follow a risk management strategy when you are in this situation
  - Keep policy loose for too long (i.e., delay exit) to over-inflate the economy and reduce the risk of falling back to the lower bound
  - *Credibly* provide "Odyssean" forward guidance to the market that you plan to do this: that your reaction function *has* changed
- ECB has not issued Odyssean guidance – on the contrary the Council insists that its guidance is "Delphic" (consistent with an unchanged reaction function)
- However, the macro suggests something different
  - **Operation Over-heat**: output gap is likely to close before the ECB stops QE and by the end of the forecast (2020) the output gap is likely to be large and positive
- The ECB is not alone in this….
  - Bank of Japan and Federal Reserve appear to be following similar strategies
  - Raises interesting questions about the consequences of a coordinate over-heat

Exit | Balance sheet run-off

- ECB can tighten either by raising rates or by running off the balance sheet
  - Not clear that the Fed strategy of active/early for rates and passive/late for the balance sheet is necessarily optimal – there is an alternative (Quantitative Tightening, or QT)
  - Since the ECB will begin exit late in the global economic cycle (please excuse the loose language) this may well be an either / or situation
- Eurozone policymakers may have particular preferences on the exit strategy
  - **Doves**: concern that the ECB will not use the balance sheet tool even if it is available next time around, so imperative to restore space on the interest rate tool
  - **Hawks**: may not be comfortable with the ECB reinvesting for the forseeable future
- The ECB will likely want to provide some guidance on the future path of both interest rates and the balance sheet
  - Track record of forward guidance by other central banks has not been exemplary
  - ECB unlikely to adopt the first best: publish optimal paths within fan charts
- The ECB has also € ¾ trillion of fixed-rate long-term “TLTRO” loans that expire by 2021. When banks “fall off the fix” that could lead a sharp tightening in monetary and financial conditions

Exit | FG-LTRO

- A possible solution to some of these problems: ***FG-LTRO***
- The ECB would offer new long-term loans out to say 2023 and allow the banks to roll out of their existing TLTROs and retain the benefits of very cheap fixed rate funding out to the expiry of those loans
- The FG-LTROs would have two key features
  - a variable rate on the loans after the expiry of TLTROs that is capped
  - an amortisation schedule, with mandatory repayments over the final 2 years
- These two features solve some of the ECB's problems
  - The calibration of the cap acts a signal on the slope of the rate path
  - The cliff edge when banks fall off the fix is transformed into a smooth wind down
- The scheme is unlikely to be adopted if it implicitly shifts the reaction function by forcing the Council to follow a too loose strategy in certain states of the world
  - The ECB could communicate today that if the cap bites then the ECB would deliver the additional tightening that is required through additional balance sheet run-off

Re-entry | Embodied reaction functions

- In the current downturn policymakers have largely exhausted easy monetary and fiscal space
  - **Monetary**: rates seemingly cut close to the effective lower bound and purchases of government bonds close to quasi-legal limits
  - **Fiscal**: increase in debt stocks to the point where the market began to run on several sovereigns
- Raises questions about how the ECB will behave in the next easing cycle, which will hinge on:
  - **Luck**: when does the next easing cycle begin? If 2019 then the ECB may not have even started tightening; If 2023 then interest rates could be back to neutral and the balance sheet may have been in run-off for some time.
  - **Judgement**: what is the ECB willing and able to do? The courageous strategy involves some mix of yield curve control (to manage the quantities problem, as the BoJ has done), very negative rates and Odyssean forward guidance
- **Change of leadership matters**: Draghi leaves in Oct-2019 and his successor may have a different perspective on the mandate and the constraints on unconventional policy
- **There is a latent risk to the nominal anchor in the Eurozone** – if there is a modest monetary and fiscal response to a major economic shock. A(nother) persistently large negative output gap could lead inflation expectations to drift below but no longer close to 2%

End state | Questions and concerns

- Reasonable questions about the optimal design of the macro policy regime *everywhere*, and the problem is particularly acute in the Eurozone, and that is going to continue to create headaches for the ECB
- Crisis exposed well-known flaws within the design of EMU. Promising reform agenda includes completion of the banking union and creation of a fiscal capacity at the centre.
- Fragilities will only be truly resolved when the **stock imbalances have unwound**, which could take generations and implies a sustained fiscal headwind. Cursory review of recent political developments suggests public support for ***perma-austerity*** could be limited
- Crisis reminds us of **the importance of "managing the financial cycle"** – monetary policy is a blunt instrument to tackle financial imbalances but unfortunately, the macroprudential toolkit is in its infancy and the objective of financial policy is essentially undefined
- **Powerful *economic* case for raising the inflation target** in a low r* world although the *political* resistance to any increase in the target is likely to be formidable
- **The monetary anchor should not be viewed in isolation**: *if* Europe is going to persist with a low inflation target and *if* politicians cannot make rapid progress on the public finances to restore fiscal space at the national or supranational level then it will remain ill-prepared to deal with another major crisis. That suggests a structurally tight financial policy stance (*don't let the party get out of control if you are unable to mop up afterwards*).

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