Monetary policy in the face of major transitions

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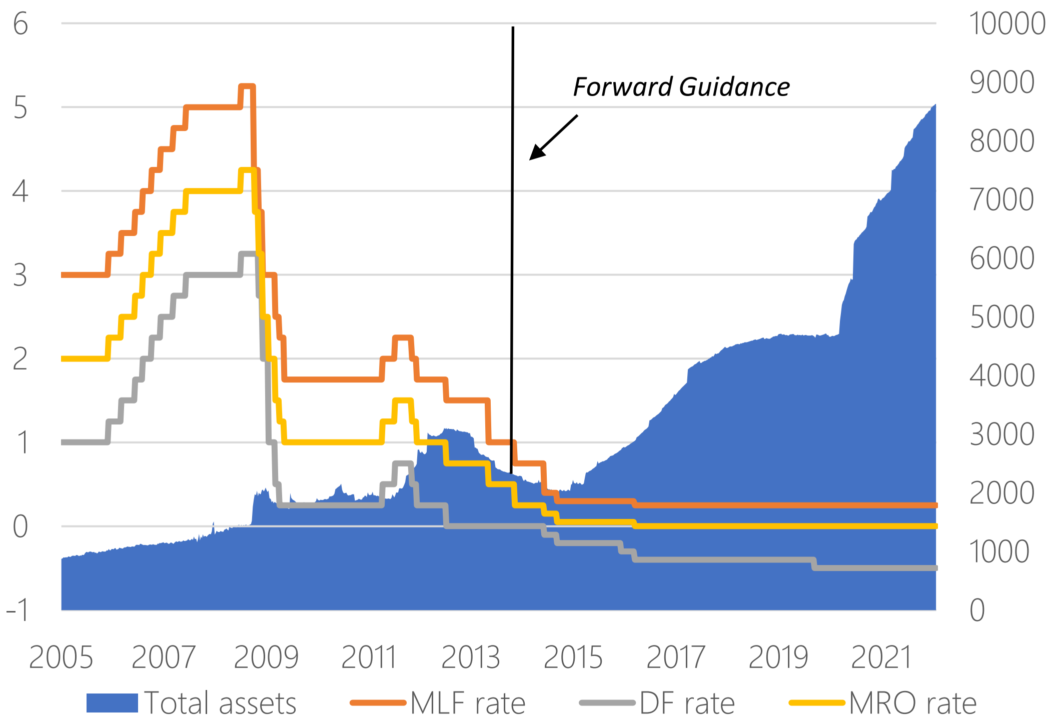
Almost a decade of accommodative monetary policy with inflation below target, until the “post-COVID-19 recovery”

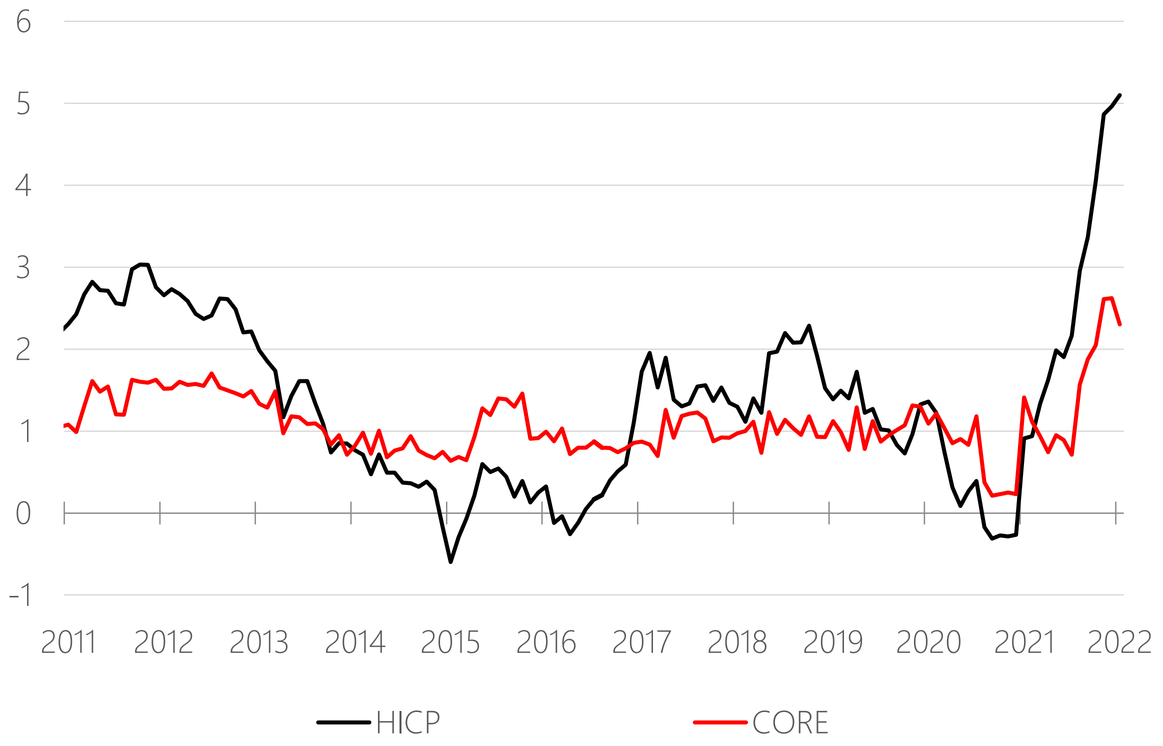
Policy rates and Eurosystem balance sheet

(lhs: percentages; rhs: billion euros)



Headline and core HICP inflation

(year-on-year percentages)



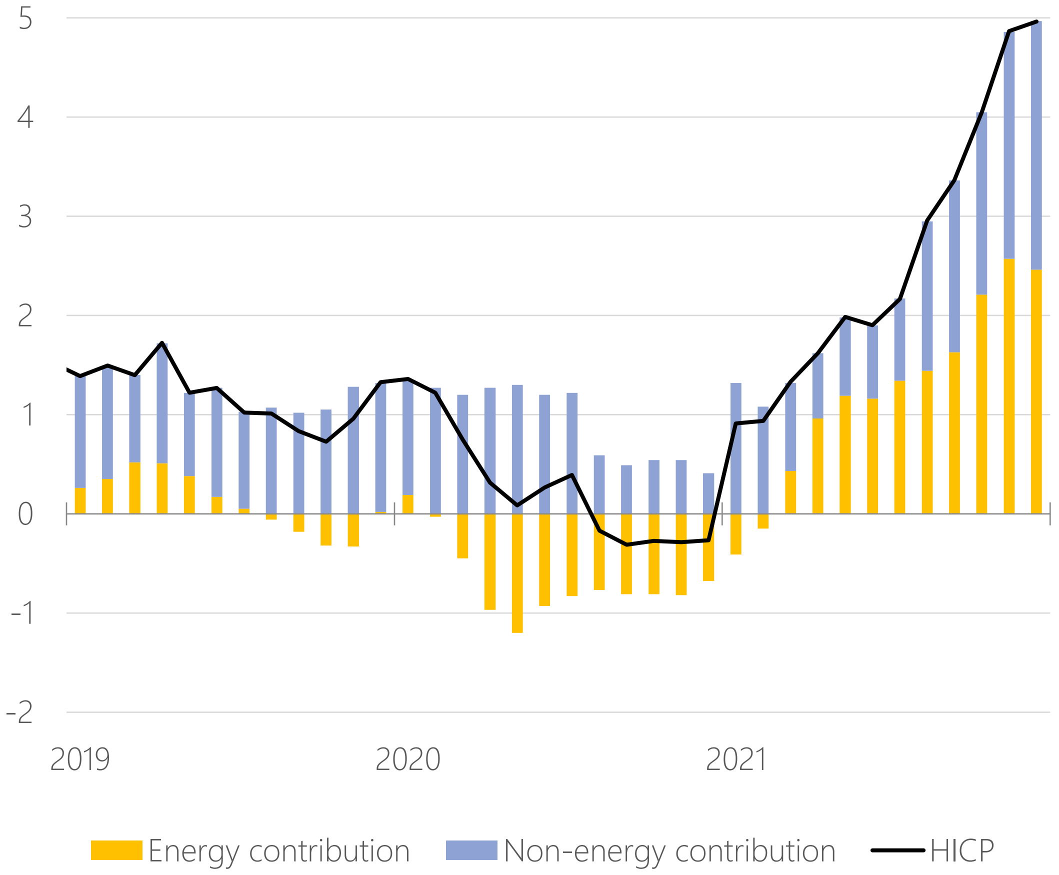
Sources: Refinitiv, ECB.

Notes: The vertical line marks the beginning of forward guidance in July 2013.

Large energy contribution to inflation

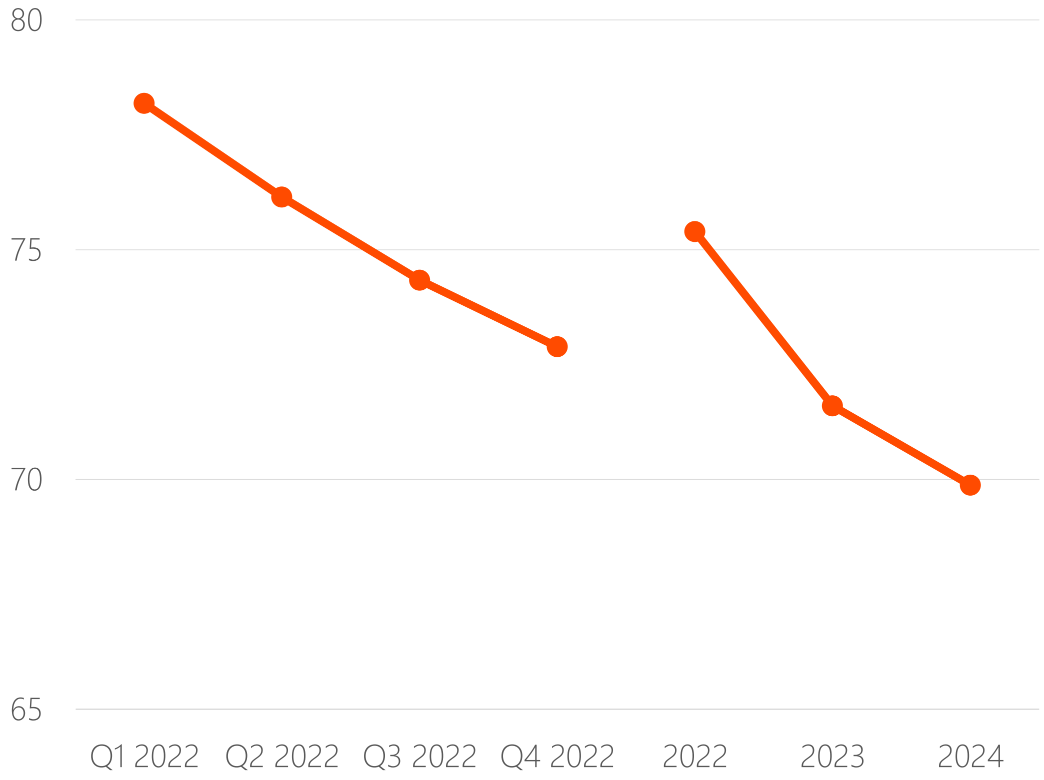
Headline HICP inflation and contributions

(year-on-year percentages)



SPF expectations for the oil price

(2022 Q1 survey, USD)



Source: ECB.

01 Present-day context

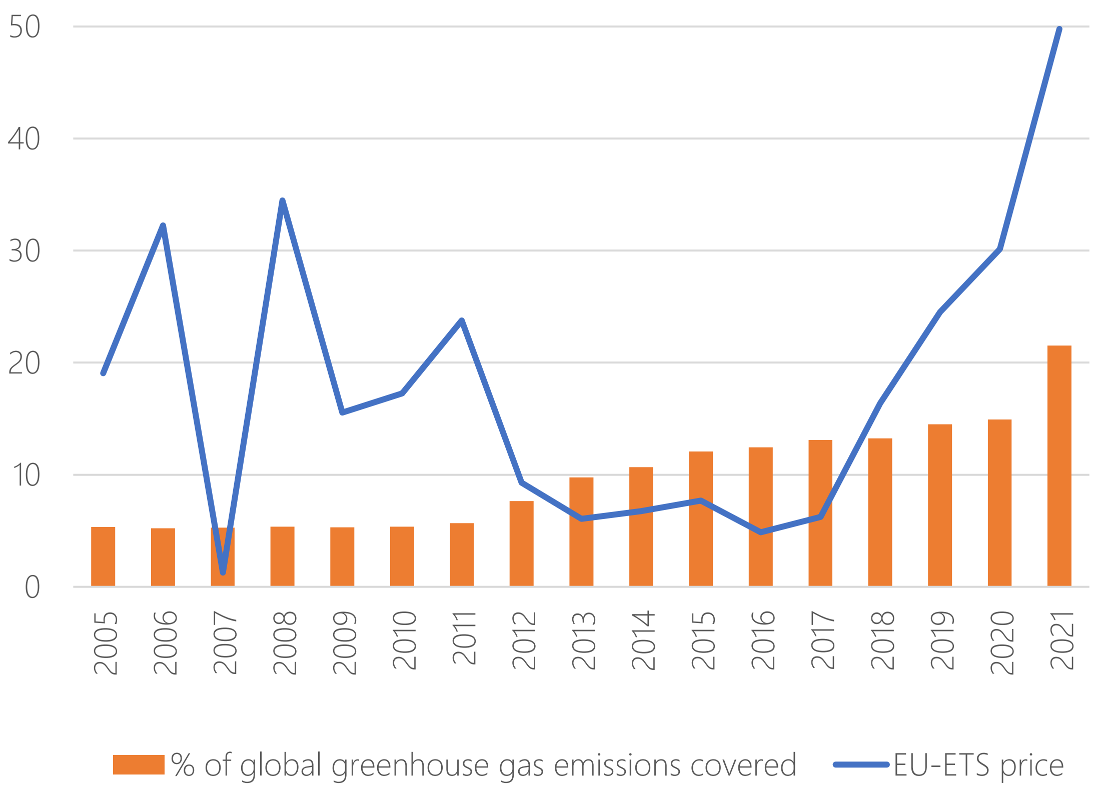
02 Climate change and green transition

03 Monetary policy normalisation: forward guidance and expectations

The importance of an orderly and gradual green transition

- Climate change must and can be tackled at a reasonable cost:
  - Estimates differ substantially, but the overall cost may well not be too high: 0.1 pp slower GDP growth between now and 2050 in Belgium?
  - But: intermediate period, risks of crowding out, uneven impact on households and firms.
- The correct price for emissions is *the* key instrument to steer our collective efforts:
  - Most effective to take the environment into account when consuming and investing, if the carbon price increase is predictable and gradual.
  - Regulation might be needed to make sure people don't postpone necessary actions.
  - Subsidies? Need continuous monitoring to avoid excessive support of some technologies. Could focus on promising but still expensive technologies.

EU-ETS price and share of global greenhouse gas emissions covered by carbon taxes and ETS
(share: percentages; ETS price: USD/tCO2e)

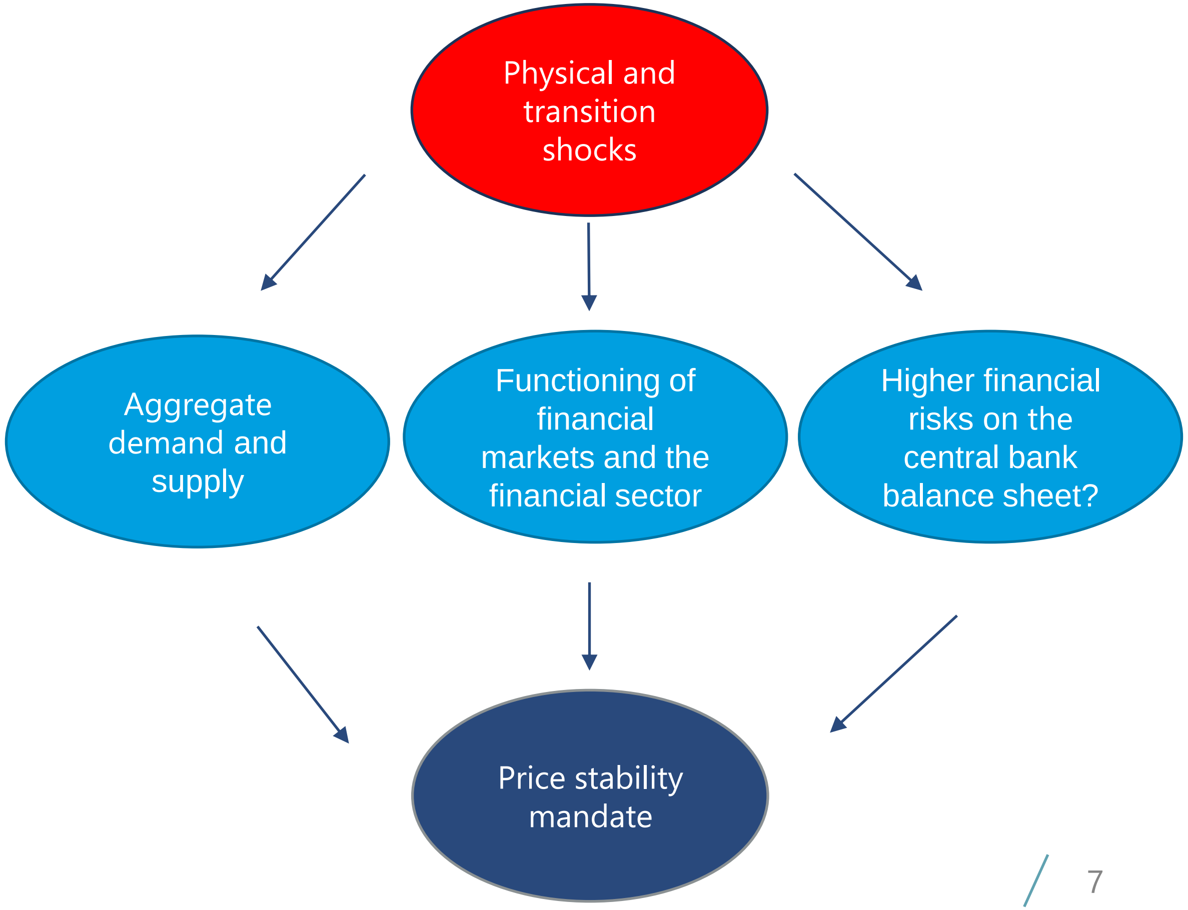


Source: World Bank.

Central banks should have a limited role to play in this, given their mandate and their instruments

- The ECB mandate is anchored in the EU Treaty:
  - Price stability is the primary objective…
  - …without prejudice to that objective, support the general economic policies in the EU with reference to Article 3 of the Treaty.
- Article 3 lists many objectives:
  - A high level of protection and improvement of the quality of the environment…
  - …but also balanced economic growth, a highly competitive social market economy, full employment, social progress, scientific and technologic advance, social exclusion and discrimination, equality of women and men.

…but the risks of climate change can justify changes in our monetary policy measures



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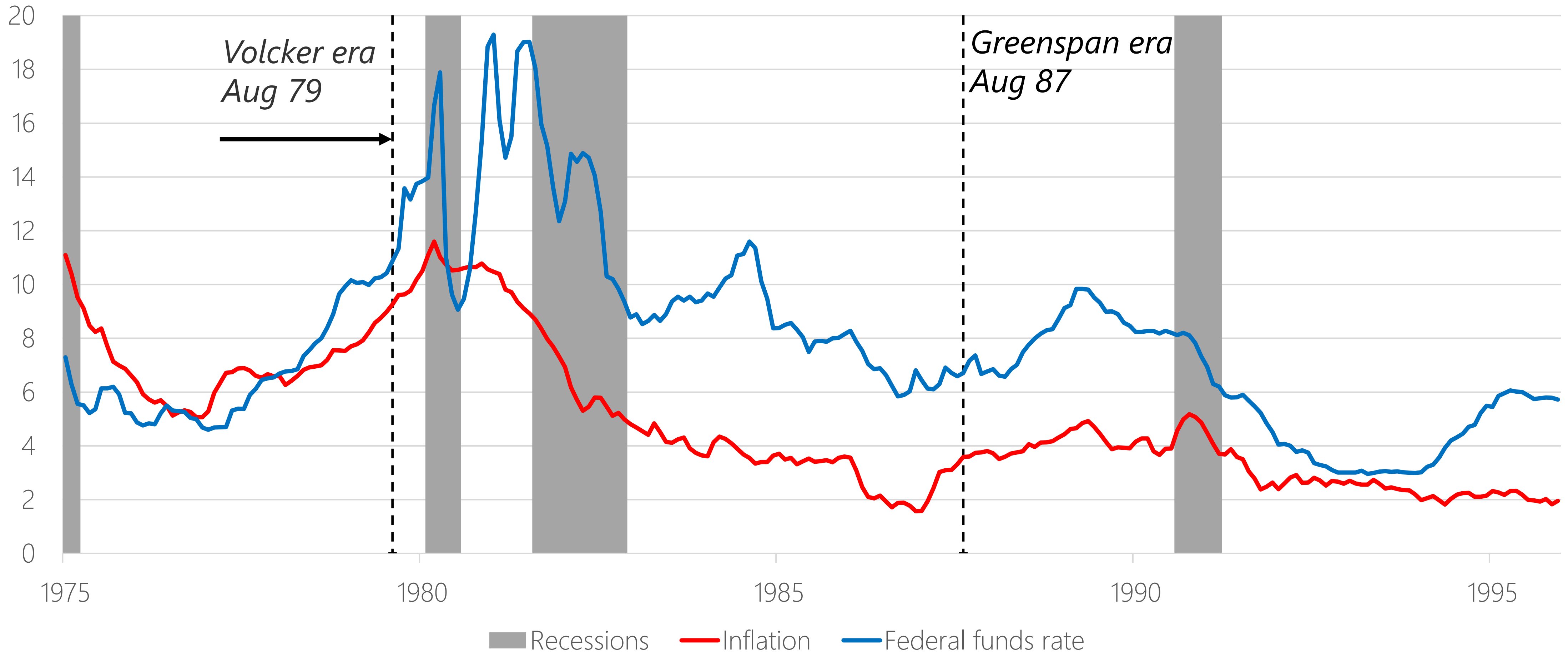
Looking through higher energy prices?

- Yes if temporary rise, but energy price forecasts are surrounded by significant uncertainty: difficult to assess the persistence of shocks ex ante.
- The green transition might create inflation volatility: more likely bottlenecks? More volatile energy prices?
- At the same time, we might expect a potential continuous upward price pressure from insufficient production capacity of renewable energies in the short run, rising carbon price, higher tax rates for fossil fuels and relatively inelastic energy demand.
- Monetary policy cannot afford looking through higher energy prices if they pose a risk to medium-term price stability:
  - Could be the case if prospects of persistently rising energy prices contribute to a de-anchoring of inflation expectations…
  - …or if the green transition boosts growth, employment and aggregate demand:
    1. If higher energy prices reflect a higher price of carbon, it is a transfer from the private to the public sector (and not to the rest of the world).
    2. r* might be raised by green projects implying a de facto more accommodative monetary policy.

Taming derailing inflation could come with significant economic costs: remember the Volcker experience

U.S. PCE inflation and Federal funds rate

(annual %)



Sources: FRED, NBER.

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The new strategy required a change in the forward guidance

New monetary policy strategy…

- Explicit 2% **symmetric** inflation target
- Near the **effective lower bound** and in case of an adverse shock, especially forceful or persistent action will be required to restore the symmetry

Monetary Policy Statement, 22 July 2021

In support of its symmetric 2 % inflation target and in line with its monetary policy strategy, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until:

- *it sees inflation reaching 2 % well ahead of the end of our projection horizon*
- *and durably for the rest of the projection horizon,*
- *and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at 2 % over the medium term.*

This may also imply a transitory period in which inflation is moderately above target.

The Governing Council continues to expect net APP purchases to end shortly before it starts raising the key ECB interest rates (sequencing).

The revised forward guidance in perspective

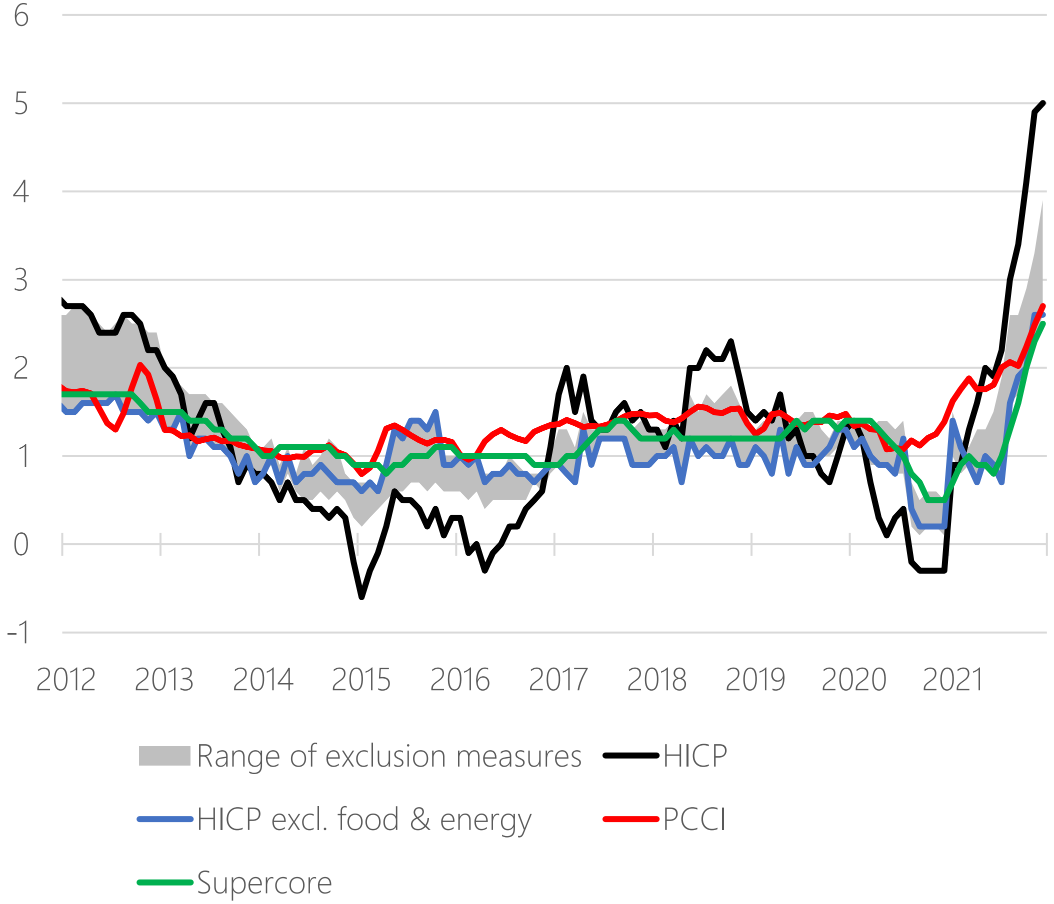
- The Governing Council uses judgement in its evaluation of the criteria. There is no mechanical link with any type of expectation or projection.

- Still, the forward guidance…
    - …would work best in a slow-moving macroeconomic environment.
    - …and might be seen as too mechanical an exercise: *have we ticked all the boxes?*

Measures of underlying inflation have increased

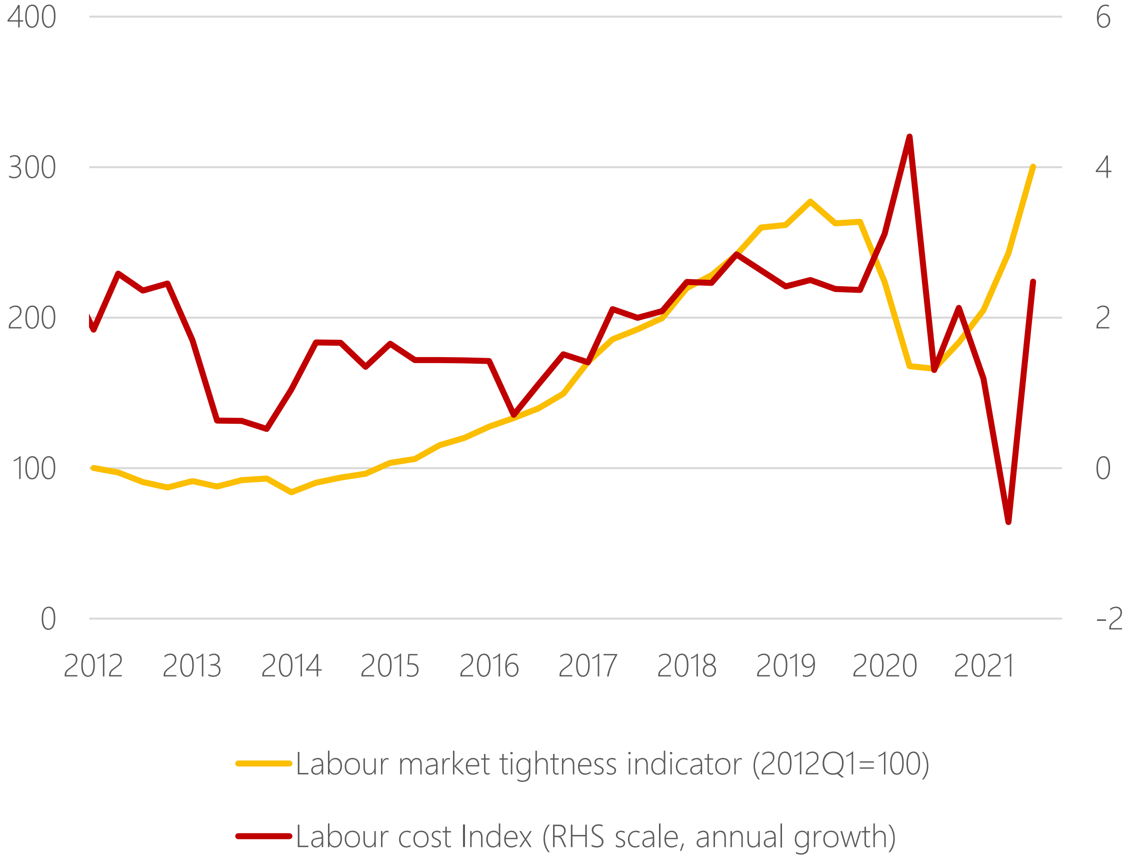
Indicators of underlying inflation for the euro area

(year-on-year percentages)



A tight labour market could spur higher wage growth

(latest value for labour cost index: 2021Q3)

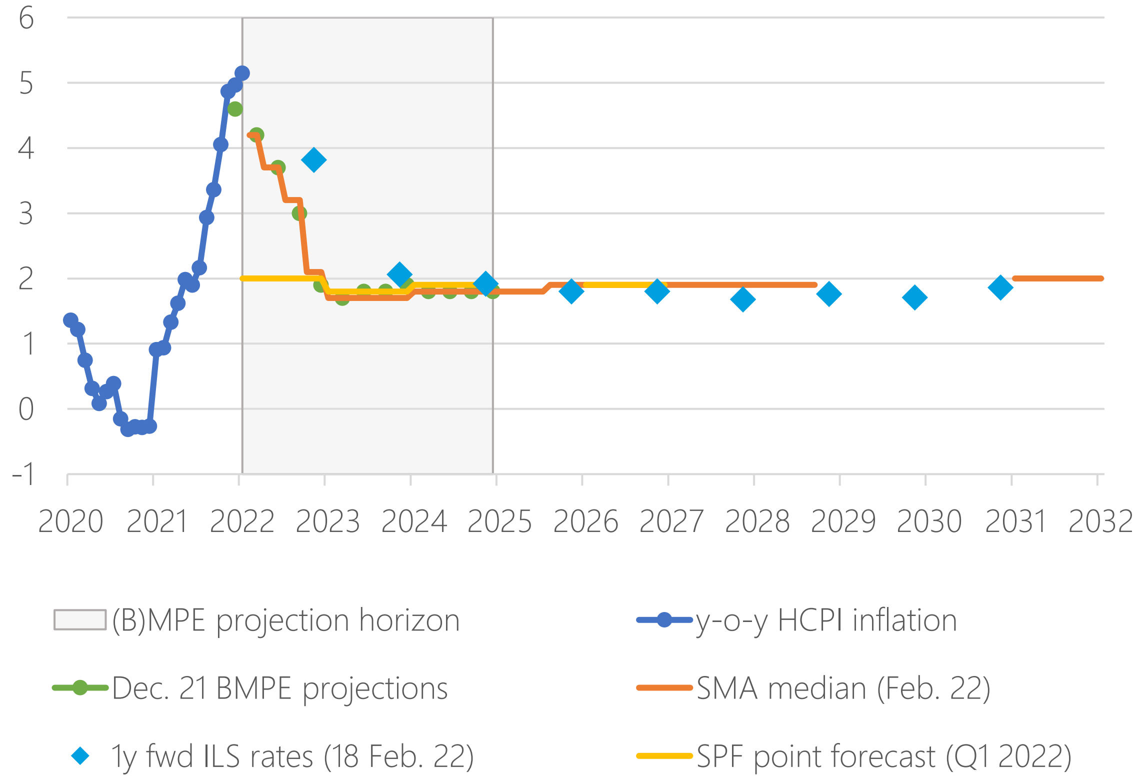


Notes: LHS: PCCI and Supercore refer to two model-based underlying inflation measures. RHS: Labour market tightness is defined as the ratio of total vacancies to total unemployed.

We are not behind the curve: inflation is expected to converge to around 2%

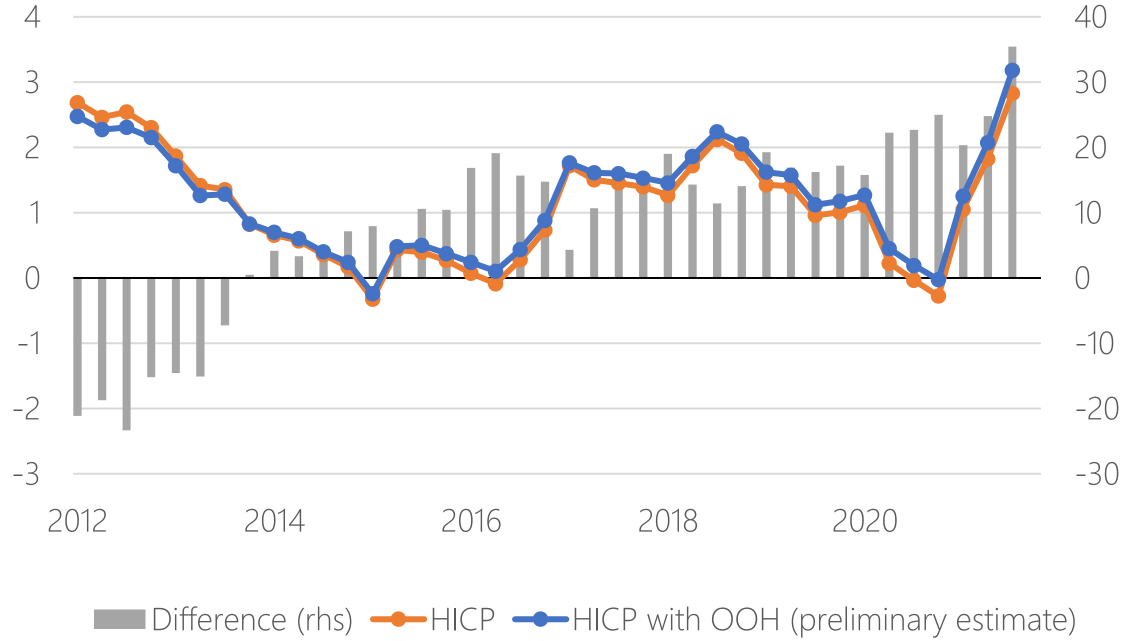
Market and survey-based measures of inflation expectations, and BMPE projections

(year-on-year percentages)



Headline HICP inflation with(out) OOH

(lhs: year-on-year percentages; rhs: basis points)

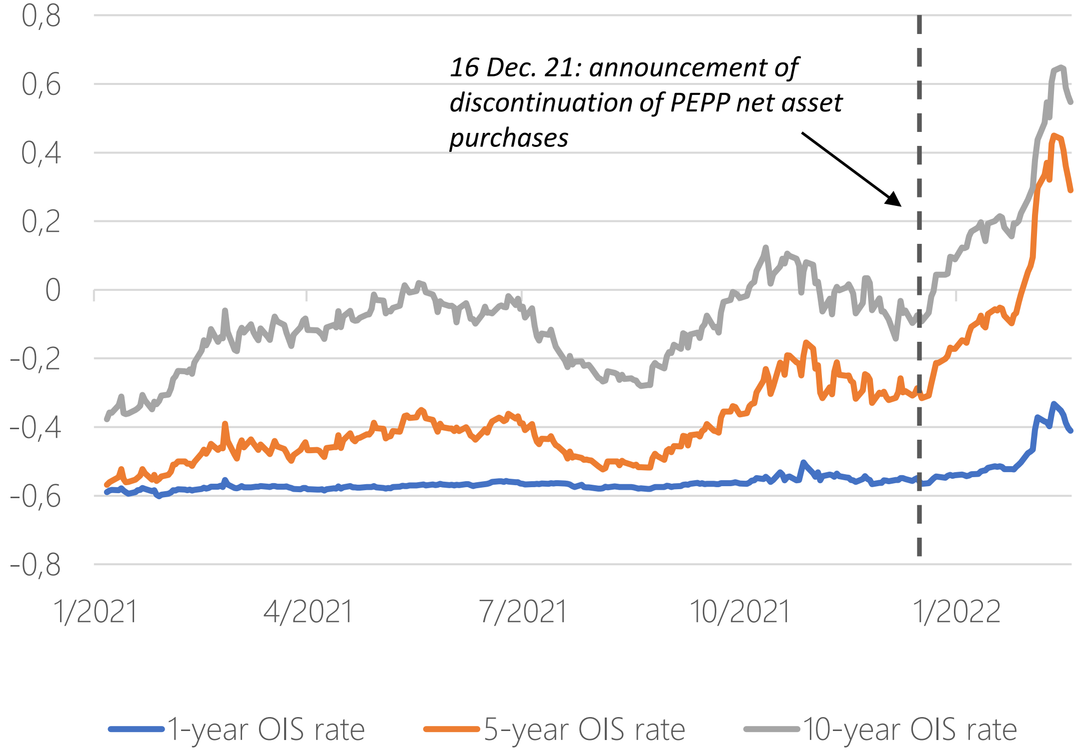


Sources: ECB calculations, Eurostat, Refinitiv, SMA, SPF, own calculations.
Notes: Owner-occupied housing (OOH) estimates up to 2021Q3. Weights are approximative. The 2020 weight was used for 2021.

Announcement of the end of PEPP net asset purchases in March 2022 preceded higher nominal rates

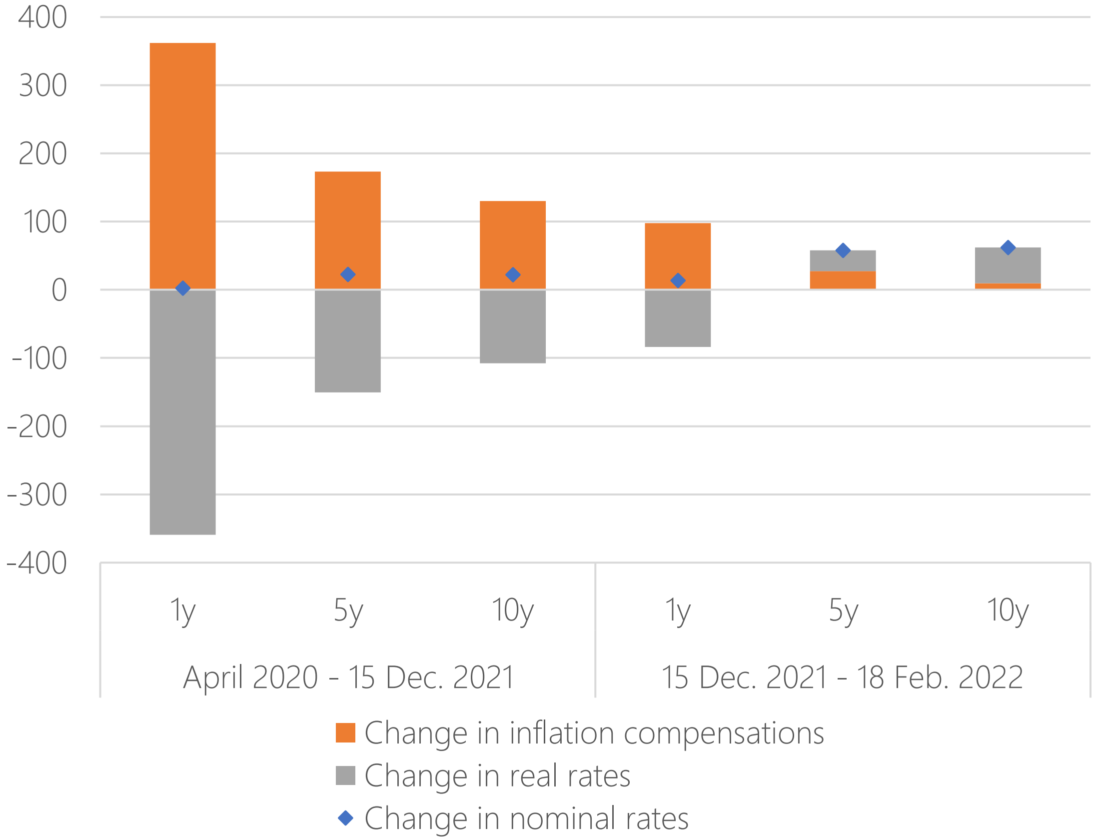
Nominal risk-free rates rose after the announcement of the end of PEPP net purchases…

(percentages)



… which coincided with an increase in longer-term real rates

(basis points)



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Three scenarios going forward

1. Baseline: inflation (mechanically) comes down to 2% and monetary policy can gradually normalise:
   - Temporary period of inflation above target…
   - …tolerating that would be in line with the strategy…
   - …and helpful in stabilising inflation expectations at 2% (after a long period of inflation below 2%) which also creates policy space.

2. Inflation goes back down below 2% and lift-off is delayed:
   - Raises questions on monetary policy's impact on inflation.
   - Makes potential costs and side-effects of monetary policy measures more relevant (negative rates, asset purchases,…).

3. Inflation remains persistently higher than 2%:
   - High inflation expectations may become more entrenched.
   - Might require to normalise monetary policy faster than expected, which could cause financial market turmoil.

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For more information

- My remarks were based on the recent interview with the Central Banking Journal (26 January 2022) and my speech given at the CFO Award Trends (20 October 2021).