National Bank OF BELGIUM
Eurosystem

Monetary policy post Covid-19: *Nobody said it was easy No one ever said it would be this hard*[1]

MNI webinar, 25 September 2020

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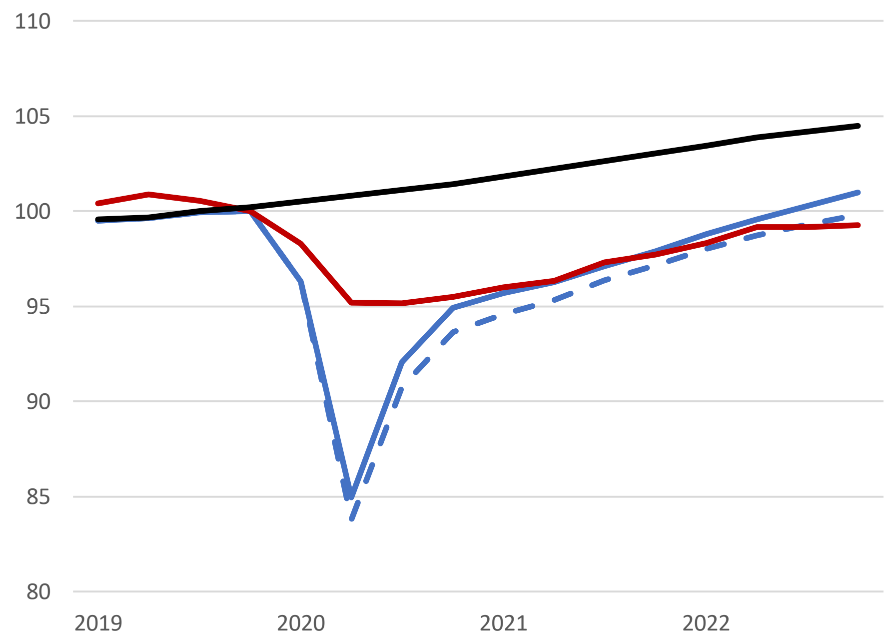
[1] The Scientist (Coldplay)

A deep recession and incomplete recovery leaves a clear footprint on inflation in the years ahead…

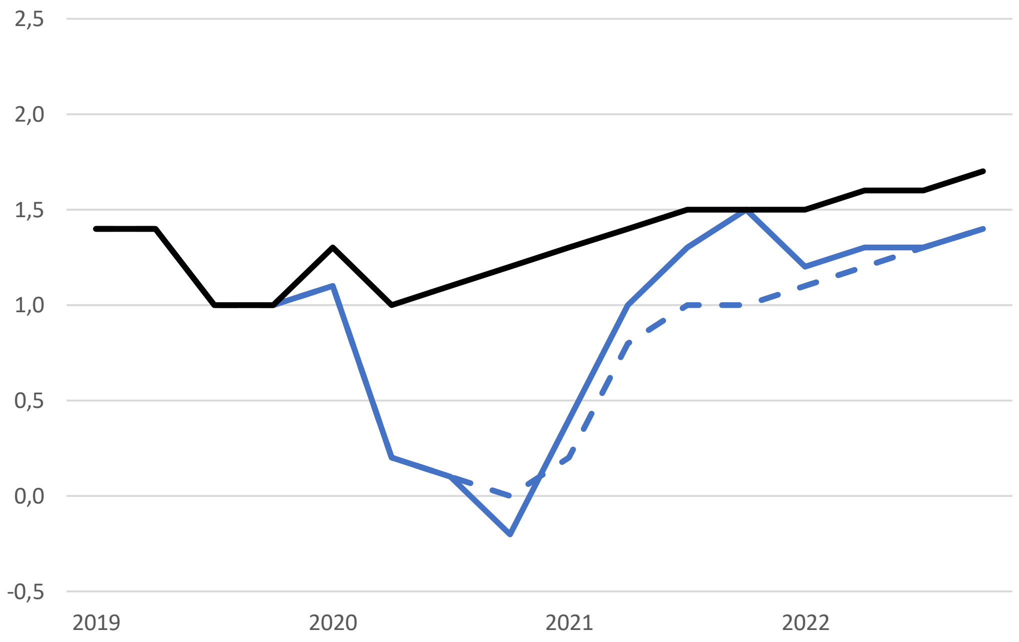
Eurosystem GDP projections

(euro area real GDP, index: 2019 Q4 = 100)



Eurosystem inflation projections

(euro area HICP, year-on-year % changes)



September 2020 projections — June 2020 projections — GFC — December 2019 projections

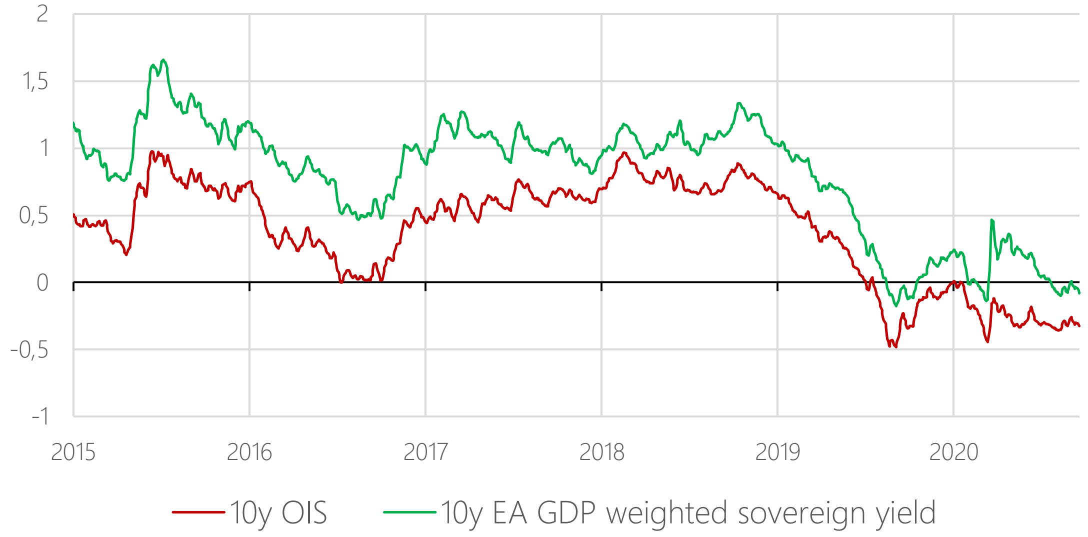
Source: ECB.

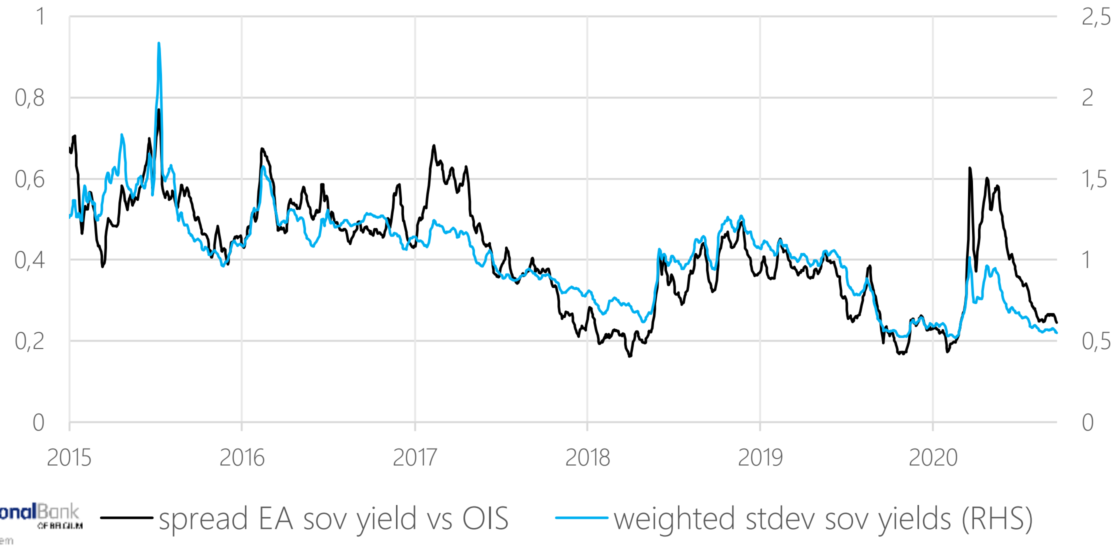
… justifying a forceful monetary policy response…

- A broad array of measures…
  - Asset purchases; larger amounts and flexible across time, asset classes and jurisdictions
  - Targeted lending to banks, interest rate as low as -1%
  - Collateral easing
  - Swap and repo lines
- … to achieve three goals:
  - Avoid a tightening of the monetary policy stance when debt issuance spikes
  - Safeguard transmission mechanism and avoid fragmentation across EA countries
  - Smooth access to credit for bank-dependent firms and households

… which, together with fiscal and prudential policy, prevented accidents from happening.

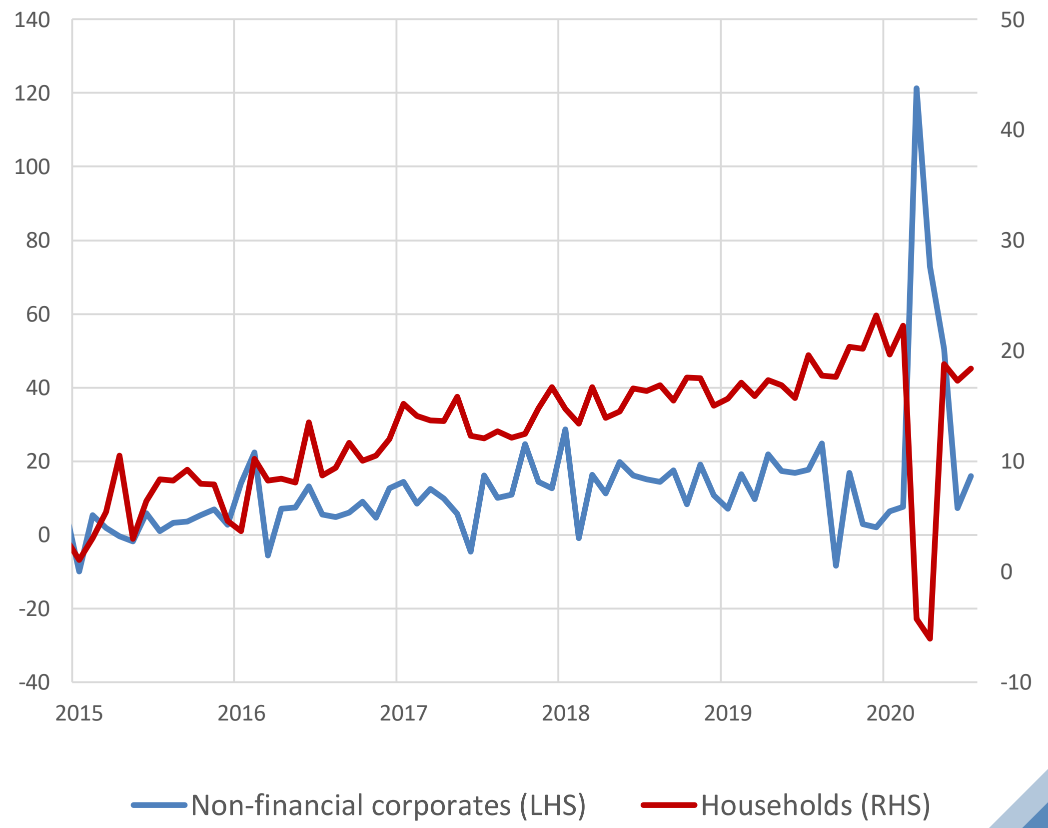
Stress on sovereign bond markets receded fast





Lending flows back to normal

(monthly flows, in billion €)



This was the easy part…

- Up until now, the GovC did not face any major trade-offs in fighting the economic fall-out of Covid-19

- Looking ahead, things look more complicated:

  - Fiscal-monetary interactions in an environment of low growth, low inflation and high debt

  - Unwarranted side-effects of very low interest rates

  - This crucially depends on the assessment of how pandemic affects supply and demand side of the economy

When demand remains persistently weak, low rates are here to stay

- Realism needed on the scope for monetary policy to support demand in case of further negative shocks: nominal interest rates already very low
  - A more active role for fiscal policy in a scenario in which sovereign debt sustainability is probably not the biggest risk?
- Financial stability risks likely to intensify in a world of persistently negative rates, raising the question to what extent macropru can deal with them
- Low interest rates and allocation in the real economy? Negative rates justify very unproductive investments, zombie firms can survive, …
  - Dangerous cocktail with a renewed focus on industrial policies ?
- More generally, could low rates beget low rates?
  - Impact on productivity or Mian et al.'s "Indebted demand" are possible mechanisms

When interest rates have to go up, fiscal-monetary interactions could become more prominent

- The present r-g outlook is extremely favourable for debt sustainability – much more so than when GFC or sovereign debt crisis hit
- No fiscal dominance so far: it reflects a low natural rate and too low inflation
- Governments should have a plan to deal with the risk of higher borrowing costs:
  - A worse aggregate supply side implies higher interest rates and lower growth
  - ECB stands ready to kill bad equilibria ≠ unconditional backing of sovereign debt
- Otherwise, debt sustainability considerations interfere with monetary policy:
  - Stress on sovereign bond markets => deflationary
  - Fiscal dominance and too slow a normalization => inflationary

Our monetary policy strategy review is a perfect occasion to reflect on these issues

- We'll leave no stone unturned in the review that has resumed this week
- Fiscal-monetary interactions will be an integral aspect
- A need to keep the analytical framework fit for purpose:
  - Implications of structural changes (digitalization, climate change, ….) for the inflation process and the transmission of monetary policy
  - Trade-offs (with fiscal policy, with financial stability risks, with climate change, …) when conducting monetary policy should be carefully looked into
  - Endogeneity of low interest rates?