FRANKFURT SCHOOL OF FINANCE & MANAGEMENT, CENTRE FOR CENTRAL BANKING

***Guest lecture by Pierre Wunsch,* Governor, National Bank of Belgium**

"Beyond hawks and doves: trying to get it right in an uncertain world"

8 May 2024 – Frankfurt

Introduction

Good afternoon everyone,

I am very happy to be here today, at Jens' kind invitation, to share a few thoughts on the art of conducting monetary policy in uncertain times. The establishment of the Centre for Central Banking by Jens and Emanuel Moench in Frankfurt is a great initiative. I very much look forward to the centre's contributions to a better understanding of the complex linkages between finance, central banking, and the real economy.

Since I joined the ECB's Governing Council in 2019 (and earlier as a backbencher), I have felt privileged to know Jens, and have learned so much from him.

At the beginning, our views may have appeared to contrast somewhat. You might recall Jens being labelled as a "hawkish member" of the Council. My institution, the National Bank of Belgium, was instead considered to be rather "dovish". And indeed, divergences were not uncommon. In September 2019, the Financial Times tagged Jens as – quote – "opposed in principle" and myself as a – quote – "supporter" of Mario Draghi's "last big stimulus".[1]

My journey through the world of central banking has taught me a few things, and Jens has been instrumental in this. That's what my speech tonight is all about. In fact, the working title of the speech has long been "The impact of seating arrangements on monetary policy". Indeed, Jens and I share the privilege of having surnames beginning with "W", meaning that we were neighbours at the Council table for quite some time.

[1] Financial Times, 27 September 2019, "Splits at the ECB top table over Mario Draghi's last big stimulus".

A key lesson learned from being in Jens' company is that giving central bankers birds' names (hawks, doves, owls, parrots, you name it) is simplistic. Let it be noted once and for all: we are all staunch supporters of price stability. Delivering it is our mission. Our mandate is not dual; we don't do trade-offs. What differentiates us, however, is our perception of risks, and relatedly, our willingness to take risks.

That clarity of purpose has been a useful compass on my journey: I have not had to balance multiple goals based on personal preferences. In fact, maintaining inflation at 2% is simply about doing the right thing, conditional on what we think we know about the state of the economy and its likely evolution over the medium term. Under uncertainty, it amounts to managing the risk of missing our goal.

Growth, of course, is in the background, but it is not the driver of our decision. Indeed, we know that being extremely risk averse or, on the contrary, reckless about inflation, invariably ends up killing economic growth. Being too tight for too long or having to put the inflation genie back into the bottle both lead to subpar growth or worse.

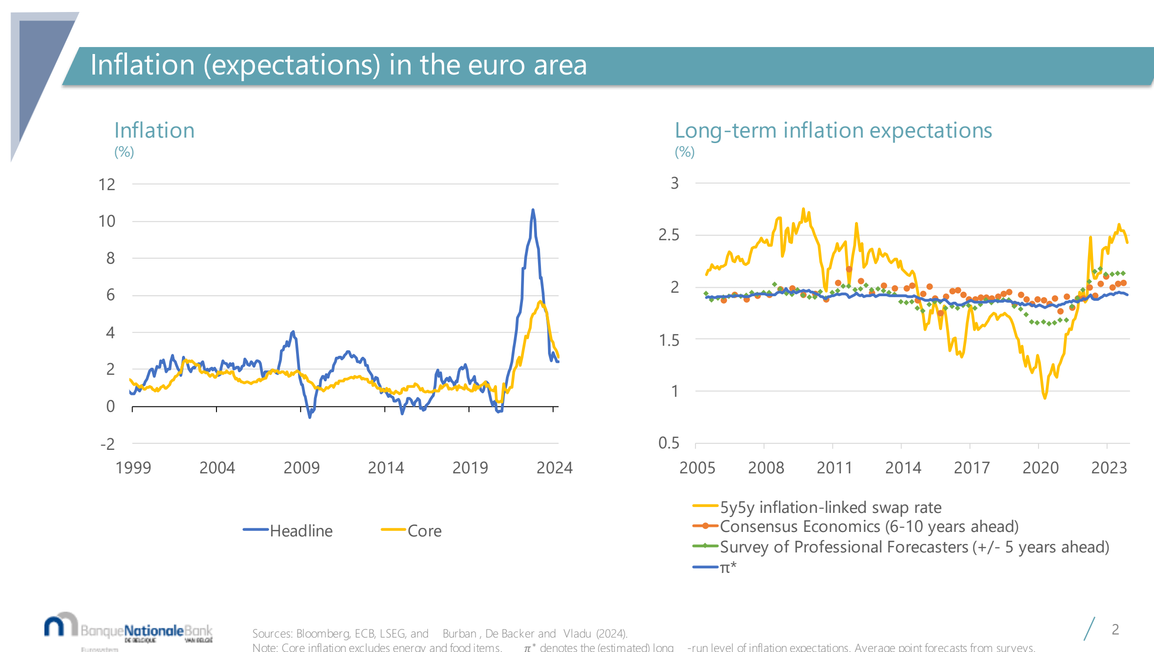
It should now be clear that, in my view, the "hawk/dove" dichotomy cannot capture the true nature of monetary policymaking. Hence, the title of my speech today: "Beyond hawks and doves: trying to get it right in an uncertain world".

Throughout this lecture, I will reflect upon my evolving stance on the primary drivers of monetary policy in recent years. I will also share some personal thoughts on the medium-term trajectory of monetary policy. Finally, I will discuss more fundamental questions around the limits of central bank mandates. Acute crises and urgent issues have clearly tested those limits. I will focus on the role of independent central banks in mitigating climate change and interacting with fiscal policy.

Before COVID-19: a well-developed theory that had to be tested

Before the COVID-19 pandemic, things seemed reasonably simple, at least by today's standards. Aggregate demand was seen as structurally weak. For a host of reasons (population ageing, rising income inequality, etc.), ample global savings appeared to be struggling to find sufficient opportunities for profitable investment. Thus, equilibrium real interest rates (often referred to

as R* in our simple macro jargon) had to be very low, and inflation hovered below official targets. There were even signs of de-anchoring of long-term inflation expectations.



In such circumstances, the conventional wisdom from central bank workhorse models (all of which belong to the class of so-called new Keynesian models) prescribes an extremely stimulative monetary policy. Indeed, in these models, imbalances stem from the demand side of the economy. This means that monetary policy can always handle such imbalances. Models describe a world of "divine coincidence" where closing the output gap (bringing Y to Y*) also brings inflation back to target (that is, pi to pi*). In the end, according to these models, our job is to align the stars (Y with Y*, pi with pi* and R with R*).[2]

The problem, however, was that monetary policy had precious little room for manoeuvre. Conventional instruments were squeezed between an already low R* and the so-called effective lower bound on interest rates. That lower bound reflects the fact that in an economy where money can be freely converted into cash, the scope for negative *nominal* interest rates is bounded by the marginal cost of hoarding cash, be it at home under a mattress or in a bank vault.

[2] Blanchard and Galí (2007).

Quite logically, the dominant view became that central banks had to provide the required stimulus through means other than conventional instruments. Beyond historically low (negative) policy rates, central banks sought to influence longer-term interest rates through forward guidance and asset purchases. They tried to boost the credit channel of monetary policy by providing ample liquidity to commercial banks, hoping they would lend more to their customers.

In hindsight, it is evident that this multipronged strategy of serial big bazookas yielded suboptimal outcomes. Inflation remained stubbornly low, while the side effects of that shock therapy became increasingly evident. I will get back to these side effects later.

Monetary policy during COVID-19: no regrets

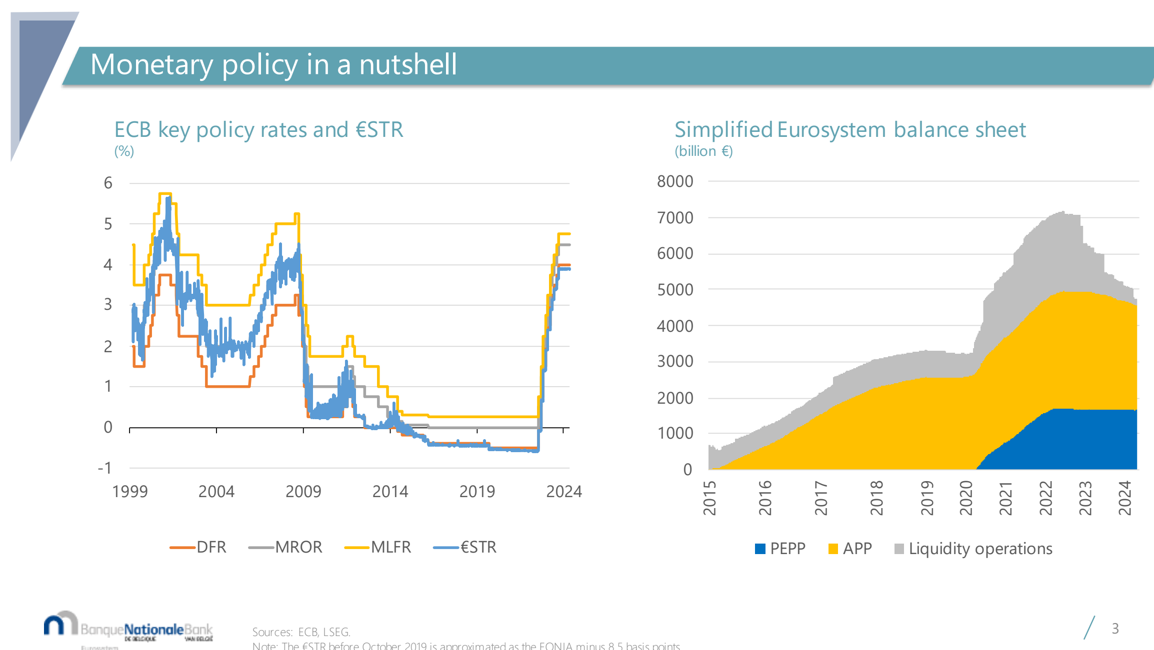
The COVID-19 pandemic erupted in this environment of chronically low demand and limited policy space. The shock was deep, sudden, and involved an unlikely combination of dislocated supply chains and suppressed demand. The costs of such disruption could not possibly be insured *ex ante* by anyone. Only governments could protect economies *ex post* against potentially huge long-term consequences that far exceeded anything a Schumpeterian creative destruction argument could justify. Instead, scarring was a clear and present danger. As moral hazard was not a consideration either, the case for protection was crystal clear.

Of course, the policy response had to be commensurate to the shock: massive, quick, but reversible. Yet, policy space was not only limited on the monetary side but also on the fiscal side, owing to historically high public debt in many countries. In addition, rapid deployment and reversibility are features of fiscal policy, not monetary policy, which only influences macroeconomic outcomes with long and variable time lags.

The need for a large-scale macro stimulus in a context of limited policy space brought the "policy mix" concept back to life. In normal times, independent actions by central banks and treasuries often lead to tensions in the mix. Typically, the central bank offsets the demand effect of fiscal policy if it sees the latter as running against price stability. Thus, unwarranted fiscal stimulus leads to tighter monetary policy, and vice versa. Game theorists would say that monetary policy and fiscal policy are strategic substitutes: it is in the

best interest of policymakers to offset their respective impacts on aggregate demand.

The situation created by the pandemic turned that game on its head. Both monetary and fiscal policies had to be deployed to protect and stabilize the economy. Monetary policy — through the PEPP and other programs — effectively worked by creating the space required for fiscal policy to act.



With the onset of the pandemic, inflation further receded. As investors and consumers were unable to respond to lower interest rates and cheap credit, monetary policy could only be effective through the government's role as the spender of last resort. It became in the best interest of the central bank to fully accommodate and even further encourage fiscal stimulus. During the pandemic, monetary and fiscal policies had temporarily become strategic complements.

One fundamental point to emphasise is that the joint fiscal and monetary expansion observed in response to the pandemic reflected the actions of two separate sets of policymakers acting independently within their remits. It was never the result of *ex ante* coordination or backdoor deal-making.

One general lesson from this peculiar episode is that quantitative easing (QE) *can* be a potent tool in times of significant shocks and constrained policy space. In fact, QE likely proved effective even when operating at the effective lower bound in the sense that it contributed to maintaining

government debt servicing costs – denoted as “r” – below the rate of economic growth “g”. A negative differential between r and g improves public debt dynamics and alleviates concerns over debt sustainability. If anything, this episode should allay our apprehensions about the effective lower bound.

2021: a change of heart in view of inflation and financial stability risks

By the end of 2020, it became clear that vaccines would help to pull us out of the mire. Predictably, policy normalisation would occur sooner or later. That meant the return of the usual interplay between monetary and fiscal policies and with it, the emergence of a clear risk that delayed fiscal consolidation would require faster and stronger monetary tightening.

Logically, I started questioning the wisdom behind our apparent commitment to persistently low interest rates. I became particularly uncomfortable with forward guidance that effectively tied us to such a stance for an extended period. A series of dissents followed, related not only to forward guidance but also to the extremely gradual unwinding of asset purchases.

I first dissented on the revision of forward guidance in July 2021, in the wake of the ECB's strategy review. You might recall that the revised guidance listed three conditions that had to be met before the ECB could consider lifting policy rates.[3] On the topic of forward guidance, I felt close to Jens, who had already highlighted several issues in 2019.[4]

I had two main concerns. Firstly, the revised guidance flew in the face of proportionality when considering financial stability. Although the ECB had explicitly recognised "financial stability [as] a precondition to price stability", the revision seemed to contradict that statement.

Secondly, the stringent conditions for liftoff attached to the revised forward guidance effectively tied our hands in a way that could soon prove untenable. I saw the distinct risk of having to change course suddenly, taking everyone by surprise. In the end, our credibility was in the balance and with it, the very effectiveness of forward guidance itself, and of monetary policy more generally.

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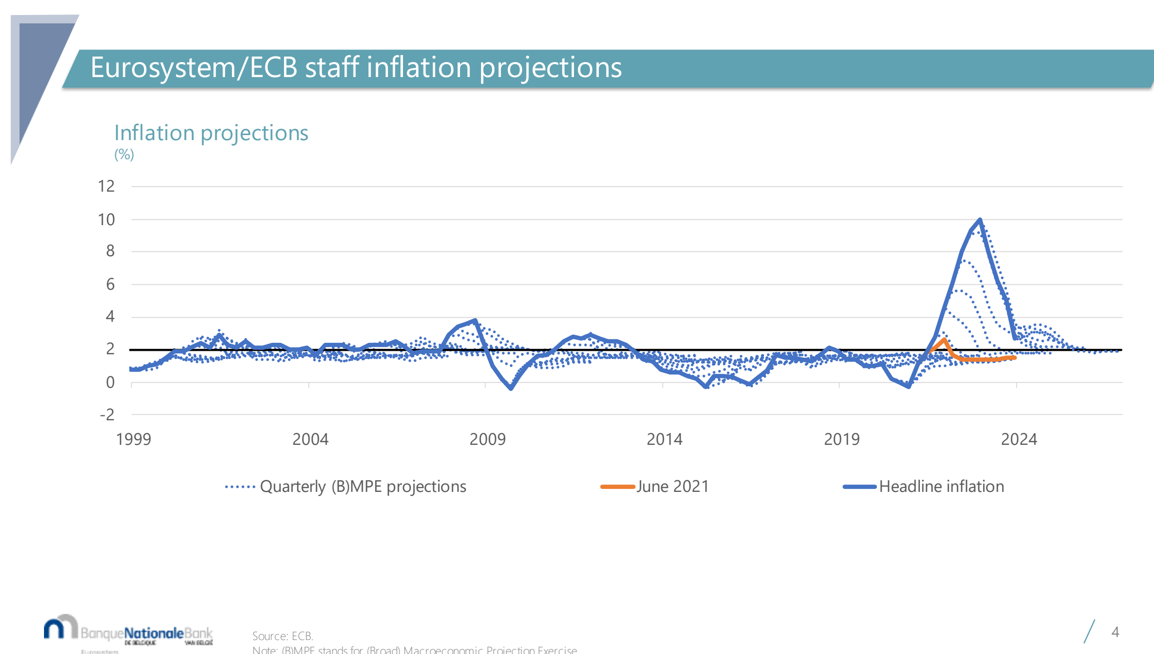
[3] The three conditions were: (i) inflation reaching 2% well ahead of the end of the projection horizon; (ii) inflation forecasts being at 2% for the rest of the projection horizon; and (iii) underlying inflation being sufficiently advanced so as to be consistent with inflation stabilising at 2% over the medium term.

[4] Central Banking, 31 January 2022, "Wunsch sceptical on forward guidance". For Jens Weidmann's speech, see "What the future holds – Benefits and limitations of forward guidance", European Banking Congress, 22 November 2019.

My discomfort about the conditions attached to forward guidance related to personal concerns about the weight of models in our strategic thinking. Much of the latter indeed seemed to hinge on models predicting that inflation would smoothly converge to 2%. But how reliable are models in times of unprecedented disturbances and policy actions? What is the value of model-based inflation predictions where the endpoint of 2% is essentially assumed, and where convergence happens quite fast, especially if expectations are rational? Besides, models are bound to miss regime shifts and to struggle with the deep impact of tail events. And since the last significant inflation surge had occurred in the 1970s, models arguably underestimated the persistence of inflation when it started to climb.[5]



Incidentally, the false sense of knowledge resulting from an overreliance on models was also at the core of the recent review of the Bank of England's forecasting approach by Ben Bernanke. This review could also inspire us in the Eurosystem.[6] On the topic of forecasts in particular, a major issue is that analysts tend to focus on the point estimate of inflation at the end of the forecasting horizon, which is about two to three years ahead. The significant uncertainty surrounding projections is only a second-order consideration. This is an issue if, like me, you believe that policymaking is about risk management.

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[5] Wunsch (2022).

[6] See also Schnabel (2024).

One can think of two technical remedies: fan charts and alternative scenarios. Fan charts have the important advantage of providing a broad idea about projection uncertainty. However, fan charts are only as good as the assumptions used to build them. For instance, many fan charts reflect either past forecasting errors — which is not useful if uncertainty rises — or normally distributed shocks calibrated against past empirical moments. Fan charts also routinely ignore model uncertainty itself. In the end, alternative scenarios reflecting various modelling assumptions and shocks might be easier to communicate to the public and might better convey differences of views among Governing Council members.

My second material dissent concerned the speed of disposal of the asset portfolio accumulated through QE. I call to mind the additional year of reinvestment under the Pandemic Emergency Purchase Programme (PEPP) sanctioned in December 2021, setting gross purchases in stone until the end of 2024. At the time of this decision, headline inflation was at 5% and core inflation was at almost 3%, but indeed our inflation projection for the end of the projection horizon was at 1.8%. Now, with the pandemic behind us and monetary policy being normalised on multiple fronts, PEPP reinvestment is being continued to honour an old promise. Fortunately, the impact of an additional year of reinvestment is limited.

Overall, I disagreed with the revised forward guidance and the slow unwinding of the accumulated portfolio of asset purchases out of concern for inflation and financial stability. With regard to the former, while the inflation spike reflected an energy crisis, it seems hard to deny that highly accommodative monetary policy facilitated the rise in inflation.

With regard to financial stability, I was fearful that the serious side effects of loose monetary policy — in the form of misallocations and financial exuberance — had been underestimated. Uppermost in my mind were the potential for over-investment in non-productive assets, the belief that budget constraints were being taken lightly, an overly enthusiastic search for yield, the risks of asset price bubbles, and excessive leverage. Let’s not forget that a long period of monetary policy accommodation had probably increased the likelihood of a systemic financial crisis.[7]

One might well say that “there is no financial stability issue this time around”. I would reply along the lines of Rajan and Acharya who warned

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[7] See e.g. Grimm *et al.* (2023).

against "[t]he dangers of forgetting the 2023 banking crisis". Time is too short to elaborate on this here, but my sense is that the link with the extremely accommodative monetary policy of the preceding years is clear.

Of course, the euro area was largely unaffected by the US banking turmoil thanks to robust capital and liquidity buffers. But a change in sentiment might have weighed on credit growth and contributed to disinflation. In such a scenario, monetary policy tightening might have been less aggressive, possibly leading to a pause in rate hikes, similar to the Fed in June 2023.[8] This is a good example of how central bankers must navigate uncertain times by remaining agile and avoiding pre-commitments to predetermined policies.

To sum up, one should not underestimate financial stability risks going forward.[9] Particularly if policy rates have to be kept high for longer. And one should keep in mind that, in principle, a central bank can only act when financial stability issues are related to liquidity and not solvency issues.[10] As a consequence, prevention is, as always, better than cure.

I could not end a discussion of the side effects of super-accommodative monetary policy without mentioning fiscal sustainability. There are two issues here. The first is that low or negative nominal interest rates on public debt, if maintained for too long, can encourage reckless spending trends. The second is that from the perspective of the consolidated public sector balance sheet, QE amounts to transforming long-term liabilities into overnight ones (bank reserves). The resulting transfer of the interest rate risk away from private sector balance sheets quickly becomes a costly proposition when policy rates must be raised.[11] Central banking today is a loss-making operation, something the public and some academics have a hard time accepting.

Here again, Jens' early warnings impacted my thinking. As early as mid-2020, he reminded us that "large-scale purchases of government bonds are associated with the risk of blurring the line between monetary and fiscal policy".[12]

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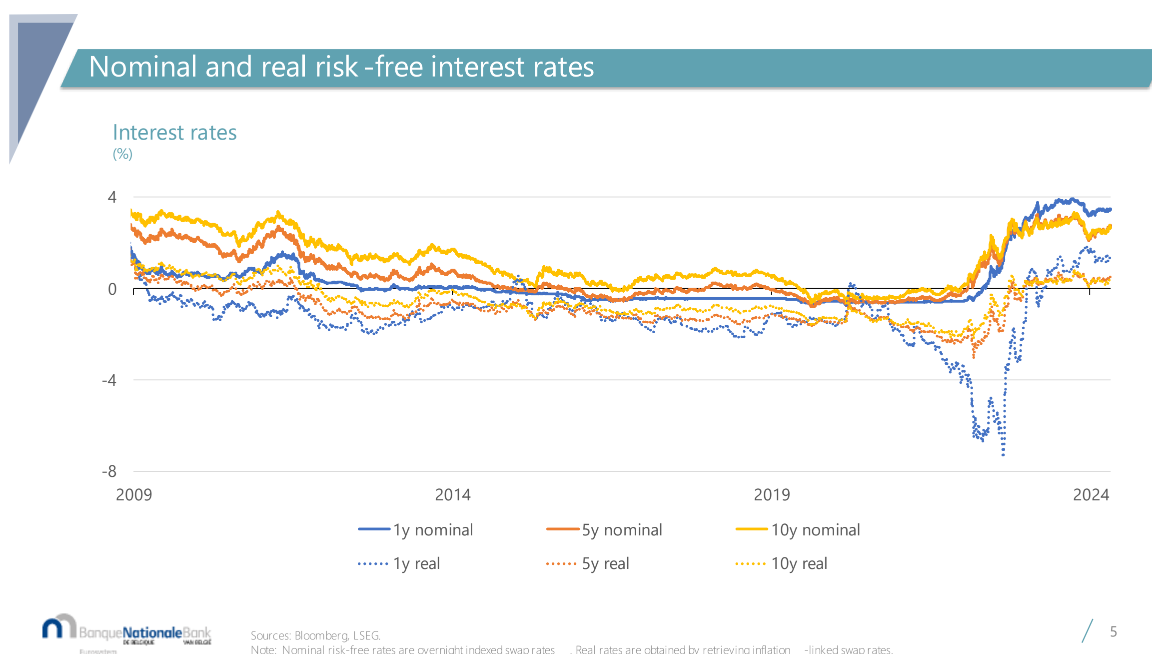
[8] Bloomberg, 22 March 2023, "ECB's Wunsch Wants Time to Assess If Rates Need to Rise Further".
[9] Wunsch (2024a).
[10] Schnabel (2023).
[11] Hall and Sargent (2022).
[12] Weidmann (2020).

2022: I became a "hawk" in the eyes of analysts

And inflation ultimately came back with a vengeance! With the pandemic behind us, a surprisingly strong recovery hit supply chains that were still under stress, and price pressures inevitably unwound. I quickly called for higher policy rates, a development that prompted many analysts to conclude decisively that I had aligned myself with the hawkish camp.

In the face of mounting inflationary pressures, our workhorse models supported a narrative of temporary developments that did not warrant a policy shift. The accumulation of inflation forecast errors nevertheless encouraged me to question openly the dominant view.[13] In early 2022, I characterised the return of nominal interest rates to zero or above by year-end as a "no-brainer".[14] By mid-2022, Russia's aggression in Ukraine had propelled energy prices in Europe to historic highs.



As inflation continued to outpace expectations, the textbook-ish "look through" advice appeared to be increasingly inadequate. I called for a hike of at least 200 basis points to bring real rates to zero, a level at which monetary policy was unlikely to harm economic prospects (monetary policy would be considered broadly neutral), while signalling a clear resolve to deliver on our

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[13] See e.g. MNI, 13 October 2021, "ECB Risking Wrong Inflation Message".
[14] Reuters, 5 April 2022, "ECB could raise interest rates back to zero this year – Wunsch".

mandate.[15] Still, that judgment call had to be made under exceptional uncertainty. Estimates of the neutral policy rate (R*) are notoriously unreliable.[16] As Fed Chair Powell succinctly put it, "we are navigating by the stars under cloudy skies".[17]

By the end of 2022, I found myself contemplating the prospect of rates reaching 3%. There was little doubt in my mind that inflationary pressures had to be tackled by strong policy action.[18] I entered 2023 convinced that rates would reach the 4% threshold, which is where we are today.[19]

Summing up and preliminary conclusions

Before moving to the current policy landscape, let me briefly recap.

Firstly, we've seen that quantitative easing proves effective in addressing the effects of tail economic shocks in a context of constrained policy space. QE worked through the monetary-fiscal policy mix.

Outside times of acute crisis, QE might well be tantamount to pushing on a string. Neither quantitative easing nor forward guidance proved effective in steering inflation back to our 2% target. Besides, unconventional policies have side effects in terms of inflation persistence, financial stability, and fiscal sustainability.

Secondly, models may not always be the reliable compass on which we should rely. We were led to believe that inflation was transitory, only to find out it was not. This underscores the need for a critical re-evaluation of our modelling frameworks and of the role of model-based projections in policymaking. The Bank of England recently indicated a way forward that we'd be well-minded to consider.

Thirdly, the costs and risks associated with the effective lower bound might not be as serious as previously thought. On the one hand, the effective lower bound did not prevent an effective response to an acute crisis such as COVID-19. On the other hand, with inflation being a regressive tax felt by all of us, the perceived cost of de-anchoring upward — say above 3% — is

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[15] Reuters, 28 June 2022, "ECB support should be limitless if fragmentation unwarranted: Wunsch".
[16] Wunsch (2022).
[17] Powell, J. H. (2023), "Inflation: Progress and the Path Ahead", Speech at Jackson Hole.
[18] Interview with CNBC, 13 October 2022.
[19] Financial Times, 3 March 2023, "ECB officials warn of more interest rate rises as high inflation persists".

arguably higher than the unease one might experience during prolonged episodes of inflation in the 0-1% range.

Two policy conclusions can be drawn.

Firstly, central banks should engage in aggressive monetary accommodation — through QE and forward guidance — when crises hit, and policy space is scarce. Outside such circumstances, "shock and awe" strategies should be avoided if inflation expectations remain reasonably well-anchored. This realisation requires a recalibration of our policy toolkit.

By implication, we should also be prepared to tolerate some flexibility in interpreting the point inflation target of 2.0%. This is to avoid mistakes such as the decision to expand quantitative easing when inflation forecasts hovered around 1.8% in late 2021.

Monetary policy at the current juncture

Thinking about monetary policy today is fraught with conceptual and practical challenges. To name but a few, I would mention the rising prevalence of supply shocks (or relative price disturbances, if you prefer), heightened uncertainty over key economic relationships that we previously took for granted (mainly the Phillips curve), and slow-moving transitions (population ageing, digitalisation and the advent of AI, climate change, or the shortening of global value chains).

Structural transformation means that the models at our disposal are intrinsically uncertain; or rather, even more uncertain than before. In a sense, the good old "Lucas critique" is back! As Bob Lucas warned us almost 50 years ago, trusting fixed parameters and functional forms reflecting past behaviours can be misleading. Conventional wisdom might not be as wise as it used to be, because "intercepts" might shift, and critical "slopes" might have become steeper as a result of thus far unsuspected "non-linearities."

What might at first sound like a curiosity of modelling carries first-order policy implications. A case in point is the traditional advice of "looking through" supply shocks. The argument is simply that if inflation expectations are anchored, the inflation effects of temporary supply shocks will self-correct without any policy action. That prescription, which stems from traditional new Keynesian models, partly explains why the ECB did not start

raising policy rates as soon as inflation emerged. Meanwhile, as we were "looking through," real interest rates dived further into negative territory, fuelling inflation.

As positive inflation forecast errors piled up, many struggled to understand the drivers of inflation persistence. This is hardly surprising if the most trusted models keep replicating a world of low and stable inflation where actual policy is seen as having little effect on the process (the "flat Phillips curve" view). Besides, many analysts and policymakers took comfort in long-term inflation expectations remaining anchored at 2%.

This forces us to think harder about the role of inflation expectations in our policy framework. In my view, we should not rest quietly on the fact that some preferred measure of expected inflation is firmly tied to the official target. Welfare reflects actual inflation, which everybody feels as the painfully regressive tax it is. To put it bluntly, "we do not eat expected inflation."

Of course, anchoring is crucial for macroeconomic stability as a deviation of long-term inflation expectations from 2% would be a sign of waning confidence in the credibility of monetary policy. And as COVID-19 showed, such credibility is crucial to deploying an adequate response during crises. However, stable long-term inflation expectations are only a necessary, not a sufficient, condition for macroeconomic stability. It only tells us the endpoint, not how we will get there.

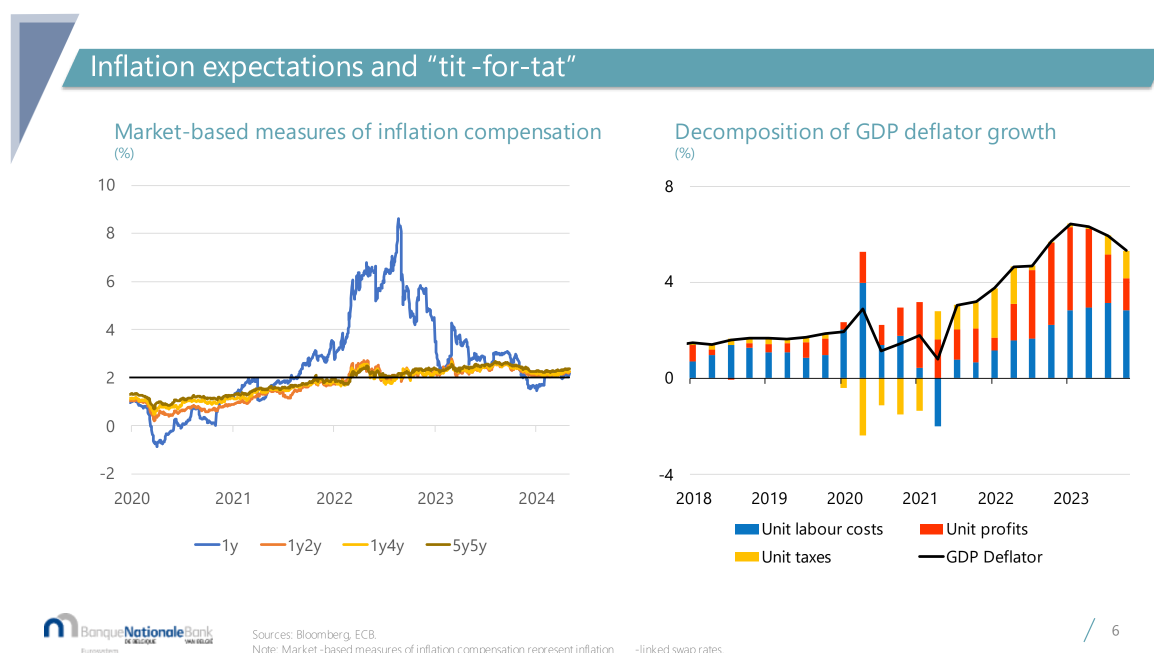
So, to understand inflation persistence — what happens between now and the fixed endpoint — we must look into the role of shorter-term expectations and their effects on wage formation. In fact, new Keynesian models tell us nothing else: long-term expectations play no role beyond their influence on shorter-term expectations.[20] And in fact, the textbook new Keynesian Phillips curve features next-period inflation expectations.

Empirically, short-term expectations are a key driver of macroeconomic dynamics. Recent evidence from wage growth data supports that view.[21] Workers seem to take short-term inflation expectations into account in the wage-bargaining process, in addition to past inflation; while longer-term expectations play virtually no independent role. Indeed, if workers know that

[20] Rudd (2022) and Blanchard and Bernanke (2023).
[21] Glick, Leduc and Pepper (2022).

they can renegotiate their wages every year or every other year, longer-term developments are largely irrelevant. A similar reasoning holds for firms' pricing behaviours.

The role of short-term expectations in price- and wage-setting behaviours feeds into one of my concerns about inflation persistence: the emergence of wage-price spirals. If short-term inflation expectations matter for wage- and price-formation mechanisms, a rise in these expectations would encourage workers to raise wage demands and firms to increase sales prices in a sort of "tit-for-tat" game.[22] A terms-of-trade shock makes such tit-for-tat dynamics even more likely, as each agent has an incentive to transfer the impact of the shock onto the other, even though the shock makes the entire economy poorer.



Thus, placing a greater emphasis on short-term inflation expectations and wage dynamics seems advisable in order to navigate the current climate.[23]

As the effects of energy shocks dissipate, firms have tended to reduce profit margins in the face of persistent wage growth. While firms may have taken advantage of the inflationary environment to increase prices (so-called "greedflation"), they may also have anticipated that wages would ultimately

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[22] Arce, Hahn and Koester (2023).
[23] See also Adrian (2023).

catch up with price increases. If so, margins would simply play a buffer role, reflecting the greater rigidity of nominal wages compared to prices.

While such conjecture appears plausible, theoretical models struggle to capture ongoing inflation dynamics. The formal debate revolves around the specific form of the Phillips curve. For one thing, the stability observed in long-term inflation expectations suggests that the curve did not shift upwards. This means that monetary policy credibility has been preserved. An upward shift in the curve would have meant higher inflation regardless of the state of the real economy, and thus a greater likelihood of tit-for-tat manoeuvres. As such, and as seen in the 1980s, central banks would have had to regain credibility at the cost of causing a protracted slowdown in economic activity, and most probably, a serious recession.

There has been even more debate around the shape of the curve, and namely, its slope and curvature. Non-linearity could mean that the slope of the curve depends on the level of inflation. This would be consistent with the view that firms would feel less constrained by competition and would be less hesitant to raise prices in an inflationary context (or one characterised by strong demand[24]) compared to a low inflation (or depressed) environment. This kind of conjecture would help explain the inflation surge as well as the seemingly painless disinflation process observed so far.

Recent empirical evidence concerning the Phillips curve is consistent with signs of a steepening trajectory.[25] While models need time to adjust to a new reality, microeconomic evidence points more clearly to an increase in the frequency of price adjustments by firms.

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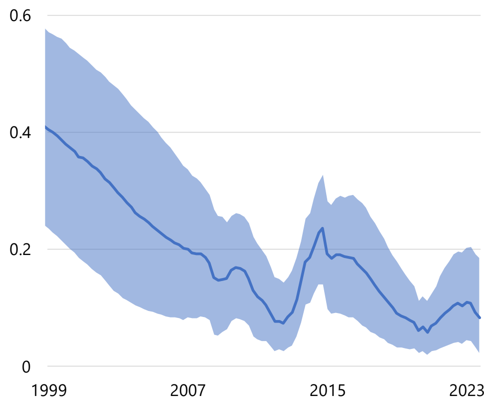
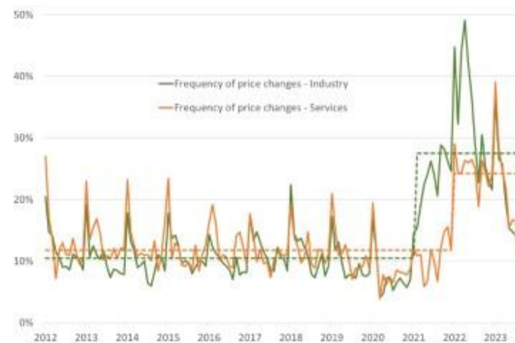
[24] Benigno and Eggertson (2023) and Erceg, Lindé and Trabandt (2024).
[25] Stevens and Wauters (2021), and Gautier, Le Bihan and Lippi (2023).

A steeper Phillips curve?

Estimates of the slope of the Phillips curve
(%)



Monthly frequency of price rises and falls
(% of companies that have raised/lowered their prices)



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Sources: Gautier, Le Bihan and Lippi (2023), and update of Stevens and Wauters (2021).
Note: Monthly business survey (Banque de France), share of business leaders reporting a price change during the month (weighted).

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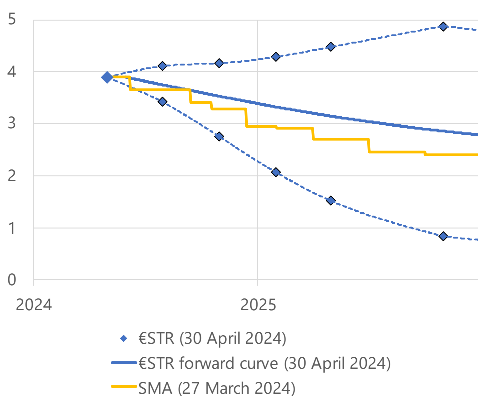
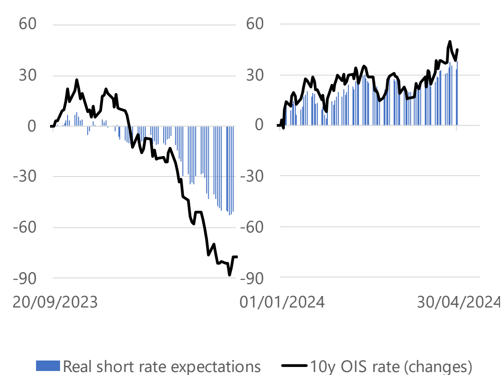
That said, since the curve does not appear to have shifted upward, policy credibility remains intact, and there is no case for maintaining tight monetary conditions beyond those strictly necessary to stabilise the economy. Not surprisingly, markets have already priced in rate cuts in the short term. Looking at the €STR forward curve, a first cut is expected in June, with one or two additional cuts envisaged by year end. A similar picture emerges from the ECB's survey of monetary analysts.

Interest rate expectations

€STR forward curve
(%)



Changes in 10y OIS rate
(basis points)



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Sources: Bloomberg, ECB, LSEG, own computations.
Note: Option-implied forward distributions for the 3-month EURIBOR rate are transposed to the €STR forward curve by keeping constant the distance to the median. Real short rate expectations are estimated from term structure models. These estimates are subject to uncertainty.

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Of course, uncertainty around such scenarios remains considerable. Distributions of €STR forward rates around the baseline are wide. In

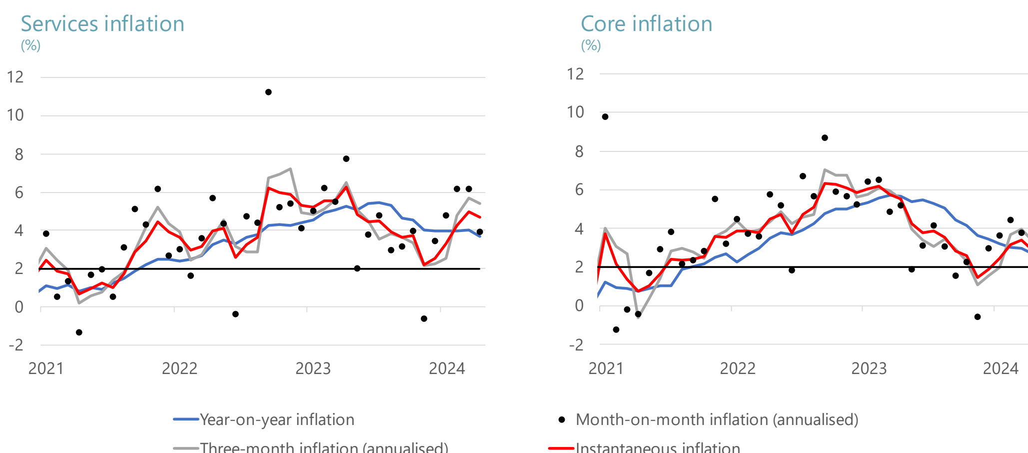
addition, the recent volatility in interest rates underscores the need for caution when looking at market prices. After the last rate hike in September 2023, long-term rates plunged by about 90 basis points by the end of the year due to expectations for monetary policy easing after better-than-expected inflation data. However, since the beginning of this year, long-term rates paired back some of their earlier decline as expectations for rate cuts moderated somewhat.

For central banks, dealing with uncertainty means remaining data-dependent. Now is not the time to commit to a preset course of action. It is about using our discretion wisely… about getting it right, as information about the state of the economy becomes available. Significant risks remain around the trajectory of wage growth and inflation in wage-intensive services. Despite recent signs of moderation, more will be known about the dynamics of wages and services inflation at the June Governing Council meeting.

Of course, data dependence also requires some willingness to take risks, as uncertainty complicates the early detection of new trends.[26] To be sure, the road ahead is likely to be a bumpy one for services and core inflation. Real-time inflation readings will likely be quite volatile over the next few months. As wages are intrinsically more rigid than prices, wage growth is expected to remain broadly constant this year. This would imply that real wages catch up with their pre-pandemic levels. Of course, we still cannot exclude that workers demand compensation for several years of depressed purchasing power.

[26] Wauters (2023).

Timely inflation measures



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Sources: ECB, own computations.
Note: The perils of tracking year -on -year inflation | nbb.be .

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All in all, and although the outlook remains foggy, I see a path for initiating rate cuts this year. Firstly, our inflation forecasts have recently become more reliable. Secondly, we continue to predict a return of inflation to the official target by end-2025. Thus, with no sign of de-anchoring in the longer term, the costs of remaining tight for too long seem to outweigh those of a premature loosening. This boils down to what I have recently described as the Governing Council having to “make a bet” on inflation staying in line with projections.[27]

One known unknown remains the role of the exchange rate and the risk of importing inflation. While monetary policy tightening was remarkably synchronous around the world, easing cycles appear unlikely to exhibit similar synchronicity. Diverging economic conditions and policies on both sides of the Atlantic might lead to significant effects from the dollar-euro exchange rate.

The mandate under pressure on two main fronts

Before concluding, I would like to take a step back and discuss two matters related to the boundaries of central bank mandates. The first pertains to the evolving public discourse on climate change and its implications for

[27] Econostream Media, 8 February 2024, “ECB’s Wunsch: ‘At some point, we are going to have to bet on where inflation’s going’”. Reuters, 13 March 2024, “ECB should ‘make a bet’ on rates before long, says Wunsch”. Bloomberg, 13 March 2024, “ECB must take a bet on rate cut as prices abate, Wunsch says”.

monetary policy. The second revolves around the interactions between fiscal and monetary policies.

While these two considerations might appear to be orthogonal to one another, they were joined at birth by the reference in the ECB’s mandate to Article 3 of the Treaty on European Union (TEU). Taken together, the ECB is expected to support EU policies as long as price stability is not jeopardised.

For many, supporting EU policies means using our very deep pockets to tilt relative prices in directions deemed desirable from a social welfare point of view. Specifically, we could buy green assets to lower the funding costs of decarbonisation. We could provide fiscal space to governments so they can meet the ever-increasing demands on already stretched domestic budgets.

Let me say it loudly and clearly: be careful what you wish for! Pushing central banks into the inherently political waters of tilting relative prices could open Pandora’s box: never-ending mission creep and ultimately, politicisation would loom large.

Let me now take these issues on one at a time.

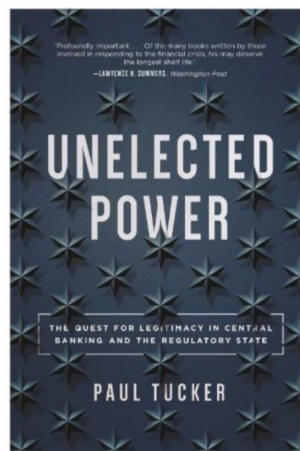
Climate change

On climate change, I have gone on the record on two key occasions in 2021 and 2023. As you might guess, Jens had already made interventions in 2019.[28]

[28] Wunsch (2021, 2023b, 2024b), Weidmann (2019b, 2021a, 2021b).

A mandate under pressure?

- Climate change
- Fiscal-monetary policy interactions



BanqueNationaleBank Source: / 10

There has been a growing chorus of voices calling on central banks to take a more proactive role in addressing climate change. While I acknowledge the criticality of a successful climate transition, let's keep in mind the inherent limitations of monetary policy in dealing with allocative efficiency issues.

Monetary policy is a blunt instrument and one unfit to tweak relative prices in socially desirable ways. To achieve the latter, an array of fiscal instruments are available which embody the key virtues of being quick, targeted and reversible.

Admittedly, my view is a minority one within the ECB Governing Council. I nevertheless take some comfort in the fact that this view is more popular in the Anglo-Saxon world. Chairman Powell famously said last year that "We [the Fed] are not, and will not be, a climate policymaker".

Another source of relief for me is that integrating climate change in monetary policy has so far remained a largely conceptual discussion. The actions taken to tilt corporate bond purchases and the collateral framework have been rather symbolic. I would be more concerned if actions went beyond symbols in the future.

That said, when discussing climate change in relation to monetary policy instruments, one should distinguish between direct action on relative prices and a risk-based approach.

A risk-based approach should be understood as recognising the higher risks of default at the *firm level* arising from exposure to climate developments or policies. In that case, it is natural to consider that risk when implementing monetary policy through asset purchases or when accepting collateral. Central banks impose similar requirements on the commercial banks they supervise. As Jens put it: “[c]entral banks should practise what they preach”. Central banks should factor in climate-related financial risks into their risk management, as they do for many other risks.

Beyond default risks at the firm level, central banks also look at climate risks from a financial stability perspective. Here, stress tests are a relevant tool. These should consider the relatively low duration of bank balance sheets. One should for instance avoid conducting stress tests with *static balance sheets* over long periods.

The calibration of stress tests is a difficult balancing act. Recently, the ECB conducted a stress test with carbon prices of \$600/tCO_2 in a so-called “orderly” scenario and \$1 000/tCO_2 by 2050 in a “disorderly” scenario.[29] The latter corresponds to a shock which would push the price of oil up to almost \$450 per barrel. Now, how likely is it that governments would produce a shock bigger than the recent energy crisis while at the same time not offering any support to the economy? Not very likely, I would say, at least, not if recent opinion polls on the coming European elections are any guide.

Regarding action on relative prices beyond individual risks of default, the role of monetary policy is most contentious. The short version of the argument is that textbooks usually give monetary policy no role in terms of allocative efficiency. Now, as a group of Belgian NGOs has actively campaigned against my reappointment as governor given my position on the topic, I might as well give you the somewhat longer version.

Proponents of an active role for the ECB in greening our economies mention Article 3 of the TEU, to which the ECB mandate refers. The mandate reads: “Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Union […]”. The general economic policies laid out in Article 3 cover many objectives. By isolating action on climate change, an “animal farm” reading of the Treaty would put us in the position of prioritising the issue without clear criteria for making such a choice nor the political legitimacy to do so.

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[29] ECB (2022).

Moreover, the condition “[W]ithout prejudice to the objective of price stability” is a weak one: with the ECB balance sheet running at about €7 trillion, one could argue in favour of spending €10 billion on any policy issue without really affecting the monetary policy stance and hence without immediate prejudice to the primary mandate.

More crucially, is a central bank’s involvement in climate policy about supporting policy or correcting policy failures? Conceptually, the economists’ first best recommendation to fight climate change would be to introduce a Pigouvian tax on carbon, to force polluters to account for their externalities. Now, if elected authorities were to set the CO_2 price at the socially optimal level, monetary policy would not have any additional role to play. And if authorities were to set the price too low, changing this price through monetary policy would be tantamount to correcting a policy failure, which is controversial.

Once again, unelected policymakers cannot legitimately make choices with first-order redistributive implications. As soon as one recognises that fighting climate change implies trade-offs, there is a very fine line between *supporting* policy and *making* policy. Conceptually, one would need to change the nature of the trade-off, with more efficient instruments than those available to policymakers, to be on safer grounds. But this is unlikely to be the case for the reasons I just explained.

Finally, monetary policy faces a communication challenge when dealing with climate change. Many people believe that central banks are just another kind of bank providing credit to the economy. But they are not. It is therefore crucial to avoid creating expectations that central banks can finance the energy transition.

Fiscal-monetary policy interactions

Another issue at the frontier of discussions around central bank mandates is the relationship between monetary and fiscal policies. I have already made some key points when discussing the role of the policy mix during the COVID-19 pandemic, but I’d like briefly to elaborate on a few more general considerations.

Since the 1990s, granting political independence to central banks, along with a well-defined mandate to achieve price stability, has been one of the most

widespread and successful institutional reforms in the world. It brought macroeconomic stability that was sorely lacking during the 1980s.

The core idea is simple and intuitive. To avoid inflationary monetary policy, it makes sense to keep the insatiable appetite of governments for spending well separated from a creditor with potentially infinitely-deep pockets and offering very generous funding terms (zero interest).

It remains that even if they live separate lives, monetary and fiscal authorities are tied by the intertemporal budget constraint of the consolidated public sector. The question then becomes: who will ultimately assume responsibility for fulfilling that budget constraint?

If monetary policy is to be credibly assigned to preserving price stability, then the Treasury must assume the sole responsibility for sticking to the budget constraint. This is sometimes known as ensuring a regime of monetary dominance, and it explains why many governments (in Europe and elsewhere) have committed to specific fiscal rules banning excessive deficits and debts. The opposite situation, in which the central bank is forced to fulfil the budget constraint, is labelled as fiscal dominance.

Recent years have blurred the previously neat demarcation lines between the two policy realms.

Firstly, as discussed earlier, the COVID-19 pandemic created a situation in which both sets of instruments were strategic complements: it was in the best interest of monetary policy to create space for fiscal policy, and in the best interest of fiscal policy to use that space to respond to the crisis. However, this made us forget that the normal situation is one of strategic substitutability, in which monetary policy offsets the effects of fiscal policy on aggregate demand.

I am afraid that to this day, too many governments are continuing to sleepwalk into a world in which central banks are expected to continue to help at any cost, given the magnitude and multiplicity of the challenges we all face. My view is different: two years of strategic complementarity and crisis management might have left governments with a sense that it was OK not to make difficult choices anymore. Well, it’s not OK.

Secondly, jitters in sovereign debt markets have prompted some central banks to intervene to avoid costly panics and preserve the stability of the

financial system. A prominent example is the intervention by the Bank of England to avert a bout of panic related to overambitious fiscal announcements. In the euro area, the fragmentation of the fiscal landscape — one central bank and many national treasuries — led to the creation of explicit, conditional stabilization tools — OMT and TPI — aimed at avoiding unwarranted market panic. Of course, these instruments only make sense in order to prevent intrinsically solvent governments being subject to devastating liquidity crises. Other mechanisms outside the ESCB — namely ESM loans — exist to handle fundamental fiscal sustainability issues.

Thirdly, a persistent combination of unsound public finances and accommodative monetary policy could have contributed to the undermining of commitments to fiscal responsibility. Jens' cautionary words from 2020 resonate loudly today: "Cheap money may be increasingly seen as the normal state. Under those conditions, even high debt burdens may appear sustainable to governments. But what if conditions change?".[30]

These considerations leave me with an uneasy feeling that fragile public sector balance sheets and mounting fiscal challenges (population ageing, defence, climate action) might become a persistent concern for central bankers. In a world in which governments have emerged from a series of crises as highly effective financiers and insurers of last resort, they are, perhaps more than ever before, too important to fail… The implication is that the risk of fiscal crisis might have become a shadow constraint on monetary policy. This is what I characterised a year ago, at the ECB Watchers conference, as a weak form of fiscal dominance.[31]

Coming back to Article 3, does it mean that we should support sound fiscal policies and tilt our purchases against high debt or deficit countries? That doing so is actually mandated by the Treaty? I do not believe so. But it does illustrate the need to better define the limits of our mandates and actions. In short, be careful what you wish for.

Conclusion

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[30] Weidmann (2020).
[31] Wunsch (2023a).

Let me now try to conclude this long voyage through the land of hawks and doves. By now, I hope that I have convinced you that we have learned a lot from the experiences of the last few years. And also, that monetary policy is about much more than a fight between two established camps, that it is more than a football match.

In a nutshell, aside from times of crisis, monetary policy has been more constrained by the effective lower bound than we thought. Persistent inflation — which our models had essentially assumed away — has come back with a vengeance, although medium-term expectations remain well-anchored. This points to the need to revisit the reliance on some instruments and tools. While QE proved effective in the midst of crises, it failed to bring us back to target within a reasonable timeframe. As regards forward guidance, it also proved relatively inefficient compared to the cost of tying our hands.

Where does this leave us? Probably with a humbler form of monetary policy. One that tolerates some more deviation from our target when economic conditions are benign and when risks of larger deviations are contained. This is more art than science.

Beyond these lessons on the inflation front, I have briefly discussed two issues pertaining to the limits of our mandates. I have argued that we are both testing these limits, with our climate policies, and being tested, with a weak form of fiscal dominance. None of the two are particularly salient as I

deliver this lecture, but they could become more prominent in the coming years, especially if public deficits do not decline as planned, and if our climate ambitions move from the symbolic to the more impactful.

Central bank independence is a humbling privilege for unelected officials. It should come with a narrow mandate. As Jens (him again) once said, “central bankers are not superheroes”.[32] Yet they must show extraordinary agility to adapt and respond to extraordinary circumstances. Be it during the recent COVID-19 pandemic or the “whatever it takes” episode, we may be called upon as architects and enablers of effective solutions. But however forceful these actions may be, they should remain exceptional and temporary. They should also pass a simple smell test: do we have tools at our disposal that elected politicians do not have, that are more efficient, and that they would want us to use?

Thank you for bearing with me. This was indeed itself an attempt at getting it right in an uncertain world.

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[32] Weidmann (2019a).

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