2. The Eurosystem’s monetary policy

2.1 In view of the deteriorating outlook for price stability, the ECB Governing Council took fresh measures in 2019

Inflation's convergence to its target slowed down significantly

Once again, inflation in the euro area hardly rose in 2019, and the Eurosystem's medium-term inflation outlook was cut in successive quarterly projection exercises – to 1 % for 2020 and to 1.4 % for 2021. Meanwhile, initial forecasts for 2022 – as evident in the December 2019 exercise – suggest an inflation level of 1.6 %. The private sector, too, has revised its inflation projections slightly downwards.

Hence the gap with end-of-2018 expectations – that is to say, a steady convergence of inflation to the ECB's objective of a year-on-year inflation rate of below but close to 2 % – has gradually widened.

How to interpret this persistently low inflation ?

The usual school of thought is that trends in prices are strongly influenced by the robustness of economic activity. An upward trend in the economic cycle, with its greater use of production factors, is supposed to cause an increase in inflationary pressures, whereas slowing activity makes for weakening price dynamics and, in the event of a serious recession, even deflation. From this perspective, the downward revisions in 2019 inflation projections for the euro area would seem to point to an increased risk of the economic growth slowdown, which started in the previous year, not just persisting but getting worse.

With projections indicating that inflation is undershooting its medium-term objective, economic activity is arguably set to trail behind the economy's output potential for a prolonged period. A less-than-optimum state of play, this suggests losses in economic prosperity, employment and incomes. After all, demand is not keeping up with economic supply. However, this conclusion can only really be drawn if inflation in a cyclically neutral period – i.e. at a time when real output is close to its potential level – effectively converges toward the central bank's target.

Alternatively, the lack of convergence towards the ECB's inflation target demonstrated by the projections might mean that economic actors have cut the figure at which they reckon inflation should stabilise when the economy reaches its potential. More specifically, this implies that these actors are pegging euro area inflation at a point clearly below 2 %.

The central bank's inflation target typically serves as a key factor for economic actor expectations. That said, past inflation levels also come into play in this – partly adaptive – process, and this retroactive or backward-looking component may become more important after multiple years of low inflation. After all, this situation might lead such actors to the conclusion that the central bank has grown more tolerant of persistent inflation spreads, and that they may even start to doubt its ability to get inflation to target.

Trends in long-term inflation expectations would appear to corroborate this hypothesis, as the downward trend in financial market prices to protect against five-year inflation has accelerated. Likewise, five-year inflation expectations emerging from surveys of private sector forecasters started to come down from the second half of 2019, whereas these had previously largely moved in line with the ECB's definition of price stability.

Why is below-target inflation an issue ?

Lower inflation and lower inflation expectations initially dampen monetary policy's accommodating effects and so also erode the policy's ability to stabilise the economy in a downturn. Although central banks can immediately intervene in nominal rates, economic agents' consumption and capital spending decisions are influenced by changes in real interest rates, i.e. nominal rates less inflation expectations for the relevant investment horizons. When inflation expectations go down, the impact of any (nominal) monetary boost to support price dynamics is lessened, as real rates contract less strongly than calculations assumed when the decision was first taken.

Other channels also come into play. With debt contracts typically concluded in nominal terms, any inflation that dips below what is expected at the time of the agreement means higher real debt repayment costs. The ensuing arbitrary redistribution of wealth from borrowers to lenders might prolong excessive debt and curb demand.

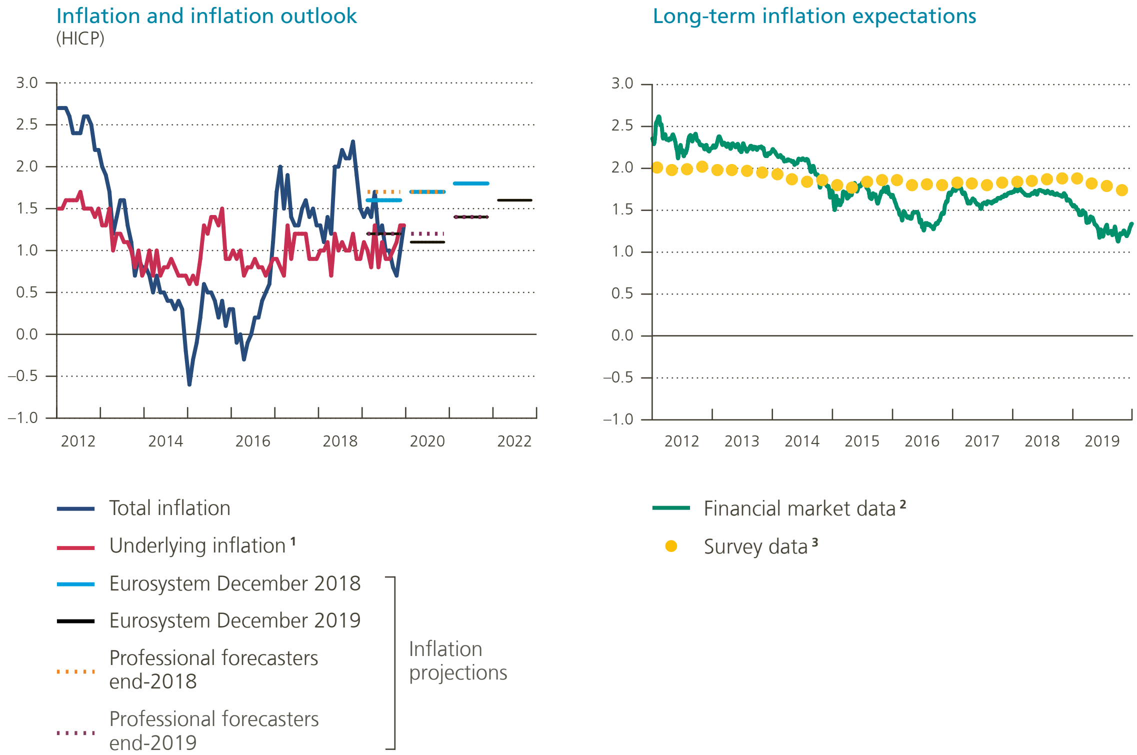
By way of both these mechanisms, low inflation turns into a cause and no longer merely an effect of economic malaise. And if the economy settles into a situation of persistently lower inflation, two additional complications emerge.

For a start, as they reflect the sum of real rates and (lower) inflation expectations for the relevant horizons,

Chart 15

Inflation's gradual convergence with its target slowed and long-term inflation expectations fell

(in %)



Sources: Bloomberg, ECB.

1 Total inflation excluding energy and food.

2 Five-year-on-five-year inflation expectations, based on prices recorded by swap contracts, which hedge euro area inflation risk over a period of five years, starting five years after the contract is concluded.

3 Five-year inflation expectations based on the ECB's quarterly survey of professional forecasters (average of the aggregated probability distribution for this projection horizon).

nominal yields will languish at permanently lower levels. Low nominal rates, however, come at an increased risk to financial stability. Pension funds and life insurance companies expected to meet their liabilities in nominal terms might, for instance, be tempted to take on excessive risks in order to achieve their promised yields. What's more, as central banks will run into the lower bound of their traditional monetary instruments more quickly during times of recession – i.e. it is tricky to make policy rates strongly negative – they will have to adopt non-standard measures more often, which in turn may have undesirable side-effects.

A second complication is that it becomes harder to reduce real wages – a useful adjustment measure when an economy slides into a recession or when its competitiveness relative to other economies needs shoring up. In a low inflation environment, nominal wages would have to be reduced frequently, an approach both employers and employees continue to be cautious about.

With the disappearance of the buffer that inflation close to 2 % in the medium term ensures in both cases, the economic system becomes less equipped to deal with shocks.

ECB Governing Council defends its price stability mandate – and symmetry

In keeping with its mandate on price stability under the Treaty on the Functioning of the European Union (TFEU), the ECB Governing Council is absolutely determined to avoid inflation staying low, and has taken a set of key decisions to address the issue, as described below.

Also, this position supports the symmetrical approach to the inflation target, as the Eurosystem's strategic monetary policy framework prescribes that inflation persistently over or under its reference point must be tackled forcefully [1]. Its aim for symmetry has been a feature of the ECB President's press conference statements since July 2019.

Symmetry may not appear self-evident when inflation continues to languish below target. For one thing, policy

1 See for instance "Delivering a symmetric mandate with asymmetric tools: monetary policy in a context of low interest rates", a speech made by Mario Draghi, the then President of the ECB, at the ceremony to mark the 200th anniversary of the Oesterreichische Nationalbank, Vienna, 2 June 2016.

rates – the instrument of choice for central banks – are asymmetrical as these cannot be endlessly cut to combat low inflation, in particular because economic agents can convert their deposits into cash. Moreover, the Governing Council's quantitative definition of price stability may be perceived to be asymmetrical in specifying a target below 2 %.

The 2019 monetary policy decisions are designed to re-anchor inflation expectations close to 2 %

The decisions taken in 2019, then, did not only serve to enhance the economy's resilience in the face of the risk of a protracted economic slowdown, they also intended to demonstrate the Governing Council's ability and determination to achieve the target in the face of many years of low inflation and a certain asymmetry in the Eurosystem's toolkit. It is an essential step that must ensure that economic agents can again assume average inflation below or close to 2 % when planning their long-term projects.

2.2 The 2019 monetary policy decisions have extended monetary easing

Prior to 2019: An unparalleled series of easing decisions, followed by emerging normalisation

The sharp fall in inflation since 2009 – a consequence of the financial crisis and the great recession – and its concomitant deflation risk prompted a raft of measures by the ECB Governing Council, including non-conventional ones, to ease monetary policy in the euro area. Policy rates were cut, resulting in negative interest on the deposit facility. In January 2015, it agreed to make large-scale purchases of government and private-sector securities under its expanded asset purchase programme (APP).

Like the Governing Council's communications about the programme's future direction, these measures were repeatedly updated for inflation trends as recorded. Increasingly persuaded that inflation's gradual convergence towards its objective had got underway, the Governing Council decided to adjust its key stimulus measures as 2018 progressed, in particular by ceasing its net AAP purchases by the end of that year. The normalisation process as planned at the time was to proceed very gradually so as to continue to guarantee solid monetary support. For example, the size of the APP securities portfolio was long kept at its then historically high level by reinvesting the proceeds from securities that matured.

The Governing Council's 2019 decisions, which aim to ward off the risks of a persistent deterioration in price stability prospects, were taken in a context of already significant monetary easing, and thus slow down the originally planned normalisation. In other words, they extend monetary easing.

September 2019's decisions mobilise the entire Eurosystem toolkit

In response to the gradual deterioration of macroeconomic conditions, the Governing Council had already announced various measures in the early months of 2019. Its September decision – undoubtedly the Eurosystem's most important monetary policy response of the year – was the outcome of three factors: a stronger-than-expected slowdown in growth, persistent downside risks to economic growth – largely due to geopolitical and trade tensions – and an overall drop in long-term inflation expectations.

These decisions, some of which the Council had already announced in previous statements, brought all of the Eurosystem tools into play. These break down into four types of measures.

Firstly, the ECB reduced to –0.5 % the deposit facility interest rate, which had been at –0.4 % since March 2016. However, it kept its two other policy rates unchanged: the rate on refinancing operations at 0 % and the marginal lending facility rate at 0.25 %.

The benchmark rate cut did not come as a surprise to the financial markets: in July 2019, the ECB's communication re-introduced the observation that policy rates might fall below their current levels, whereas this signal had been dropped from its communication around two years previously. With that communication element retained since then, fresh rate cuts remain possible in the future.

Secondly, the ECB upped its language on future trends in policy rates. From mid-2018, its communication had included a time reference (for instance, in December 2018, it clarified that interest rates would stay at their then rates "at least through the summer of 2019") and linked this to the achievement of the inflation target (it announced that interest rates would remain at historically low levels, in any case for as long as necessary to ensure the continued sustained convergence of inflation to its target). In March and June 2019, it extended the time reference, whereas from September it no longer focused on the calendar, but rather highlighted inflation developments. This connection has since been reflected around three points:

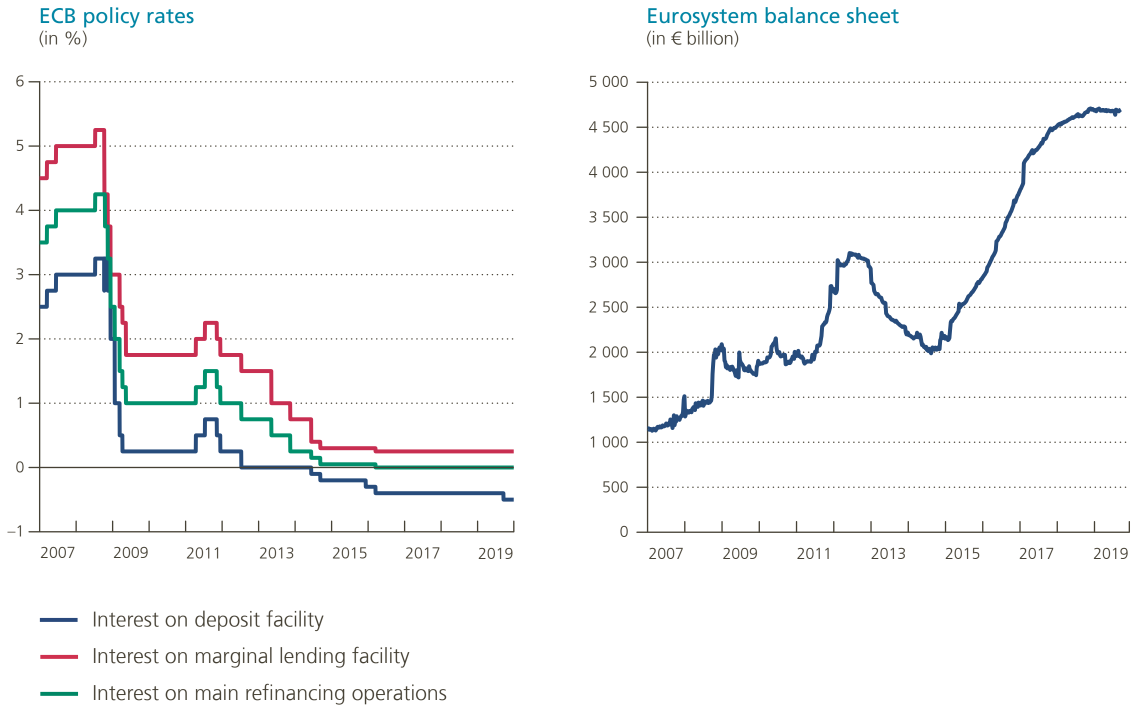
- That interest rates will remain historically low – at current or lower levels – until the Governing Council decides that the inflation outlook robustly converges to a level sufficiently close to, but below, 2 %;
- The convergence should be considered over the Eurosystem's projection horizon, i.e. two to three years;
- The convergence consistently reflects underlying inflation dynamics.

By adding a backward-looking component to what is essentially a forward-looking statement, the ECB has tightened up its story: convergence should not just be sustainable – temporary price rises will clearly be ignored – it must also be supported by an effective and consistent increase in the pressure on domestic prices. This latter precondition will absolutely need to be verified in view of the ongoing uncertainty over the nature of the factors – supply or demand – in the way of euro area growth prospects.

Third, from November 2019, the ECB decided to resume its net purchases of government and private securities under the APP to the tune of € 20 billion a month. These asset purchases will be continued at that rate for as long as is necessary to enhance the accommodating effects of policy rates. The ECB also

Chart 16

Monetary easing extended



Source: ECB.

intends to stop them prior to policy rates going back up.

The continuation of asset purchases now being firmly linked to interest rate decisions implies that these purchases will be linked to price dynamics. This is a clear chain of measures: the convergence of the inflation outlook determines the trajectory for interest rates, which in turn is decisive for the duration of the net purchases. What this boils down to is that the asset purchases will continue as long as the inflation outlook fails to improve.

The ECB reactivating the APP complements the accommodation arising from its rate decisions. Its net purchases in the financial markets of long-term government and private sector bonds effectively help it to exert a rather more direct downward influence on long-term yields and, as a result, the relevant financing costs for households and companies. What is more, these net purchases also have a clearer impact on long-term inflation expectations, as they make it crystal clear that the Governing Council will do everything needed to put all its available resources towards achieving the ECB's inflation target.

The timeframe for these measures to stay in place is explicitly linked to the inflation outlook – a strong automatic stabiliser

In addition, the resumption of net asset purchases was accompanied by confirmation that the ECB will continue its policy of reinvesting the principal of maturing securities purchased under the APP until well beyond the date on which the Governing Council starts raising policy rates. This policy will stay in place "for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation".

As the period for these measures to stay in place is now explicitly linked to the inflation outlook and a calendar indication is no longer given, the package comes with an inbuilt stabiliser and a predictable sequence of monetary policy decisions: if inflation moves towards the 2 % target more slowly, the assumption is that these measures will stay in force longer. If inflation converges more rapidly, monetary policy will be normalised sooner.

And, fourth, as this package of measures implies an extended period of low interest rates, in September 2019, two measures were added to support banking transmission.

To start with, TLTRO III implementing provisions were eased relative to their original plans. TLTRO III is the third series of targeted longer-term refinancing operations that was announced in March and launched in September. For example, the length of the seven scheduled three-monthly refinancing operations for banks in the euro area was extended from two to three years, and at even more favourable rates. TLTRO III's basic rate was set at the average rate for main Eurosystem refinancing operations during the term of a TLTRO. If the lending bank issues sufficient loans, this rate could even fall to the average rate on the deposit facility over the life of the TLTRO.

In addition, a two-tier system for remunerating reserves was put into place at the end of October 2019. Under this system, a proportion of reserves held by euro area banks with the Eurosystem is exempt from the negative deposit facility rate and remunerated at 0 %. Box 2 explains more.

BOX 2

Innovating monetary policy decisions in 2019: the two-tier system for remunerating reserves

In addition to the mandatory reserves they are required to keep with the Eurosystem, banks also deposit their excess liquidity holdings with the ECB. Interest on the deposit facility applies on these excess reserves, and this has been negative since June 2014. This situation may become an issue for some banks as the interest they pay on their retail customers' deposits – i.e. households and non-financial companies – seldom dips below 0 %. Their reluctance to introduce negative interest may have three reasons: (1) the existence of cash, which households and non-financial companies can retain as a last resort to hold their money: (2) the money illusion, which causes retail customers to consider negative nominal rates as theft, or at the least, as an abnormal situation: and (3) legal constraints.

Against the backdrop of this negative interest rate policy, the downward rigidity applicable to a proportion of their funding costs might squeeze banks' net interest margins. If interest rates stay low/negative, these same banks must, all other things being equal, effectively invest or reinvest assets at lower interest rates than they used to, while their costs remain largely unchanged [1].

If banks' profitability is hit too hard or for too long, monetary policy transmission might be hampered. To keep their margins sufficiently ample, these banks could choose to reduce the interest they charge on their loans less rigorously, for instance, or cut their lending.

With a proportion of excess reserves exempted from negative interest rates, some banks will see the negative impact of this downward rigidity of financing costs on their net interest margins tempered somewhat, benefiting their intermediation capacity and smoothing monetary policy transmission. That's why the ECB Governing Council gave the go-ahead to the two-tier system of remunerating reserves in September 2019. The system came into force on 30 October 2019.

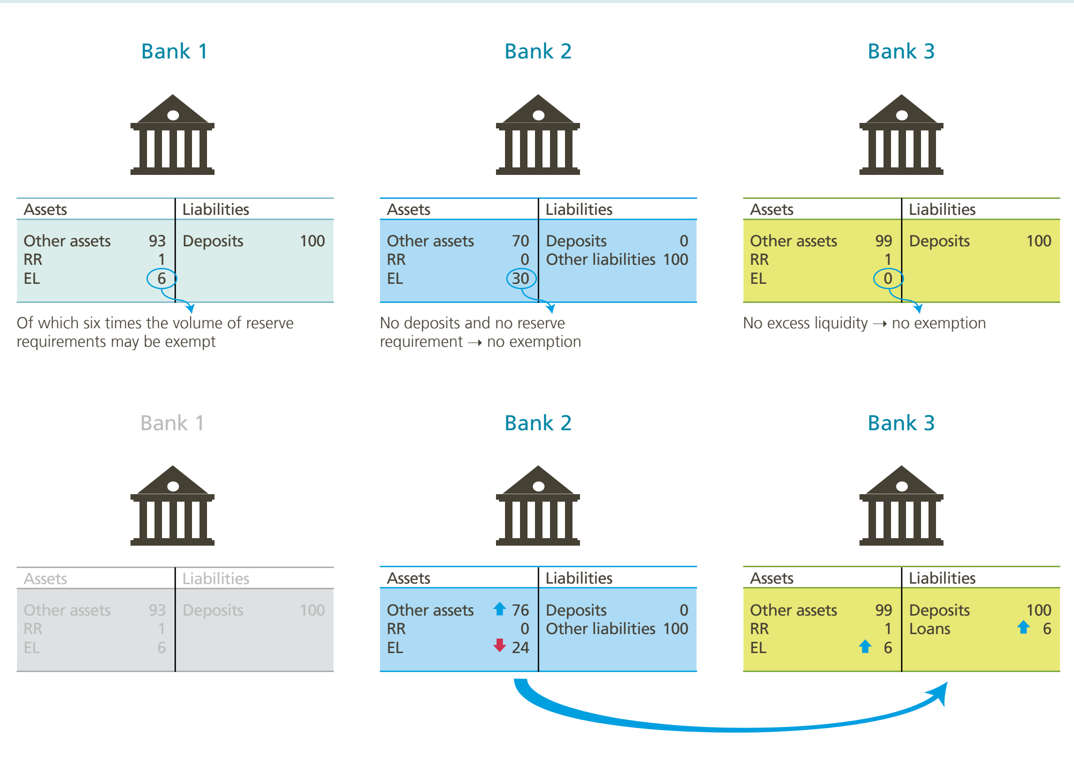
Under this system, the proportion of excess reserves that is exempt from negative interest closely ties in with retail deposit volumes, the reason being that minimum interest rates for such deposits often amount to around 0 %. The system's implementing provisions state that an amount of up to six times the relevant banks' reserve requirements could be remunerated at 0 % instead of at negative interest on the deposit facility. These reserve requirements equal 1 % of banks' short-term liabilities, with the exception of some categories (e.g. interbank loans). In practice, the reserve requirements mostly depend on retail deposits, from households in particular.

1 This is just part of the analysis. At the same time, a policy of negative interest rates, just like reductions in positive policy rates, leads to capital gains on securities portfolios. This policy also benefits banks' credit portfolios, in particular as the demand for and quality of loans increase on the back of improved macroeconomic conditions resulting from a policy of negative interest rates. It is therefore unclear what the total effect is of negative interest rate policies on banks' profitability and hence their intermediation capabilities, particularly at the start of the adjustment stage after the cut in policy rates. For more information, see de Sola Perea M. and M. Kasongo Kashama (2017), "The negative interest policy in the euro area and the supply of bank loans", NBB, *Economic Review*, December, pp. 43-61.

In concrete terms, the Eurosystem's two-tier system for remunerating reserves implies lower costs for banks that attract retail deposits and have excess reserves, such as Bank 1 in the diagram below. By contrast, a bank that does not attract its funding in the shape of deposits doesn't really stand to gain from this measure. That said, the latter would in any case be impacted less by the unfavourable effects of negative interest rates, as these are primarily associated with the lower bound on the deposit rate. A bank that does attract deposits but does not have any excess reserves, such as Bank 3 in our diagram, will also not be a direct beneficiary of the system. Unlike Bank 2, it might still be hit by negative rate policies, as the assets it finances or refinances are earning it less in the way of profits, whereas the costs of its funding through retail deposits are virtually unchanged.

However, banks with excess liquidity over the exemption upper limit and banks not having any excess liquidity (or below the upper limit, in any case) may benefit (more) from the arrangement by tapping the interbank markets. The diagram pictures Bank 2 lending to Bank 3 (see lower half of diagram).

The two-tier system for remunerating reserves may lead to transfers of excess liquidity between banks [1]



Source: NBB.
1 'RR' in the diagram stands for reserve requirements and 'EL' for excess liquidity.

In principle, any such a transaction would have to be carried out at a rate between the interest on the deposit facility – which has been at –0.5 % since September 2019 – and 0 %, i.e. the interest remuneration on exempt excess reserves. Bank 2 would earn higher interest on lending (non-exempt) excess liquidity than on the deposit facility, while Bank 3 would generate a profit margin for borrowing at interest rates below 0 % while receiving 0 % on this cash as soon as it is placed with the central bank.

However, a sharp increase in such transactions could push up interest in the money markets, for instance if they involve banks that did not used to be overly active in the interbank market. In light of reduced banking sector fragmentation – and consequent moderate interbank spreads – this risk does not yet seem to have emerged since the implementation of the system in the euro area. Still, the ECB Governing Council has said it will closely monitor money market developments and will be prepared to adjust the multiplier of the reserve requirements (currently equalling six) to prevent things from taking a turn for the worse.

2.3 Euro area financing conditions remained highly accommodative

As box 1 in chapter 1 set out, overall financing conditions – i.e. low interest rates – in the world's financial markets, including in the euro area, are primarily explained by fundamental factors supporting savings supplies and depressing investment demand. At the same time, the Eurosystem's monetary policy also impacts financing conditions in the euro area.

The euro area's reduced risk-free interest rates from a monetary policy perspective

Against this backdrop of excess liquidity, the EONIA – the reference rate on unsecured interbank overnight deposits in the euro area – stood at a couple of basis points over rates on the deposit facility, both before and after the latter were reduced. By contrast, the €uro short-term rate (€STR) – i.e. the indicator that the ECB has been reporting since October 2019 and which will replace the EONIA as reference rate for the euro in due course – stabilised at a few basis points below the floor policy interest rate. The difference is attributable to the fact that the €STR, unlike the EONIA, also comprises the rates for euro area banks' unsecured overnight loans with non-banking and foreign counterparties that have no access to the Eurosystem's deposit facility.

The ECB's 2019 decisions on policy rates triggered significant falls in short-term and long-term risk-free interest rates [1] in the euro area. Investors appear to have a solid grasp of the Eurosystem's response function: in light of deteriorating economic prospects, they have systematically and preventively lowered their expectations of current and future policy rate

1 A risk-free rate is an interest rates which excludes credit risk as far as possible and only reflects interest rate risk, i.e. the risk that the underlying asset falls in value when short-term interest rates rise.

trends, as a result of which short-term and medium-term risk-free interest rates have automatically come down.

As 2019 progressed, risk-free returns have gradually declined and levelled across the curve, including at the long-term end. Risk-free ten-year rates, for instance, plumbed historic lows, to some extent in line with trends in their counterpart yields in the United States, which saw policy rates cut three times in the second half of the year.

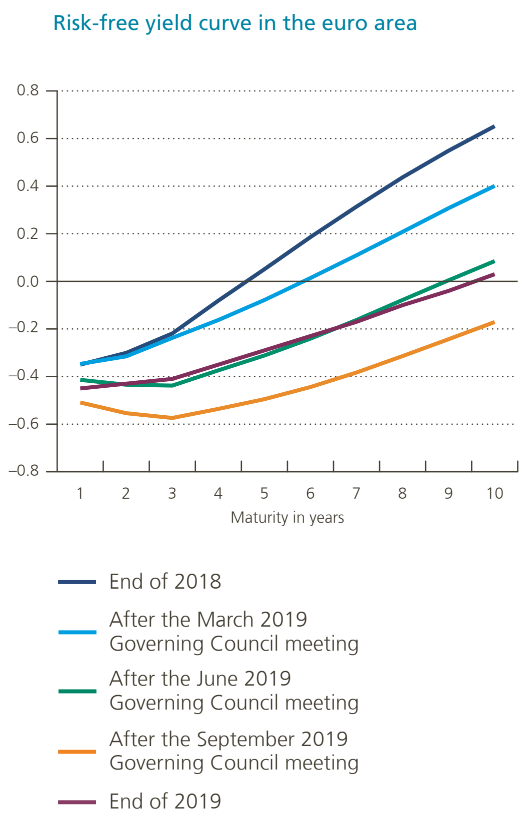
So how has the Eurosystem's monetary policy contributed to developments in 2019? A breakdown of risk-free nominal ten-year rates in the euro area into a real component and an inflation compensation factor reveals the effectiveness of the monetary stimulus. Despite a significant drop in the inflation compensation factor – caused by deteriorating macroeconomic prospects – the central bank impetus ushered in enough of a fall in nominal interest rates to reduce real interest rates.

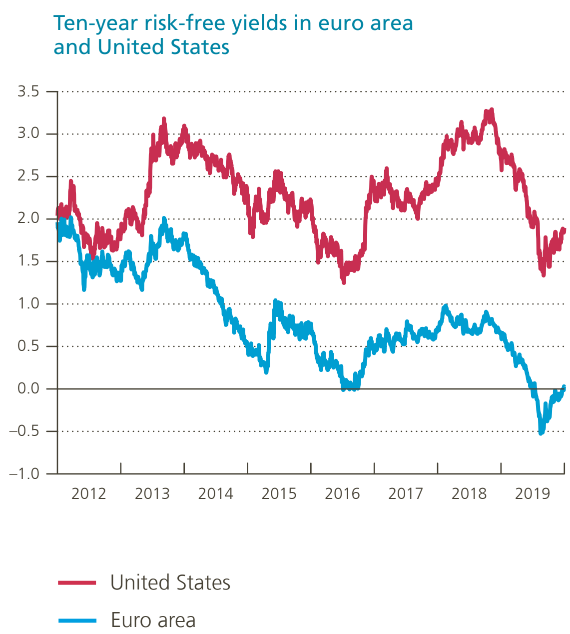
In the final quarter of 2019, interest rates recorded an upturn, in both nominal and real terms. This coincided with a tentative improvement in the economic outlook, playing down the restrictive nature of the upward trend in interest rates.

Chart 17

Euro area risk-free interest rates were down

(in %)



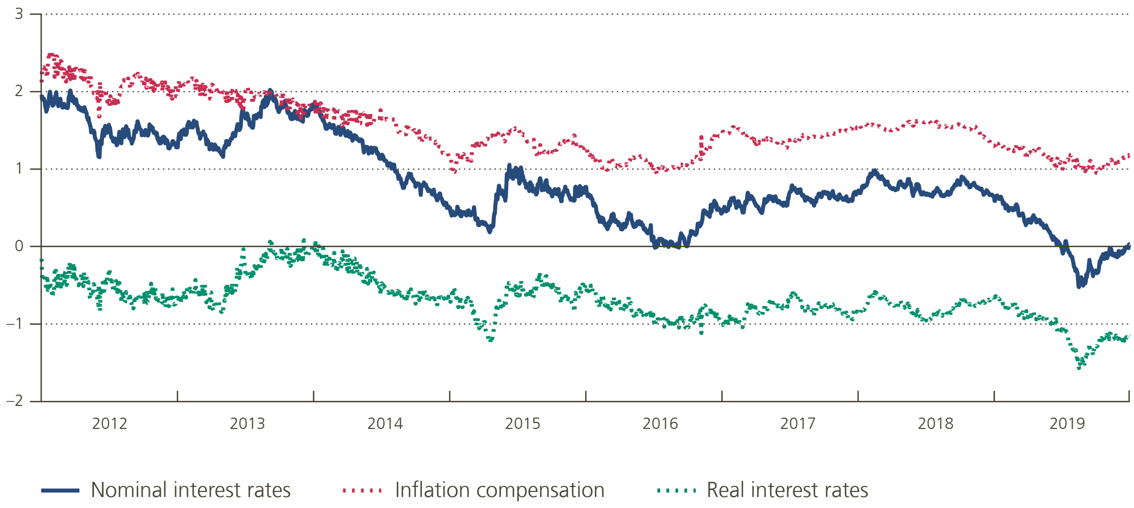


Sources: Bloomberg, Refinitiv.

Chart 18

The extension of accommodating monetary policy helped lower real interest rates despite falling inflation expectations

(breakdown of risk-free nominal ten-year rates in the euro area, in %)



Source: Refinitiv.

Monetary easing extends to financing conditions in a broader sense

The transmission of easier conditions to riskier financial markets proceeded without a hitch for both government and private sectors. In contrast to some tensions in the riskier euro area financial markets as observed towards the end of 2018, the extension of monetary policy accommodation in 2019 apparently prevented financial variables from further dragging down macroeconomic prospects.

Yields on ten-year government bonds declined, with spreads falling relative to German Bunds. Spread narrowing accelerated in a context in which the resumption of the APP without a specified end-date equalled a strengthened and extended presence of the Eurosystem as a major buyer in the markets for government debt. Italian yield spreads clearly narrowed from the summer, when the Italian government displayed some response to European Commission concerns over the country's budget direction.

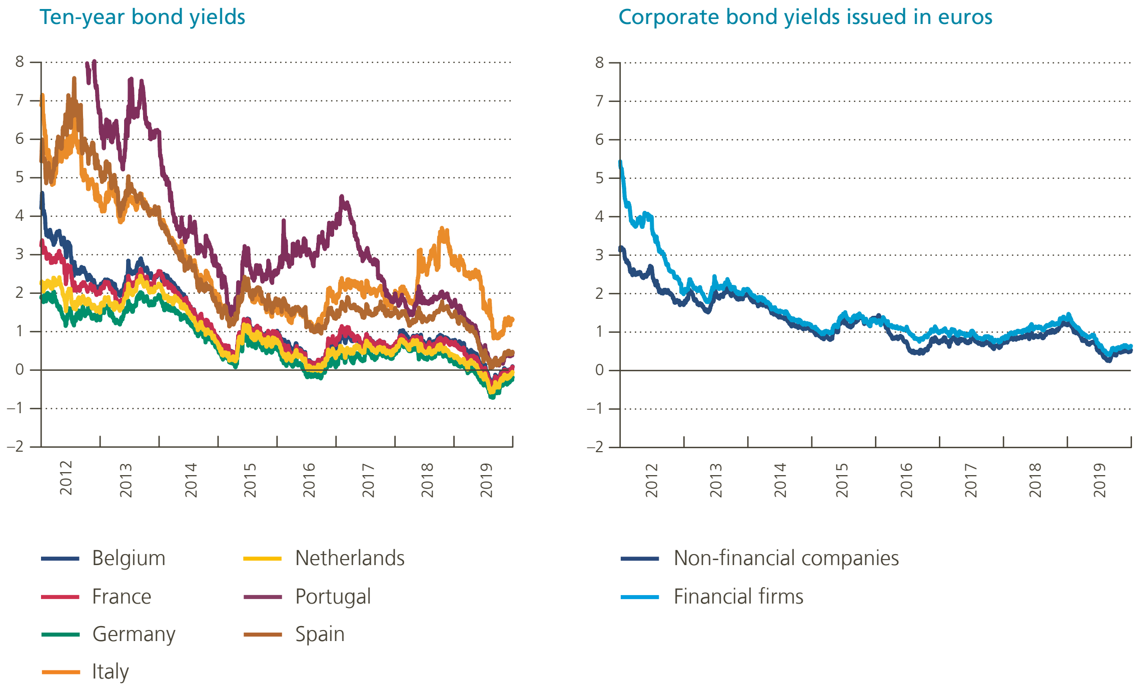
Yields on non-financial and financial bonds also recorded significant falls and stabilised at historic lows from September. The downward trend was across the board, regardless of issuers' credit ratings.

In addition, 2019 saw a constant strong flow of bank loans to non-financial corporations, even if this growth stabilised. Ongoing volume dynamics despite slowing economic growth were due in part to persistently low interest rates.

Chart 19

Easier conditions transmit to riskier financial markets without a hitch

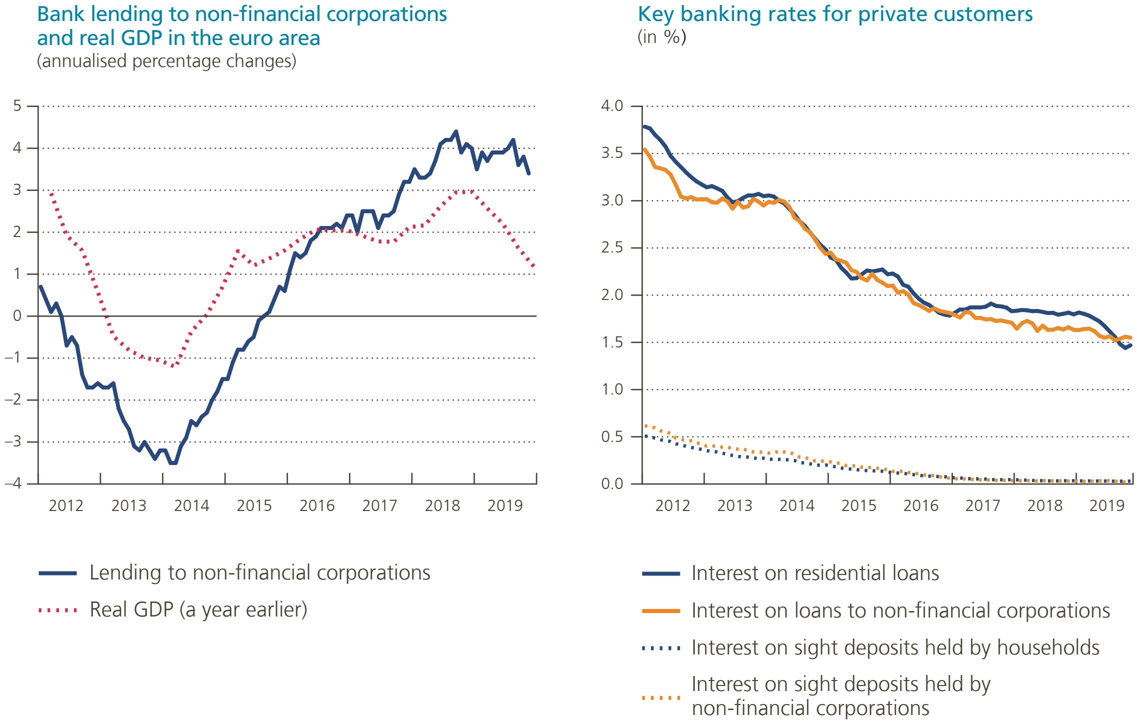
(in %)



Source: Refinitiv.

Chart 20

Historically low interest rates kept bank lending robust despite slower economic growth



Source: ECB.

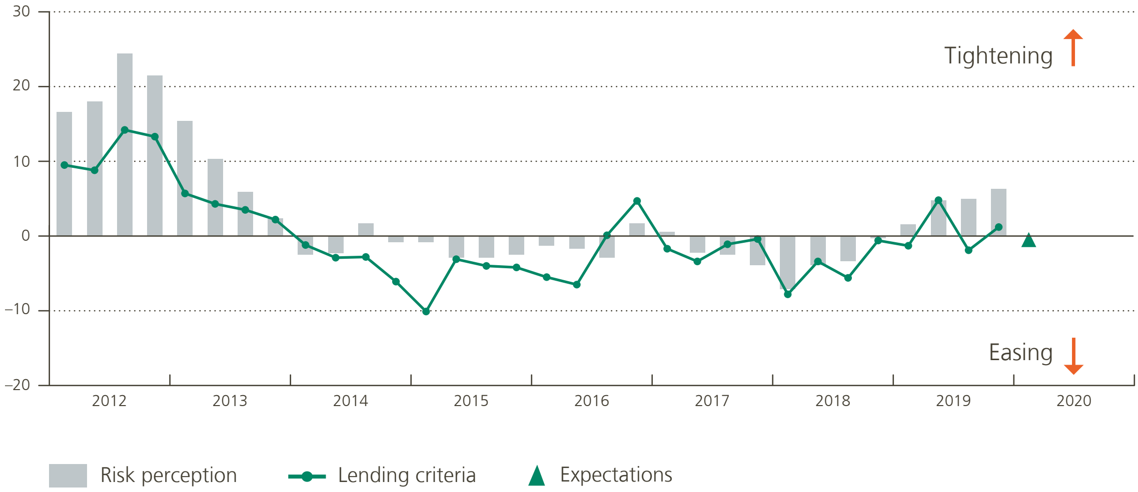
Trends in the criteria governing lending to companies, as evident from the responses to the Eurosystem's three-monthly bank lending survey, would appear to point to early signs of a tightening credit market. Banks attribute these tighter criteria to a higher risk perception as a result of slowing economic activity rather than to factors to do with balance sheet restrictions. In addition, the economic slowdown is starting to percolate through into credit demand.

Although banks noted in 2019 that the ECB's negative interest rate policy had an adverse effect on their margins, they noted that low interest rates did not get in the way of the policy's transmission: negative interest rates continued to help interest on loans come down and loan volumes edge up.

Chart 21

Lending criteria to companies were tightened slightly in 2019 due to increased risk perception at banks

(trends in loan criteria to companies, and risk perception as contributing factor: in net percentages [1])



Source: ECB.

1 Net percentages reflect the difference between the percentage of banks' responses pointing in one direction and the percentage of responses pointing to trends in the opposite direction.

2.4 Delayed monetary policy normalisation begs questions

The stimulus measures revealed in September 2019 imply that interest rates will remain low – and even negative – for longer. Although it is looking to prop up economic activity and inflation this way, the ECB Governing Council has been receiving criticism for its loose monetary policy. Some argue that monetary policy is too aggressive and ambitious, as the measures barely impact on inflation and cause unwanted side effects. Others would like to see the central bank and fiscal authorities work closely together to kick-start economic dynamics.

Two factors are currently making it harder for the ECB to stabilise inflation around 2 %. The first is the low equilibrium interest rate (see box 1), as the degree of monetary stimulus is determined by the relationship between interest rates in the economy and equilibrium rates. Current low rates do not point to an overly strong monetary stimulus, which might partly explain the slower recovery in inflation. A second factor is the weaker correlation between inflation and domestic economic activity (called a flat Phillips curve [2] by economists). This is making it more difficult to get too low an inflation rate back to its target.

Do stimulus measures have the desired impact on inflation ?

Significant monetary stimulus notwithstanding, euro area inflation remains way below its target, raising questions about the effectiveness of these measures. The answers are not easy, as a proper analysis of monetary policy's macroeconomic impact involves more than the mere observation that negative interest rates do not go hand in hand with an inflation rate of around 2 %. After all, any analysis of the impact of the stimulus must establish what the inflation figure would have been if the central bank had not taken these exceptional measures.

Besides, any assessment of monetary policy's efficacy is hobbled by being carried out in an ever-changing context in which new economic shocks mask the impact of previous measures on inflation and may even require further easing of monetary policy. Various studies [1] – although subject to great uncertainty – suggest that the exceptional measures have had a visible impact on economic growth and inflation in the euro area.

Do the benefits outweigh the drawbacks ?

Another criticism is that accommodating monetary policy has perverse side effects. For instance, low interest rates may encourage excessive risk behaviour, create bubbles – in the housing market for instance – and punish savers. Insofar as the low interest rate environment reflects a lower equilibrium rate, the role of monetary policy is limited. That said, the ECB Governing Council is aware of these side effects, monitors them and tries to limit them as much as possible – a case in point being that TLTROs do not apply to mortgage loans. Importantly, other policy areas will also have to step in to temper any undesirable side effects and facilitate a normalisation of monetary policy.

1 See Mouabbi S. and J.G. Sahuc (2019), "Evaluating the Macroeconomic Effects of the ECB's Unconventional Monetary Policies", Journal of Money, *Credit and Banking*, June, pp. 831-858, and Rostagno M. et al. (2019), "A Tale of two Decades : The ECB's Monetary Policy at 20", ECB, Working Paper Series, 2346.

2 See Cordemans N. and J. Wauters (2018), "Are inflation and economic activity out of sync in the euro area ?", NBB, *Economic Review*, June, pp. 79-95.

Prudential policies, for instance, are much better suited to addressing specific financial vulnerabilities, as they offer more focused instruments than monetary policy. The Belgian prudential authority, for one, has imposed specific measures on the country's banks to prevent overheating in its housing market (see chapter 4). If such side effects spread across the euro area and can no longer be addressed with targeted prudential measures, they may become a relevant factor for monetary policy decision-making.

Any undesirable consequences of loose monetary policy may also be curbed by intelligent fiscal policies, which see all Member States aim for growth-friendlier government finances. Governments of euro area countries with a degree of budgetary scope – such as Germany and the Netherlands – should preferably use this scope, while highly indebted governments had better commit to observing European fiscal rules. Governments can help support the demand side of the economy in the short term by investing in infrastructure, green and digital projects, thus lightening the stimulatory job of the central bank and helping to reduce the need for non-standard monetary policy measures. In fact, in the long term, such government spending can make the economy more productive and push up the equilibrium rate, affording additional room for policy manoeuvre to the central bank. And the importance of structural and institutional reforms should not be overlooked. Extending working lives, for instance, can reduce the urge to save and help achieve a balance between saving and investing at higher interest rates.

Are there more efficient alternative measures?

Rather than arguing the case for fiscal policies to complement monetary policies, some are urging a strong fiscal stimulus, ideally in close cooperation with the central bank. This conviction is underpinned by the awareness that the world is facing the need for major and wide-reaching climate change investment. Proponents of the modern monetary theory (MMT) argue that the central bank could boost the demand side of the economy by printing 'free' money to help the government fund a whole raft of projects. This sounds like an attractive proposition but quickly runs into a whole range of objections. For one thing, Article 123 of the TFEU prohibits monetary financing of government debt: and besides, experience has shown that, in practice, it is hard to calibrate a monetary boost in such a way that it ushers in a controlled, on-target increase in inflation. Rather, past experiments have seen hyperinflation ensue.

As a matter of fact, there is nothing at all 'free' about such an alternative measure: government and central bank balance sheets demonstrate that the monetary financing of government interventions boils down to short-term loans at the interest rate on the deposit facility. As soon as inflation moves back up, the central bank has to raise this rate and thus be exposed to growing losses, which at the end of the day would have to be financed by additional inflation or by the government[1].

The 2020 review of the strategy will include a careful reflection on how to guarantee the effectiveness of the Eurosystem's monetary policy

The success of any such a radical proposal would largely hinge on close coordination between central bank and government, but it is unclear how such coordination would work (well) in the real world.

Monetary policy-makers open to reflection

Monetary policy faces major challenges and concerns. It therefore requires careful reflection on how to keep it effective in a changed environment (marked, for instance, by a low equilibrium rate). Central bankers are very aware of the challenges. New developments and insights may trigger adjustment of the monetary policy framework, as they have done in the past. The Bank of Canada, for instance, reviews its monetary policy framework every five years to see if it needs innovating, while the US Federal Reserve embarked on an evaluation of its monetary policy strategy in 2019.

In January 2020, the Eurosystem launched a review of its monetary policy strategy, the last one having been in 2003. The price stability mandate is not being called into question, but the elements under review cover the qualitative formulation of price stability, the effectiveness of potential side effects of monetary policy instruments, the economic and monetary analyses used for monetary policy decisions, as well as communication practices. The Governing Council will also take into account how other considerations, such as financial stability, employment and environmental sustainability, can be relevant in pursuing the ECB's mandate. At the heart of this process will be thorough analysis and open minds, engaging with all stakeholders.

1 For more information, see Kasongo Kashama, M. (2016), "Helicopter money and debt-financed fiscal stimulus: one and the same thing?", NBB, Economic Review, December, pp. 31-40.