EUROPEAN CENTRAL BANK
EUROSYSTEM

Report

on the Academic Roundtable organised by Central Bank of Ireland

I. Event overview

The Central Bank of Ireland organised an Academic Roundtable on 18 December 2020. The event was attended by 13 academics (see Annex for a list) and Central Bank of Ireland staff. The event took place online and this report has been compiled under the Chatham House Rule.

The event had three sessions: (i) Long-Term Secular Trends, (ii) Transmission of Monetary Policy and (iii) Central Banks' strategy and tools. Central Bank of Ireland Governor Gabriel Makhlouf opened the event and provided introductory remarks, while the three sessions were hosted by Mark Cassidy (Director of Economics and Statistics), Gillian Phelan (Head of Division, Monetary Policy) and Sarah Holton (Head of Function, Monetary Policy) respectively.

II. Key themes in discussions

1. Long-Term Secular Trends

The first session opened with a request for views on long-term secular trends, the factors driving the trends, and the implications of such trends for the conduct of monetary policy. Participants were asked for their views on the appropriateness of an inflation aim of "below, but close to, 2% over the medium-term" when frequently operating at close to the effective lower bound on interest rates.

Participants mentioned the importance of the lower natural rate of interest and in particular, the heterogeneity of the natural rate across euro area countries. Due to the nature of the decline in the natural rate and increased probability of secular stagnation, fiscal policy measures were viewed as necessary. Participants felt that the ECB's Governing Council should be more transparent on its expectations for the natural rate, similar to the Federal Reserve, which publishes short- and long-term forecasts for inflation and interest rates.

The monetary policy toolkit is also important, and could require changes as a result of secular trends. For example, due to the lower equilibrium real rate in economies, asset purchases need to be considered as part of the longer-term monetary policy toolbox, and therefore consideration should be given to the potential limits that may be imposed by the European Court of Justice (ECJ). The consequences and limits of monetary policy decisions should also be communicated with the public, for example, on the effects of negative interest rate policy that may become adverse over time.

Participants felt that the use of quantitative easing blurs the lines between monetary and fiscal policy. Monetary policy will operate in a world of higher sovereign debt. Higher debt levels may make monetary and fiscal interactions more important in the future and there was a view that the ECB is already more proactive compared to other central banks in commenting on fiscal developments.

The role of inequality in the labour market could help to explain secular stagnation. Market power and higher levels of corporate savings have led to a reduction in aggregate demand and it is therefore important to try to shift money towards those that spend, i.e. workers.

2. Transmission of monetary policy

In the second session, participants were asked for their views on how the transmission of monetary policy has changed, how monetary policy transmits through banks and what issues have contributed to fragmentation in the transmission of policy and heterogeneity across member states. More broadly, the session focused on the overall structure of financial markets, in light of changes in the non-bank financial sector and financial innovation and on the long-term structural forces that could have weakened the link between the real economy and inflation.

The structure of European economies is fundamentally different, which was noted in the context of the asymmetry of shocks across countries. It was noted that monetary policy appears to be aimed at stimulating export demand and while this is beneficial for select economies, those with a higher percentage of domestic demand suffer. In order to stimulate aggregate demand, money needs to be fed into the real estate and construction sectors and this will stimulate wage demand and will help to boost inflation in Southern European economies.

The second speaker highlighted the risks to banks from cutting monetary policy interest rates further into negative territory. This can be seen through the decline in banks' equity prices. While the overall effect of negative rates remains stimulative for the economy, that effect has weakened over time. The TLTRO has been positive for growth, while the decision to decouple the interest rate underlying the operations from the main monetary policy interest rates has been powerful. Concerns were also raised over the 'doom loop', whereby the state is exposed to bank risks and banks are exposed to their sovereign state through holding significant portions of government debt.

On the implications of the lower level of the natural rate for sovereign debt, lower interest rates are important in the context of fiscal constraints, which are now viewed differently than they were historically. Traditionally, metrics such as the ratio of debt to GDP were important and a primary surplus would be needed to avoid an explosive path for debt. However, a change has occurred where interest rates have fallen below growth rates.

The discussion then moved to the Phillips Curve. It was noted that in Ireland at least, there is evidence that the wage Phillips Curve still working. However, a decline in wage-bargaining power and uncertainty associated with employment contracts were noted as factors playing a role in a flatter Phillips Curve. There is strong collective wage bargaining in Germany in contrast to other euro area countries that do not have a coordinated wage setting approach. Another participant argued that wage increases do not stem from union negotiations in modern times, but rather from people moving jobs. This development has left those with lower education and less ability to move severely disadvantaged.

On the role of banks in the transmission of monetary policy, a participant highlighted the changes in the operation of banks following the financial crisis. There has been a pullback from cross-border banking and this has ultimately damaged growth and the transmission mechanism in Europe. The varying interest rates in markets across the euro area was highlighted as a challenge, particularly in light of a single monetary policy. The ECB should help to smooth the transmission mechanism by advancing the banking union.

The effects of low interest rates for the banking system were discussed and it was highlighted that while the ECB has the primary objective of price stability, it also has secondary objectives, including financial stability. The main instruments of the ECB's monetary policy have become costlier for achieving the second objectives, with financial stability concerns complicating the use of interest rates changes as a tool. This applies also to negative rates, and the passing of those rates to the public.

3. Monetary policy implementation

The third session posed a number of a number of questions relating to the most effective methods and tools that the ECB should use to stabilise the economy. Topics for discussion included the two-pillar strategy of the ECB (including the future role for the monetary pillar), the inflation aim, standard and non-standard tools used, and communication among others.

Participants felt that the inflation target is a key concept for the credibility of the ECB, especially since current measures of inflation expectations suggest that the ECB will fail to meet its aim going forward. The current wording of the aim is perceived as asymmetric, with a disinflationary bias, and therefore a point target is needed. For example, a longer-term inflation expectation from 1.9% down to 1.6% could be seen as consistent with the current inflation target of “close to, but below, 2%.” It was noted that a point target of 1.8%, with a symmetric band of one percentage point above and below could be beneficial. Still, a move to average inflation targeting or price level targeting may be more beneficial than a point target. The ECB needs to consider a longer-term target, as persistent shortfalls from the inflation target diminish credibility. Clear communication is needed from the ECB on the inflation target.

A possibility that could help in moving away from the effective lower bound in the future could be to raise the inflation target to between 3% and 4%. However, this must be balanced against the legal definition of price stability, and also the credibility of the ECB. There is likely to be a political challenge to raising the target also. If an inflation target of 2% is not being achieved, then a higher target may not be credible. There are also other possible measures of inflation, such as wages, house prices or asset price inflation. It was highlighted that increased liquidity coupled with lower interest rates has driven asset prices higher.

On the topic of the ECB’s two-pillar strategy, one issue highlighted was that we are seeing an increase in broad money growth that is essentially financing fiscal expansions. This should point to higher inflation, especially when coupled with pent up demand due to the postponement of expenditure amid the pandemic. However, communication on the monetary pillar is difficult, and there have been examples where the ECB has ignored money growth despite having targets in this regard. The monetary pillar could be removed in order to simplify ECB press conferences, and going forward it could be used only when relevant for price stability.

With regard to unconventional monetary policy, their consequences needed to be fully explored in the strategy review, particularly in light of the differences between booming asset prices and weaker real economic growth. The length of time that non-standard monetary policy tools were in place means that they could now be deemed as conventional and could be made permanent. Central banks have implemented a lot of expansionary monetary policy to promote price stability. The EU Treaty outlines broad based goals, however inflation remains subdued. This suggests that the ECB can do a lot without inflation increasing out of control. There should be a discussion on what the ECB is willing to do to meet its objectives more broadly. This has started with the climate change discussion, which is positive and timely, as action can be taken now.

Finally, on communication, the ECB can take into account its secondary objectives but this increases communication difficulty. For example, it could be hard to explain why inflation may not be targeted over a short horizon due to financial stability or climate change goals. Communication also feeds into the role of central bank independence and in this context, the role of the ECB in moving to a greener economy should not be as big as governments, as a failure in meeting these goals could further undermine the ECB’s credibility. It was felt that politicians can communicate better than central banks in general and that efforts should be made to communicate more directly with the public to win them over. The ECB needs to call out the constraints they face in meeting their inflation target, for example those based on the Treaty.

III. Summary of main recommendations, questions and concerns

Most participants agreed that the ECB should move to a point target for inflation, while the use of make-up strategies could also be implemented. A point target would provide more certainty and be easier to communicate for the ECB. Raising the inflation target is seen as legally and politically difficult, and therefore an inflation target in the region of 2% is adequate.

The monetary policy toolkit is important, and could require change as a result of secular trends. For example, due to the lower equilibrium real rate in economies, the role of asset purchases needs to be considered as part of the longer-term monetary policy toolbox. On the role of banks in the transmission of monetary policy, dispersion in retail interest rates across the euro area was highlighted as a challenge in the context of a single monetary policy. The ECB should help to smooth the transmission mechanism by advancing the banking union.

Communication is important and should be clear. It can take into account secondary objectives, however, this increases the difficulty of communicating. Communication also feeds into the role of central bank independence. The ECB needs to call out the constraints they face in meeting their inflation target, for example those based on the Treaty. However, while the EU Treaty outlines broad based goals, inflation remains subdued despite monetary policy easing. This suggests that the ECB can do a lot without inflation increasing out of control, for example, targeting climate change policies.

The consequences and limits of monetary policy decisions, such as the negative interest rate policy, should also be communicated to the public. While the overall effect of negative rates remains stimulative for the economy, that effect has weakened over time. Concerns were also raised over the ‘doom loop’, whereby the state is exposed to bank risks and banks are exposed to their sovereign state through holding significant portions of government debt.

Evidence that the wage Phillips Curve still works was mentioned. However, a decline in wage-bargaining power and uncertainty associated with employment contracts were noted as factors playing a role in a flatter Phillips Curve.

IV. Annex

List of Participants (affiliation)

- Samuel Brazys (University College Dublin)
- Seamus Coffey (University College Cork)
- John Cotter (University College Dublin)
- Gregory Connor (Maynooth University)
- Gabriel Fagan (Goethe University)
- John Fitzgerald (Trinity College Dublin)
- John McHale (National University of Ireland, Galway)
- Michael McMahon (University of Oxford)
- Alessia Pacagini (University College Dublin)
- Aidan Regan ((University College Dublin)
- Davide Romelli (Trinity College Dublin)

- Karl Whelan (University College Dublin)
- Johnathan Wright (Johns Hopkins University)

Overview of the Events

9:00-9:10 – Introduction

9:10-9:40 – Session 1: Long-term secular trends

9:45-10:15 – Session 2: Transmission of monetary policy

10:20-10:50 – Session3: Central Bank's strategies and tools

10:55-11:00 – Concluding remarks