Belgian Financial Forum

NationalBank OF BELGIUM Eurosystem

SUPPORTED BY

Towards a "new normal" for the monetary system?

Friday May 20, 2022

1:00 PM – 2.30 PM (UTC/GMT +02:00 – Europe / Brussels)

WEBINAR

Freddy Van den Spiegel, Professor VUB

Gert Peersman, Professor University Ghent

Wim Boonstra, Special Economic Advisor, Rabobank

Bruno Colmant, Professor ULB

Freddy Van den Spiegel
Professor VUB and Vlerick Business School

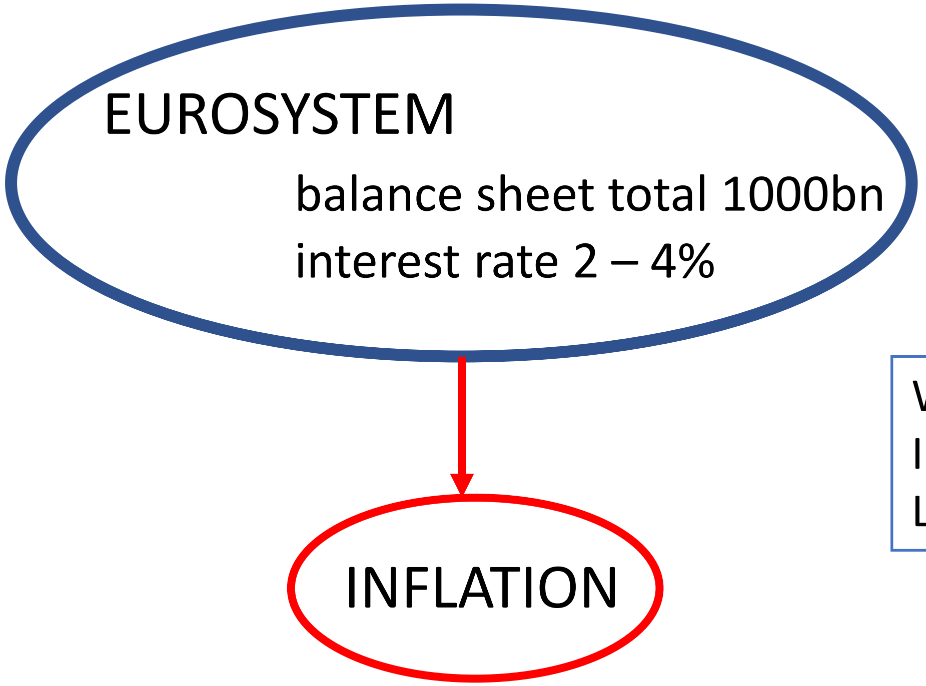
May 2022

Challenging times for the ECB

Freddy Van den Spiegel
Professor VUB and Vlerick Business School

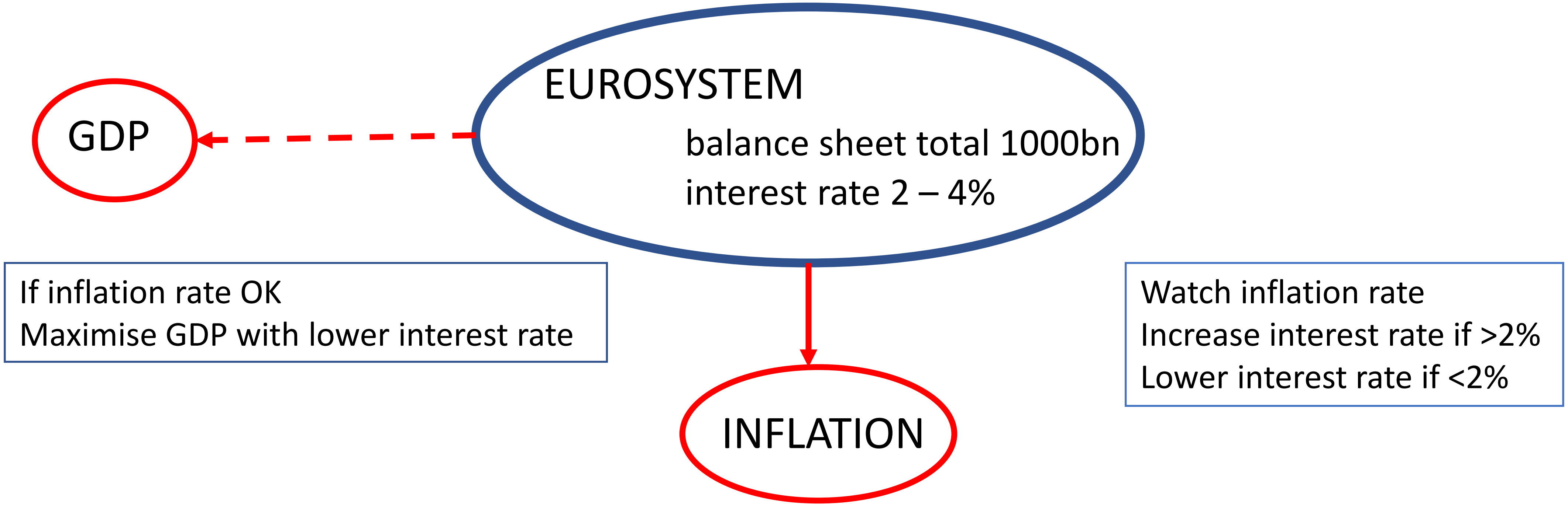
May 2022

Easy life for the ECB before the financial crisis



Watch inflation rate
Increase interest rate if >2%
Lower interest rate if <2%

Easy life for the ECB before the financial crisis



Complex life for the ECB after the financial, the sovereign-EURO, the health and the Ukrainian crisis.

EUROSYSTEM

balance sheet total 8500bn

interest 0%

A huge and growing balance sheet and zero interest rate. Unsustainable or the new normal?

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GDP

Already low growth, to get even lower? Recession?

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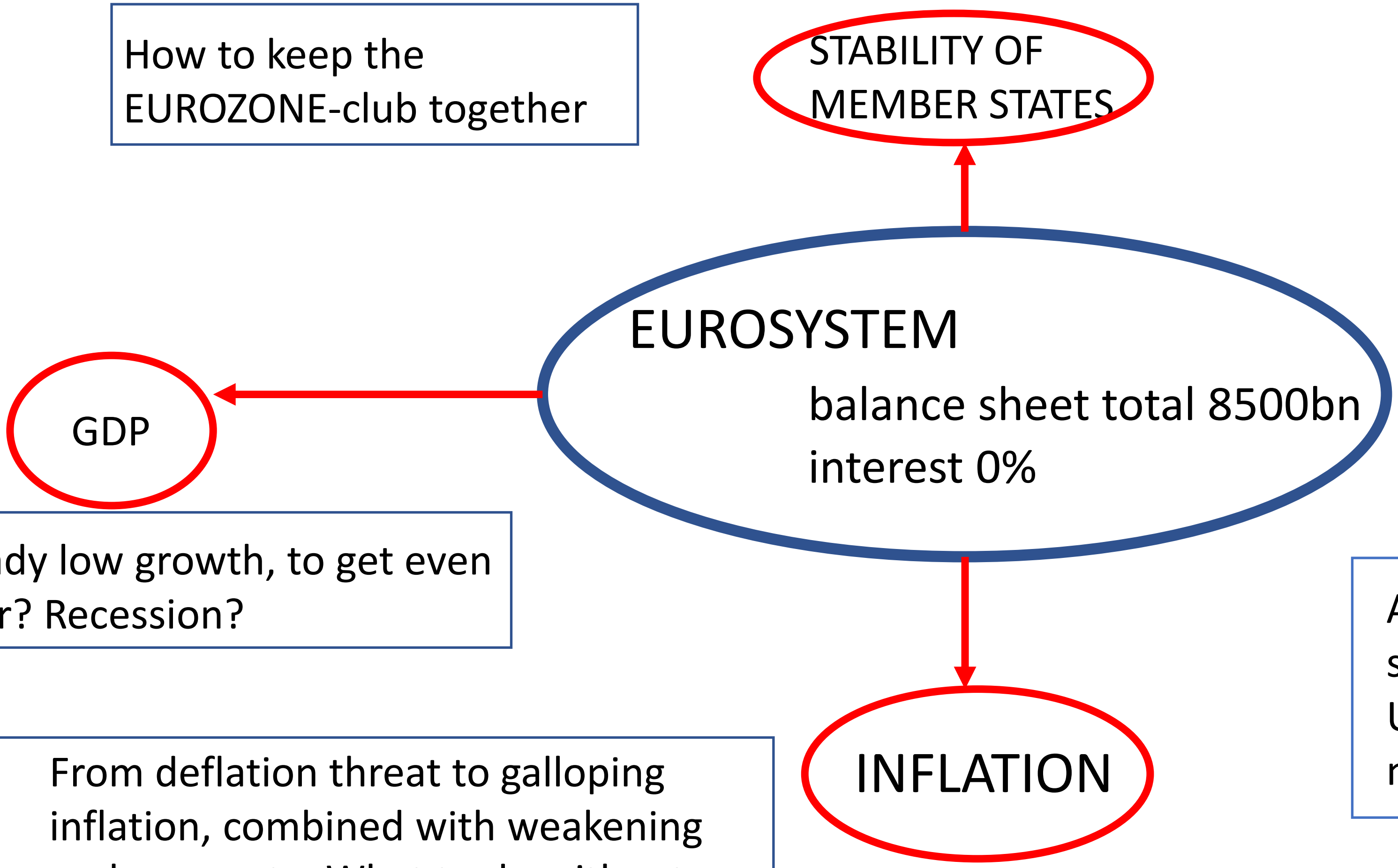
How to keep the EUROZONE-club together



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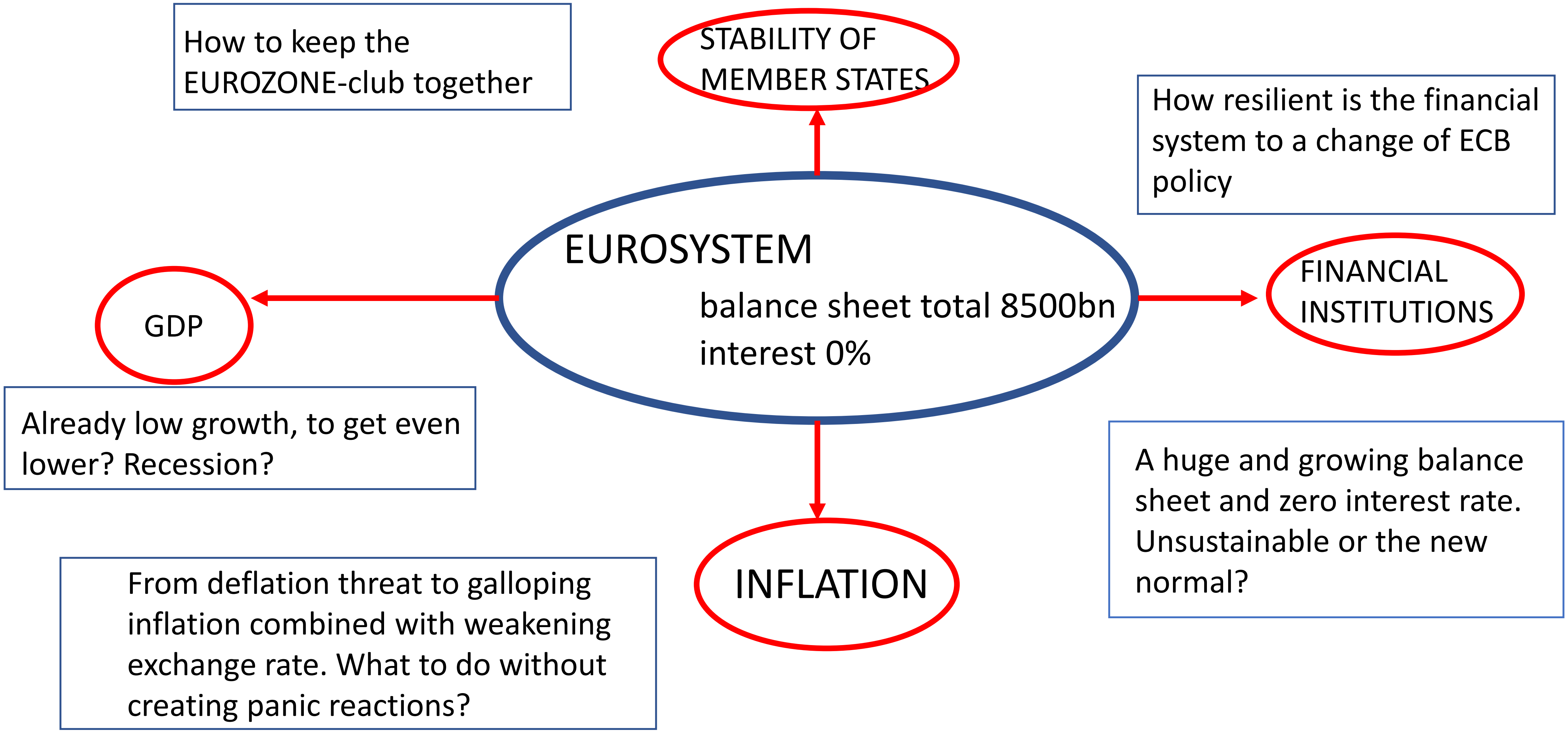

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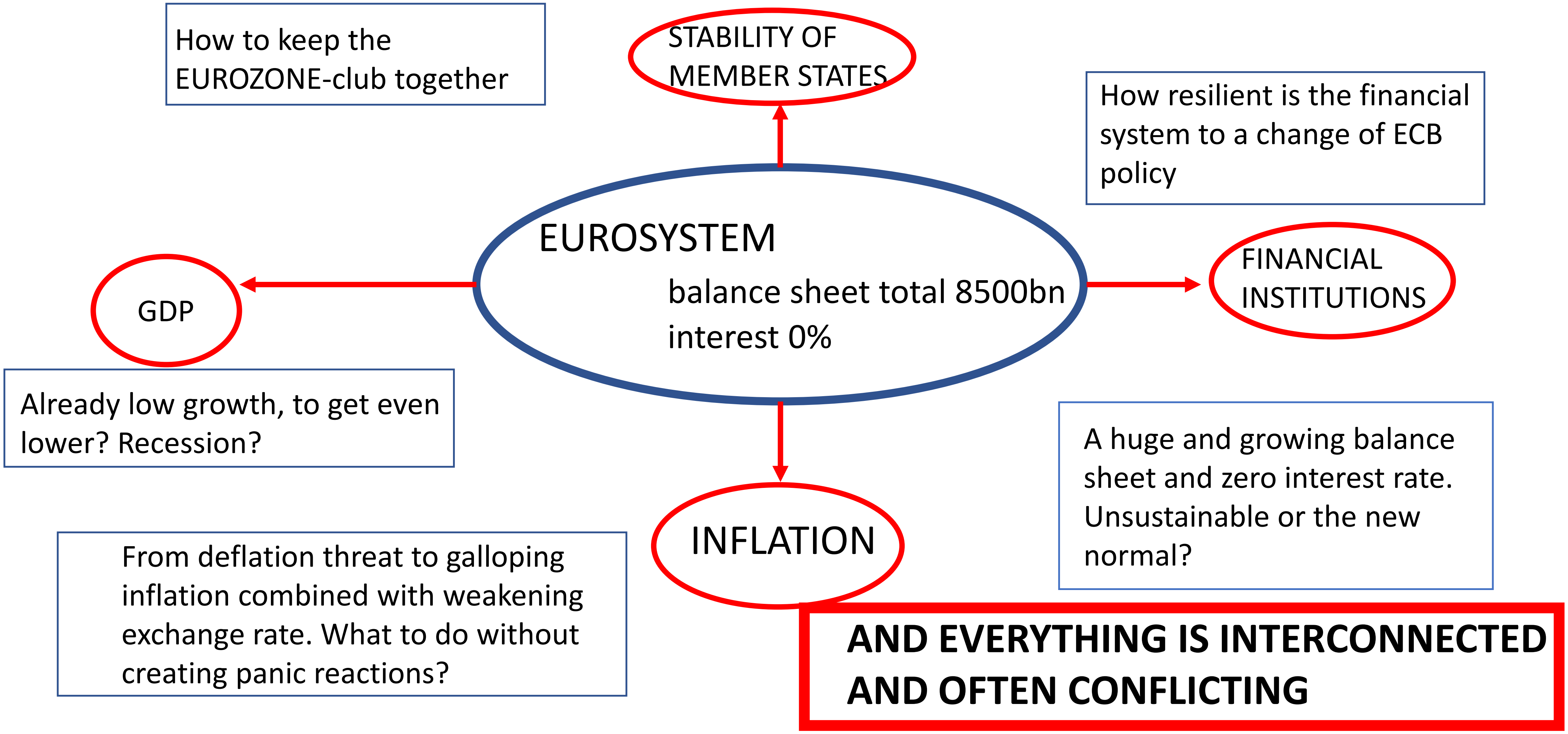

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The comeback of inflation and higher interest rates?

Gert Peersman

UGent

Inflation target of the ECB

Statutes (article 2): *the main objective shall be to maintain price stability*

ECB (2021 strategic review): *We are targeting an inflation rate of 2% over the medium term. Our commitment to this target is symmetric: we view inflation that is too low just as negatively as inflation that is too high*

> *The medium-term orientation is important to account for uncertainties in the inflation process and the transmission mechanism, so as to recognize the imperfect control of inflation by monetary policy in the short run, owing to variable transmission lags to the economy and inflation.*

> *As different types of shock may move inflation and real economic activity in the same direction (as in the case of demand shocks) or create a temporary trade-off (as in the case of supply shocks), the medium-term orientation also provides the policy flexibility to assess the origin of shocks and look through temporary shocks that may dissipate of their own accord, thus avoiding unnecessary volatility in activity and employment.*

Monetary policy response and the origin of shocks

When the source of inflation is "domestic" and demand-driven (overheating of economy, tight labor markets, …), interest rates should increase in order to reduce aggregate demand: this is the case in the United States

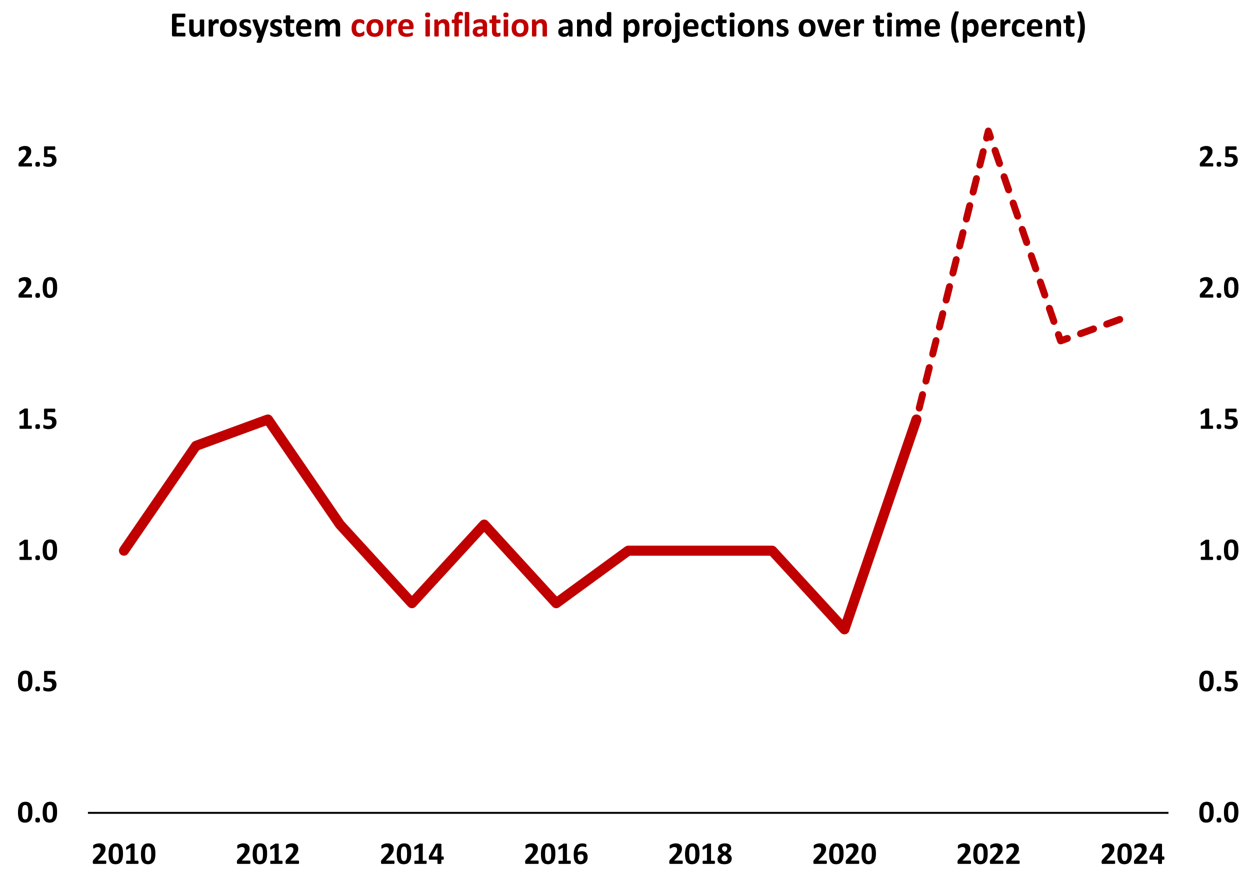
When the source is imported inflation (e.g. energy, food and industrial commodities), central banks should not react and tolerate the (one-time) price increase

- Monetary policy tightening does not solve the problem, while it would deteriorate the economy

- This is a popular narrative for the euro area

What is the problem?

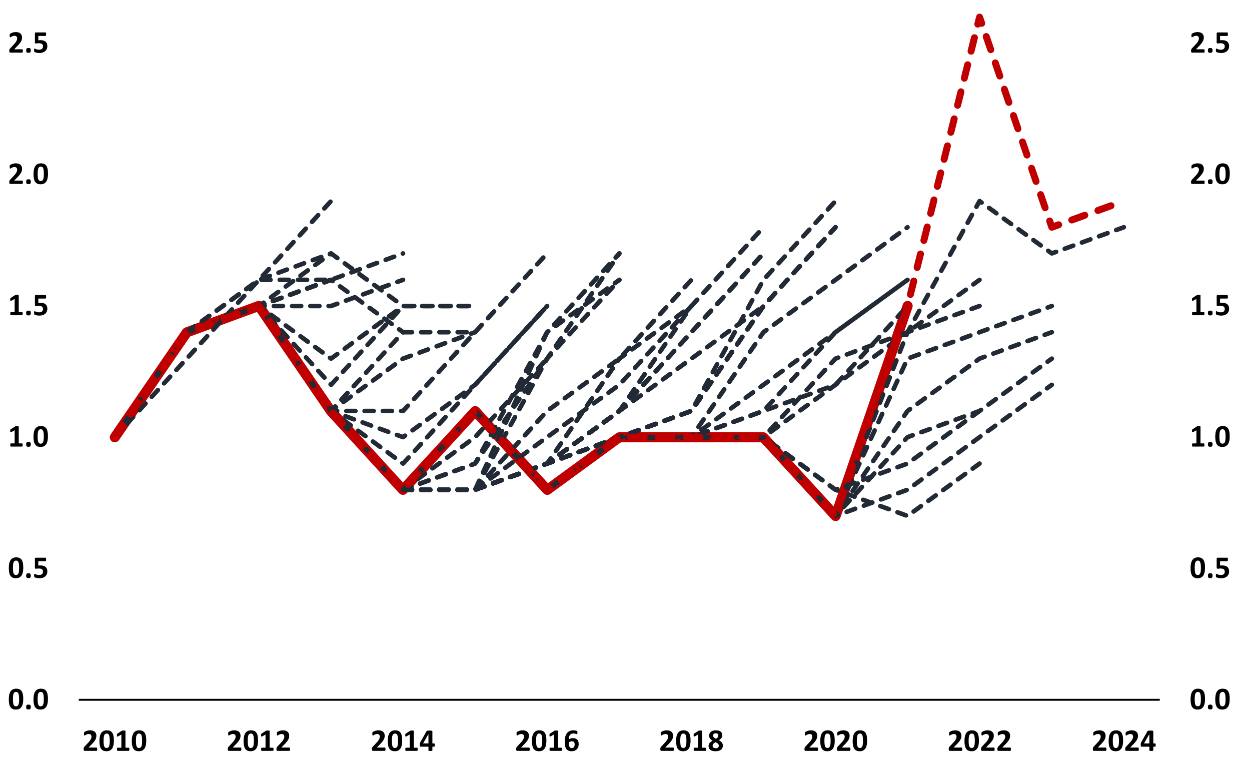
Core inflation is projected to decline again below 2 percent…



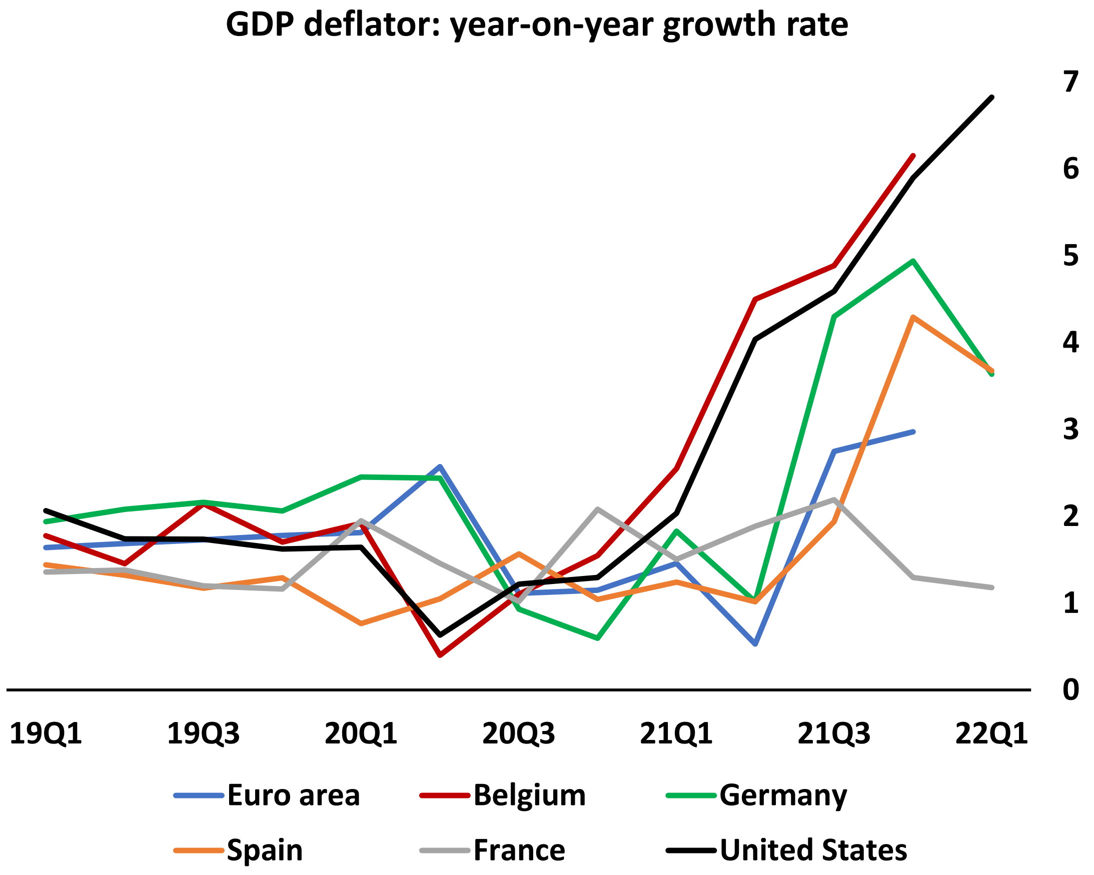
What is the problem?

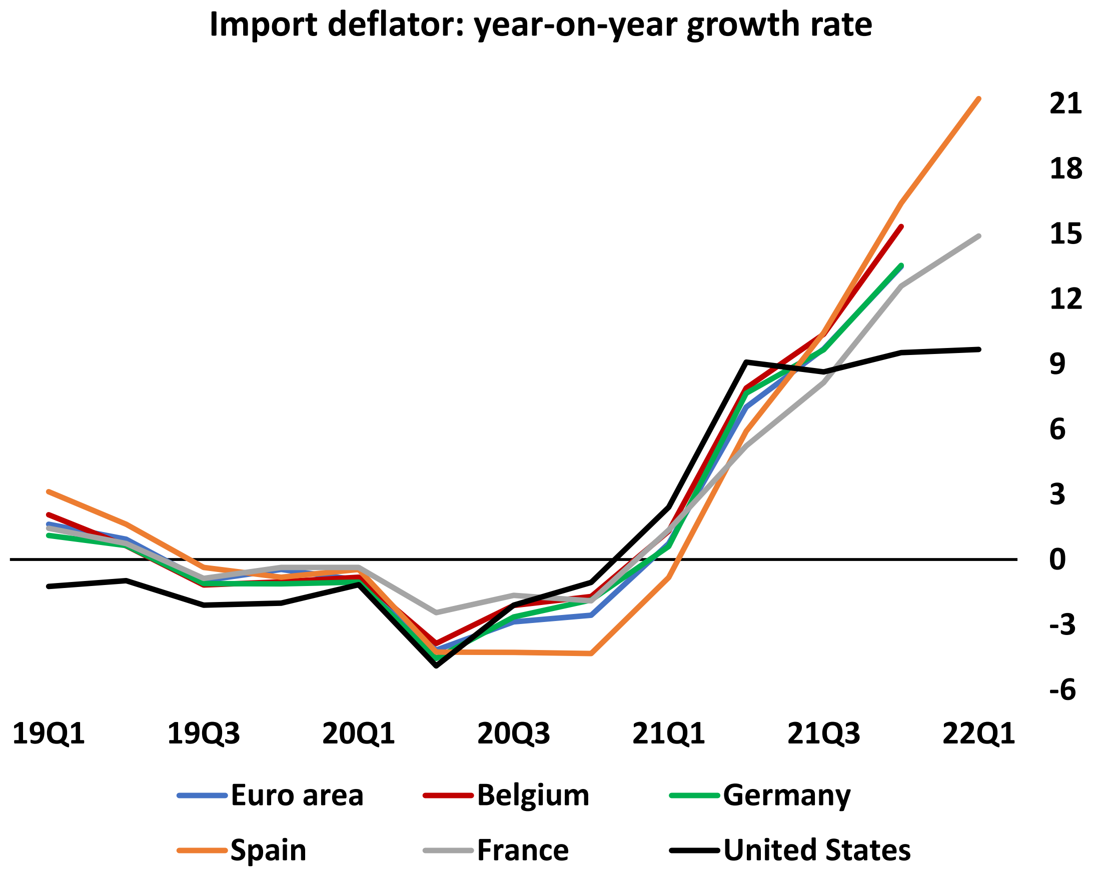
… but forecast errors suggest there has been a regime shift: from systematic overestimation to systematic underestimation of inflation => high inflation may stay longer than we think (or hope)

Eurosystem core inflation and projections over time (percent)



Source euro are inflation has become domestic phenomenon





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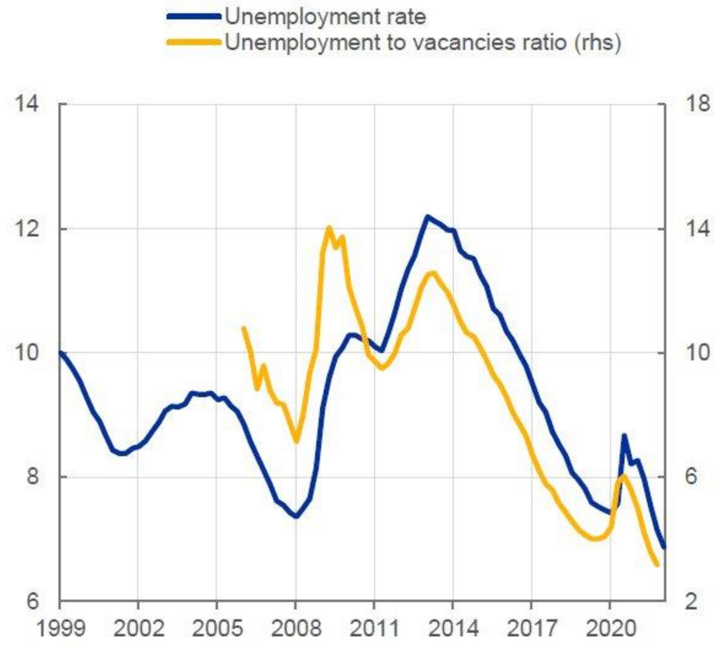
Unemployment and vacancies

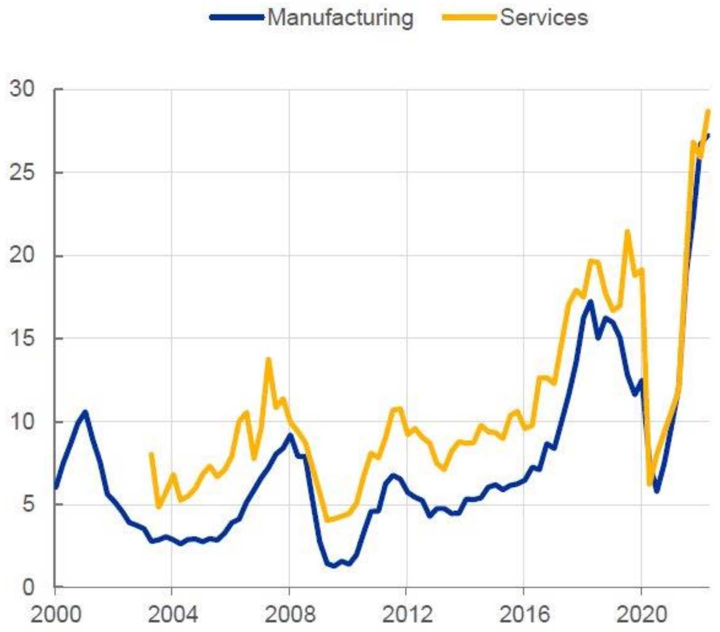
(LHS: percent; RHS: ratio)



Source: Eurostat and ECB staff calculations.
Last observations: 2022Q1 for unemployment rate and 2021Q4 for unemployment to vacancies ratio.
Notes: IT and EE vacancies data not available. Vacancies data for FR only available for size-class greater than 10 employees.

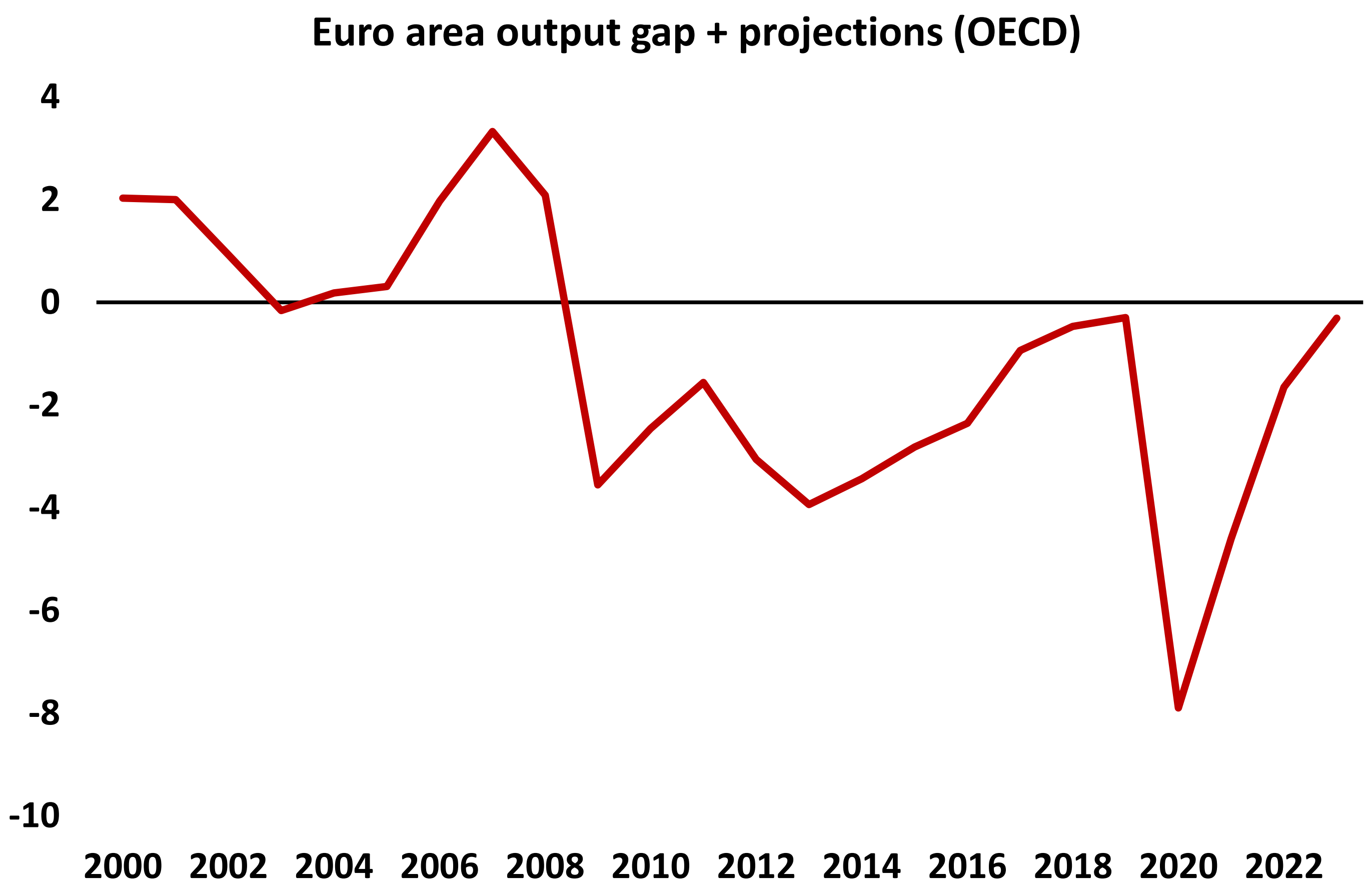
Limits to production – shortage of labour

(percentage balances)



Source: European Commission.
Last observation: 2022Q2.

Source euro are inflation has become domestic phenomenon



- **Caveat**: war in Ukraine could have negative impact on economic activity, reducing domestic inflationary pressures

Shift in fiscal policy regime

Fiscal policy support to households and firms during Covid-19 avoided a collapse of the economy and contributed (substantially) to strong recovery

It is very tempting for governments to use the same approach to solve any economic problem, such as rising energy prices and losses in purchasing power more generally

- This is also what people expect from the governments

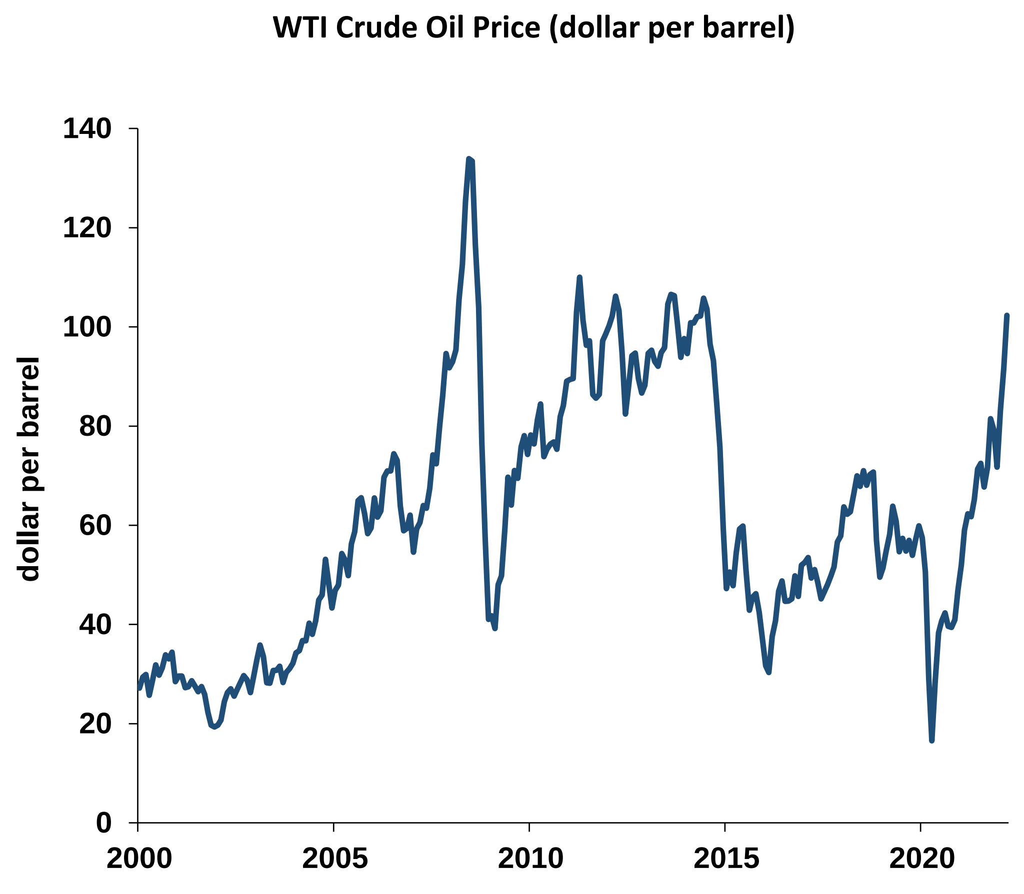
- But expansionary fiscal policies (including vat reductions) when the economy is at full capacity only leads to higher inflation…

Second-round effects

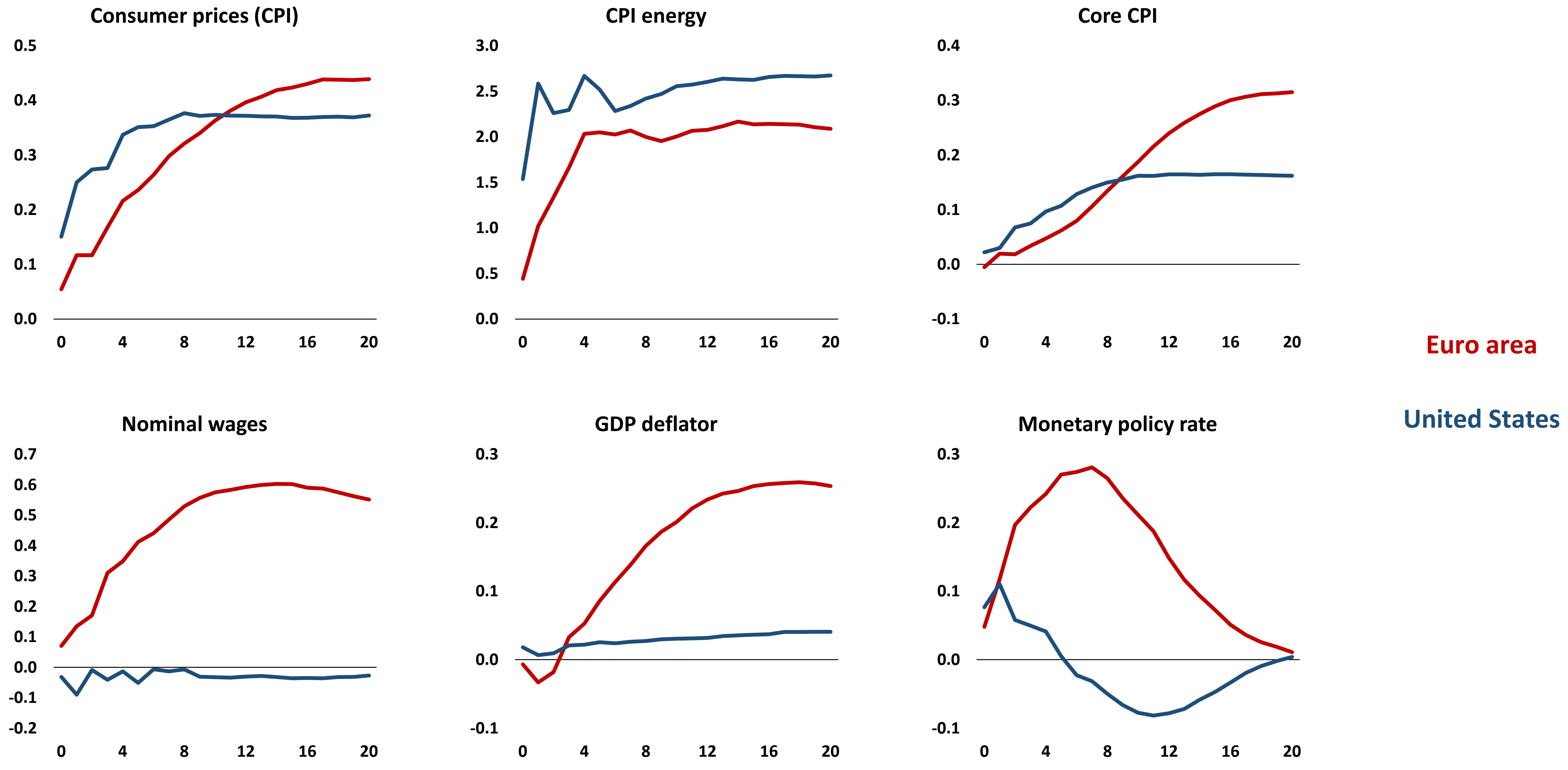
Imported inflation could become a domestic problem that requires a monetary policy response if there are so called second-round effects

- For example, when it triggers wage-price spirals

- This is typically the case for oil (energy) price shocks in the euro area…

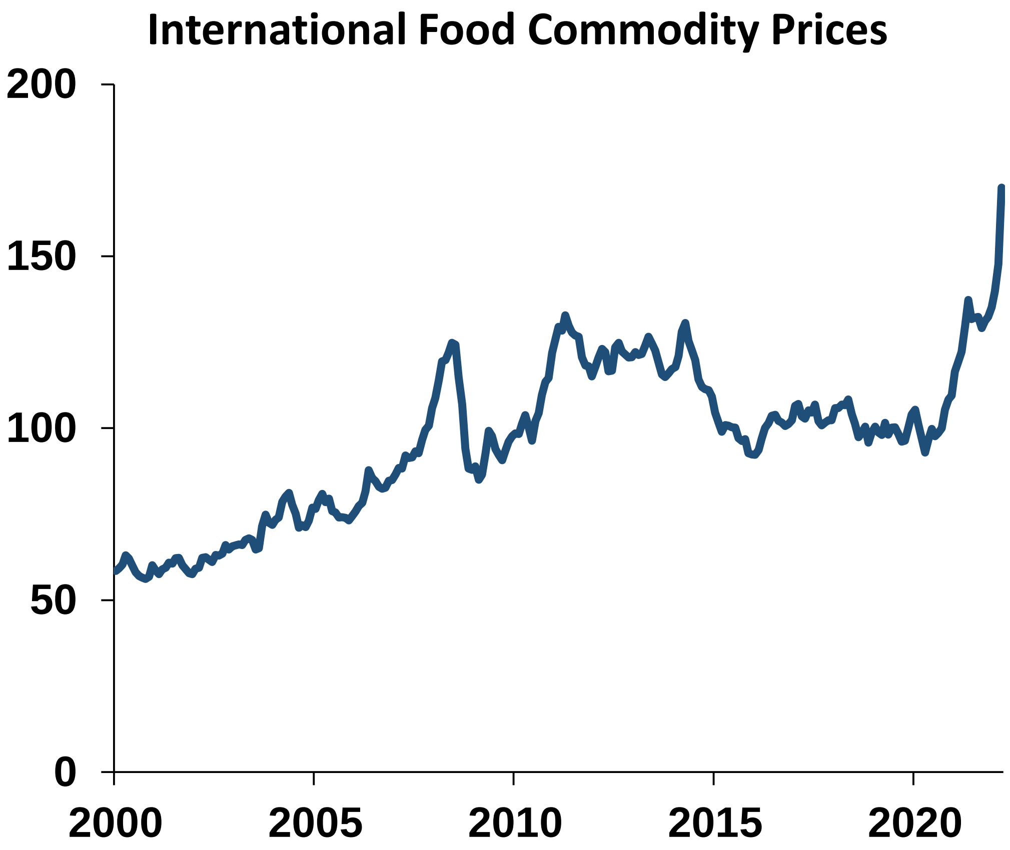


Dynamic effects of a 10% increase in global crude oil prices

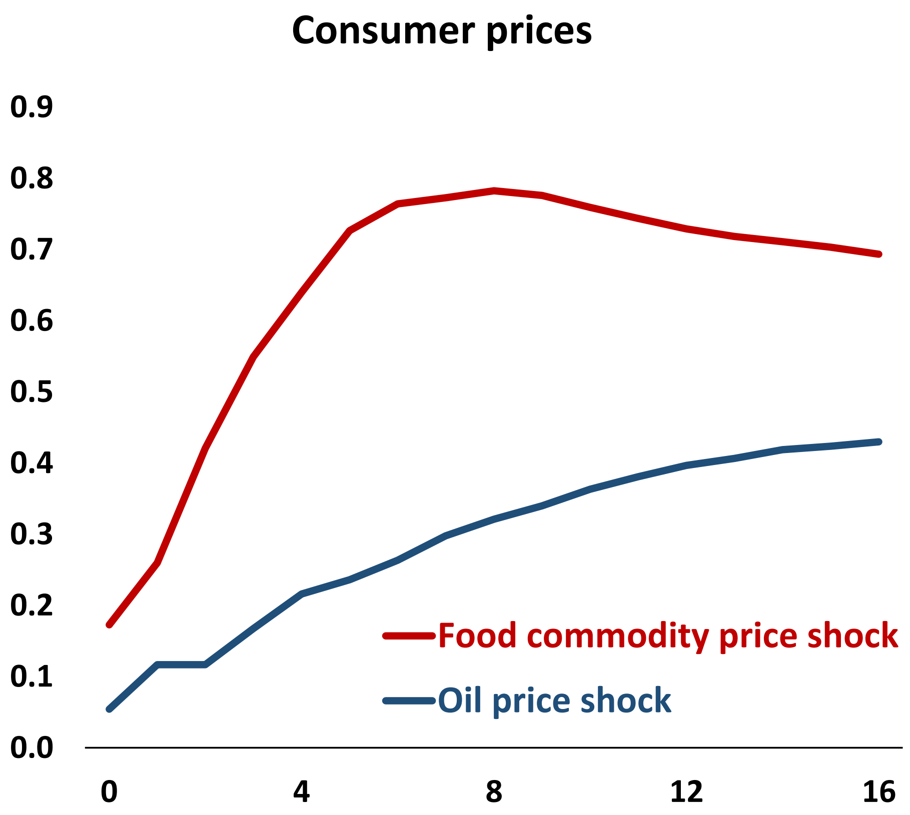


Source: Peersman and Van Robays (2009); horizon is quarterly

Elephant in the room: international food commodity prices



Dynamic effects of a 10% increase in international prices



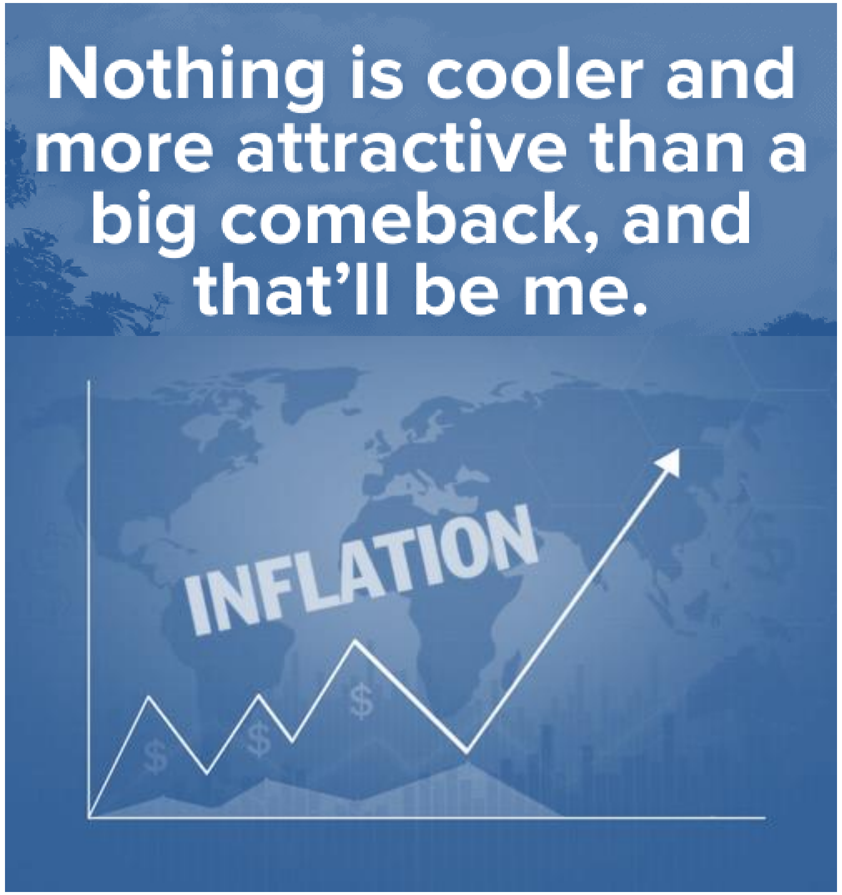
Source: Peersman (2022); horizon is quarterly

- Second-round effects (wage-price spirals) are again crucial amplification mechanism
- Note: impact is even much stronger in Belgium (due to automatic wage indexation)
- Large differences across euro area countries: complicates a “single” monetary policy stance

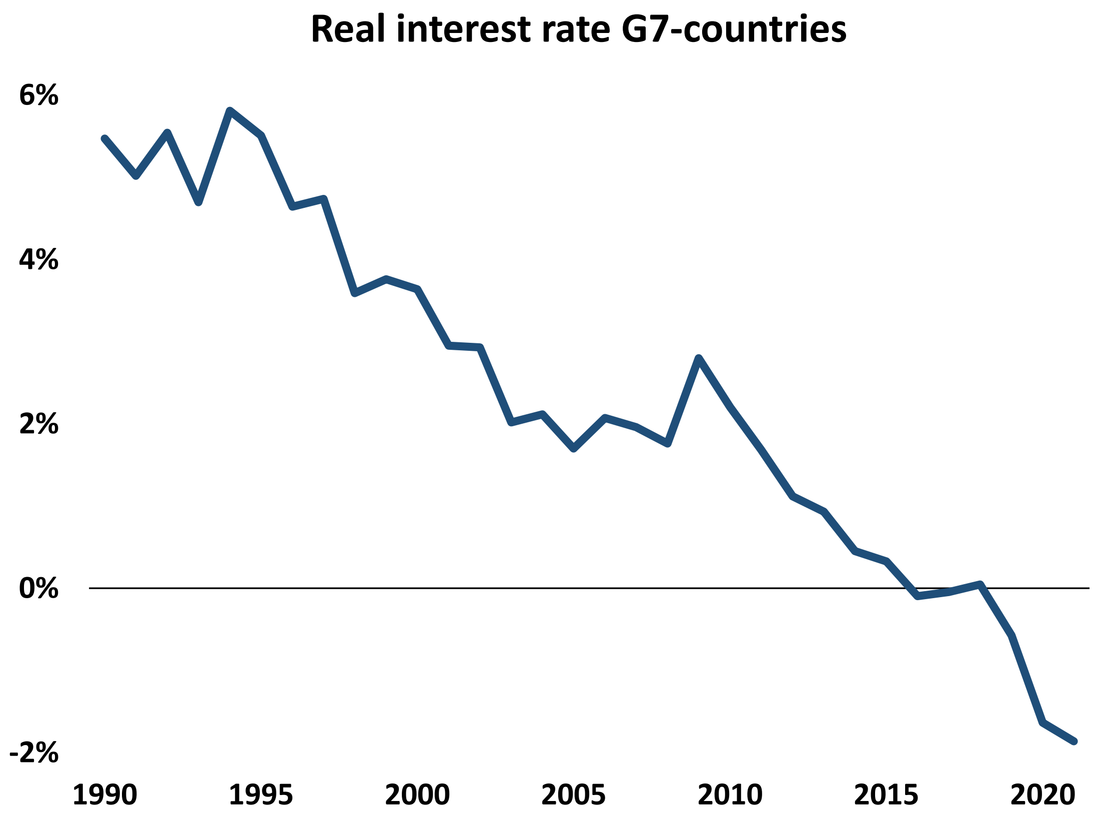
Monetary policy

Euro area inflation is clearly a domestic problem

- Higher inflation might last longer than expected due to fundamental shift in fiscal policy and second-round effects
- Unless war in Ukraine depresses aggregate demand in the euro area: downturn/recession would also stop second-round effects (*as was the case in the Great Recession*)
- Balance of risks: ECB should end expansionary balance sheet programs (QE) and start increasing interest rates



What about the long run?



- Fundamental determinants that have lowered (real) interest rates over time (e.g. demographics, inequality, low productivity growth, lower investment demand) are projected to last
  - Unless there is a substantial increase in government debt and/or productivity growth

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Monetary challenges for the ECB
(and some possible solutions)

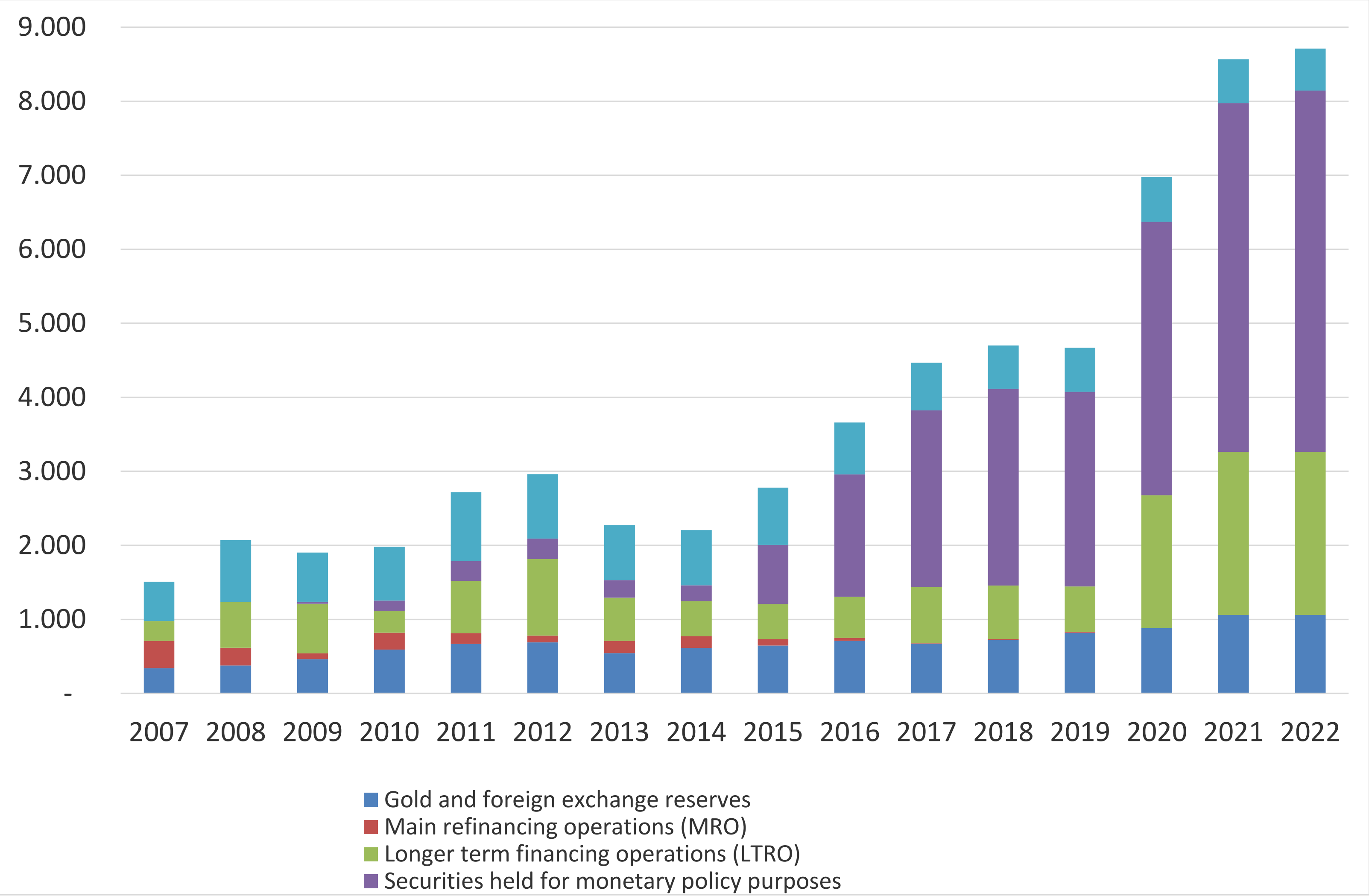
Presentation at the Financial Forum
At the NBB, Brussels, May 20th, 2022
By Wim Boonstra

Rabobank

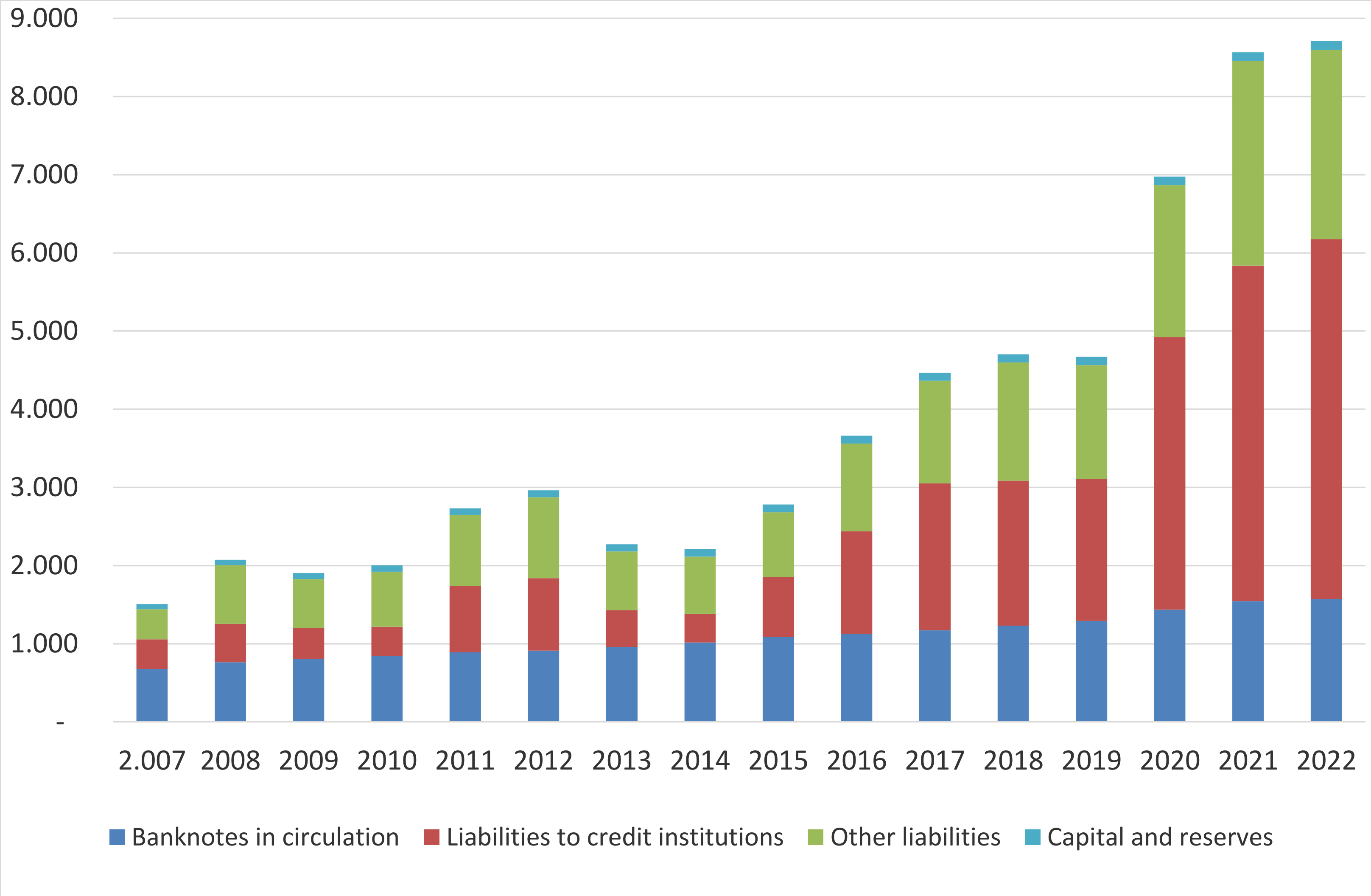
Content

- The situation
- The challenges
- The solutions
- The consequences

The situation: the ECB has acquired a major security portfolio



The consequence: banking liquidity has reached unprecedented proportions



The consequence (2): under the PSPP, the ECB owns around 20% of the public debt issued by eurozone countries

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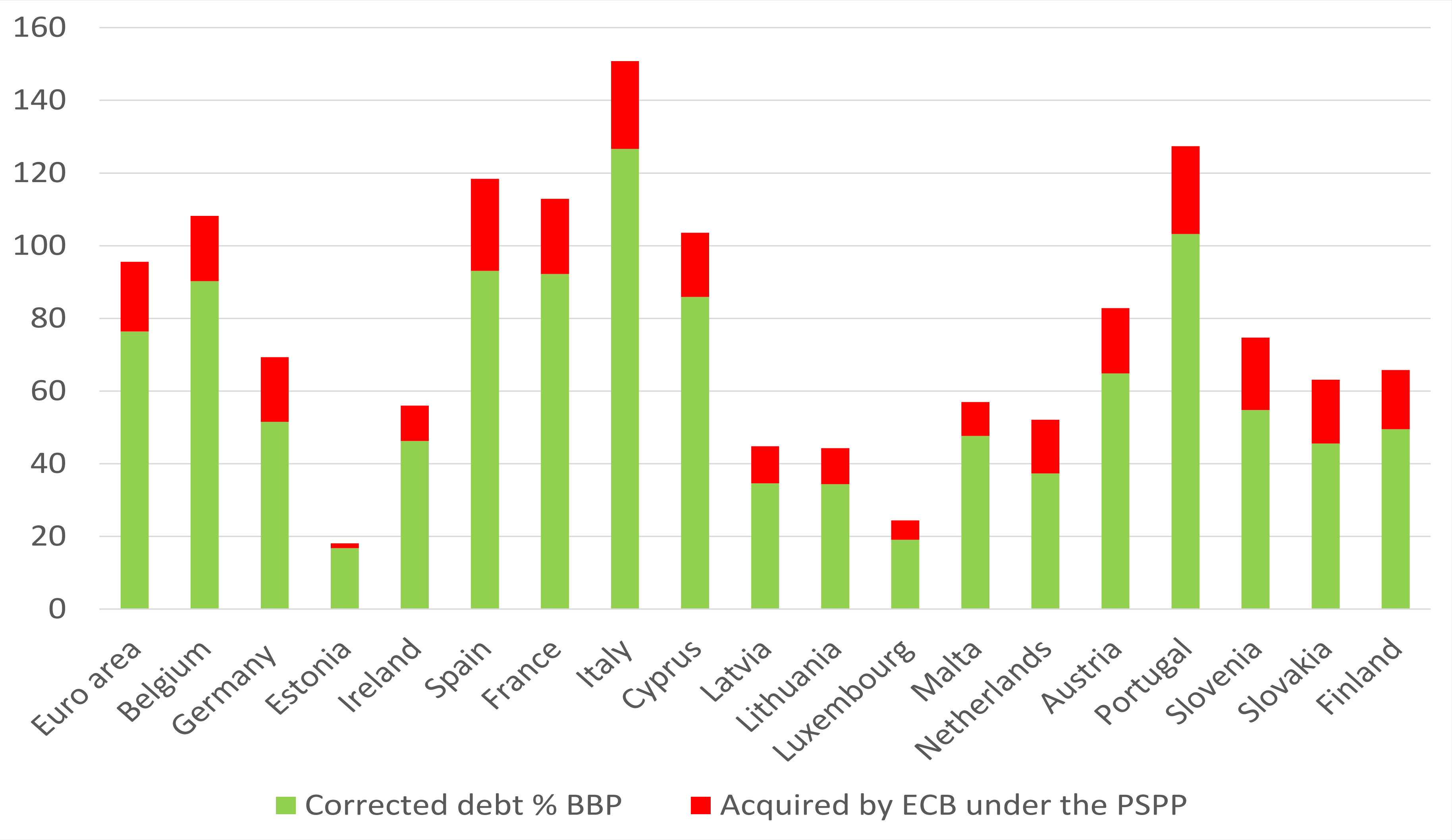

Challenge: how to normalize the situation?

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- The PSPP: ex-post monetary financing of public debt
- Should the ECB ‘de-monetize’ this public debt?
- Or should the ECB keep it on its balance sheet ‘forever’?
- Questions to be answered:
- 1) what are the consequences for the SGP?
- 2) does this challenge also bring further opportunities?

Answer 1a: de-monetizing is a bad option

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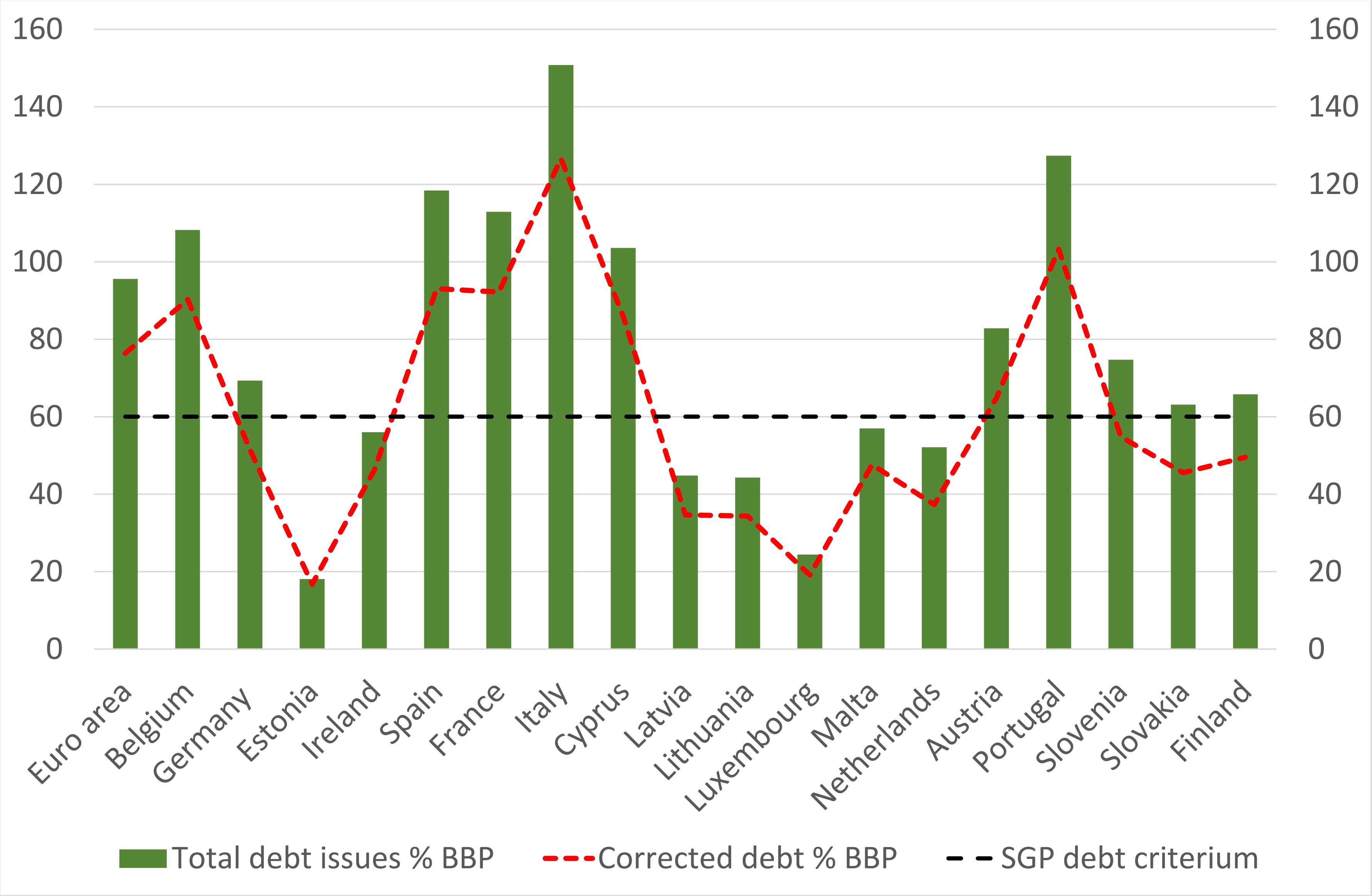
- Public debt that is acquired by the central bank. It has lost its monetary significance, because ultimately the government is the shareholder of the central bank (De Grauwe, 2021).

- The central bank can keep this debt on its balance sheet into eternity. This does not add to new inflationary pressure.

- If the central bank would decide to 'de-monetize', there are basically two way to do this:

1. Stop with replacing maturing debt. The result: the debt will gradually disappear from the balance sheet. Negative side effect: it will take decades (read: several business cycles) to complete this process.
2. Actively reselling its portfolio to market participants. This would bring two negative side effects:
    1. It will probably a major turmoil in financial markets
    2. It does absolutely not make any sense from an economic point of view.
3. Basically there are two options: rewrite the SGP or redefine the relevant debt.

Answer 1a: debt acquired by the ECB lost its relevance



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Should the acquired be scrapped?

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- Technically not a problem, but the ECB would have a negative equity (De Grauwe, 2021)
- The central bank could decide to keep this debt on its balance sheet into eternity
- This will not add to new inflation, but would certainly help to prevent a too restrictive fiscal policy in Europe (Boonstra, 2021)
- The real problem: moral hazard. Once policy makers see this as a major bail out, they may draw wrong (and dangerous) conclusions
- The solution:

1) Only countries that meet the deficit reduction targets are rewarded by changing part of their debt into perpetual debt.
2) The eurozone should be redesigned in a way that market discipline improves. This brings us to the next topic: strengthening the eurozone

The eurozone needs a common safe asset

- One of the reasons why the international position of the euro is stagnating is the absence of a common safe assets (securities guaranteed by all member states)

- The euro is running the risked that its international role is surpassed by the Chinese renminbi

- The issuance of conditional Eurobonds would bring safe assets (Boonstra, 1991; ELEC 2011; Muelbauer, 2013), but this debate has become too politicized.

- There are other ways to organize this (Boonstra and Thomadakis, 2020).

- One of the most promising options is the issuance of securities by the central bank

Central Banks issuing debt securities

- The issuance of central bank securities is a tested instrument ('one of the most market friendly approaches') of open-market policy (Gray, S. & R. Pongsaparn (2015))

- The central banks of Sweden and Switzerland do to regulate liquidity

- According to the IMF, about 30 percent of central banks issue securities

- The Riksbank and the SNB use short term instruments

- Some central banks issue central bank securities to establish a yieldcurve (BoT, BoK, HKMA) (Gray, S. & R. Pongsaparn (2015))

- There is no reason why a central bank should limit itself by issuing only short-term notes (Boonstra & Van Geffen, 2022)

Central Banks issuing debt securities
How does it work?

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- The central bank issues debt securities in order to drain liquidity form the market

- The CB sells the securities to banks, but the securities may trade on the secondary market and can be bought by other domestic and international investors as well

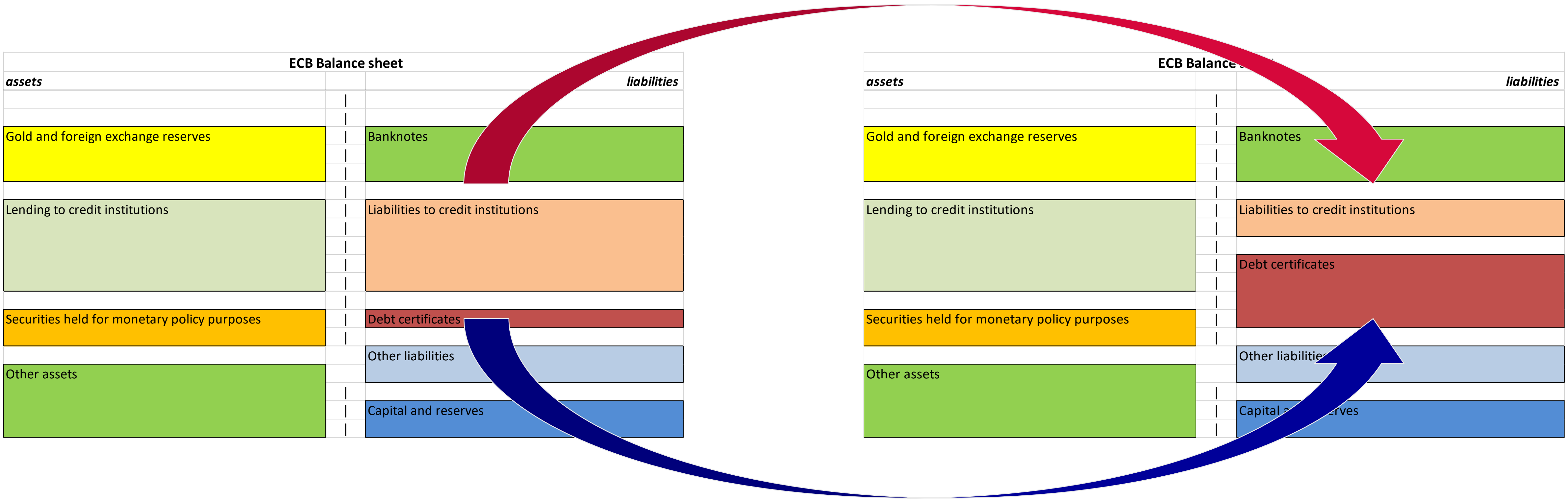
- CB securities are not part of the monetary base (Mo) and do not officially count as banking liquidity.

- The next two slides offer stylized examples of the impact of the issuance of bills by the ECB

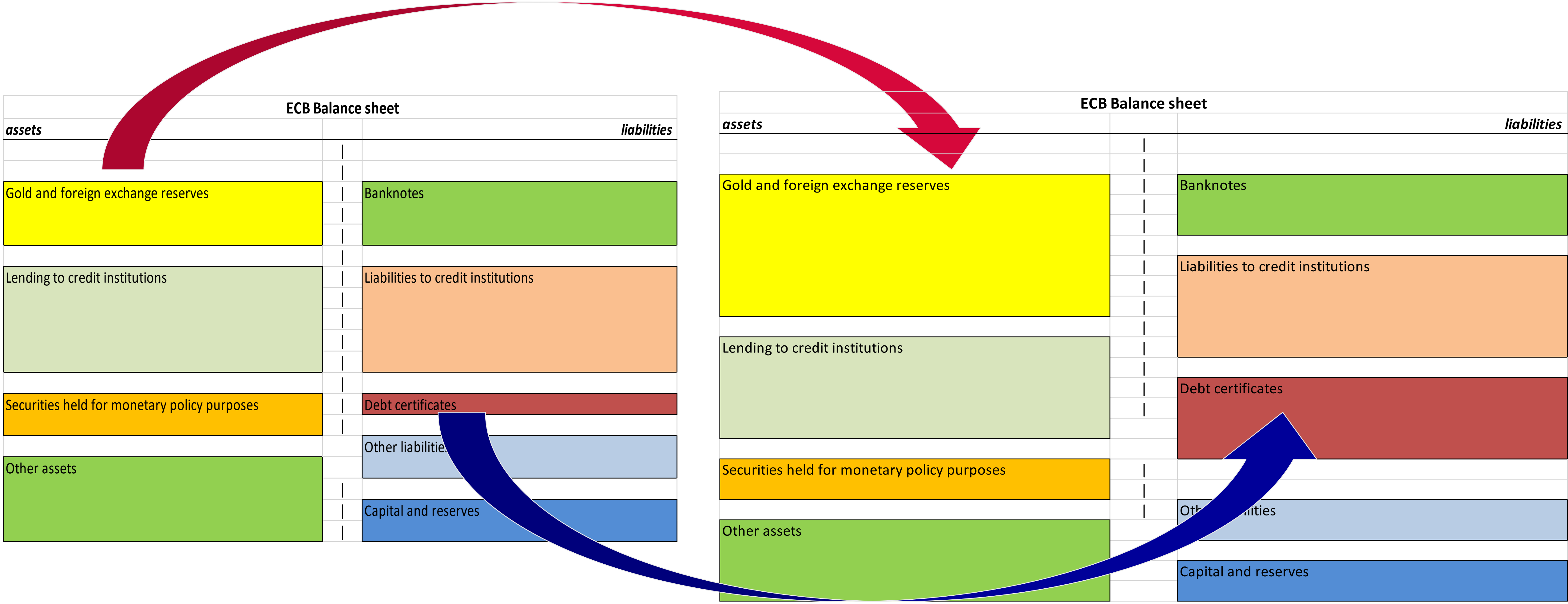
1) Neutralization of existing liquidity
2) Neutralization of new liquidity (relevant for central banks that intervene in the currency markets)

- In reality both effects could manifest themselves simultaneously, although the ECB usually does not intervene in currency markets

Stylized scenario 1 :
ECB issues securities, reducing liquidity
(Balance sheet size constant, substitution on the liability side)



Stylized scenario 2:
ECB issues securities, in reaction to liquidity inflow
(Balance sheet grows, liquidity effect of money inflow is neutralized)



Conclusion

- The current situation offers several opportunities:
- The debt acquired by the central bank opens the opportunities to start with a lower public debt level. The real caveat of course is moral hazard.
- Draining of liquidity can be done by the issuance of securities by the ECB. This will bring less turbulence in financial markets than an active reselling of its portfolio. It is, in the words of the IMF, one of the smoothest ways of conducting open market policies .
- A very positive side effect is that it would bring the eurozone a large and liquid market of common safe assets.
- This would be an important pillar under the Capital Market Union and substantially strengthen the international position of the euro

Thank you

Any questions?

Read our publications on: https://economie.rabobank.com

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Literature

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PROF. DR. BRUNO COLMANT
Member of the Belgian Royal Academy

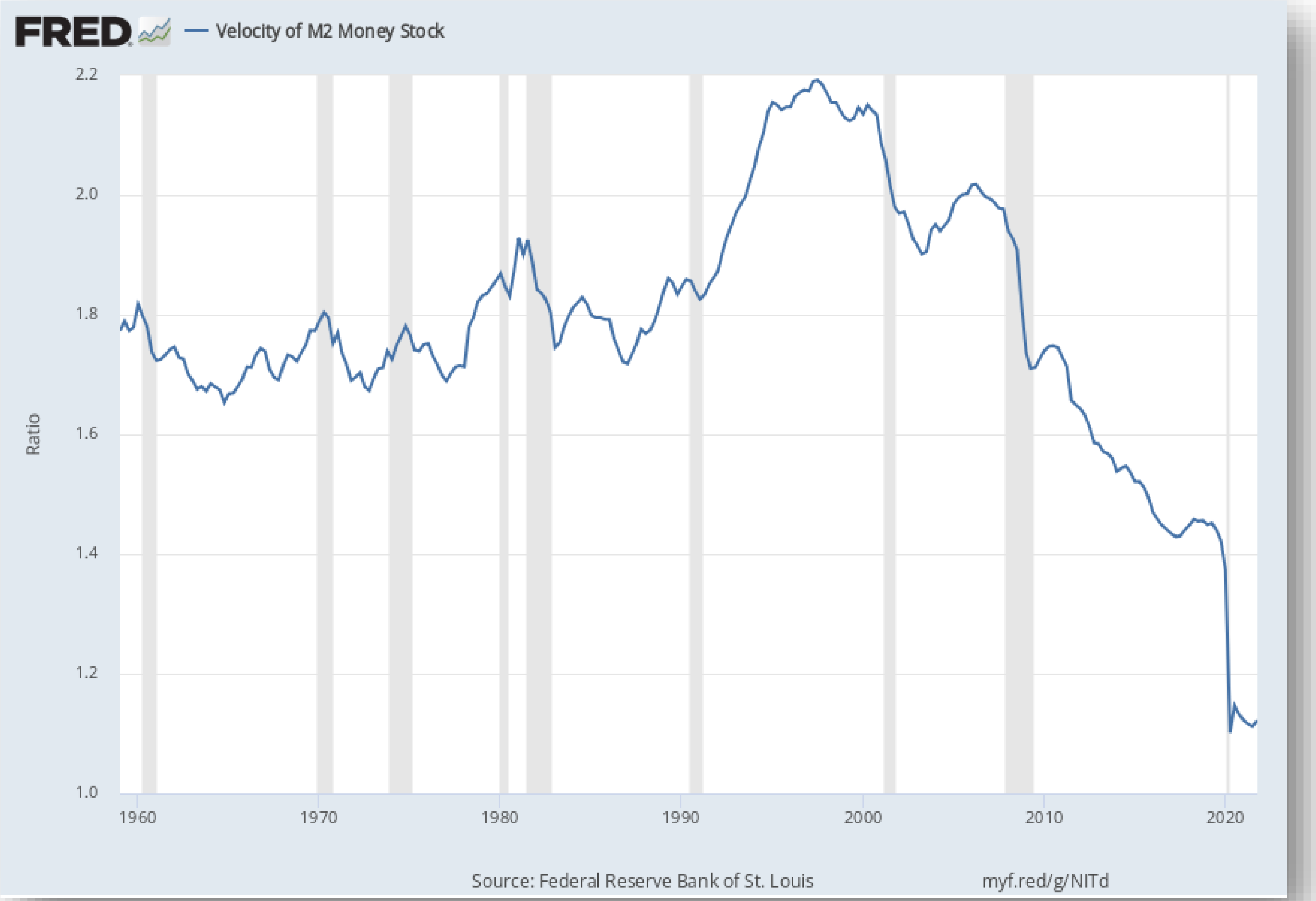
A NEW MONETARY ORDER

SOME INTUITIONS

Money

- It is a public good, mainly created by private institutions
- A stock and a flow (old debate *Banking* vs. *Currency School*); credit multiplier
- Public money stock has increased, money velocity has continuously decreased

Velocity of M2 money stock



The euro has fundamentally changed

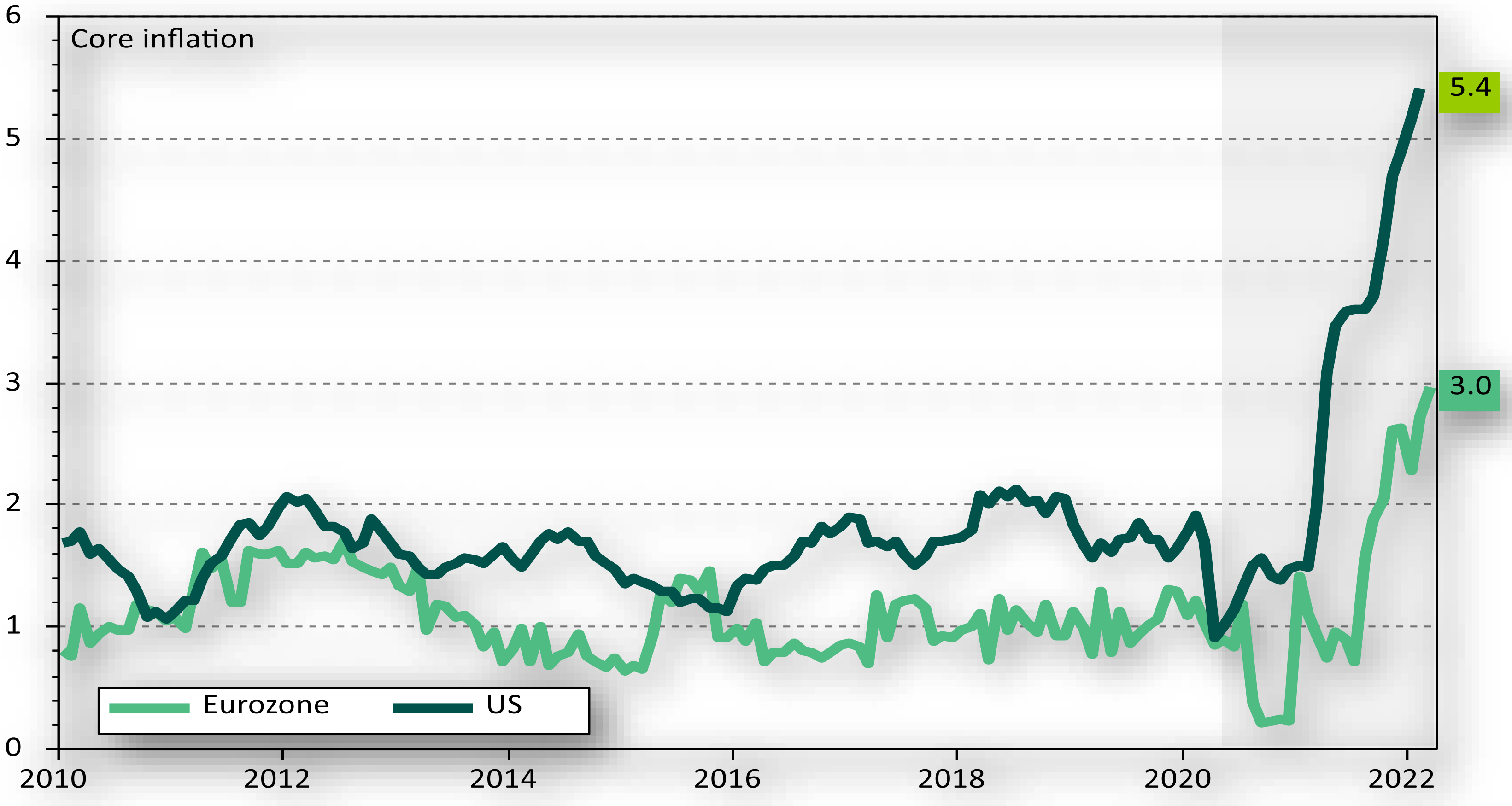
- The fallacy of labor mobility: the euro was a postulated neoliberal choice
- Defined by its own inflation rate
- But after the Sovereign and the Covid crisis

- The euro has changed: from the protection of savers towards the (ongoing) support to the economy
- And now inflation with an unfortunately powerless ECB

Inflation is there to last

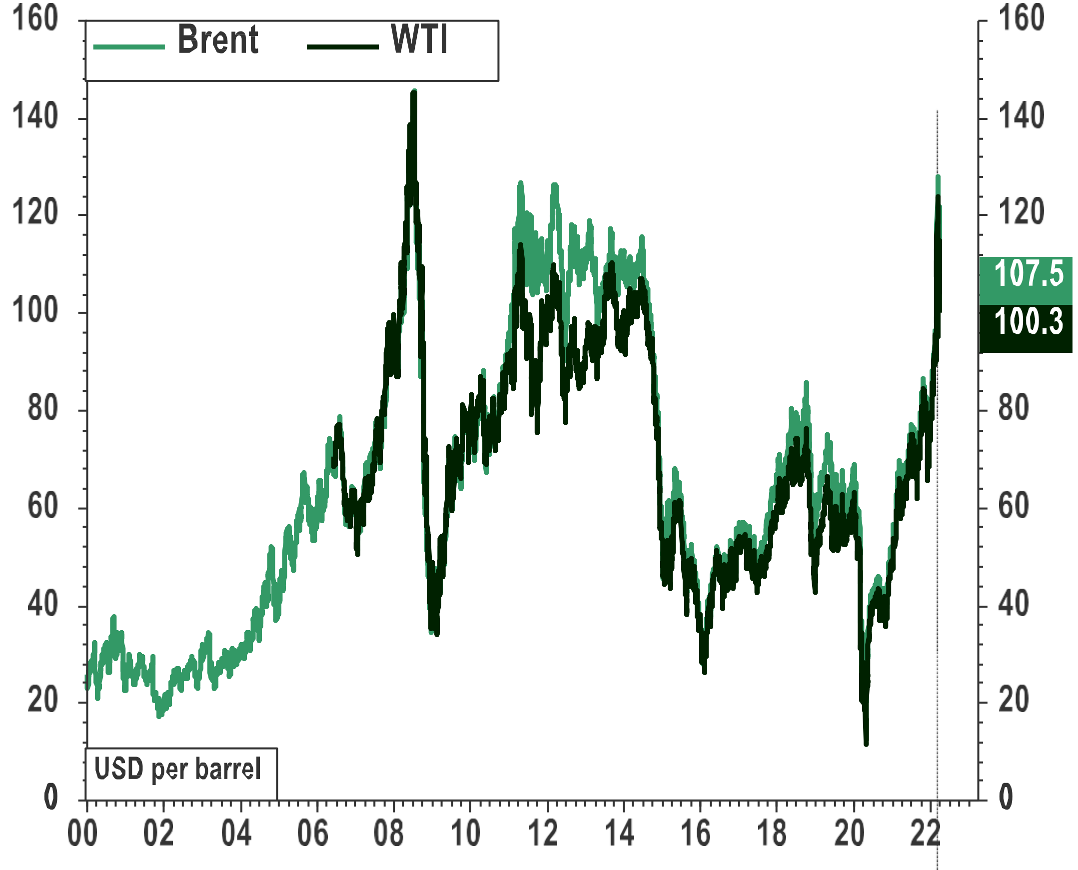
- The disinflationary globalization has probably come to an end
- Globalization will become more expensive
- Climate transition has to be financed, plus disruptions in the supply chain, war, food shortage, etc.
- Eventually, social unrest (end of the great wage moderation) ?

Core inflation Eurozone & US

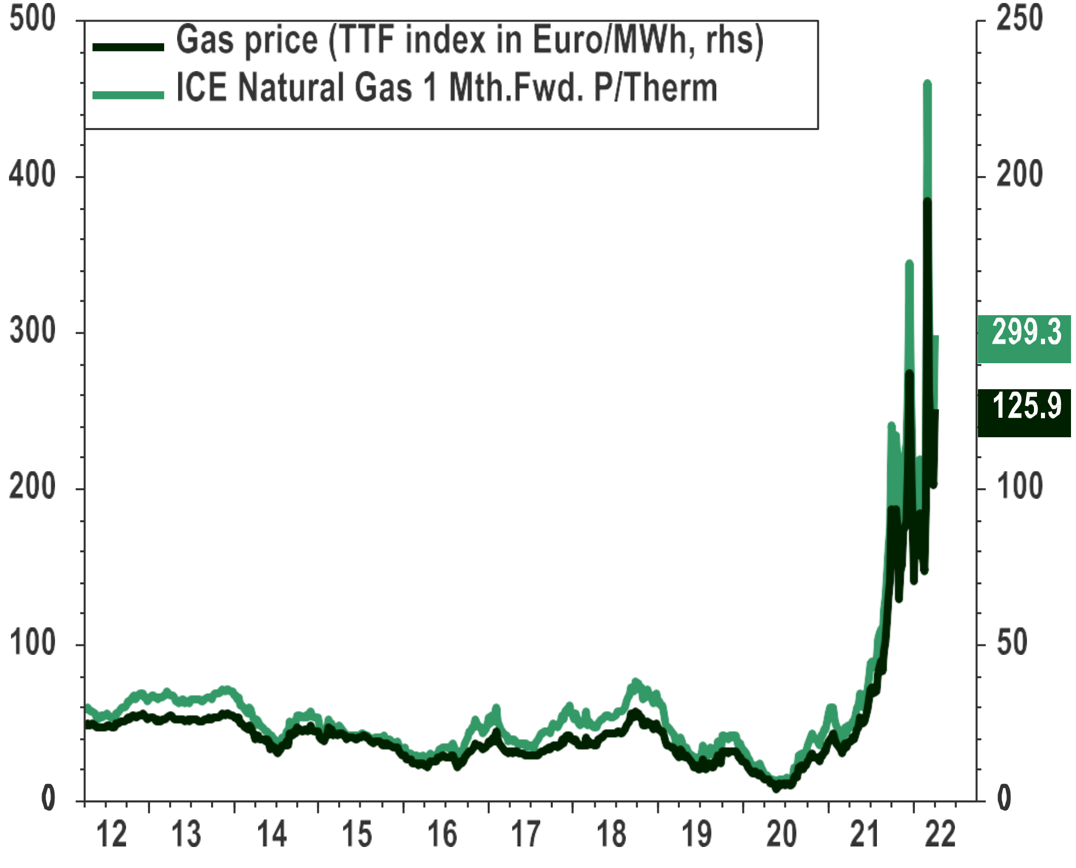


Source: Refinitiv Datastream - PETERCAM

Energy prices

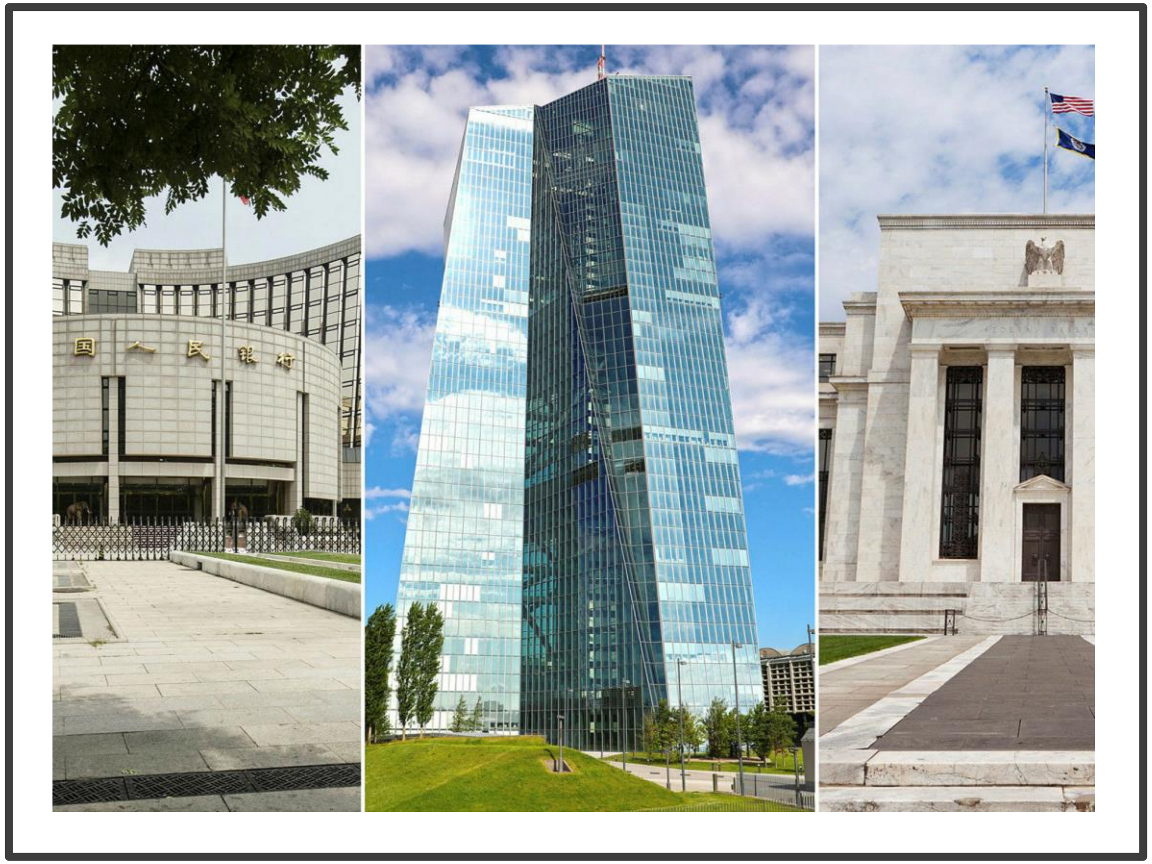


Source: Refinitiv Datastream, Degroof Petercam



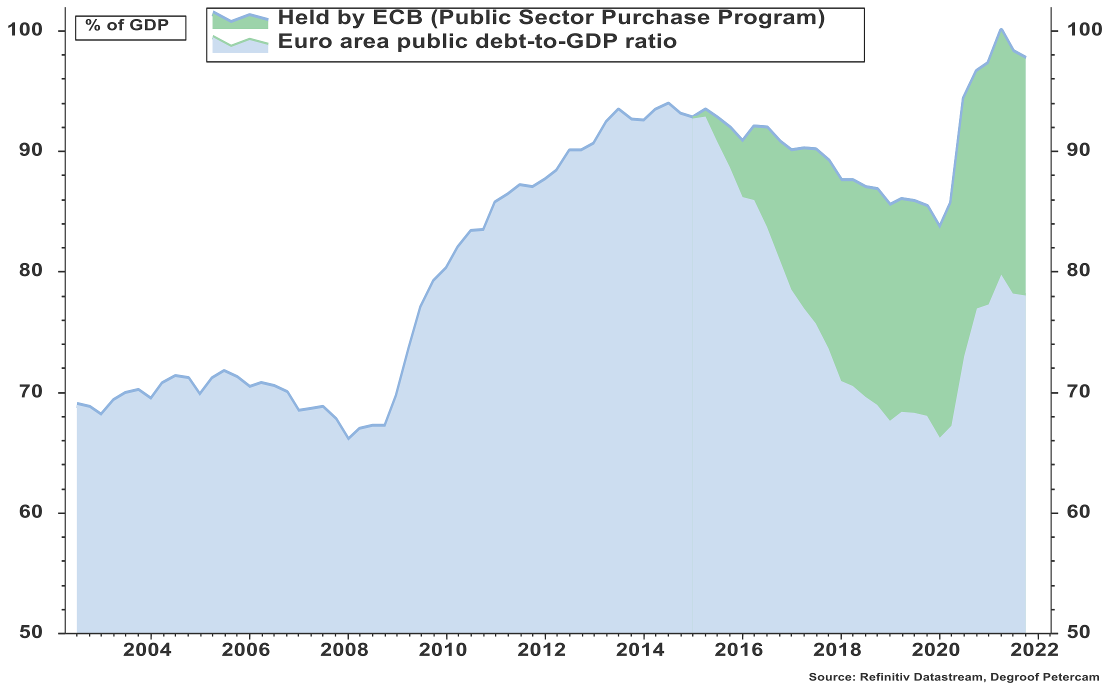
Source: Refinitiv Datastream, Degroof Petercam

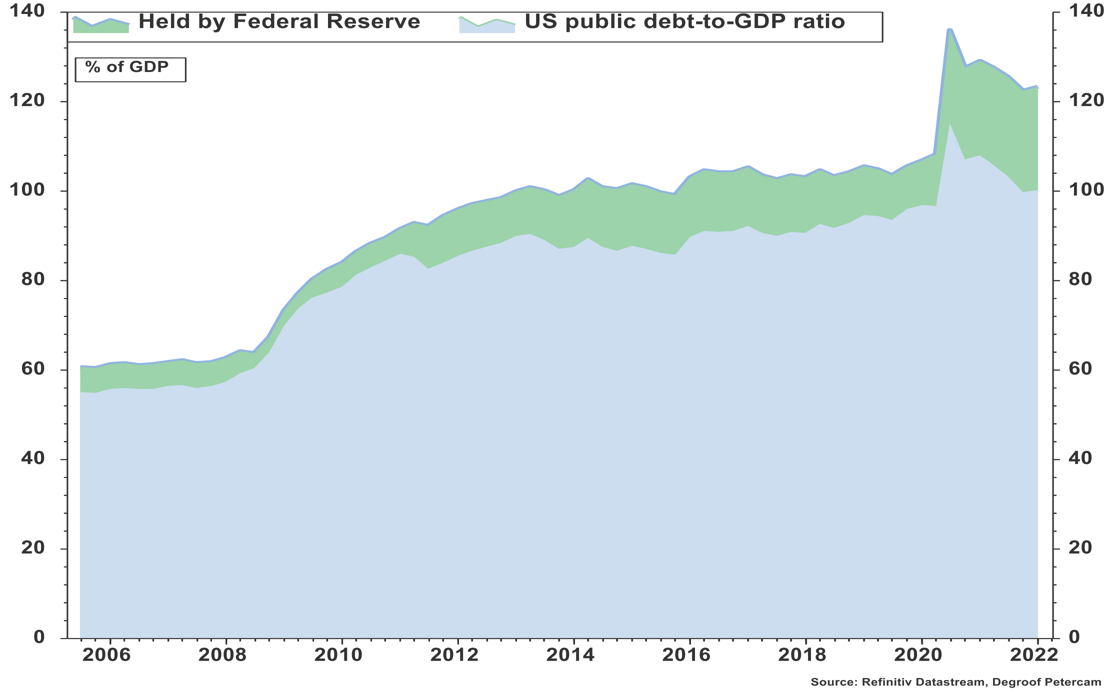
The role of central banks has deeply changed



- The central bank "put option": started in 1998 (LTCM)
- Full control of the yield curve
- Governments and the ECB have exchanged their assets and liabilities
- Refinancing of the european "welfare state": from refinancing with existing savings towards money supply
- Inflation was temporarily subdued by the aging population and globalization, digitalization
- "renationalization" of the money: we get closer to the Chicago Plan (Fisher, 1933) and the melting money (Gesell, 1916)
- And tomorrow : challenge of CBDC, crypto’s, financing of the climate transition

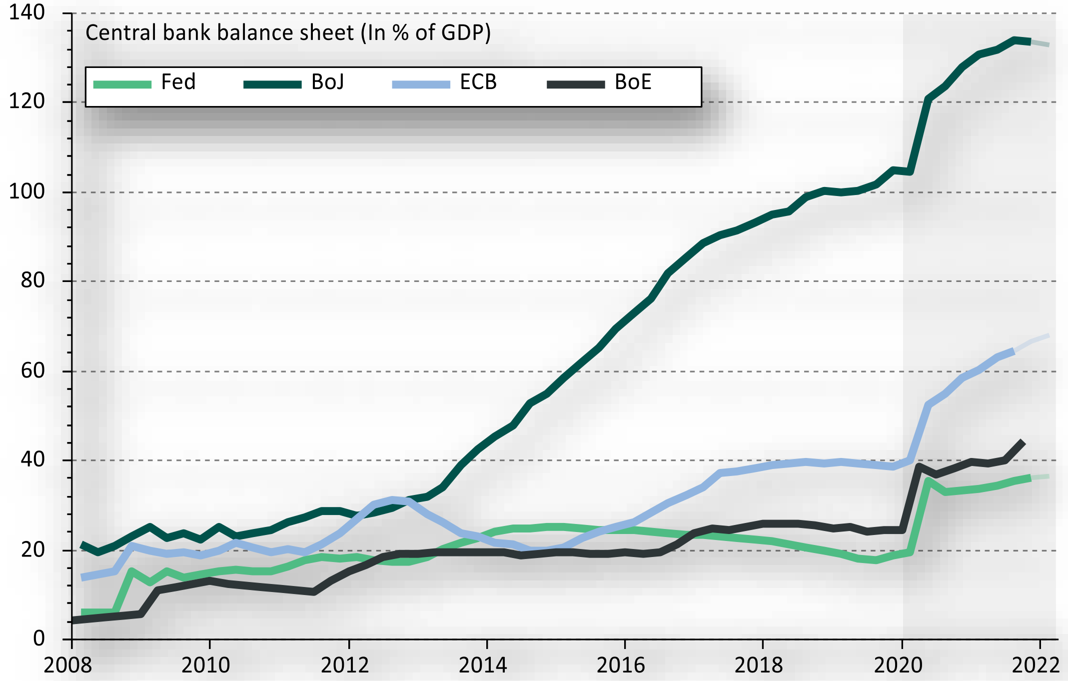
Debt to GDP Eurozone & US





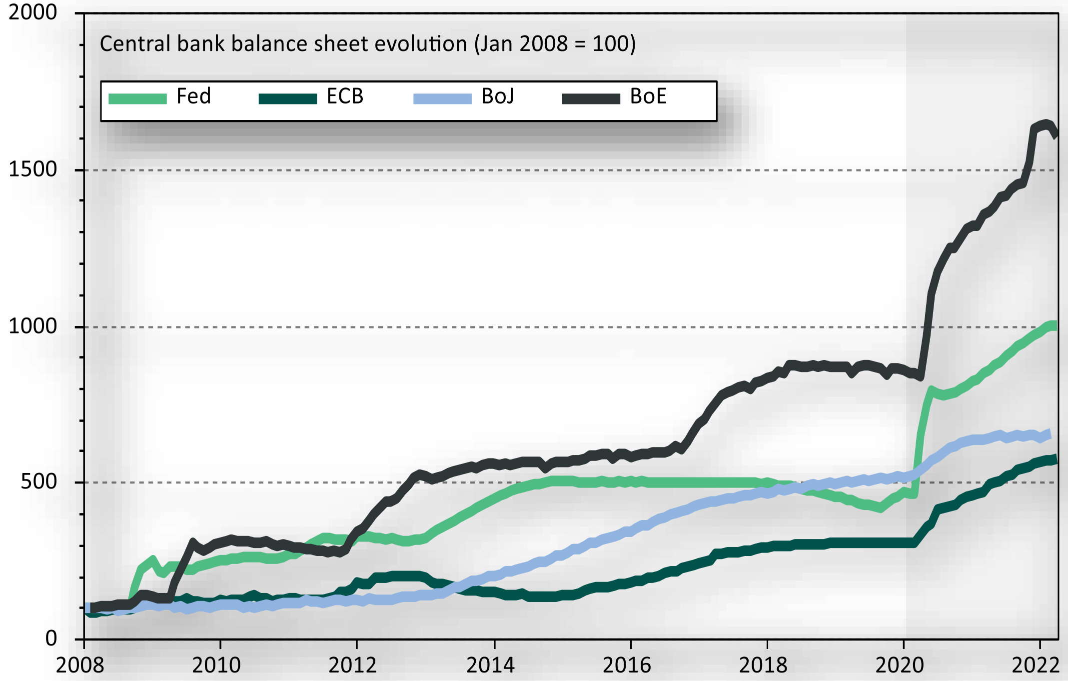
Central bank balance sheet

Central bank balance sheet (in % of GDP)



Source: Refinitiv Datastream - PETERCAM

Central bank balance sheet evolution



Source: Refinitiv Datastream - PETERCAM

Who will pay for this vast "social" refinancing: savers

- Beyond everything, money is a ratio between production factors (labor and capital)
- Substantial public debt with increased asset values BUT increasing social disparities (also fueled by inflation)
- Public debt will continue to increase (= the price of social peace)
- Excess capital must be depleted, while wages must increase
- A probable outcome : first inflation, then taxation of capital?   Pusch-back of neoliberalism?
- The risk : what is ultimate at stake (and will be hit) : social disruption ; private property is at stake in a huge redistribution scheme
- Tacit nationalization of private savings ?


William Shakespeare in King John:
« So foul a sky clears not without a storm. »