since
1999

THE ECB
AND ITS
WATCHERS

The ECB and Its Watchers XXI
September 30, 2020

Abstract

Program

09:15 – 09:30	**Welcome** **Volker Wieland** (Institute for Monetary and Financial Stability) **Birgitta Wolff** (Goethe University Frankfurt)
09:30 – 10:15	**President's Address** **Christine Lagarde** (European Central Bank)
10:15 – 11:45	**Debate 1: The ECB's Mandate: Does It Need to Be Modified to Be Fit for the Future?** Chair: **Jens Weidmann** (Deutsche Bundesbank) Speakers: **Christian Noyer** (Banque de France) **Jordi Galí** (CREI and Universitat Pompeu Fabra) **Helmut Siekmann** (Institute for Monetary and Financial Stability) Lead questions: **Thomas M.J. Möllers** (University of Augsburg) **Elga Bartsch** (BlackRock) **Jörg Zeuner** (Union Investment)
11:45 – 12:00	*Break*
12:00 – 13:30	**Debate 2: The ECB's Instruments for Crises and Normal Times** Chair: **Pablo Hernández de Cos** (Banco de España) Speakers: **Lucrezia Reichlin** (London Business School) **Athanasios Orphanides** (MIT Sloan School of Management) **Claudio Borio** (Bank for International Settlements) Lead questions: **Katharina Utermöhl** (Allianz) **Ulrich Kater** (DekaBank) **Jari Stehn** (Goldman Sachs)
13:30 – 14:30	*Lunch*
14:30 – 16:00	**Debate 3: The ECB's Monetary Policy Strategy: Lessons from the Financial Crisis, Debt Crisis and Double Recession** Chair: **François Villeroy de Galhau** (Banque de France) Speakers: **Otmar Issing** (Center for Financial Studies) **Petra Geraats** (University of Cambridge) **John B.Taylor** (Hoover Institution, Stanford University) Lead questions: **Dirk Schumacher** (Natixis) **Julian Callow** (Element Capital) **Sylvain Broyer** (S&P Global Ratings)
16:00 – 16:30	**Conference Wrap-Up** **Philip Lane** (European Central Bank)

Welcome

Birgitta Wolff, Goethe University Frankfurt

In her speech, Birgitta Wolff, President of Goethe University, welcomed all participants to the conference “The ECB and Its Watchers,” which since 1999 has developed into a platform where the ECB President as well as Board and Governing Council Members meet financial market participants and academics to discuss current issues in monetary policy and financial stability at the invitation of the Institute of Monetary and Financial Stability (IMFS).

According to Wolff, Goethe University is proud of gathering economic expertise in various research areas under the roof of the House of Finance where the IMFS has worked out clearly its focus on central banking based on interdisciplinary research in economics and law for more than ten years.

She explained that this year’s conference was a special event in many respects as “The ECB and Its Watchers” would contribute to the strategy review of the European Central Bank. The ideas presented, the discussions, and arguments would be taken into account in this process of making sure that the ECB will be able to fulfill its mandate of keeping prices stable in the future.

Furthermore, the 21st edition of the conference was taking place in a new format. Due to the coronavirus pandemic, only a very small number of panelists and participants gathered on-site whereas several speakers and most of the audience took part remotely.

Wolff also welcomed ECB President Christine Lagarde to the conference. Since she took up office in November, this was her first appearance at this conference. Wolff referred to an interview of President Lagarde with the Washington Post where she formulated a “theory that women are generally given space and appointed to jobs when the situation is tough. In times of crisis, women eventually are called upon to sort out the mess, face the difficult issues and be completely focused on restoring the situation.” Finally, Wolff handed over to President Lagarde who spoke via videostream.

- Video

President’s Address

Christine Lagarde, European Central Bank

Christine Lagarde
European Central Bank

In her speech at the conference “The ECB and Its Watchers”, Christine Lagarde, President of the ECB, shared some preliminary considerations regarding the monetary policy strategy review. In this context, she also referred to the Federal Reserve’s strategic shift to let inflation overshoot to compensate for periods when inflation was below the Fed’s target.

“Now is the time for listening and reflecting,” she said in her first appearance at the event. She emphasized that her speech had nothing conclusive except being “decisive” to explain the ECB’s tasks better to the people, including those that the bank “do not normally reach,” and to incorporate issues that people care about, such as climate change and inequity.

In the first part of her speech, in which she addressed the ECB’s inflation objective, President Lagarde pointed out current discussions on letting inflation overshoot after “quite some time” when central banks miss their inflation targets. She pointed to research that such a shift in monetary policy strategy, if credible, can help stabilizing the real economy in the era of low interest rates, and indicated that the “usefulness of such an approach could be examined”.

President Lagarde also mentioned that the ECB’s principle to maintain price stability in the medium term, rather than expecting monetary policy to take effects in the short term, gives the flexibility to deal with real-economy issues, including employment and growth. However, she suggested that a “persistent failure” to achieve the inflation target may well call for shorter policy horizon to be considered.

In recent years, prices have apparently become less responsive to developments in the real economy, President Lagarde said, yet the empirical Phillips curve remains intact but “may be rather flat.” In the second part of her speech, she suggested three factors contributing to that discrepancy: Economic slack larger than previously expected owing to difficulty in measuring economic activities relative to their potential; structural forces such as globalization that distorts historical regularities; and the loosened anchoring of inflation expectations.

In the last part of her speech, President Lagarde brought up two questions arising in the context of a low natural interest rate that leads to central banks frequently resorting to balance sheet policies. She first asked what the standardized toolkit should be when unconventional policy becomes “normal,” and indicated that the key is to further understand the transmission channels of different instruments and evaluate their side effects.

The second issue concerns the interactions between monetary and fiscal policy that are also a focal point in the ECB’s current strategy review. Although recognizing the benefits of these two policies complementing each other, President Lagarde underscored potential problems to be examined, such as high-level public debts and an appropriate design of the EU’s fiscal framework.

- Full speech
- Video

Debate 1: The ECB's Mandate: Does It Need to Be Modified to Be Fit for the Future?

Jens Weidmann, Deutsche Bundesbank

Jens Weidmann, President of the Bundesbank, identified the risk of blurring lines between monetary policy and fiscal policy amid central banks' efforts to boost inflation by launching large-scale asset purchases. As chair of the first panel discussion on the ECB's mandate, Weidmann took the chance to express his concern over a wider interpretation. "The more widely we interpret our mandate, the greater the risk that we will become entangled with politics and overburden ourselves with too many tasks," said Weidmann in his introduction to the first panel of the conference which focused on the ECB's mandate.

Citing a speech by the ECB's first president Wim Duisenberg in 1998, Weidmann pointed out the clarity of the mandate and concluded that it had been a key element in achieving price stability since then. He pointed out questions to be examined such as how to define and measure price stability and how to specify a hierarchy of monetary instruments to fulfil the mandate.

Referring to the Federal Reserve's recent strategy shift, Weidmann compared it with the ECB, highlighting the former's dual mandate which "cannot simply be transferred" to the euro area.

Despite his cautious attitude toward multiple mandates, Weidmann suggested that a monetary policy strategy should be "flexible enough" to deal with long-term risks to price stability that result from the built-up of imbalances in the financial system. He noted that such imbalances could be fueled by an "enduring easy-money" policy.

Weidmann discussed the problem of coping with disinflation by pushing the real interest rate below the natural rate of interest, or "r-star." He mentioned the difficulties in measuring r-star given different methods and datasets, and attributed the problem to r-star's variant nature shaped by fundamental forces such as demographic trends or productivity growth. He illustrated how "central banks around the world are searching for ways to respond to the decline in the natural rate."

- Full statement
- Video

Debate 1: The ECB's Mandate: Does It Need to Be Modified to Be Fit for the Future?

Christian Noyer, Banque de France

In his speech, Christian Noyer, former Governor of the Bank of France, discussed whether the ECB should have a single, dual, or multiple mandate, and interpreted the mandate. He investigated the quantitative definition of price stability as well as possible changes to the definition by elaborating on their main advantages and disadvantages. He argued that, "having an objective in the medium term and the possibility of forward guidance gives the best flexibility that the ECB can have."

In the first part of his presentation, Noyer reminded the audience that the ECB has one primary objective: price stability. However, the ECB should support the objective of the Community, which includes, according to Article 2, low unemployment and growth. Noyer had objections to formally incorporate these elements as secondary objectives of the ECB as price stability and monetary policy are forward-looking, while unemployment and growth are a short-term concern. Furthermore, price stability tends to stabilize output growth around its potential and thus to stabilize unemployment around its natural rate. According to Noyer, in contrast to the Fed, the ECB should not incorporate full employment in its mandate. Due to structural differences in the euro area, full employment means different unemployment rates in each country – a phenomenon that is hard to explain to the public. Some central banks include financial stability in the mandate as a secondary objective. Noyer pointed out that effective monetary policy required financial stability of the ECB. Otherwise, there would be deficiency in its transmission channel at banks or the market. Consequently, for price stability in a meaningful sense, which he described as relatively close inflation rates in the whole euro area, there is the need of an effective transmission everywhere in the euro area to avoid excessive segmentation. In Noyer's view, this is already implicitly included in the ECB's mandate. Although climate change affects the long term and conventionally monetary policy has no impact on long-term growth, Noyer argued that climate change risk was already considered in the natural equilibrium interest rate, which affects the medium term. He also explained that extreme weather events have consequences on the short term by negatively influencing supply and by that affecting output and prices. However, the ECB would already consider this in its mandate.

Regarding the definition of price stability, Noyer commented on the price index, the time horizon, and the definition of price stability. He argued that inflation is defined in the medium run, so volatile components should not influence the price index, unless there are structural changes. In his view, the ECB could use core inflation, which is more stable, provided one could incorporate the missing components. He proposed to take a moving average of the volatile components in the price index to reduce their volatility. The time horizon of price stability is around two years and there is no need to change it.

Finally, Noyer explained the historical validation of the "below but close to 2%" target. An important point is that the measurement bias in inflation of the new price index of the EU would not overshoot inflation by 1.1-1.3% but below 1%. Not stating a precise range of the inflation target aimed at ensuring flexibility in monetary policy. According to Noyer, there is no need for strongly revising the definition of price stability. It is true that the natural inflation trend of the last decade seems to be closer to 1-1.5%, but there is no evidence of a permanent shift. In his view, it is dangerous to regularly change the definition of price stability, which would reduce the credibility of the ECB. Although logical given the natural variations of inflation during an economic cycle, a range of admissible variations has drawbacks. If the range were too broad, then the ECB could be perceived as tolerating inflation too much. If, in contrast, the range is too narrow, the ECB might reach its inflation target range infrequently, which would reduce its credibility. Noyer warned that an average inflation target was extremely risky because periods of low inflation must be followed by periods of very large inflation, and then, the transition back to 2% inflation would be extremely costly. Consequently, in his opinion, any change should be weighted with extreme caution.

- Slides
- Video

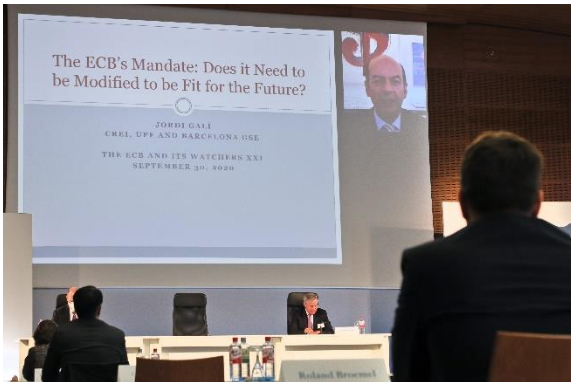
Debate 1: The ECB's Mandate: Does It Need to Be Modified to Be Fit for the Future?

Jordi Galí, CREI and Universitat Pompeu Fabra

In his speech, Jordi Galí, Senior Researcher at CREI, discussed four possible changes in the strategy of the ECB, with the first two likely to be less controversial than the last ones. He called for an open discussion about all possible strategies and requested that the ECB clearly explain why each strategy or element of a strategy is implemented or averted.

Galí proposed the adoption of a *symmetric* inflation target as a first desirable change. He argued that the "downward bias" in the current target specification is hard to justify given that by now we have learned that low inflation is at least as bad as high inflation. The announcement of a symmetric inflation target may, by itself, raise inflation expectations a bit. In addition, Galí believes that the ECB could consider an inflation target band, possibly a narrow one. That option would give clarity to the meaning of "close to 2%."

The second aspect of the ECB strategy that, in Galí's opinion, requires a change is the two-pillar structure. He reflected that the ECB has established a good reputation after twenty years. Therefore, there is no need for the monetary pillar anymore, on the grounds of continuity with historical Bundesbank practice. Also, the monetary pillar was originally introduced on the basis that there is a fundamental direct relationship between monetary aggregates and price level. However, this view is at odds with modern monetary theory. According to the latter, monetary policy influences inflation only indirectly, through its impact on aggregate demand, output, employment, and marginal costs, which eventually influences the price level. On the other hand, the monetary pillar has not been harmful either in practice. Galí reminded the audience that large growth in M3 had no significant effect on monetary policy decisions. But the ECB always had to struggle to justify large fluctuations in monetary aggregates. Galí argued that the ECB should monitor financial indicators rather than monetary aggregates, given their ability to predict financial crises, and that any necessary asset purchase programs should not be precluded by constraints on monetary aggregates.



A third desirable change would be the introduction of an average inflation target (AIT). Galí views average inflation targeting as "systematic forward guidance" because it should reduce the uncertainty about the future monetary policy stance. Galí proposed asymmetry in the implementation of AIT, which should be adopted only when inflation undershoots the target, but not in the case of overshooting. Another feature he proposes is "double-contingency." This means that the ECB adopts AIT only when the Effective Lower Bound (ELB) is binding. Otherwise, it would stick to flexible inflation targeting. In addition, the ELB would not be abandoned until the average inflation target is reached. This feature clarifies the amount and duration of an overshoot. Without this clarification, average inflation target may have little impact. Galí warned, however, of a tradeoff between how specific are the details about the AIT adopted and the ability to attain the target. Furthermore, an AIT strategy requires "near-surgical" capabilities on the part of the ECB to steer inflation towards the desired rate, which may raise some eyebrows.

A final and possibly more controversial change would be the adoption of a higher inflation target. Theoretically, a higher inflation target is desirable in response to a permanently lower r*. If the inflation target remained unchanged, the average nominal interest rate would be lower and the incidence of a binding ELB would be higher. On the other hand, the estimated costs of inflation are almost marginal at this relatively low level of inflation, compared to the benefits of having more policy space. Galí believes that introducing a higher inflation target in the current period of undershooting would raise some credibility issues. It would make more sense to first announce that the ECB may consider increasing the target in the future. The ECB should announce the higher target when inflation will have been persistently above the current target. Galí reflected that this way, the ECB would not be accused of "trying to manipulate the target to be closer to current inflation."

- Slides
- Video

Debate 1: The ECB's Mandate: Does It Need to Be Modified to Be Fit for the Future?

Helmut Siekmann, Institute for Monetary and Financial Stability (IMFS)

Helmut Siekmann, Distinguished Professor at the IMFS, discussed the legal aspects of the ECB's mandate. He used the asset purchase programs of the ECB as an example of discord between different courts. The discussion included how much leeway executive bodies of the EU should have in defining their competences. Siekmann argued that the mandate, in a strict interpretation, needed to be amended. He concluded that the primary law neither acknowledged an average inflation target nor supported the fiscal needs of sovereigns in the EU.

At the start, Siekmann discussed the mandate of the European System of Central Banks (ESCB), whose legal limits, mainly its tasks, objectives and competences, have been "object of fierce legal dispute," referring to the Outright Monetary Transactions (OMT) and the Public Sector Purchase Program (PSPP). Depending on volume and timing, the purchases are judged as either monetary policy, which is an exclusive competence of the EU and hence legal, or as economic policy, which is a competence of the member states. Despite concerns of the German Federal Constitutional Court (GFCC), the Court of Justice of the EU (CJEU) did not see a "transgression of competences nor a prohibited monetary financing of government deficit." Due to this statement, a deficit in fulfilling its tasks and a transgression of competences by the Court of Justice has been considered by the German Court in view of the principles of conferral and proportionality. Regarding the amount of leeway the Eurosystem should have in defining its tasks and competences, Siekmann pointed out that although the framers of the Treaties have implemented precise primary law, representatives of the ESCB use the term "mandate" when referring to its competences. In his view, this term has room for interpretation. He warned that the "CJEU has further diluted the legal rules on the distribution of competences by conceding a wide margin of discretion to the ESCB in deciding on the limits of its competences." This would turn the strict rules of the primary law into non-binding guidelines, which widely lack judicial control. The principal objective of the ESCB is price stability. To achieve this, the ESCB is confined to monetary policy. Although it can support the member states' economic policy, the ESCB is not allowed to pursue its own economic policy, including fiscal policy. Siekmann expressed reservations against a "situation-oriented understanding" of the terms "monetary policy" or "maintaining price stability." Concerning the question whether the "mandate" of the ESCB needed a modification, Siekmann distinguished between the term "mandate" in a wide understanding and a strict understanding. In the first case, the ECB would operate in discretion, as mentioned above. In Siekmann's view, there would be no necessity for a modification of the legal framework. In the case of a strict understanding of the competences of the ESCB and an effective control by the judiciary, "an amendment of the Treaties would appear to be indispensable."

Regarding the legal aspect of two possible new competences of the ESCB, average inflation targeting and monetary financing of sovereign debt, Siekmann argued that setting an inflation target by an executive body like the ECB hardly be compatible with the primary law of the EU if it is understood literally, regardless of the numerical value. Since the ESCB was strictly bound to maintaining "price stability," an average inflation target had no legal basis. Siekmann reminded the audience that "price stability" was established by German law as "0% inflation" as a target. Without changing the treaty, the GFCC would not accept switching to an average inflation target. Siekmann argued that without a defined exit the PSPP comes close to monetary financing, which is not allowed. Moreover, it can be costly, "even in an environment of real and nominal negative interest rates." Siekmann was concerned that the ECB might lose its independence because it might be dominated by fiscal policy. Furthermore, the distributional aspects of this policy are often not sufficiently considered.

- Prepared remarks
- Slides
- Video

Debate 2: The ECB's Instruments for Crises and Normal Times

Lucrezia Reichlin, London Business School

In the second panel on the ECB's instruments, Lucrezia Reichlin pointed out that in order to frame any discussion on the effectiveness and the risks of non-standard policies, it is important to understand that the consensus on how monetary policy is to be conducted and how it works has changed since 2007. Non-standard policies have become standard, not only for the reason that central banks had to implement certain measures but also because the financial crisis taught us that the interaction between economic policy, monetary policy, and financial markets must be understood in a different way than in the 90s. For example, it is now understood that financial frictions are pervasive not just in crisis times, that the central bank's market-maker role can go beyond the traditional lender of last resort function and that balance sheets can be used pro-actively also away from the zero lower bound. Central banks have now more instruments than just the short-term interest rate. Moreover, they have now new responsibilities. She was convinced that there is a new reality and no way back for many reasons: excess demand for safe assets is going to continue to be large because of precautionary savings; demographic changes; deleveraging; new risks including climate change, technology, health as well as large legacy public debt.

Having set up the context, Reichlin asked three main questions. First, is there any quantitative evidence for the effectiveness of unconventional monetary policy and its transmission mechanism to the economy? Second, what are the risks involved? Third, what would be an adequate institutional design acknowledging the "new normal" but being coherent with price stability and allowing managing risks associated with balance sheet monetary policy?

As concerns effectiveness, there are two rationales for implementing non-standard policy measures. The first stresses complementarity between balance sheet policies and interest rate policy: central bank intermediation serves as a substitute for private market activity when financial markets dry up. The second stresses substitutions: balance sheet policy replace interest rate policies when interest rate has reached the effective zero lower bound.

Are these policies effective? While in many of the standard economic models unconventional policies do not work due to "irrelevance theorems," recent research shows that these irrelevance theorems break down once financial frictions are taken into account. The underlying key mechanism is the compression of spreads which by reducing the borrowing costs of both firms and government relaxes financial constraints. These effects have large distributional consequences (they are "non-neutral") which, given the size and the composition of the central bank balance sheet today, are larger than those implied by standard interest rate policy.

Coming to the empirical literature focusing on the euro area, Reichlin pointed to three lessons. First, the presence of multiple equilibria. Evidence pointing to that is the powerful effect on the sovereign spreads of the 2012 Draghi's speech in which he pledged to do "whatever it takes to save the euro" and announced the OMT program. The different degree of effectiveness of the OMT and the SMP can be explained by the fact that, while in announcing the OMT Draghi could speak with the backing of the fiscal authorities and on the basis of an agreement that had been reached by major euro area governments to support the integrity of the euro, two years earlier, when he launched the SMP, Trichet could not rely on this support. As a consequence, the SMP program lacked the credibility of the OMT. The lesson – according to Reichlin - is that the credibility of monetary policy largely depends on general 'fiscal backing' (the support by the political and fiscal authorities). Another piece of evidence – according to Reichlin – is based on a study by Leombroni et al which shows that in the period 2012-2015, before QE was introduced, monetary easing policy announcements resulted in increased credit risk premia and amplified sovereign yield volatility, in contrast with pre-crisis period and post-QE sample. This suggests that the market interpreted ECB announcements as signaling a lack of consensus for QE. In such situation, forward guidance and other policies were interpreted as lack of commitment to protect the integrity of the euro, resulting in undesired effects on spreads. Indeed, after the implementation of QE, central bank communication started to deliver benign effects again.

The second lesson – according to Reichlin, is that asset purchases can be very powerful and have large effects on term spreads, credit spreads, and the exchange rates, but it is difficult to identify large effects on inflation and output or at least results on those are not sufficiently robust. The latter discrepancy is worth to be investigated further. A conjecture is that the macro effects of these non-standard monetary policy shocks are not well captured in empirical models which do not allow for changing trends (for example the decline in potential output and long-run inflation expectations) and changes in regimes due to multiplicity of equilibria.

Indeed – the third lesson – is that, in the euro area, unlike the US, trend inflation declined since mid 2011 and stabilized only after the implementation of QE. This decline was associated by both a shrinking of the euro-system balance sheet and fiscal consolidation.

These three lessons carry the message that balance sheet policies can be powerful when they are implemented but also when they are not. Their effect depends on communication and credibility which, amongst other things, depends on the relationship with the sovereign (the sovereigns in the case of the euro-system).

Considering the risks of non-standard policies, Reichlin acknowledged that mostly the national central banks are bearing the credit risks and argued that it is important to consider the implicit risk sharing mechanism in the euro area in case a member state defaults. These risks are particularly high when the level of debt is high and central bank balance sheets are large. Furthermore, there is a risk of moral hazard, crowding out of market activity and the central bank being overburdened. However, these risks have to be compared to what would have happened if this tool had not been used.

For this reason, in Reichlin's view, a risk management approach to credit and fiscal risks triggered by balance sheet policies needs to be developed. In particular, there is a need to develop an economic governance of the euro area based on the commitment of fiscal authorities to absorb potential losses of the central bank.

As the present setting becomes the new normal, Reichlin emphasized the necessity for an agenda that recognizes that innovative monetary policy is necessary, that monetary policy may have distributional effects, and that explicitly acknowledges that the interaction between monetary and fiscal policy is relevant. But to maintain the credibility of the price stability objective this would have to be associated with a commitment by both fiscal and monetary authorities to a target which would serve as a nominal anchor.

Furthermore, the objective of price stability requires coordination of monetary and fiscal policy to avoid fiscal policy undoing the impact of monetary policy. To achieve this in the monetary union the central bank would need a federal fiscal agency to function a counterparty. This is difficult to achieve with fiscal sovereignty still at the national level. Clearly, this discussion goes beyond what the ECB can address in its revision of the strategy and relates to the broader agenda regarding the governance of the euro area.

- Slides
- Video

Debate 2: The ECB's Instruments for Crises and Normal Times

Athanasios Orphanides, MIT Sloan School of Management

The ongoing policy strategy review is a unique opportunity for the ECB to examine how to adapt its policies to better serve the people of Europe. At present, there are two main challenges for monetary policy: First, the low interest rate environment—a challenge common with other central banks. Second, the incomplete nature of the EMU—a challenge unique to the ECB. In addition, two issues are still unresolved from the euro crisis: First, lowflation, related to the reluctance of the ECB to implement policies other central bank did more promptly. Second, the impairment of monetary policy transmission mechanism relating to implementation aspects of monetary policy strategy. A main question to be asked is whether the ECB has the authority and the tools to fulfill its mandate under current circumstances.

In a low interest rate environment, the ZLB constrains policy easing. The literature related to the ZLB, motivated by the Japanese experience since 1999, suggests that the efficient response to the ZLB is the prompt adoption of quantitative easing (QE). The risks are asymmetric calling for action even before the ZLB is reached with normal policy. Yet policy multipliers are uncertain, and QE can have side effects which make policymakers uncomfortable. Sometimes this may lead to inaction or hesitation—a policy error. In the 2000s, the Bank of Japan hesitated to adopt forceful QE and undershot its price stability goal. Similar to Japan, hesitation by the ECB in the 2010s resulted in 'lowflation.'

A glance at the Fed and ECB balance sheets since the GFC suggests that while the Fed substituted rate cuts for QE systematically, the ECB has been relatively timid. From 2012 to 2015, the ECB reduced its balance sheet by one third, a significant quantitative tightening. From 1999 to 2011, the annual rate of euro area inflation was 2 percent on average. Since 2012, it has only been 1.1 percent on average, raising the question what is the ECB's goal. This is one of the most important elements that must be clarified with the policy strategy review. Under former president Jean-Claude Trichet, the ECB kept reiterating a symmetric inflation target of 1.9 to 2.0 percent. During the GFC and early in the euro crisis, the ECB benefited tremendously from this commitment. However, this subsequently changed. Inflation swaps and survey data suggest a disanchoring of inflation expectations occurring precisely in the period of missing QE. Unfortunately, while in 2014-15 the ECB recognized the problem, it did not follow up with decisive action. The ECB adopted QE timidly and discontinued QE before sufficient progress on inflation was made. Comparing the experience of the euro area with that of the U.S. suggests that a clear communication of the central bank's inflation goal and the adoption of a systematic policy in line with this goal has important benefits.

To answer the question whether the ECB has sufficient authority to meet its mandate, a brief glance at its statute suggests that it has the authority to carry out any necessary asset purchases, even in foreign currency, and has tremendous flexibility to define collateral policy. Furthermore, the Governing Council is entitled to adopt new measures 'as it sees fit' which other central banks do not have at their disposal, implying a larger discretionary authority than most central banks.

A further important issue that requires attention in the ongoing policy strategy review relates to the impairment of the monetary transmission mechanism. The key problem with the ECB's monetary policy implementation strategy is the excessive reliance on "markets" and private credit rating agencies. Since the euro crisis, this aspect of ECB policy strategy has had inadvertent adverse consequences: It has induced debt roll-over crises and has validated adverse expectational equilibria in sovereign debt markets.

A key question is whether the ECB has made satisfactory use of the authority delegated to it. Judging from sovereign spreads and repeated episodes of market tensions, it is clear that this was not the case during the euro crisis. Yet, following the outbreak of the current pandemic, the ECB has made better use of its authority. The response to the pandemic started with a communications mishap and market tensions that impaired monetary policy, but the ECB quickly recognized that it needed to act. It first reacted with asset purchases. Although the announcement of the PEPP on March 18, 2020 played a crucial role, asset purchases proved insufficient to deal with the underlying concerns as they did not address the cliff effects in the ECB's collateral framework and potential debt roll-over crises. A more important decision followed on 22 April: The ECB decided to suspend the role it had given to private credit rating agencies to determine collateral eligibility. In this manner, the ECB provided collateral certainty and succeeded in diffusing market tensions.

Before the pandemic, the ECB embarked on a welcome strategy review. The pandemic delayed some of the work on the review, but it also made improvements to the pre-pandemic monetary policy strategy more urgent. To limit the lasting damage from the pandemic, and to make current policy more effective two issues must be urgently addressed. First, it is important to adopt a clear symmetric 2% inflation goal and calibrate QE in a systematic matter to achieve this goal. Providing ECB Governing Council inflation projections similar to other central banks, would buttress the ECB's commitment to implement policies consistent with its 2% inflation goal. These steps would help re-anchor inflation expectations and improve economic outcomes. Second, and even more important, the ECB must correct the fragility-inducing aspects of ECB's policy implementation strategy. It can draw on the success of the temporary measures adopted in response to the pandemic to eliminate cliff effects in the collateral framework on a permanent basis, and end the delegation of policy implementation to private credit rating agencies.

The ECB has the authority and the tools to deliver on its mandate better than in the past. Improvement of the ECB's policy strategy is a matter of urgency.

- Slides
- Video

Debate 2: The ECB's Instruments for Crises and Normal Times

Claudio Borio, Bank for International Settlements

To begin with, Claudio Borio briefly retraced the extraordinary monetary journey since the Great Financial Crisis (GFC). In particular, he stated that it was a sign of the extraordinary times that the central bank tools for normal and crisis times are increasingly hard to distinguish. Formerly, in 'normal times', central banks would steer the market overnight rate within a positive range, while in crisis times they would actively use their balance sheet in order to stabilize financial markets and the system as a whole, typically through emergency liquidity assistance to banks. However, following the eruption of the GFC, central banks started to actively deploy their balance sheet, push interest rates into negative territory, provide forms of subsidized lending to banks, and rely heavily on forward guidance, upending the simple world from the past. As a response to the Covid-19 crisis, central banks have done even more, in terms of both scope and amounts, thereby crossing a number of red lines with their eyes wide open. Looking forward, if the post-GFC experience is anything to go by, it is not inconceivable that some of these tools will survive and become part of the normal toolkit.

In the remaining part of the speech, the focus was on three issues: the lessons, the caveats, and the challenges. The main lesson to be learned is that unconventional monetary policies (UMPs) have been much more successful than generally expected. The instruments can have a substantial impact on financial conditions, through which monetary policy influences economic activity. Testimony to this power is the strong market rally triggered in April during the Covid-19 crisis. In fact, the rally has been so strong that it has raised questions about a possible disconnect between asset valuations of both equities and corporate bonds, on the one hand, and the underlying economic reality, on the other.

The main caveat is that UMPs are neither a panacea nor come for free. First, the tools may have diminishing effectiveness, as there are limits to how far interest rates can be lowered and credit spreads compressed. In addition, the compression of banks' interest margins can weaken their lending capacity. Ongoing work finds some evidence that the lower interest rates are, the smaller the effect is on economic activity. Moreover, the impact of the duration of low rates is also worth examining. Secondly, there is a consensus that, while effective, the tools have limitations. In particular, there is agreement on four issues. First, unusually easy financial conditions can spur excessive risk-taking. Second, they can sap the resilience of financial intermediaries, not just banks but also insurance companies and pension funds. Third, they may contribute to the misallocation of resources, essentially by softening budget constraints. Fourth, they raise questions about the relationship between the central bank and the government, as the risk of fiscal dominance and loss of autonomy may be material.

The challenges ahead follow from the caveats. The wide-ranging and forceful measures recently put in place have narrowed the room for policy manoeuver, and economies with small safety margins are exposed and vulnerable. The major challenge of the decade ahead will be to rebuild monetary policy buffers, alongside those for prudential and fiscal policies.

As regards monetary policy, in order to succeed in normalizing, there is a need to address both economic and intellectual issues.

The well-known economic issue is the limited responsiveness of inflation to monetary policy: a number of central banks, including those in the leading economies, have tried very hard to push inflation up to target, and they have failed. The two underlying reasons are that the Phillips curve has proved to be very flat and that inflation expectations appear to be rather backward-looking. Peering into the future, the picture is unlikely to change significantly.

The main element of the intellectual issue concerns the notion of r* – the real interest rate that equilibrates the goods market – which is regarded as independent of monetary policy. The notion implies that the only way to gain policy headroom in the future is to reduce it today, ie it is to ease the policy stance in the expectation that inflation will rise so that nominal interest rates can increase alongside it. Given the difficulties in raising inflation, this could perversely end up narrowing the headroom. And coupled with the view that the long-term side effects of unusually and persistently easy monetary policy are not significant or can be effectively managed through other policies, it could contribute to the build-up of vulnerabilities that could weaken the economy's ability to withstand higher rates – a kind of "debt trap".

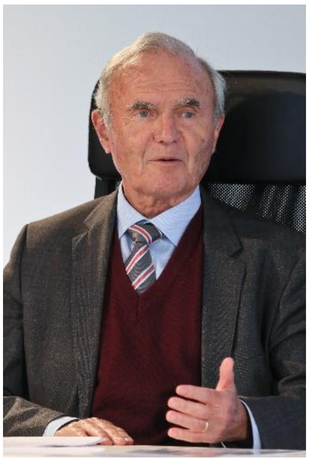
This implies that there is a need to recognize the limits of monetary policy as well as the importance of flexibility in the framework, allowing sufficient weight to be placed on the longer-term factors on which monetary policy has a significant influence. In addition, it has to be ensured that for both prudential and fiscal policies, adequate buffers are in place. Last but not least, while policy buffers promote badly needed economic resilience, the key to more robust and sustainable growth is structural reforms, which have lost momentum. To conclude: building policy buffers is essential – in monetary policy, just as in other areas. The challenge ahead is how to achieve this.

- Remarks
- Video

Debate 3: The ECB's Monetary Policy Strategy: Lessons from the Financial Crisis, Debt Crisis and Double Recession

Otmar Issing, Center for Financial Studies

Otmar Issing, President of the Center for Financial Studies at Goethe University, stressed the importance of monetary analysis as part of the ECB's two-pillar approach in its monetary policy strategy. As the first speaker in the third discussion panel, Issing also questioned the ECB's *de facto* adoption of the policy of inflation targeting.



Issing urged the ECB to "think twice" before following the new strategy recently adopted by the Fed. Its average inflation targeting concept would entail serious risks and is not an appropriate way to anchor inflation expectations. So far, no model of inflation targeting exists which integrates the risks from the banking system and financial markets with all their dynamics, non-linearities and overall complexity.

Acknowledging that the ECB's pivot toward inflation targeting was supported by the "observational equivalence" between economic and monetary analyses – which refers to the latter's long-run approach sending no signal of risks over the past decade, compared with the former's short to medium-run orientation – Issing argued that such a "coincidence" could result from the horizon covered so far not long enough, and extending the scope would enable the incorporation of financial stability into ECB's monetary policy framework.

In response to President Lagarde's reference point of the strategy review set at 2003, Issing suggested that the ECB should go back to 1998 when the strategy he had proposed found the "full support and confirmation" by the Governing Council and considered the "special circumstances" when the euro was introduced. He explained that minor adjustments were made in the 2003 strategy review.

Issing recalled that the entire Governing Council of the ECB was against his idea of the below 2% definition of price stability proposed in 1998 as he traced the origin of this threshold. "Otmar, you are crazy!" Issing cited the response from his colleagues, as some opponents worried that announcing such a concrete number would only create problems to the ECB, some thought the number was too "ambitious," even at the Bundesbank standard, and some were puzzled by this definition since the inflation was falling towards 1% back then.

"It is extremely important that we explained to achieve price stability only in the medium term," Issing added. When he testified at the European Parliament, as Members questioned the exact definition of medium term, he explained that this is a "moving timeframe" according to incoming shocks.

The strategy announced in 1998 received sharp criticism and eventually prompted the creation of "The ECB and Its Watchers," which, Issing said, provided an opportunity to explain and defend the strategy.

- Video

Debate 3: The ECB's Monetary Policy Strategy: Lessons from the Financial Crisis, Debt Crisis and Double Recession

Petra Geraats, University of Cambridge

Petra Geraats, Senior Lecturer at the University of Cambridge, objected to the adoption of an average inflation target, a move made by the Federal Reserve after the coronavirus crisis. She also called for a faster release of the ECB's account of monetary policy meetings to improve transparency.

In her response to recent debates on whether or not the ECB should follow the Fed's decision to adopt an average inflation target, Geraats said, as the second speaker of the third panel discussion, that "I do not think this is a good idea".

Geraats pointed out that an average inflation target is "very attractive in theory" but poses four risks. According to her comments, aiming for higher inflation may be hard to achieve, as the world has seen in the case of Japan, and an average inflation target could create uncertainty about the size and duration of inflation overshooting. This also risks loosening the anchoring of inflation expectations and thereby further increasing volatility. She also warned that, if average inflation targeting were introduced, inflationary supply shocks would require even more painful monetary tightening.

Instead, Geraats suggested, the ECB should first focus on improving the fundamentals of the European monetary union, including a proper banking union with effective supervision and resolution to prevent another debt crisis, along with effective macroprudential policy to manage the risks created by loose monetary policy, as well as a fiscal policy framework that allows greater flexibility and more public investment.

"When it comes to macroeconomic policy, it takes two to tango," said Geraats, who urged ECB President Lagarde to persuade governments that expansionary fiscal policy needs to "play its part" in stimulating the economy and enabling structural reforms, alongside the ECB's monetary policy stimulus, as governments appeared "too afraid to do it."

Specialized in the research of monetary policy transparency, Geraats recommended a more timely release of the ECB's account of its monetary policy meeting, within two weeks instead of three to five, especially in a period with "lots of volatility and uncertainty" that could make information "stale" quickly. However, she opposed the Bank of England's decision to release its minutes at the same time as the monetary policy announcement, because it requires distorting the monetary deliberations process.

Geraats also recommended greater clarity about the ECB's "fuzzy" goal of inflation 'below, but close to, 2%'.

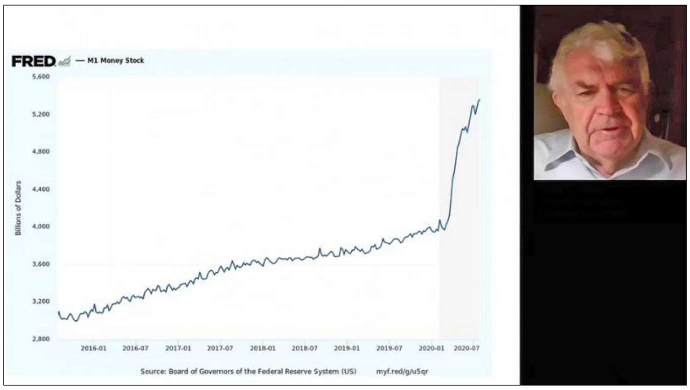
Given the topic of the panel discussion, Geraats said a major lesson learned from the debt crisis is the "power" of central bank communications as she cited the "whatever it takes" speech from the previous ECB President Mario Draghi, and the mere announcement of the Outright Monetary Transactions program, as an "incredible" example.

Regarding lessons learned from the financial crisis, Geraats noted that the ECB's Longer-Term Refinancing Operations were effective at providing cheap and ample liquidity for the banking sector with a fixed horizon, while allowing gradual or natural unwinding. However, this liquidity may not be passed on to bank lending and the real economy, and could even increase financial fragility through purchases of risky assets, like euro-area periphery sovereign debt. This liquidity, said Geraats, has also pushed eurozone interbank rates close to the ECB's deposit rate such that the ECB's main refinancing rate no longer indicates its monetary policy stance, leading to "monetary policy easing by stealth."

- Slides
- Video

Debate 3: The ECB’s Monetary Policy Strategy: Lessons from the Financial Crisis, Debt Crisis and Double Recession

John B. Taylor, Stanford University



John Taylor, Professor at Stanford University and Senior Fellow at Hoover Institute, urged a more rules-based monetary policy as central banks around the world scramble to rescue the economy damaged by the coronavirus pandemic. He also criticized the “vagueness” in the Federal Reserve’s recent announcement on its shift to average inflation targeting.

“Stick with what works. Don’t throw out things that are working as you modify to get a better system,” Taylor said when he concluded the third panel discussion. He pointed out that previous Monetary Policy Reports released by the Fed had a section of monetary policy rules, which are “gone” in the most recent publication.

Taylor took the financial crises in the euro area’s peripheries as an evidence of deviation from monetary policy strategy, namely interest rates lower than what policy rules suggested, but he emphasized that this example by no means refers to the famous “whatever it takes” speech made by Mario Draghi, the last president of the ECB, since that is “a matter of communication.”

Several positive aspects of the ECB’s policy strategy were acknowledged by Taylor in the beginning of his speech, including its emphasis on transparency and clear communications about monetary policy, the goal of price stability, frequent endorsement of structural and market-based reforms in member states, the principle that automatic fiscal stabilizers and sound budget policy are complementary parts of macro policy, as well as the encouragement of open capital markets.

Speaking of the Fed’s shift to the flexible form of average inflation targeting, Taylor called for further clarity on how long “this average” will last. He also criticized the vagueness in the Fed’s announcement on not tying to a “particular mathematical formula.”

“If you don’t like formulas, I think this is fine,” said Taylor in response to the Fed’s decision on not to be “dictated by any formula.” However, he reminded the event’s participants of Christine Lagarde’s speech delivered earlier that morning, in which the ECB president put an emphasis on formulas and techniques. “That is how various policies have been evaluated,” he added.

Taylor suggested having more discussions on how and when the monetary policy should return to normal as the recent pandemic shock has taken the attention away from these issues. When pointing out that the Fed’s balance sheet has bloomed since the coronavirus crisis, Taylor asked “how long that should continue?” He believes there is a time to adjust to bring monetary policy back to “some kind of strategy.”

“You need to be concerned about that,” warned Taylor when he presented two charts that showed surges in the US’s money stocks, which did not occur when the Fed launched quantitative easing to cushion the impact from the 2008 financial crisis. He encouraged further examinations on this phenomenon, which, he indicated, is related to the banking system and different policies.

Taylor hinted that the economic recovery from the pandemic is likely in “V shape” and therefore recommended that monetary policy should return to “strategy that works.”

- Slides
- Video