Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Central Bank of Ireland Academic Roundtable

Summary of the event

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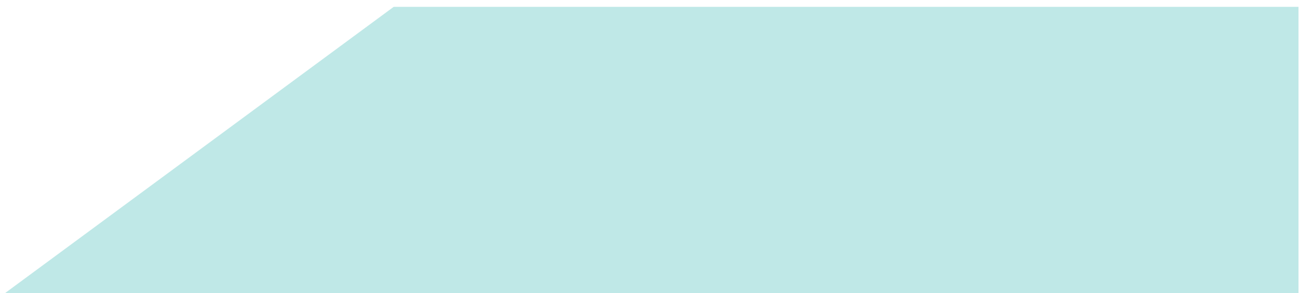
Contents

Introduction 3
Session 1: Long-Term Secular Trends 4
Session 2: Transmission of monetary policy 5
Session 3: Monetary policy implementation 7
Concluding remarks 9
List of external guests 10



This note is a summary of the Central Bank of Ireland's Academic Roundtable, hosted on 18 December 2020.

The aim of this event was to hear views on issues relevant to the strategy review from the academic community, as part of a range of listening events organised to gather perspectives from society. In attendance were a number of academic participants and staff from the Central Bank of Ireland. The event had three sessions: (i) Long-Term Secular Trends, (ii) Transmission of Monetary Policy and (iii) Central Banks' strategy and tools.[1]

Introduction

Since the last strategy review in 2003, there have been profound changes in the economy relevant for the formulation of monetary policy. For instance, inflation dynamics have weakened substantially in the euro area and interest rates have been at historically low levels. A number of structural changes have become more prominent like climate change, globalisation, rapid pace of digitalisation and the changing shape of financial structures. The onset of the COVID-19 crisis has also brought new topics into focus, most notably the interaction between fiscal and monetary policy. All of these topics and more are being studied and discussed in workstreams comprised of people from across the euro area.[2] The goal of the strategy review is to make the ECB's monetary policy strategy fit for purpose in the years to come. It will not affect the current monetary policy decision-making which continues in the meantime as the Governing Council continues to monitor the economy in the short- to medium-term, and take its decisions as appropriate.

The event was structured along three sessions. The first session discussed the secular trends in the economy, their drivers, and their impact on the conduct of monetary policy. Most advanced economies have witnessed a long-term decline in the natural rate of interest combined with anaemic growth levels, owing to numerous factors such as, demographics, globalisation, rising inequality and market power, waning productivity, pre-cautionary savings and an increased appetite for safe assets. The second session focused on the transmission of monetary policy to the real economy, discussing impairments to the pass-through, the 'low-flation' environment, and the interactions with other policies. The final session examined monetary policy implementation, including the two-pillar strategy, the inflation objective, the tools, the communication, and the broader goals that central banks can adopt.

The discussions will be summarised in a report as part of a range of listening events, so that the ideas and perspectives of participants will feed into the strategy review.

[1] The event took place online and this summary was compiled under the Chatham House Rule. "When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed."
[2] https://www.ecb.europa.eu/home/search/review/html/workstreams.en.html

Session 1: Long-Term Secular Trends

The host of 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 the effective lower bound.

The first participant opened the session with a discussion on secular stagnation. Due to the nature of the decline in the natural rate, fiscal policy measures were viewed as necessary due to the increased probability of secular stagnation. The role of demographics, technological changes and the Global Financial Crisis are important drivers of the low level of interest rates in recent years. The decline in the natural rate of interest is very important development for central banks globally.

There are a number of aspects were highlighted in relation to the impact of a lower natural rate of interest. Of particular importance within the euro area, is taking account of the heterogeneity across countries. The use of structural models, for example Dynamic Stochastic General Equilibrium (DSGE) models, can offer a better alternative than many existing models, while time-varying and non-linear relationships must also be taken in considerations, for example through constraints to model the effective lower bound. For better estimation of the natural interest rate, central banks should use non-linear modelling rather than relying on linear estimation.

The second speaker discussed the effectiveness of the non-standard measures implemented within the Eurosystem in the context of a deflationary trap and liquidity spiral. While it was agreed that non-standard measures had helped to prevent a more severe economic crash, the measures do not appear to have adequately stimulated aggregate demand, especially at the household level. Finding monetary policy tools to help pull the economy away from the threat of deflationary spirals and low inflation is therefore very important and failing to do so represents a significant danger to the economy over the next 10 to 15 years.

The third speaker argued that the aging population in Europe is a notable factor in driving secular trends and there has been a behavioural shift with regards saving. Traditionally, people would save when younger, and run down those savings as they age, however, this does not appear to be the case more recently. Coupled with this, the population growth has slowed significantly and as such, investment needs are not growing. Manufacturing has migrated away from Europe, and this has meant less demand for financial capital. Given the structure of the economy, policies and expenditures required to tackle climate change may help to promote economic growth. Should such policies be able to boost growth to a level of 1-2%, this may help Europe's economy substantially.

In light of low natural interest rates and persistently low interest rates, it was argued that the inflation target could be shifted higher. Upward pressure on the exchange rate in Europe may drive down inflation, with deflation cited as damaging economically. It was argued that the ECB's Governing Council should have more transparency on its expectations for the natural rate. This could be more aligned with that of the Federal Reserve, where the short- and long-term forecasts for inflation and interest rates are published. This may help in avoiding 'taper tantrum' type events, when the central bank moves into a cycle of increasing interest rates, as the public will have information available about the path for rates.

The final speaker of the session noted that the lower equilibrium real rate within the economy is crucial for central banks. The Governing Council should be mindful as to how it communicates on its tools and on the impacts of policies, such as negative interest rates. The consequences and limits of monetary policy decisions should also be communicated with the public. For example, more research is needed on the 'reversal' interest rate, that is, where the adverse consequences of negative interest rates begin to offset the stimulatory impact. The introduction of tiering is a tool to

help to avoid hitting the reversal rate. The role of asset purchases needs to be considered as part of the longer-term monetary policy toolbox, and the limits that may be imposed by the European Court of Justice (ECJ) should asset purchases become part of the permanent toolkit. The role of monetary financing may come into question should this materialise. The potential effectiveness of the Outright Monetary Transactions (OMT) programme may be impacted by the amount of assets acquired under other Eurosystem portfolios; OMT could potentially be squeezed out due to a lack of bond availability.

Finally, the potential for helicopter money was questioned. There are possibly legal constraints in terms of monetary financing and while this tool that was not envisaged at the initialisation of the euro area, it is something that could be re-visited as part of the monetary policy.

The session opened up for discussion. The first point raised was on the use of helicopter money, which was considered more as a fiscal policy. It was noted that the use of quantitative easing blurred the lines between monetary and fiscal policy. Monetary policy will operate in a world of higher sovereign debt and the cost of pensions will rise, as mentioned in the Long-Term Stability Report of the Irish Fiscal Council. 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 commentating on fiscal developments.

The low levels of the real rate will continue to be a complicating factor for the ECB over the next 10 years, as interest rates will likely remain close to 0%. This represents a significant challenge for the ECB in trying to meet its inflation aim.

The role of inequality in the labour market could help to explain secular stagnation, according to a participant. Marker 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. Another participant questioned the extent to which the significant increase in the monetary base because of quantitative easing fed into the economy. They suggested that financial asset prices and housing have increased and the market expectations for forward price earnings are approaching 'dot.com' bubble levels, but felt that these developments are unlikely to have any real impact on current inflation indicators.

Session 2: Transmission of monetary policy

In the second session, participants were asked for their views on how the transmission of monetary policy has changed since the last strategy review, how monetary policy transmits through banks and 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. As the strategy review will examine the interaction of monetary policy with a broad range of issues such as climate change, financial stability, macroprudential policy and fiscal policy, participants were asked to consider the implications of diverse fiscal policies and capital markets in the euro area for the conduct of monetary policy.

The first speaker discussed asymmetric shocks and highlighted that the structure of European economies is fundamentally different. Monetary policy appears to be aimed at stimulating export demand and while this is beneficial for smaller-open economies and Germany, economies with a higher percentage of domestic demand suffer. The heterogeneity could provide an explanation for the flattening Phillips Curve in those countries. The speaker suggested that in order to stimulate aggregate demand, money needs to be fed into the real estate and construction sectors. This will

have a beneficial impact in stimulating wage demand and will help to kick-start inflation in Southern European economies. The transmission of monetary policy is also dependent on 19 different national banking systems. A market-based capital market that enhances transmission to the real economy is needed. The exclusion of mortgages for the current TLTRO was questioned, with the speaker proposing including lending for real estate within the benchmark calculations for the operations.

The second speaker highlighted the risks to banks from cutting monetary policy interest rates further into negative territory and that the adverse effects of the policy can be seen through the decline in banks' equity prices. While the overall effect of negative rates remains stimulating for the economy, that effect has weakened over time. The discussion then turned to the Phillips Curve and how it has both shifted lower and flattened for the euro area. This poses a challenge for stimulating the economy. 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. Finally, the potential political and legal limits to asset purchases were again highlighted, particularly if the purchases are targeted toward certain countries in a manner similar to the Pandemic Emergency Purchase Programme (PEPP).

The next speaker discussed 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. This proves a challenge for communication of both fiscal and monetary policies, where the lower natural interest rate environment needs to be recognised and explained, particularly where high debt levels are still considered risky. An incomplete political union and an unwillingness to participate in fiscal transfers were mentioned as problems, but it was unclear what an optimal and politically feasible fiscal regime would look like.

The final speaker raised concerns 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. This issue resurfaced during the COVID-19 crisis, as outflows from peripheral countries increased. In order to avoid the doom loop, it was stated that EU-backed debt is needed with mutual resolution functions in place.

The session was then opened to other participants for discussion. One participant felt that the ECB is essentially engaging in fiscal policy through the PEPP, which was indirectly acting as a backstop for countries. In the context of the strategy review, the roles of monetary and fiscal policy need to be made clear, while the relationship between the two needs to be formalised. In order to do this, the ECB should have clear discussions with the EU Council.

The discussion then moved to the Phillips Curve, where a number of participants spoke. The first asked the question of whether the price or wage Phillips Curve still existed, noting that in Ireland at least, there is evidence for the wage Phillips Curve working. A decline in wage-bargaining power and uncertainty associated with employment contracts were noted as factors playing a role in the flatter Phillips Curve. Another participant agreed that there was more evidence for a flattening of the price Phillips Curve than of the wage Phillips Curve and that this was true more so for the goods sector than for services.

The role of collective wage bargaining with respect to the Phillips Curve was debated. One participant noted that the wage-setting mechanism is different now, when compared to the past. There is strong collective wage bargaining in Germany in contrast to other countries that do not have a coordinated wage setting approach and therefore struggle to internalise monetary policy to

the same extent. It was then noted that wage inflation is more likely to receive a push from collective bargaining. Another participant argued that wage increases do not stem from union negotiations in modern times, but rather from people moving jobs. With a more educated workforce, it is less likely that workers will band together for higher wages in their current employment and more likely people will move to a new employer to increase pay rather. This development has left those with lower earning power severely disadvantaged. A speaker highlighted that such circumstances do not hold for all countries, noting that most workers in Scandinavia fall under collective wage agreements.

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 pull-back from cross-border banking and this has ultimately damaged growth and the transmission mechanism in Europe. This has led to a fragmented banking system in the euro area, with different conditions existing in different economies. Another participant highlighted the improved prudence of banks in recent years, which has been a positive development particularly amid the COVID-19 shock. They felt that the banking system is not likely to be the source of a crisis in Europe in the future, but rather, this will be driven by the higher sovereign debt burden of countries. Another participant noted the varying interest rates in markets across the euro area, which is relevant for the transmission mechanism through banks, particularly in light of a single monetary policy and mentioned that the ECB should help to smooth the transmission mechanism by advancing 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. Feedback and communication needs to be provided to the public on the secondary objective, and on how achieving the primary objective may impact the secondary objective. A horizon to act for both may be beneficial, and this should be communicated by the ECB. The interaction between the primary and secondary objectives is important and needs to be understood.

Session 3: Monetary policy implementation

The third and final 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 target, standard and non-standard tools used, communication and how much power this can have in achieving inflation goals and broader goals such as financial stability and environmental targets.

The first participant of the session highlighted three points in response to the questions. The first point was in relation to the inflation aim, which 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. A move to average inflation targeting may be more beneficial than a point target. The ECB needs to consider a longer-term target, as any gap to the current inflation target diminishes credibility. Second, while the ECB has made big efforts to improve communication with the public in recent years, some practical improvements are still possible. For instance, the content on the ECB's website is too basic for academics. In terms of social media platforms, there are too many stakeholders communicating. For example, on Twitter, President Lagarde has 700,000 followers; however, the ECB has only 600,000. There can be conflict for the public in the main platform for communication and the ECB needs to make its communication strategy clearer. 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. Third, with regard to unconventional monetary policy, the consequences of their 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 next speaker mentioned the narrow definition of the ECB's inflation target, which is "below, but close to, 2%" growth in the HICP.[3] However, there are 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. The participant suggested that the European Court of Justice (ECJ) could challenge the definition of inflation under its interpretation of price stability. It was then noted that prices have been falling in particular markets without devastating effects, and that deflation may not be as economically problematic as text book descriptions suggest.

The next participant outlined the role of the decline in the natural rate of interest, which means that the ECB is more likely to hit the effective lower bound in the future. An increase in the inflation target would mean that reaching the effective lower bound is less likely, with some economists calling for an inflation target of between 3 and 4%. However, any increase in the target needs to be balanced against other considerations. The first consideration is legal issue; an increase to a target of 4% would equate to a doubling of prices every 18 years and this may not be allowed under the definition of price stability. The second consideration is a potential move to a price level target, which would remove the need to raise the inflation target. The third consideration is about the credibility of raising the inflation target; if there is a struggle to achieve 2% inflation, how credible would a 4% target be? The fourth consideration is the non-linearity around the zero lower bound. An announcement of a higher inflation target when at the zero lower bound could lead to lower inflation in the short-term. The final consideration is that the Federal Reserve decided not to raise their inflation goal from 2% in its strategy review. Overall, the participant was not in favour of raising the ECB inflation target, but felt that price level targeting could work. The current inflation target gives the impression of a disinflationary bias due to the language of "below 2%". The participant favoured a symmetric point target for the ECB.

On the topic of the ECB's two-pillar strategy, it was noted that the relationship between money growth and inflation is historically established. It was stated that it is not a good time to abandon money, as we are seeing an increase in broad money growth that is essentially monetarily financing fiscal expansions. This should point to higher inflation, coupled with pent up demand due to the postponement of expenditure. It is not a good time to cease consideration of monetary indicators as a result.

The next participant highlighted the difficulty of communicating on the ECB monetary pillar. As an example , they said that in the early days of the ECB, the Governing Council largely ignored that M3 was growing at 12% even though the target was 4.5%, but then subsequently surprised markets by announcing that it would suddenly take action to counter growth in M3. In terms of the inflation target, the participant noted that the current wording is asymmetric, with a disinflationary bias, and that a point target is needed. For example, 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%." A point target of 1.8%, with a symmetric band of one percentage point above and below would be beneficial. The participant also noted the difficulty of raising the inflation target when it is not being currently met, and highlighted the credibility issue surrounding this. Moreover, the length of time that non-standard monetary policy tools were in place means that they could now be deemed as

[3] Harmonised Index of Consumer Prices

conventional and could be made permanent. Finally, on communication, the participant noted that 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 of climate change goals. It was felt that politicians can in general 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 discussion opened to the wider group. The first person to intervene noted that the ECB chose a close to 2% inflation target originally and this will be difficult to change politically and legally. The speaker agreed that the target should be made symmetric in the future. For example, if there is a positive inflation shock coming out of the COVID crisis, to which the ECB do not respond, it would be much easier to communicate this stance ex-ante. Another participant noted that they would be in favour of average inflation targeting over a specified horizon, which would be different from price level targeting, and would be less rigid particularly as an inflation target of higher than 2% may prove to be legally problematic. 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.

The discussion then focused on the expansionary tools of the ECB in promoting price stability. 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. The discussion should be had on what the ECB is willing to do in meeting objectives more broadly. This has started with the climate change discussion, which is positive and timely, as action can be taken now. Another participant noted that it not clear whether the ECB has the tools to meet its goals and in particular the inflation target. The central bank needs to be more credible in meeting its target. In terms of communication, the ECB needs to call out the constraints they face in meeting their inflation target, for example those based on the Treaty.

Concluding remarks

The event concluded by thanking all participants. A key take away from the event that was the need to avoid ‘group-think’ and there was general appreciation for the interaction between the Central Bank and academia. The event allowed for a range of perspectives and expertise on the many issues and was therefore highly valuable for the Central Bank’s work on the strategy review.

List of external guests

Samuel Brazys

Seamus Coffey

Gregory Connor

John Cotter

Gabriel Fagan

John Fitzgerald

John McHale

Michael McMahon

Alessia Pacagini

Aidan Regan

David Romelli

Karl Whelan

Johnathan Wright

T: +353 (0)1 224 6000
www.centralbank.ie

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