

# The ECB in the inflation target trap

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“Economic prospects for the European Union – Challenges for economic  
policy until the end of the decade”

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## Main points

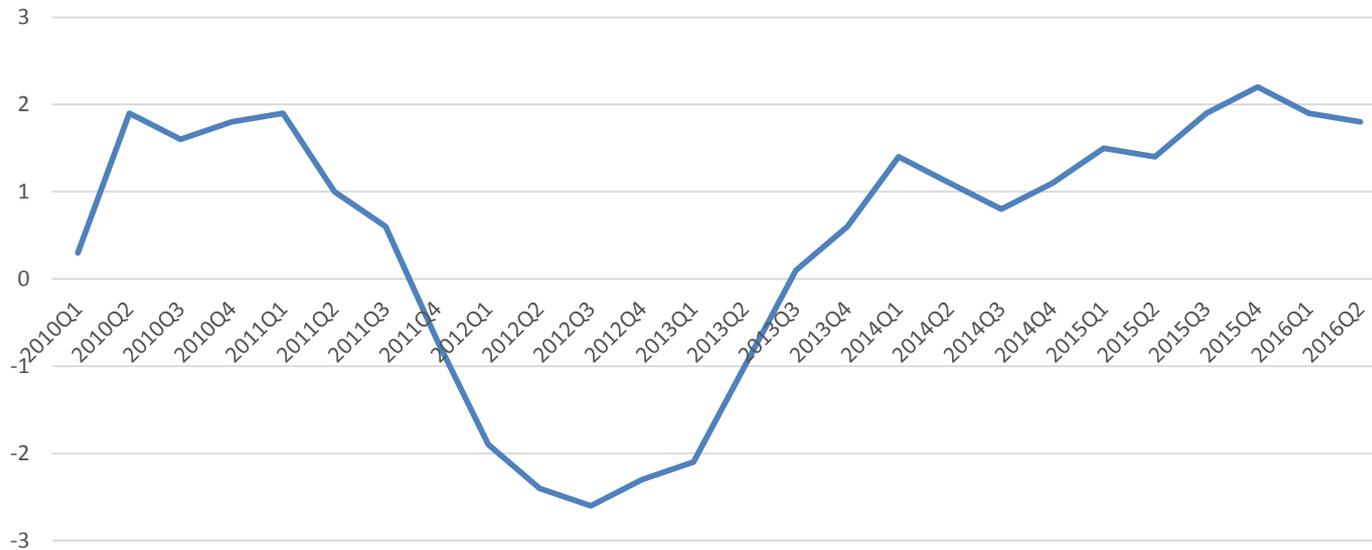
1. Euro-sclerosis instead of euro-crisis?
2. Slow recovery continues – and shifts composition (domestic demand instead of exports).
3. Labour markets continue to improve, no sign of discouraged workers.
4. QE-euro = national debt management rather than monetary policy.
5. Who determines long rates? ECB or global capital market?
6. Negative rates? Might be counterproductive.

## Where are we now?

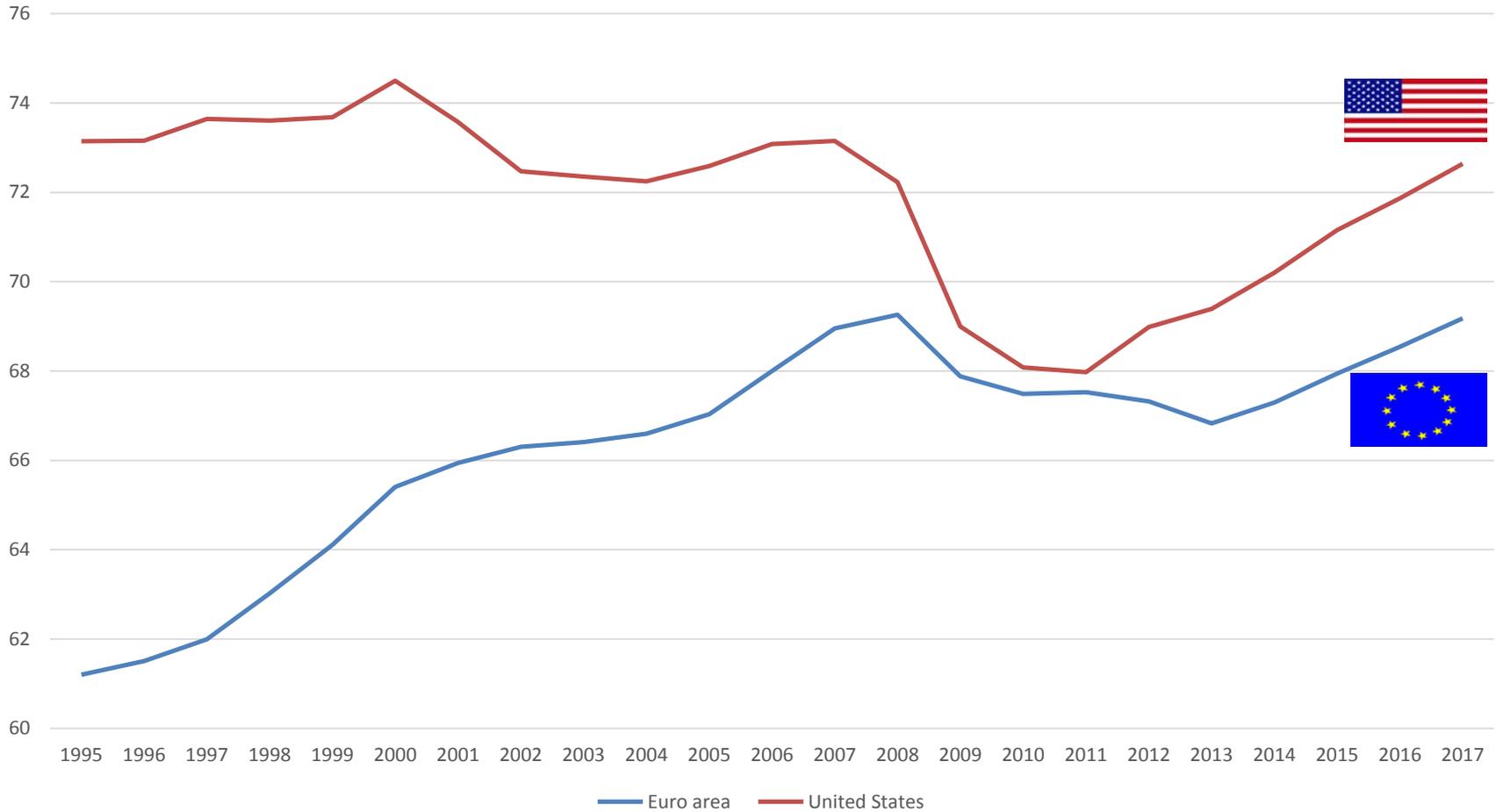
- Modest recovery. Too modest?
- Domestic demand growing at pre crisis rate (with fiscal policy neutral).
- Labour market structural improvement:
- Employment rate close to pre-crisis peak (like US).
- Activity rate surpasses US, continued structural improvement
- (No discouraged workers in Europe. Important since puts argument that long unemployment is self-perpetuating on its head!)

# Where are we now? Recovery on course (since ‘whatever it takes’)

EA: Contribution of Domestic Demand to growth  
(annual %)

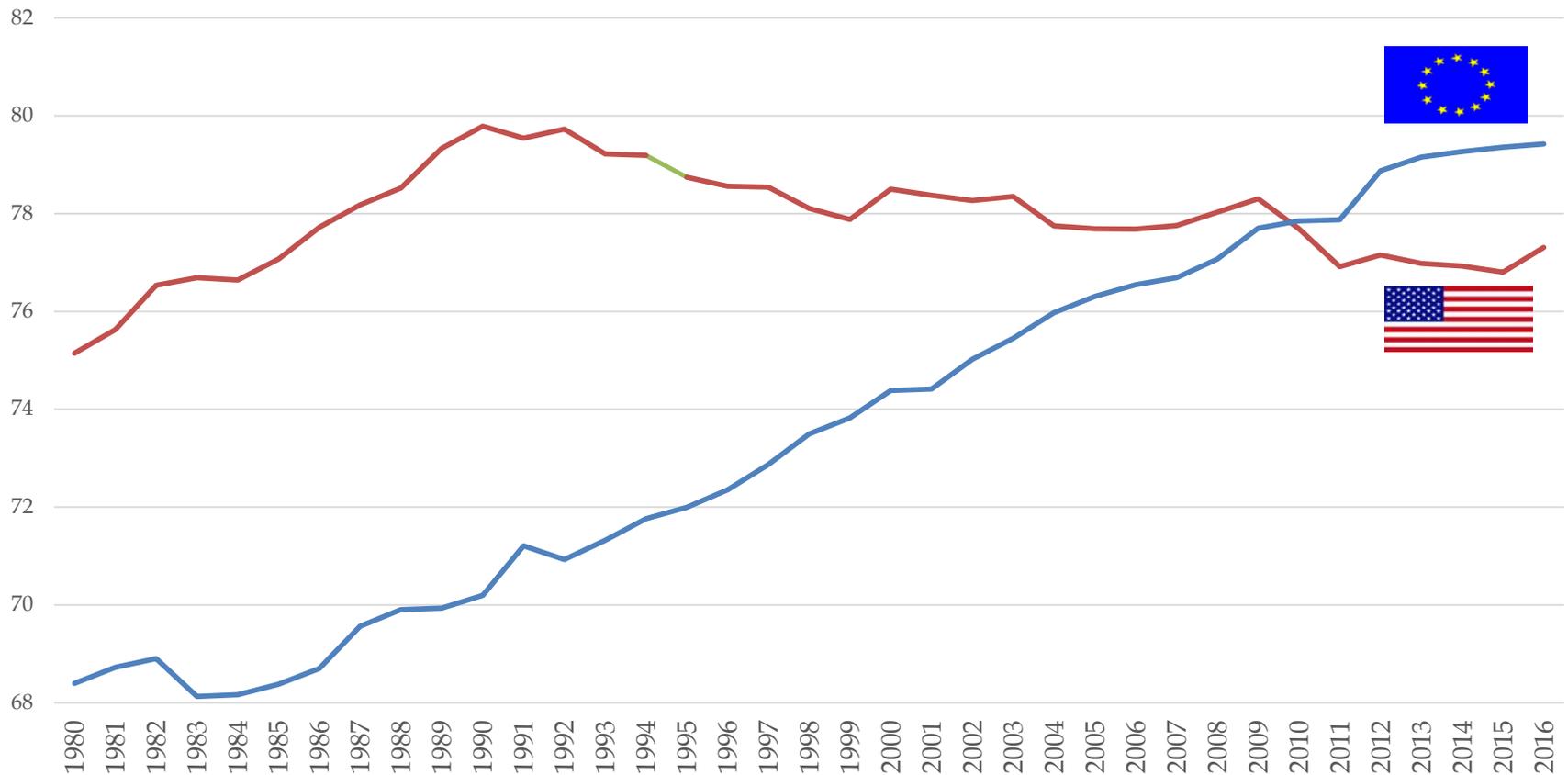


## Employment as % of working age population



# Euro area doing better than US in key labour market indicator

Activity rates: UE and EA12 compared

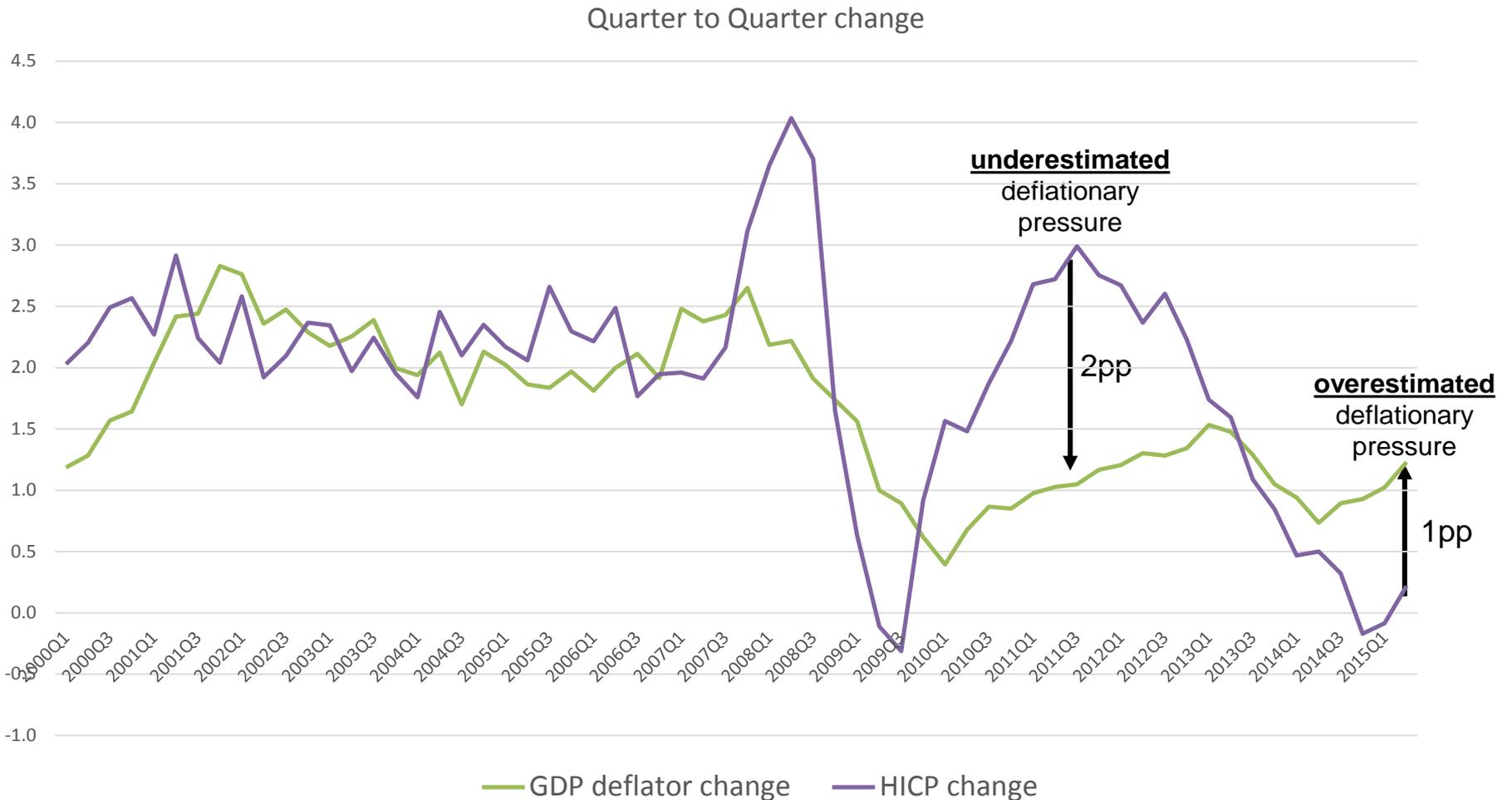


# Deflation danger imminent?

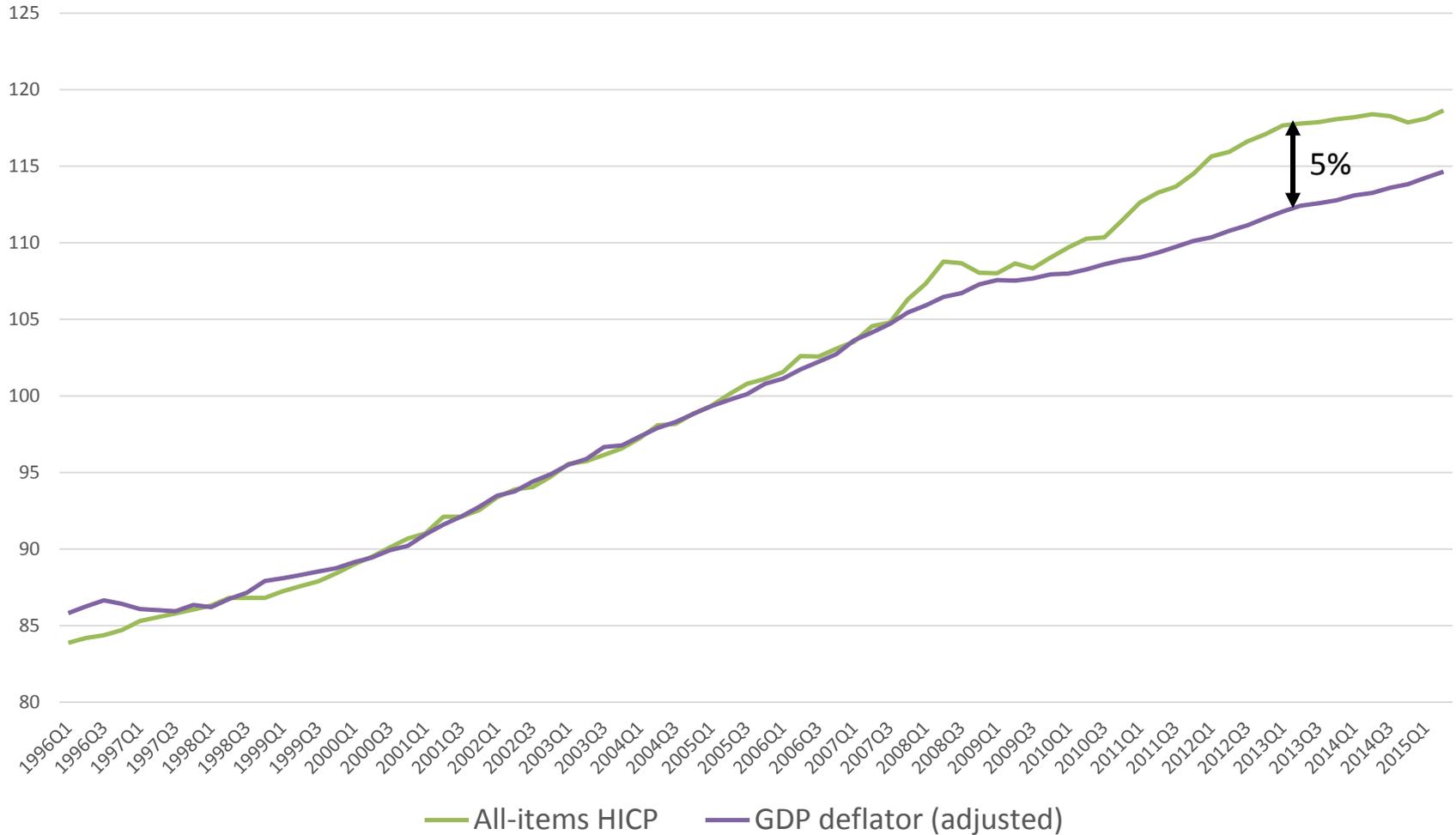
ECB seems to think so. But

- $CPI < GDP$  deflator!
- The latter matters for debt sustainability.
- No sign of 'Fisher debt deflation'.
- On the contrary measured by 'natural rate' policy already more simulative than ever.

# Focus on CPI under-estimated deflationary pressures 2009-2013 opposite since 2014



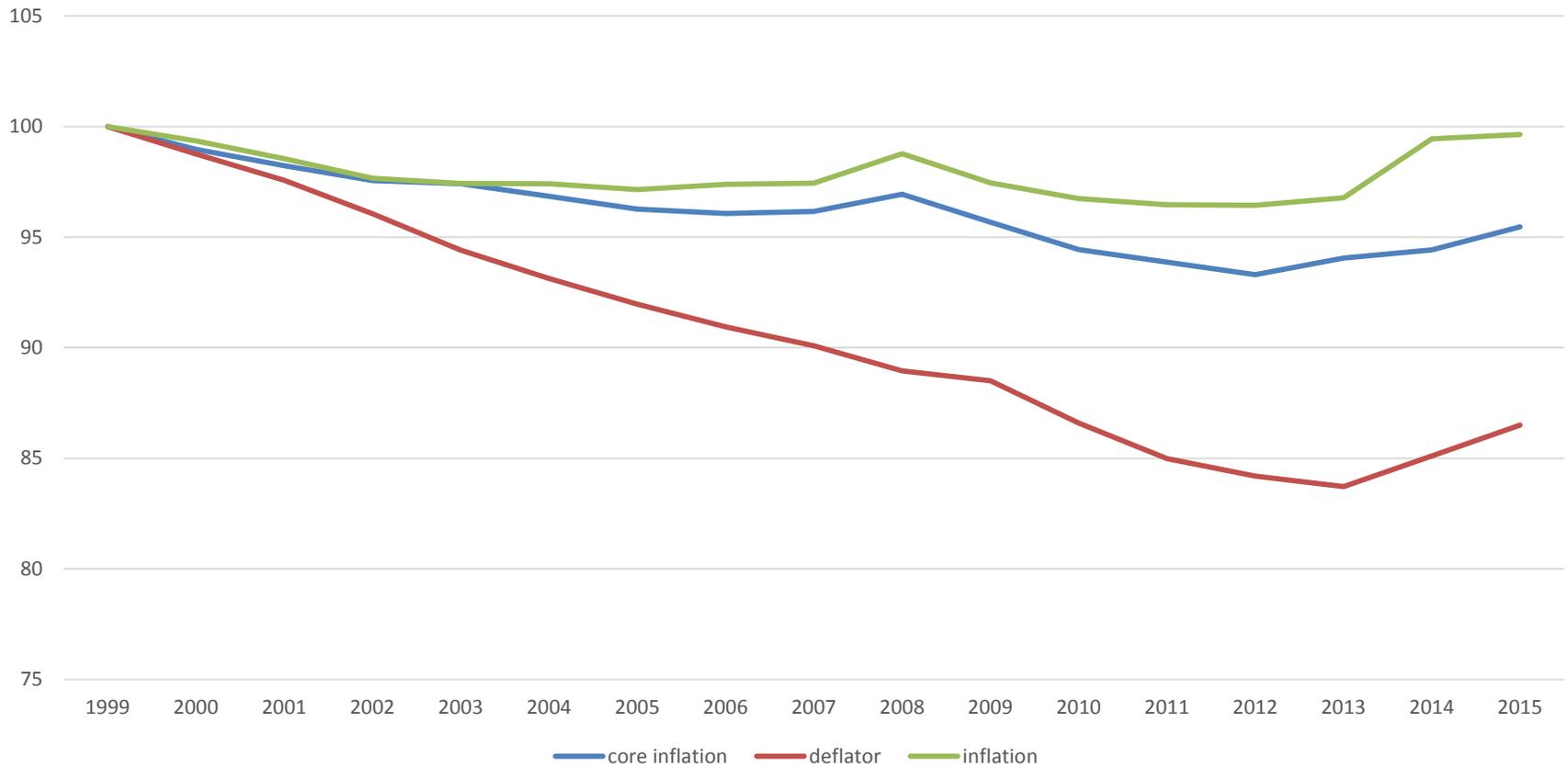
# Cumulative 'error' large: +/- 5 %





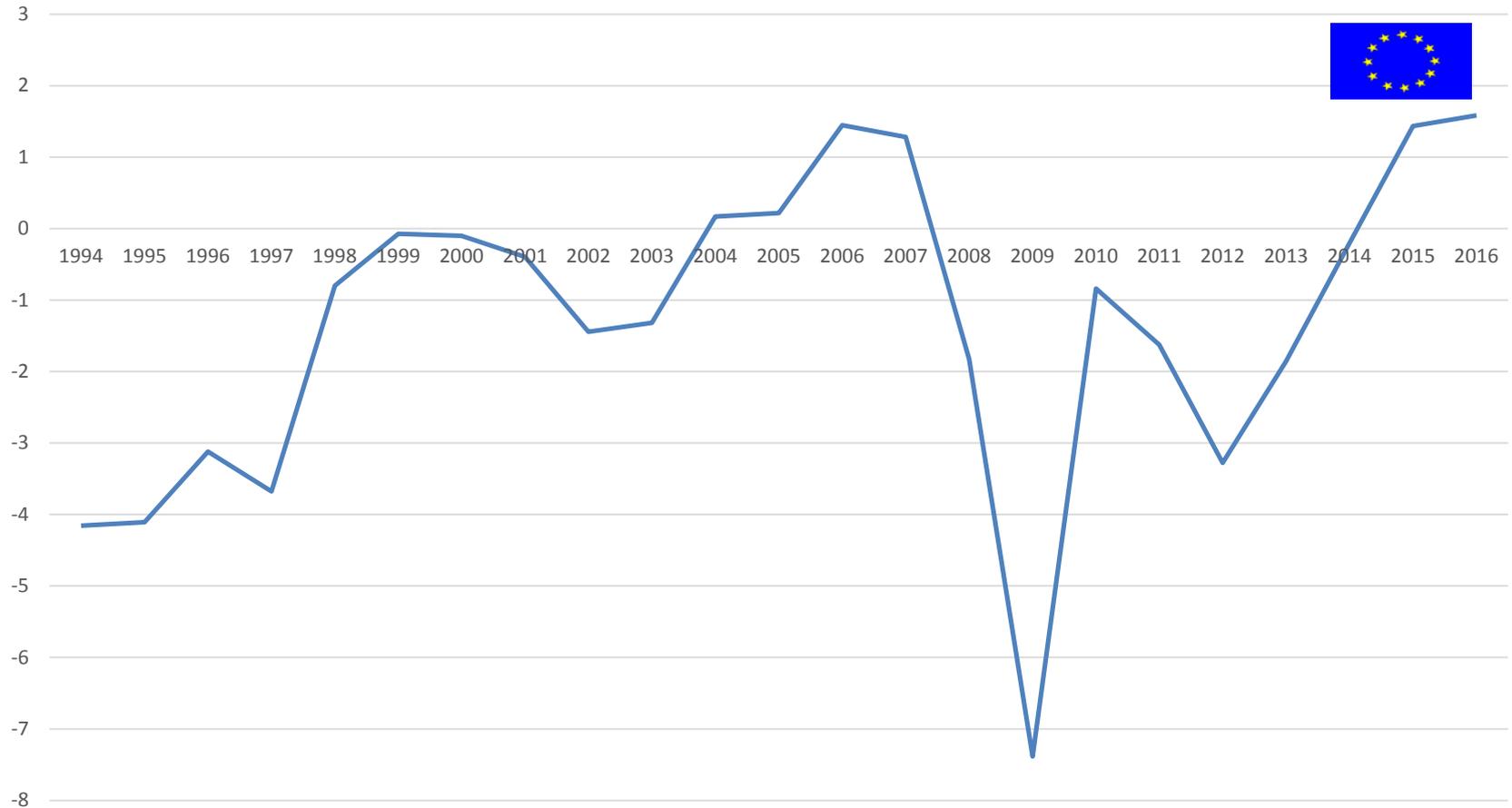
# Japan is (was) different: it had debt deflation

Japan: GDP deflator vs (core) inflation



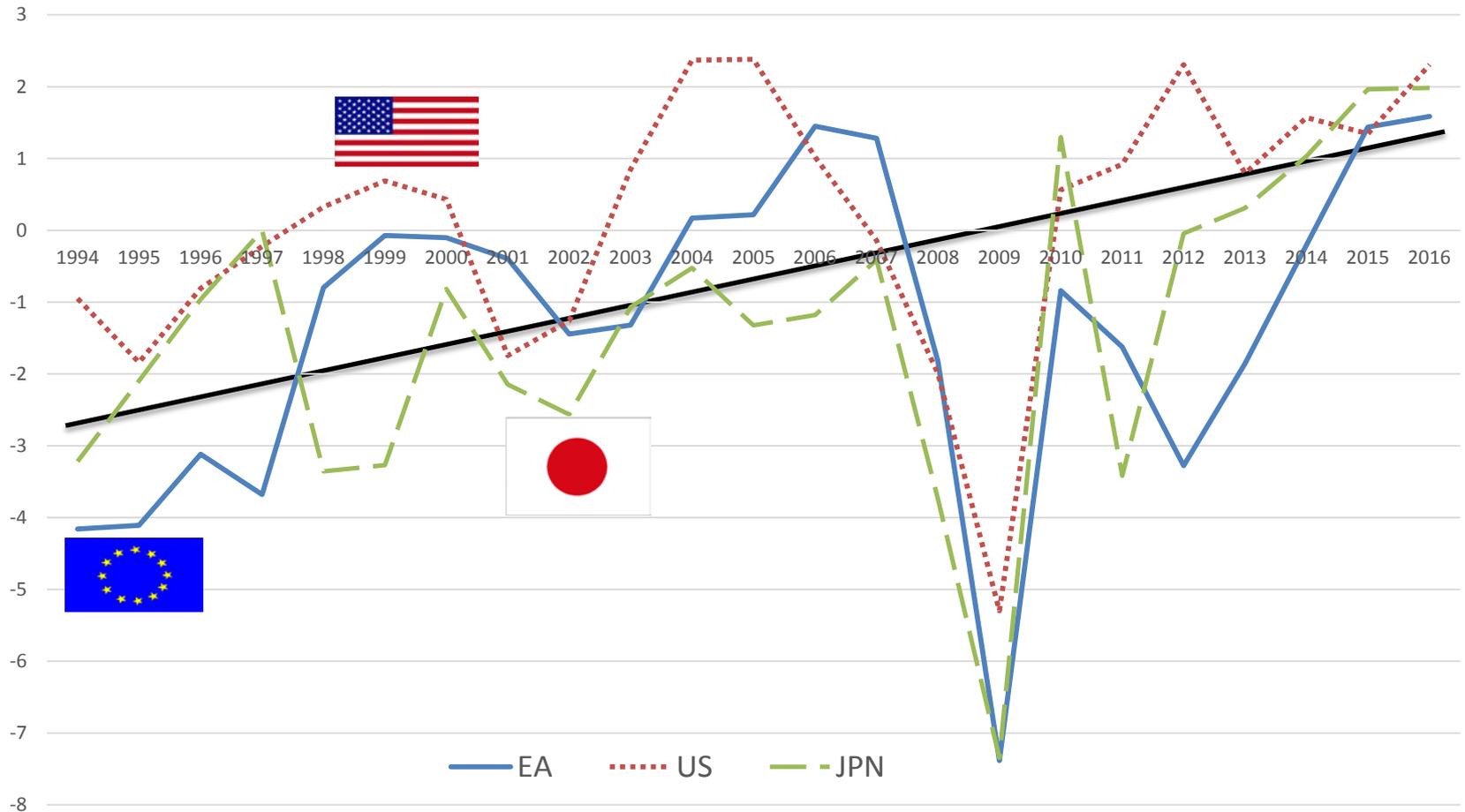
# Financial conditions close to pre-crisis peak

EA Snowball effect: nominal growth rate minus interest rate



# ... everywhere!

Snowball effect?: nominal growth rate minus interest rate



# What role for monetary policy?

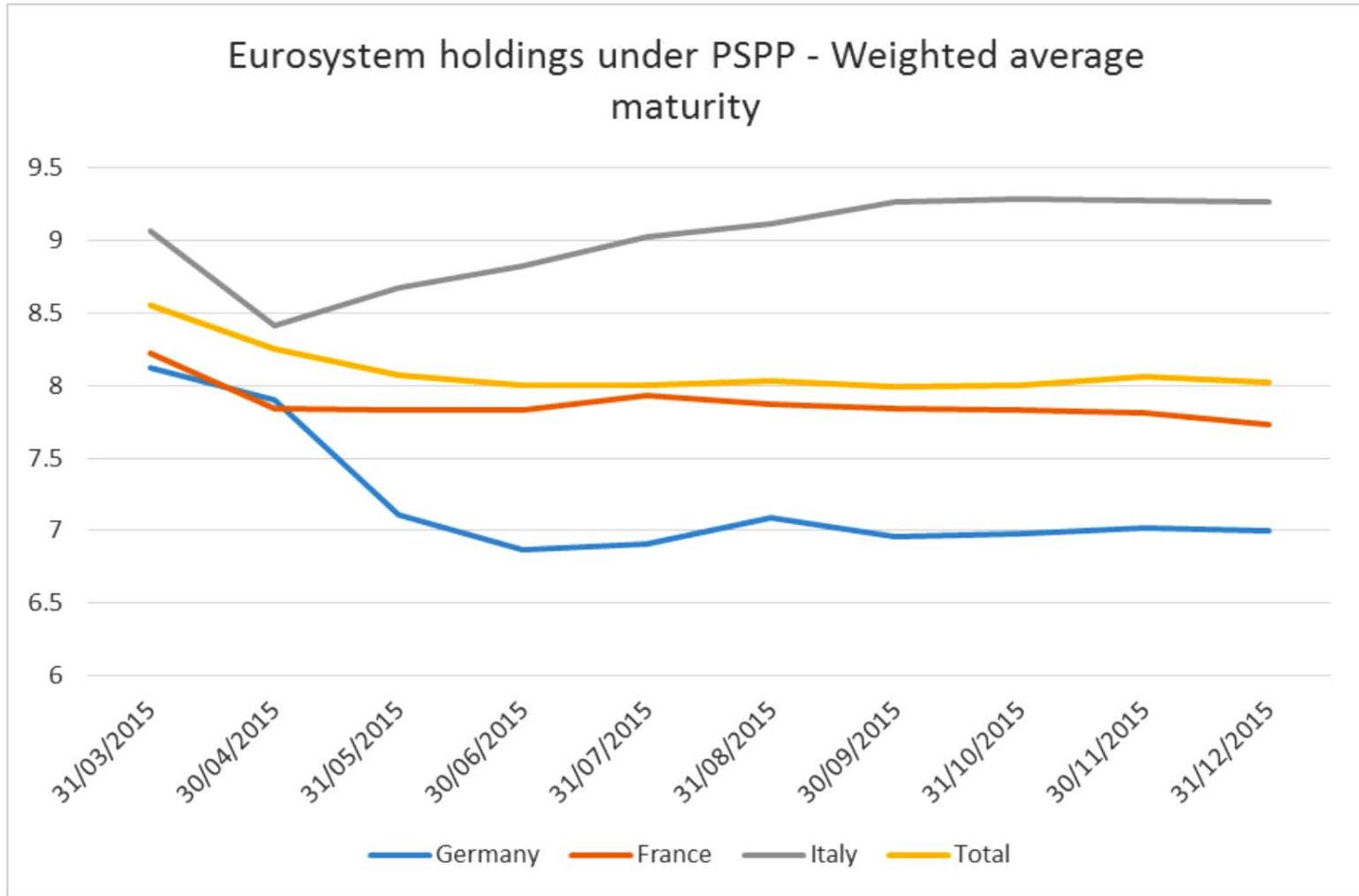
- With dual target the ECB could relax as labour markets are improving and financing conditions very favorable.
- But only HICP inflation counts.
- ECB tries to bring inflation closer to its 'below, but close to 2%' target, but is fighting windmills – QE + negative rates are unlikely to achieve much.
- Both work differently in creditor economies like the euro area (and Japan).

# QE = Fiscal policy? Or rather debt management?

- With own currency can consolidate central bank and treasury.
- QE = exchange of long term bonds against short term central banks deposits.
- => **QE lowers average maturity of public debt.**
- QE could be undone by more long term issuance by national treasuries. (Partially the case in US, not much in EA.)

# QE = Fiscal policy? Or rather national debt management?

- Euro area QE (= PSPP) not considered 'normal' monetary policy operation: normal risk sharing rules do not apply to 80 % of purchases, done by NCBs on own account.
  - Different implementation across countries, maturities differ substantially.
- => Monetary policy no longer 'single'.

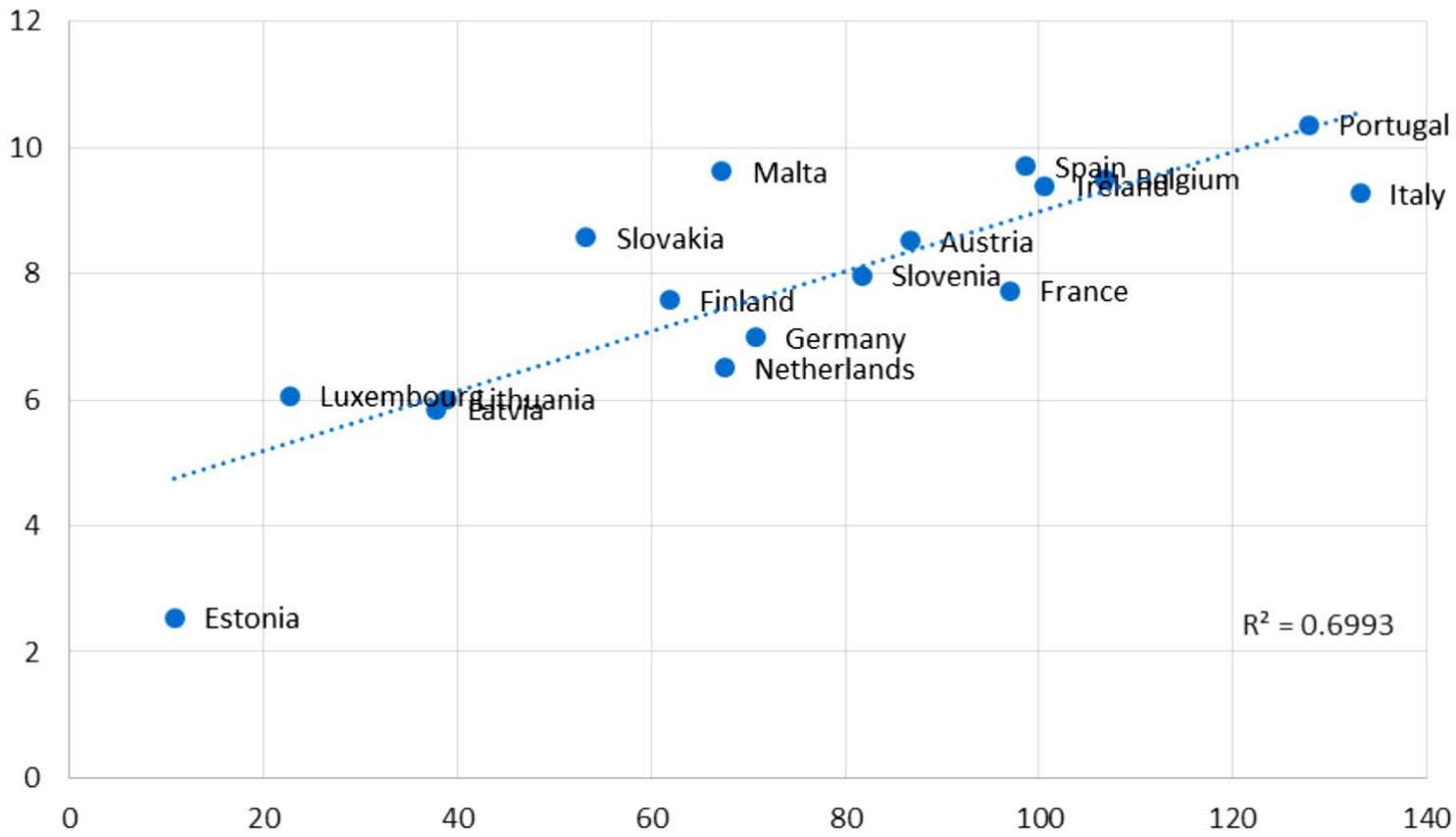


## Does it matter?

### (The shortening of maturities)

- Illustrative calculation:
- Eurosystem buys 25% of outstanding bonds.
- Average maturity of PSPP purchase for IT is 9 years => reduction in WAM = 2.25 years (compared to 7 today).
- For DE reduction is 1.75 years.
- Reduction in maturity is risky if debt/GDP high.
- Impact larger when more maturity taken out of market.

Gross debt to GDP ( in %, x-axis) and WAM of holdings under PSPP (in years, y-axis)



# Conclusions on fiscal aspect of QE

- Impact on maturity of public debt certain.
- QE in euro area: to 80 % national 17 different debt management operations only weakly coordinated.

# Perceived need of monetary easing

With perception arises need for action.

1. (Short term) policy rates more negative
2. Drive long term rates down by bond buying (QE).

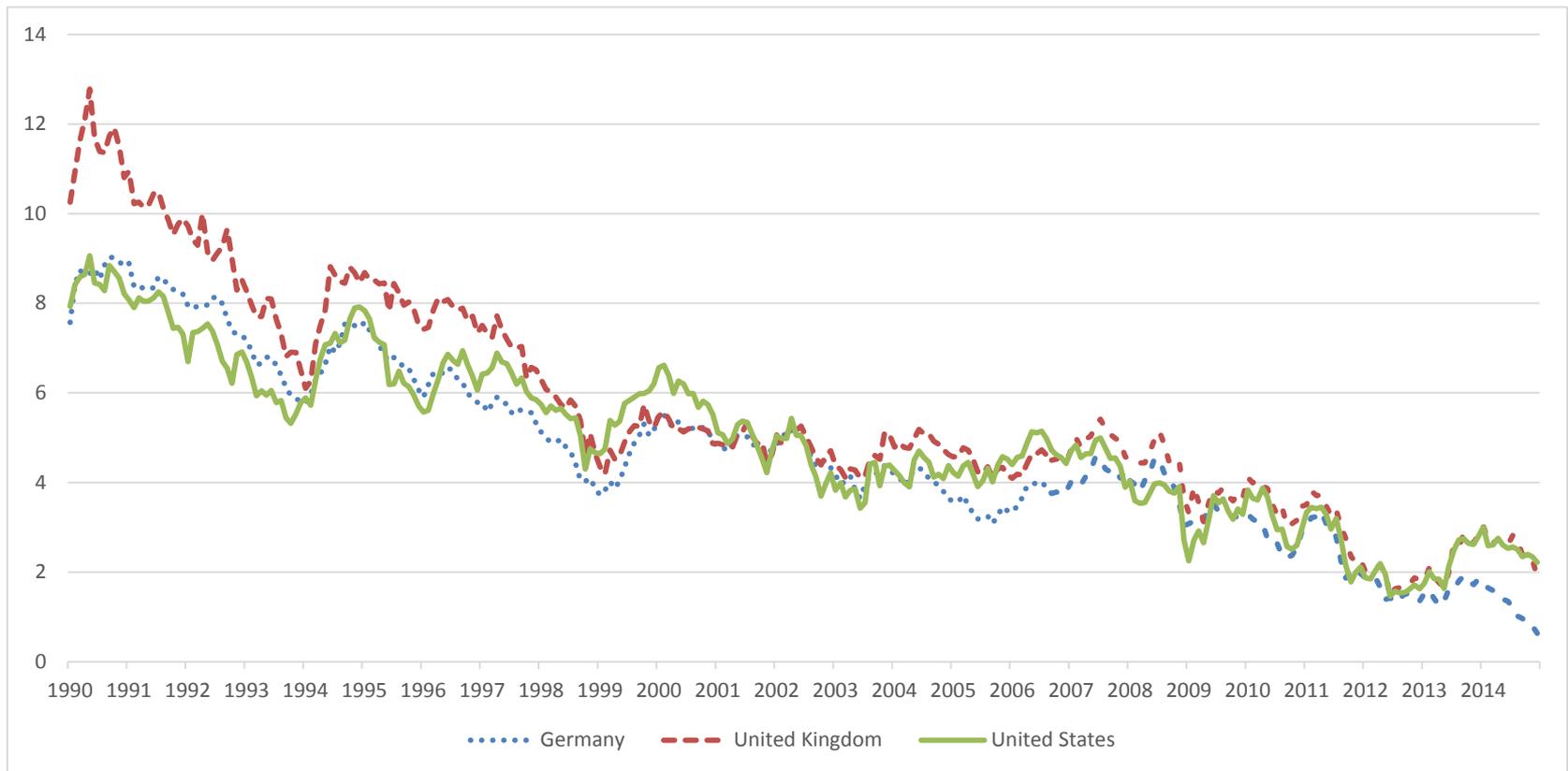
Two issues:

1. Who determines long rates?
2. Impact of lower long term rates?

# Low rates global phenomenon

- Strong global trend, common to all developed economies.
- Rates generally lower in savings surplus countries (= with persistent current account surplus) than in deficit countries.
- Compare US, UK to EA, Japan, DK, CH, etc., but differences have narrowed recently.
- => If global trend, what is role/influence of any one central bank?

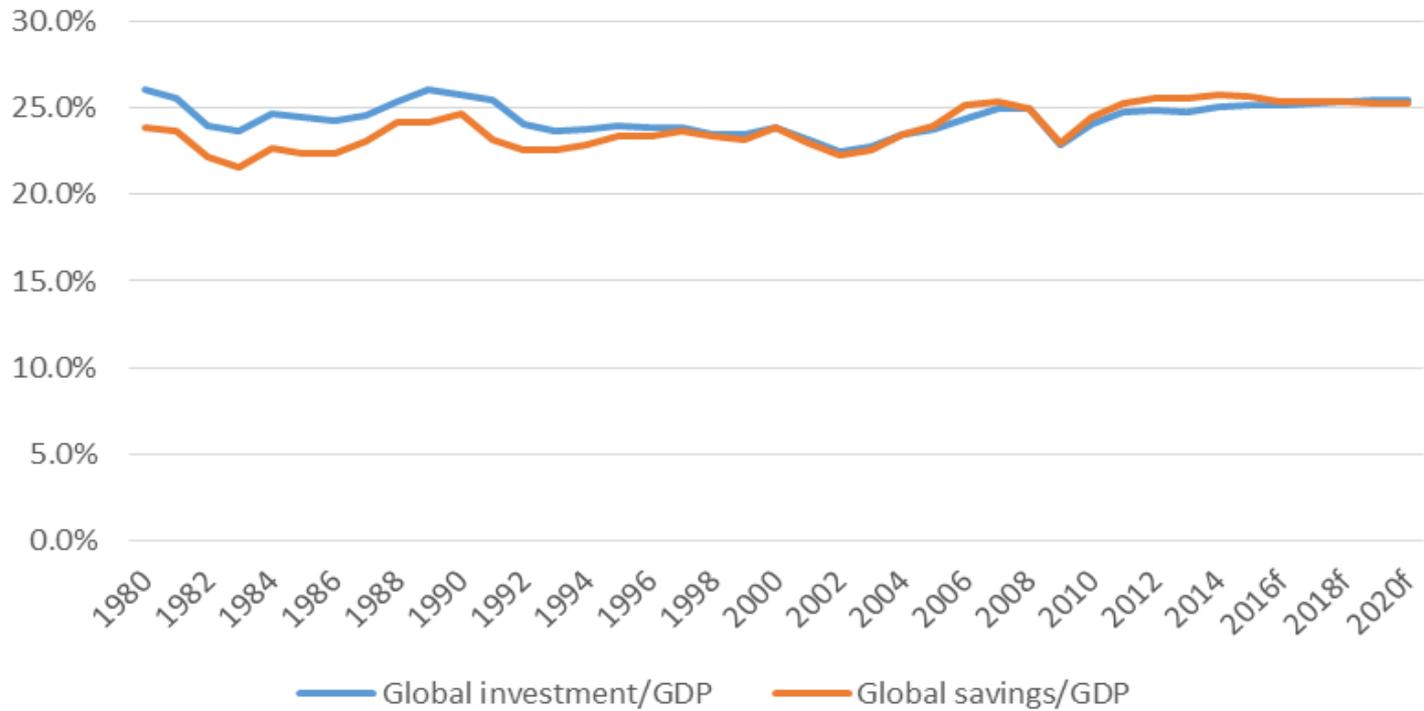
# Common trend across the Atlantic (long terms interest rates)



# Reasons for global low real rates?

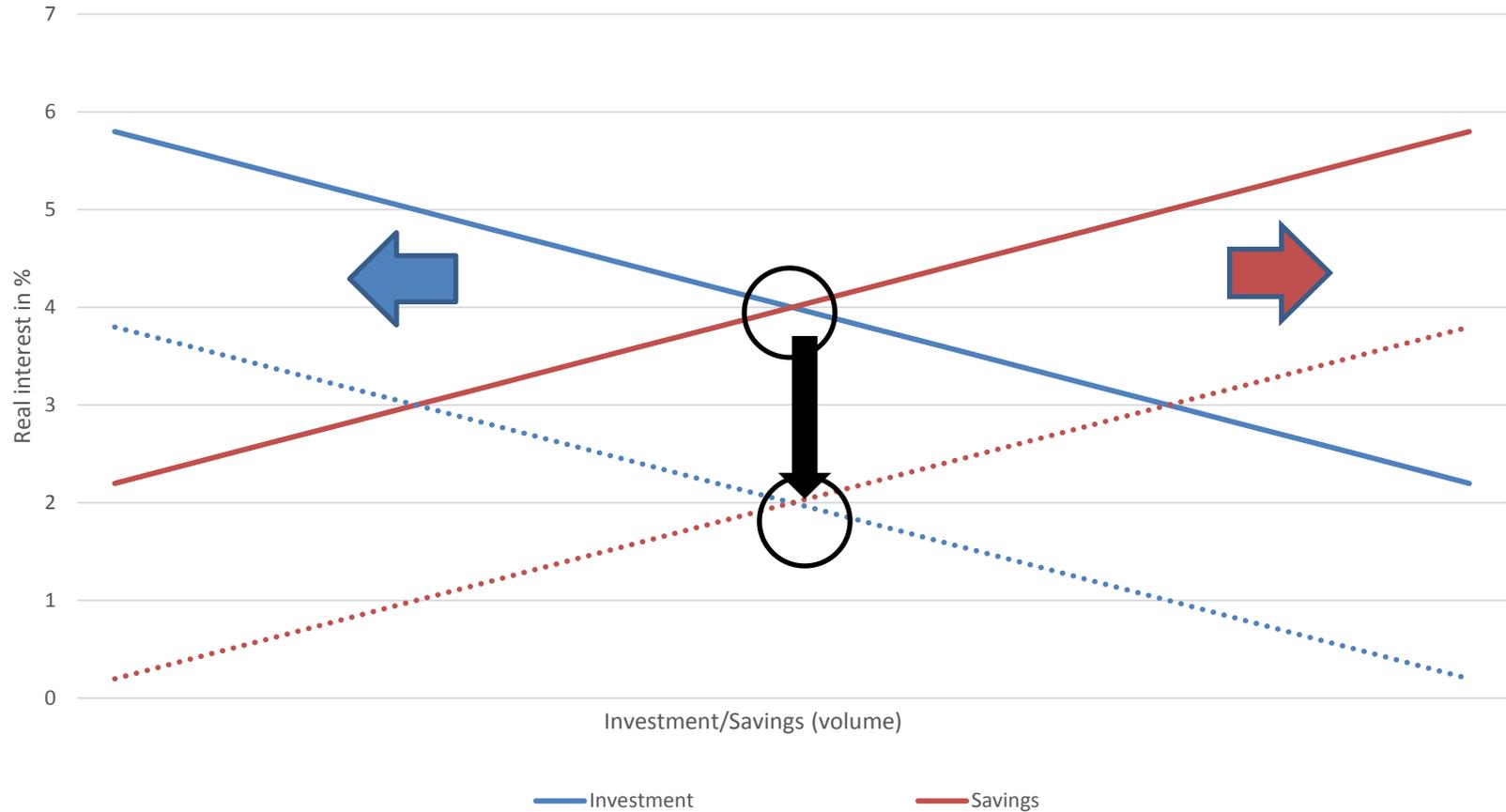
- Investment demand down ( $\Rightarrow$  investment down)?
- Savings supply up ( $\Rightarrow$  more savings by lower rates)
- Globally  $S=I$ .
- Need combination!

### Global investment and savings



Source: IMF WEO data

# Lower rates at stable I/S rates



# Reasons for global low real rates?

- Can 'explain' post facto:
- Decline due to lower growth plus higher savings and lower investment propensities.
- Estimates of 'equilibrium' real rate today highly uncertain.
- Small positive (about 1%) to zero are recent results.

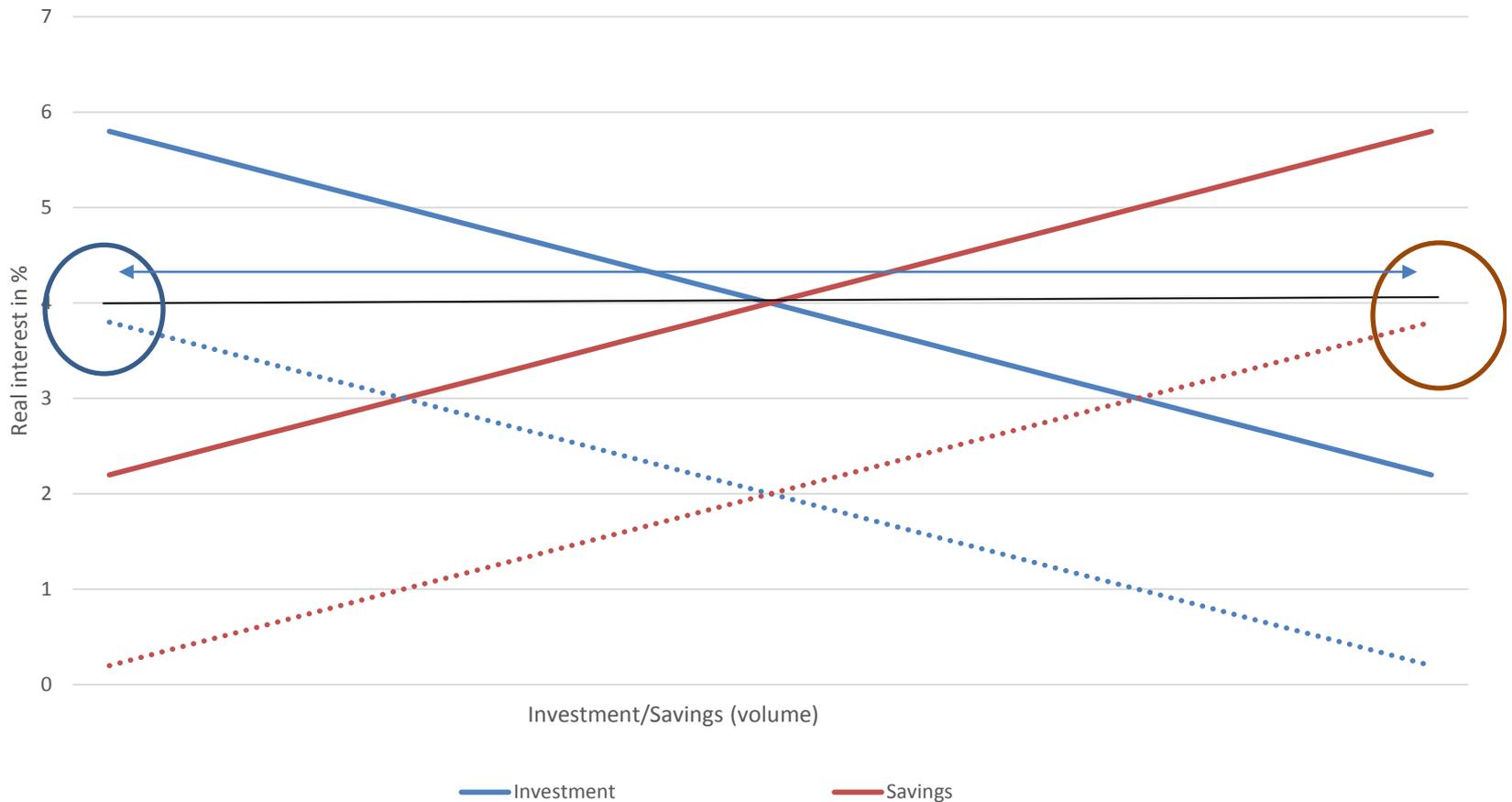
# Reasons for low nominal rates

- With stable prices a decline in real rates implies a decline in nominal rates.
- if equilibrium real rates became negative, zero lower bound on nominal rates binding?
- => higher inflation target?
- Little evidence that this is needed at present. Estimates of the 'equilibrium' rate about 0-1 % recently. Implies nominal rate of 2-3 % with inflation (target) of 2 %.

# Small country equilibrium totally different

- Assume savings up only in euro area (ageing)
- Investment down only (low potential growth, risk premia, euro crisis)
- Result with integrated markets?
- Interest rate unchanged.
- I down, S up => current account surplus.

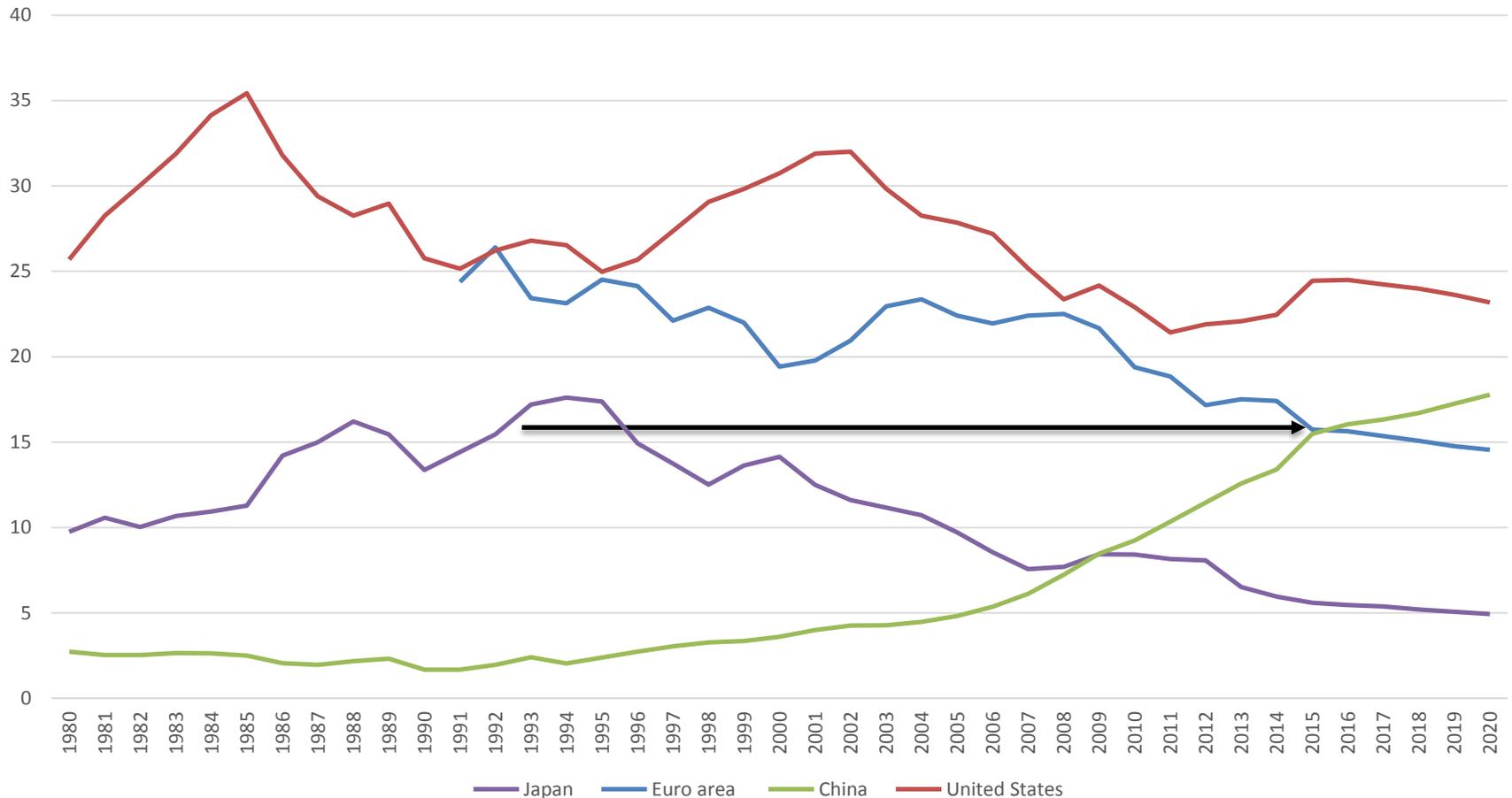
# Shifting savings and investment schedules with globally integrated capital markets



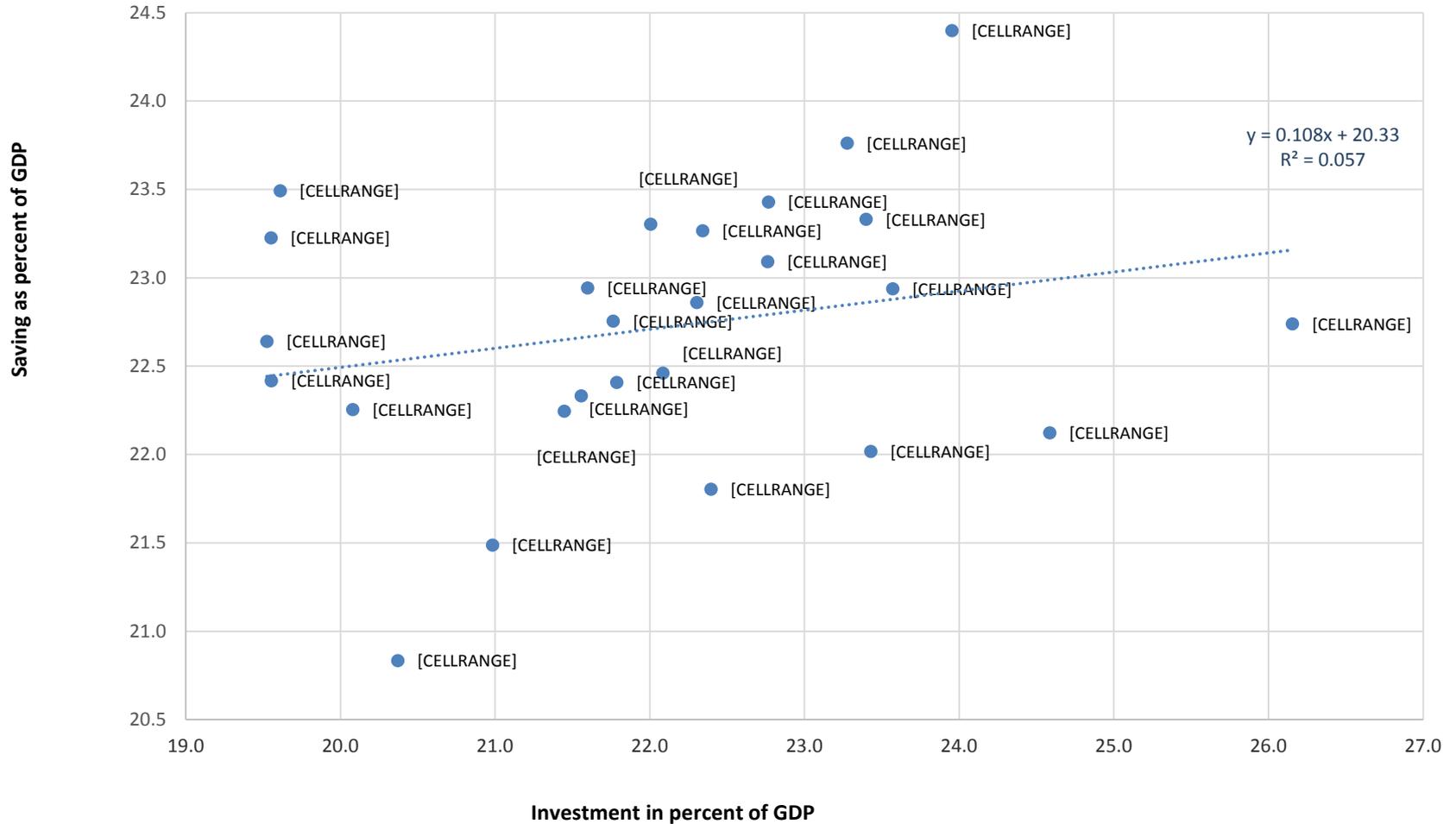
# Is euro area small country?

- Data says euro area has become small.
- Open capital market?
- I and S uncorrelated? (Feldstein & Horioka)  
Evidence mixed.

# Euro area behaves like a small economy, because it has become one (Share in world GDP = Japan in 1990s)



# Investment and savings in the euro area



# Monetary policy implications

- If global trend plus integrated markets what can/should ECB do?
- (Draghi) Monetary policy should try to lower (real?) rates below the equilibrium when output gap persists and inflation below target.
- But ECB does not control directly long term rates, hence QE and negative rates + 'forward guidance'.

# Step II effectiveness of low rates?

- ECB can set short term rates negative
- Maybe nudge yields on euro-area long-term bonds down.
- But effective in stimulating spending?

Creditors lose income (Germany) => spend less?

Debtors gain => do not spend more to deleverage, SGP for governments?

Private sector in periphery on floating rates!

# Unintended effects of QE?

QE leads to higher asset prices(?)

Equity: Over 50 % of DAX foreign owned.

Housing:

In Germany majority rents => higher house prices  
and rents => lower disposable income!

Higher house values locked up in financial  
institutions.

Difficult to extract home equity for owner occupied  
housing.

# QE: the euro area is different

In US (perhaps in UK) QE could work:

Housing equity extraction 'normal'

US large net debtor in own currency (7 trillion of debt).

Lower rates through QE means higher income for US (of about 0.5 % of GDP for every 1 %).

Euro area approximately balanced externally with large stock imbalances inside.

EA has current account surplus: increase even further by driving euro down?

# Negative rates useful in Europe?

- Bank deposits main vehicle for savings. Difficult to tax savers => negative rates become tax on banks.
- Possibly negative impact on consumption,
- Negative impact on bank's returns more relevant given weak capital position of European banks.

=> very uncertain impact on investment.

Not sure negative rates will work domestically

But impact via exchange rate?

# Financial stability issues

- ‘Low for long’ now priced in the market.
- Normalization of rates (= return to equilibrium) could lead to financial stability problems (value of bonds held by intermediaries declines suddenly as rates normalise).
- (Balance sheets are drawn up in nominal terms => nominal rates matter, the economy reacts to real rate.)

# Who has negative rates?

Only creditor countries (= persistent current account surpluses)

EA, Japan and small European nations (with surpluses): DK, SW, CH.

The stronger the creditor position the higher the likelihood that negative rates do not work (except through housing boom in Sweden?):

Keep currency weak: exacerbates c/a surplus.

# Bank based versus market based monetary policy instruments

- In euro area bank based measures probably more effective.
- But marginal impact of TLTRO II (targeted long term refinancing operations) still limited.
- Banks can (re-)finance 30 % of existing loan book at zero.
- Total amount up to 1 500 billion euro potentially.
- Length of financing (4 years) important than size.

# Cash for loans

- Sweetener to TLTRO II: rate goes to minus 40 bps if loan book by January 2018 exceed benchmark by 2.5 %.
- Implicit incentive large:  $0.3 * 0.4 * 4(\text{years}) = 0.48\%$ .
- $0.48/2.5$  approximately 20 % subsidy.
- But impact on real economy doubtful: easy to window dress loan book.
- Total subsidy to EA banks large: 1500 billion  $* 0.4 * 4 = 24$  billion.

# Conclusion:

## Don't worry – be happy

- Euro area economy is steadily improving, especially employment.
- No sign of deflation, even less of 'debt deflation'.
- GDP growth low despite more employment means productivity stagnates.
- Not a problem monetary policy can solve.

# Conclusion II: Don't worry – relax

- Strong evidence of global trend in long term rates.
- Euro area now 'small open economy', with long term rates determined by global capital market.
- => Impact of QE and negative policy rates limited.
- Limited impact might go in wrong direction: lower long and more negative short rates might backfire and delay recovery.

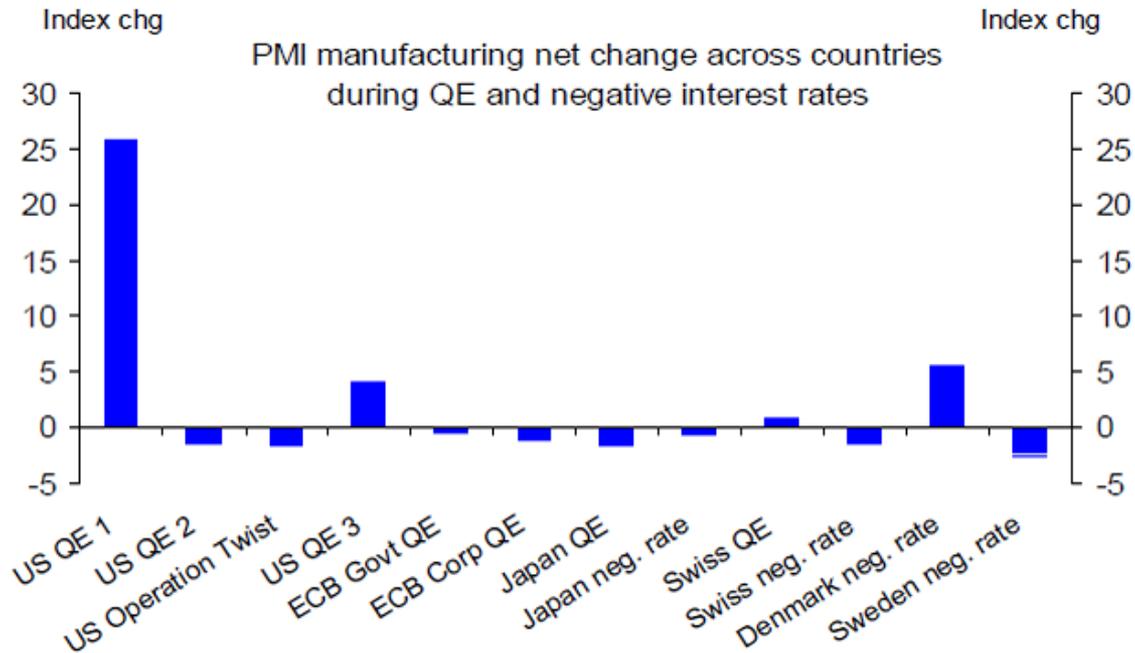
## How to measure impact of QE

- QE is supposed to affect long-term rates.
- But investors tend to anticipate policy (jumps in bond prices would provide large profit opportunity).
- In academic literature impact of QE is measured by ‘event studies’: change in bond prices around major announcement dates should show impact of QE (provided announcement was at least partially a surprise).

# What Impact?

- Conventional wisdom: QE lowers (long-term rates) and hence stimulates spending.
- Central banks: Measure reduction in rates and use standard model to translate lower rates in more spending and higher prices (Philips curve).
- But what if lower rates do not stimulate spending?
- Should look at impact of QE on inflation expectations.

Report card for unconventional monetary policy:  
QE1 in the US worked. Nothing else has really worked



Note: Manufacturing ISM used for the US, manufacturing PMIs for all other countries

Source: ISM, HIS Markit, Nikkei, SVME, Bloomberg Finance LP, Haver Analytics, DB Global Markets Research