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- Directorate A -
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Topic 1

Monetary policy achievements / innovations under Draghi's Presidency and challenges ahead for the monetary policy architecture

Issues

Interest rates are expected to remain close to the effective lower bound for long. Will this limit the amount of monetary easing available to the ECB to counter the next cyclical downturn or does it still have enough ammunitions at its disposal? The ECB's new TLTROs and asset purchase programme (APP) ensure that euro area banks already have ample liquidity for the foreseeable future. The ECB could further expand its monetary arsenal either by buying riskier private assets (i.e. equities, corporate bonds, and senior bank debt) or by lifting the central bank's self-imposed limit on sovereign debt holdings. However, both measures would be delicate/controversial and could expose the ECB to significant credit and political risks. Even assuming that the ECB successfully manages to stabilise euro-area inflation (and therefore output) at the desired level, this does not exclude persisting imbalances at the country-level. How to deal with them? Would limited room for monetary easing make fiscal policy more crucial? If not, how to foster adjustments, knowing that relative price movements (wages) in a low inflation environment are difficult to achieve? What are the pros and cons of adjustments through higher inflation (e.g. rising the euro area target) or through financial repression (wages)?

Papers:

Draghi's Term as ECB President and the Challenges Ahead - Karl WHELAN (University College Dublin)

Mario Draghi took over as ECB President at a time of recession for the euro area economy and widespread concerns about whether the euro project could be sustained. The years since have seen an easing of fears of the euro breaking up and the economy recover without triggering inflation above its target level. As such, his presidency must be judged a success. Draghi's achievements go beyond the successful implementation of monetary policy. He also played a key role in encouraging Banking Union and other important institutional reforms. The new ECB President faces a difficult set of challenges. The ECB is not meeting its inflation target; inflation expectations are falling; and there are signs of economic weakness. Like Draghi, the next President will require strong communications, diplomatic and political skills to face these challenges successfully.

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- The years since have seen fears of the euro breaking up reduced and the economy recover without triggering inflation above its target level. As such, Draghi's presidency must be judged a success.
- Draghi's achievements go well beyond the successful implementation of monetary policy and have required skills that rise above just the technocratic ones we associate with a trained macroeconomist. His "whatever it takes" speech in July 2012 and the subsequent announcement of the OMT programme were sufficient to prompt financial markets to reverse course in their assessment of redenomination risk in the euro area.
- Draghi also played a key role in encouraging Banking Union, putting forward the case for greater centralisation in banking supervision and resolution and arguing for the ECB to take over as the single supervisor of the euro area's banks. The process of the ECB taking over as the single supervisor has helped with recapitalising the euro area's banks and with assuring investors that similar approaches are being taken across the euro area to supervisory issues and the treatment of bad loans.
- The new ECB President faces a difficult set of challenges. The ECB is not meeting its inflation target; inflation expectations are falling; and there are signs of economic weakness.
- Questions are being raised about whether the ECB is "out of ammunition" to address economic weakness and meet its inflation target. However, even with its traditional policy rate at zero, there is still room to provide further monetary stimulus.
- The deposit rate can be set to even more negative levels, perhaps with the introduction of "tiering" of reserves to offset the implications of negative rates on bank profitability.
- The Asset Purchase Programme can be restarted without triggering legal problems.
- Targeted Long-Term Refinancing Operations (TLTROs) can be made more generous to banks and more precisely targeted to meet some of the EU's other policy goals or to target the interest rates on the associated loans provided by the banks receiving TLTRO funds.
- The ECB should also clarify that its price stability goal is a 2 percent average inflation rate over a specified period of time.
- There are still many reforms of institutions and rules that can make the euro area economy function better, particularly during recessions. Draghi has been an effective voice in favour of these reforms and the ECB should continue playing an important role in this area.
- Draghi's designated successor, Christine Lagarde, has the communications, management, diplomatic and political skills to be an effective ECB President but Mario Draghi will be a hard act to follow.

Challenges ahead for the European Central Bank: Navigating in the dark? - Grégory CLAEYS, Maria DEMERTZIS, Francesco PAPADIA (BRUEGEL)

Monetary policy must reinvent itself in the wake of the crisis. Reinvention is particularly important because the system is riddled with uncertainties and the scope for applying conventional and unconventional instruments is limited. The architecture of Economic and Monetary Union makes the challenge even greater, because alignment of preferences and policies only goes so far. The European Central Bank (ECB) will have to be clearer on what it can do, while remaining flexible in order to manage uncertainties and unknowns. While the ECB's *main objective is price stability, it will also have to contribute to the identification of, and response to, financial imbalances, while preserving its independence.*

- The ECB enters a potentially difficult period with limited space to cut rates and a large balance sheet, making it more difficult to use its current conventional and unconventional tools. In addition, the marginal return on these tools might be diminishing. This represents a major challenge for the ECB which will have to review its strategy and toolbox, and innovate further in the next few years to be able to fulfil its mandate.
- Another major challenge for the ECB is the peculiar, incomplete nature of monetary union, in which coordination between monetary and fiscal policy is flawed. There is no fiscal tool at the euro-area level, and national fiscal policies are under greater market scrutiny than in other jurisdiction because of the prohibition of monetary financing, which can result in self-fulfilling liquidity crises, especially in countries with more fragile debt situations. This gives the ECB a crucial role to play in the euro-area architecture.
- A third challenge is the lack of understanding of what the 'new normal' looks like. Neutral rates, which are an important guide for policy rates, have probably declined, but the estimates are poor and it is difficult to know if the current historically low level of rates are a short-term phenomenon or a secular one. More generally, this shows that the central banks' underlying models – their interpretation of how the economy works – are also poor.
- To be able to face these challenges, Bruegel experts urge the ECB to review its strategy and framework, including the way its target is precisely defined.
- They also also urge the ECB to be ready to apply all the tools at its disposal if the economic situation deteriorates (quantitative easing, generous refinancing operations, forward guidance, etc) and to start thinking about other potential tools if the current ones are insufficient (e.g. helicopter money, etc). But the ECB must also be ready to use Outright Monetary Transactions (OMT) in case sovereign debt markets face new liquidity crises.
- Finally, despite the primacy of its price stability mandate, the ECB will have to play an important role in promoting financial stability. Low rates for a long period, which are necessary to bring inflation back to 2 percent and support growth, could nevertheless have some financial stability implications, meaning the ECB could face some dilemmas in the future. This means that macro-prudential measures will have to be the first line of defence against financial imbalances. The current institutional setup in the euro area might not be capable of doing that. Therefore, the ECB should contribute to stronger analytical foundations for these policies, make proposals to improve the European framework and monitor carefully the financial stability risk to alert the institutions responsible for implementing these policies.

Monetary Policy in the Euro Area after Eight Years of Presidency of Mario Draghi: Where Do We Stand? - Salomon FIEDLER and Klaus-Jürgen GERN (Kiel Institute for the World Economy)

Against the backdrop of slowing growth and subdued inflation in the euro area, this paper addresses the question to what extent additional monetary stimulus can be expected from the ECB if needed. The authors find that "more of the same" policies will probably not be effective and that there are no attractive alternatives there. After more than ten years of exceptionally loose monetary policy it is now the turn of fiscal and structural policies to reinvigorate the European economies.

- In the aftermath of the global financial crisis and especially after the euro area was hit by a second crisis centred on euro area sovereign debt, the ECB used a range of unconventional monetary policy measures in addition to its interest rate tool which led to a massive expansion of its balance sheet.
- However, credit growth did not respond to the dramatic increase in the monetary base. The apparent breakdown of the money multiplier, which is evident in the rapid accumulation of excess reserves, is showing that the response of the economy to an increase of central bank money has changed after the financial crisis.
- Available empirical evidence suggests that currently very large unconventional programmes would be needed to achieve even modest effects on inflation. At the same time, there are considerable risks from side effects associated with these policies, including the build-up of financial imbalances, misallocation of resources, or "zombification" of the economy, and these risks may increase with the duration of the expansionary policies. Some of the ECB's extraordinary measures specifically reduced the risk premia on certain government bonds which may have delayed the adoption of needed structural reforms. Finally, large scale asset purchases expose the central bank to the risk of considerable losses, which may impair the independent conduct of monetary policy in the future.
- In the context of serious concerns that central banks will be unable to achieve their inflation targets going forward with their current tools, a number of farther reaching proposals have been made. It is, however, either not clear how alternative strategies could actually be implemented (higher inflation target, price level targeting) or associated with serious drawbacks such as the risk of a loss of confidence in the currency (abolishing cash) and loss of control (helicopter money). The possibility suggested by Neo-Fisherian theory that raising interest rates may lead to higher inflation seems to depend on critical assumptions that may not hold in reality.
- All in all, it seems there are not many attractive options left for the ECB to effectively loosen its policy stance further in case the economy deteriorates further. After more than ten years of exceptionally loose monetary policies, other policy makers will have to contribute much more decisively to reinvigorate the European economy.
- The problems in the architecture of the Eurozone with its combination of centralized monetary policy and decentralized fiscal policies have raised demands for increased fiscal risk sharing. Proposals to introduce or broaden elements of risk-sharing are, however, suffering from the suspicion that they would lead to permanent one-sided transfers, given the legacy of fiscal or structural problems in some countries.
- An alternative way to go would be to strengthen self-responsibility as the increasingly complex European system of macroeconomic monitoring and fiscal supervision is deficient. Policies such as fiscal consolidation or structural reforms on goods and labour markets to increase the growth potential can be expected to be more successful if they are owned by national decision makers and their voters. An important prerequisite to re-establish the no-bailout rule is a reduction of the home bias in bank's bond portfolio to reduce the vulnerability of banks to their own sovereign and a financial backstop on the European level which is responsible to stabilise the domestic financial sector.

Challenges ahead for EMU monetary policy - Christophe Blot, Jérôme Creel & Paul Hubert (OFCE)

With the economic slowdown in the Euro area, questions arise as to whether the ECB retains some economic and political margins for manoeuvre after a decade of active policies. This note highlights three possible monetary policy developments and discusses their pros and cons according to four dimensions: political constraints, technical constraints, independence and interactions with fiscal policy.

- This policy brief deals with the options for the ECB to mitigate the current economic slowdown, foster higher inflation and inflation expectations. It seems that monetary policy in the euro area is not constrained and that further stimulus may be implemented if needed. The note discusses political constraints, technical constraints, independence and interactions with fiscal policy;
- The ECB may contemplate another allocation of bonds purchases than the ECB capital key, an extension of Quantitative easing (QE) towards corporate bonds or stocks, and a QE oriented towards the households (or QE for the people);
- Considering the re-activation of the PSPP (Public sector purchasing programme), the ECB would have more leeway if it departs from the capital key. The capital key is one weighting scheme among others. An alternative is to purchase sovereign debt according to public debt weights. The distribution might otherwise be based on the distance of each national inflation rate to the ECB target such that the stimulus needed in each country is appropriate to reach the ECB mandate. In any case, the marginal technical constraints compared to the current PSPP are weak whereas the political constraints are more important;
- The ECB could buy private assets, hence re-orienting the QE towards firms and purchase either corporate securities or stocks. The technical and political constraints for this option are small. However, in the Euro area, firms rely more on bank funding and wealth effects are weak, reducing the effectiveness of a QE for firms. Considering the potential side-effects (creating bubbles and increasing inequalities), the purchase of stocks may not be the first best option;
- Finally, the ECB could carry out a lump-sum transfer to citizens. Such a strategy would be similar to the image of helicopter money – printing money and distributing it to the public. The objective would be to fund directly household spending by increasing disposable income. There are several options to implement a QE for households raising significant technical concerns. With respect to political constraints, nothing in the EA rules forbids the ECB from doing so;
- The implementation of unconventional measures has reinforced the interactions between monetary and fiscal policy. Some unconventional measures would entail an implicit fiscal transfers for the agents. QE for firms and households would notably lead to a trade-off between the lack of accountability of an implicit fiscal transfer and the need for closer cooperation that would weaken the independence of central banks;
- There is a need to understand why inflation is so low in the euro area. If it is a related to the persistence of economic slack, additional stimulus is clearly needed and may be complemented by an expansionary fiscal policy. Low inflation may also be related to structural economic changes, which have increased job insecurity and weighed workers' bargaining power. Therefore, monetary and fiscal stimulus may be needed but they should also be complemented by structural policies improving job security.

The ECB's Unfinished Business: Challenges ahead for EMU Monetary and Fiscal Policy Architecture - Corrado MACCHIARELLI, Eddie GERBA (LSE) and Sebastian DIESSNER (EUI)

Under Mario Draghi's Presidency, the range of measures and tools of the ECB expanded significantly, both by enhancing transparency and in the direction of stretching the ECB's competences beyond the limits to the existing monetary framework. Notwithstanding these achievements, significant challenges remain. This note assesses the potential limits to the amount of ECB's easing available for the future, including credit and political considerations. It argues that monetary policy stimulus alone may not resolve the situation of having the euro area stuck in a slowing growth environment, and asks whether the next President may want to pass the ball more strongly to national governments.

- Together with pushing the deposit facility rate into negative territory, in recent years, the ECB has focused on using a broad range of instruments, including forward guidance on the forthcoming path of the EONIA, outright balance-sheet policy through its (Expanded) Asset Purchase Programme, and targeted LTROs.
- The observed extent of stubbornly low inflation expectations certainly poses a challenge in terms of consistently and proactively responding to shocks that might delay convergence to the ECB's (medium-term) inflation objective. To this end, in a world of subdued growth prospects (i.e. secular stagnation), forward guidance is regarded as a crucial step to providing the necessary state-contingency of policy to revive the euro area economy. It is vital, at the same time, that the central bank will remain available to maintain the most effective tools to deliver on its mandate. The decision, among others, of 12th September 2019 of the ECB's Governing Council meeting to restart its net purchases "for as long as necessary" under the APP confirms this necessity.
- As it stands, the package of measures that the ECB announced in September 2019 include a further deposit facility rate reduction; additional open-ended balance-sheet purchases starting in November 2019; a new (pre-announced) round of TLTRO, with the introduction of a two-tier system for reserve remuneration.
- While the evidence suggests improved financing conditions and improved macroeconomic performance overall as the result of QE, the association between core inflation and longer-term expectations, based on the Survey of Professional Forecasters, has weakened again recently.
- In discussing the limits that politics and credit risk may create in making quantitative easing more aggressive, authors ask whether the economic slack is a fiscal, rather than monetary, issue. In particular, the question remains as to which other instruments the ECB will still have in its arsenal. Those could be summarised as:
    - Unconstrained monetary policy, i.e. the ECB could embark into ever more negative interest rates, by so-doing relieving the government from using fiscal policy;
    - Extension of asset purchases, as well as changes to its technical rules;
    - Outright money creation to support aggregate demand, in the form of direct cash transfers to economic agents or other measures of outright finance via the central bank's balance sheet (also referred to as 'helicopter money' or central banks 'going direct', respectively);
    - Lifting the optimal inflation target in order to achieve the anchoring of expectations.

- The extension of asset purchases could be both *qualitative*, i.e. an extension of asset purchases particularly in the realm of corporate sector bonds – as well as the purchase of other risky private assets including equities (such as exchange-traded funds or ETFs); and *quantitative*, i.e. purchasing larger amounts by lifting the issuer and issue limits of the PSPP and/or deviating from the Eurosystem's capital keys.
- The Governing Council has faced calls to raise or even overthrow the self-imposed issue and issuer limits on the PSPP and to reconsider its adherence to the capital key. The ECB itself assumes to have broad technical discretion over these limits: particularly, the increasing scarcity of bonds in a number of jurisdictions had to be offset by increased purchases in other jurisdictions, above and beyond the predicted capital key shares.
- While buying equity/ETF purchases would mark uncharted territory for the ECB, risk-taking and potential balance sheet losses would, in theory, carry less of a political threat in the euro area given the ECB's far-reaching independence. At the same time, the finance ministers of the Member States have not provided the ECB with an explicit recapitalisation guarantee.
- Arguably, expansionary fiscal policy – in conjunction with continued expansionary monetary policy – could boost aggregate demand, and therefore push wage and spending growth up, resulting in a substantial rise in GDP and inflation.
- The empirical evidence reviewed in this note finds that spending policies are more effective in expanding output during less turbulent times when less uncertainty prevails. In addition to that, unless the intertemporal effect of debt is taken into account, the fiscal multiplier tends to be biased and overstated. This means that debt in the euro area represents an important constraint on potential growth, and therefore fiscal expansion is likely to have limited (although) positive impact, specifically in fiscally constrained countries.
- Considering that financial policy – both micro-and macroprudential – has gained much significance since the Great Recession, the scope of conventional monetary policy has been significantly reduced. The 'new monetary policy' should be much more considerate of low growth prospects, the interplay between macroeconomic-and financial cycles, private sector balance sheets, and interaction with other policies, in particular, financial policy.
- In this respect, having the ECB to target an inflation interval, of for instance between 1.5-2.5%, also going beyond the current target of 2%, might be a more effective way to proceed, as the evidence suggests, particularly considering the significant uncertainty on the expected inflation path and the context of structural change and demographic shift taking place.
- Other structural policies could entail taking into account technologies and prepare societies for the automation age.

Topic 2

Global/structural factors underlying persistently subdued inflation dynamics in the euro area and worldwide: Time to update inflation targets and monetary policy cooperation?

Issues:

Low inflation in an increasingly competitive global environment has led to a debate on the importance of globalisation for domestic inflation. What are the implications of a low inflation structural trend for the monetary policy of the next decade? Can the ECB injections of liquidity ensure, in the absence of any effective stimulus from the real economy, the achievement of the inflation target for the euro area? How important is the cooperation between central banks for the achievement of the inflation targets in the medium term?

Papers:

Global Trends in Inflation: Are Central Banks Barking up the Wrong Tree? - Daniel GROS (CEPS)

The ECB will not be able to achieve its inflation target over the foreseeable future. Further expansionary measures will have at most a modest impact on financial market conditions and even less on overall demand. Moreover, the impact of any demand stimulus on inflation is highly uncertain. The reasons for low inflation persistence despite tight labour markets almost everywhere are not fully understood. It is a global phenomenon, but not necessarily due to globalisation. One global factor seems beyond dispute, namely a fall in global equilibrium real interests. However, different views of how the economy operates lead to very different views how central banks should react to this phenomenon. There is little evidence that cooperation between central banks would have a significant impact on their (limited) ability to achieve their inflation targets.

- Persistently subdued inflation despite improving labour markets and other indicators of economic slack constitute a global phenomenon which characterises most developed economies. It is thus a global phenomenon. But this does not imply that it is due to globalisation. It seems more likely that a number of trends affect most developed economies in parallel.
- Low inflation despite economic slack (i.e. the absence of a reliable Phillips curve relationship) affects different economies to a varying degree: in Japan, one cannot detect any slack; low inflation seems ingrained, whatever the employment situation. By contrast, inflation has remained below, but much closer to the target in the Anglo-Saxon economies, e.g. US and UK. The euro area seems to occupy an intermediate position. It experiences similar low inflation like Japan, its labour market is also tightening, but it still has pockets of high unemployment.
- A caveat: it remains to be seen whether the current weakening of the economy will turn into a real recession which could interrupt the ongoing tightening of labour markets (on average) throughout the euro area. This was not the case in 2015/6 when growth also slowed down, but could happen this time.
- Recent research suggests that the most important common or global trend affecting advanced economies is the decline in the 'equilibrium' real interest rate, called r*, in central bank parlance. The causes of the decline in r* are disputed, ageing, low productivity growth, after-effects of the global financial crisis and central bank policy itself, have probably all contributed. But there is

no dispute that real rates have indeed declined; and that central banks need to take this element into account when setting policy at the national level.

- Central bank policy, including in the European Central bank (ECB), is dominated by the idea that monetary policy should be eased when r* declines. The line of reasoning is the following: prices are sticky, at least in the short run. This means that if the equilibrium real rate (=r*) declines a central bank needs to lower the policy interest rate (or increase asset purchases if the policy rate is already at zero), to avoid a situation in which the actual real interest rate, deflated by today's inflation, is above the global long run one.
- A minority view has taken the opposite stance. The, so-called, Neo Fisherian view is based on the generally accepted idea that in the long run r* is determined by global capital markets. This view implies that central banks should increase the policy rate (or reduce asset purchases) when r* is low. Under this view, a higher inflation rate is required to keep the real rate constant if the nominal interest rate increases.
- The ongoing weakness of inflation in the face of ultra-low rates into the foreseeable future should make the ECB reflect whether its approach will ever bear fruit.

Fighting the Previous War: Does the World Economy Face a Deflationary Threat - Marek DABROWSKI (CASE)

Inflation in advanced economies is low by historical standards but there is no threat of deflation. Slower economic growth is caused by supply-side constraints rather than low inflation. Below-the-target inflation does not damage the reputation of central banks. Thus, central banks should not try to bring inflation back to the targeted level of 2%. Rather, they should revise the inflation target downwards and publicly explain the rationale for such a move. Risks to the independence of central banks come from their additional mandates (beyond price stability) and populist politics.

- In the years following the global financial crisis (GFC) of 2007-2009, annual inflation in advanced economies remained at a low level. For some periods, it amounted to less than 2% – the target declared by central banks. This concerns especially Japan and partially the euro area (EA).
- However, the world economy, including the largest advanced economies (AEs) such as the United States, the EA and Japan, does not face a threat of deflation. On the contrary, inflationary pressures continue to be seen on the stock and real estate markets, both in the United States and Europe. The additional risks of pushing prices up can come from protectionist trade policies and the disintegration of the global trade system.
- Despite the lack of deflationary symptoms, several central banks, including the European Central Bank and the Bank of Japan, continue very accommodative monetary policies, including quantitative easing, and postpone their normalisation. The US Federal Reserve Board, which started to increase interest rates and reduce its balance sheet first, returned to monetary easing in July 2019, evidently under political pressure.
- Economic growth in the largest AEs is slower than before the GFC and faces potential headwinds such as trade conflicts, protectionism and security risks. However, most AEs (except Japan) have closed the output gap – they grow at or above potential. Unemployment levels are low as compared to previous decades. Growth constraints are on the supply side (mainly demography and slow productivity growth since the mid-2000s) and monetary policy is unable to relax them.

- The deflationary impulses observed in the decade following the GFC, such as financial disintermediation or declining money velocity, seem to have exhausted their potential. More likely, financial intermediation will gradually rebound and the money multiplier, which fell dramatically after the GFC as result of new financial regulation and as a side-effect of unconventional monetary policies, will increase again.
- There is much confusion and misunderstanding surrounding low inflation. First, there is no evidence that it may damage economic growth. Therefore, attempts to bring it back to an earlier declared target (in most cases, 2%) seem misguided. Second, below-the-target inflation should not be a matter of shame for central banks. On the contrary, it confirms that price stability and low inflationary expectations are better rooted than one might have expected a few years ago. Consequently, central banks should not apologise for low inflation; rather, they should correct numeric inflation targets downwards and explain to the general public why it makes sense.
- The challenges to the reputation and independence of central banks are coming from other angles. First, these are the continuous expectations that central banks can help boost economic growth. However, under current circumstances, growth is constrained by supply-side factors and monetary policy can do little or nothing to boost it. Second, engaging central banks to support economic growth, employment, and financial stability and to deal with macroprudential regulation and bank supervision can undermine their primary mission – that is, their responsibility for price stability. In some extreme cases such as rescuing banks in distress, central banks may be forced to conduct quasi-fiscal operations, which is a slippery slope towards losing their institutional and economic independence. Third, the increasing incidence of political extremism in both EMDEs and AEs makes central banks vulnerable to populist attacks (observed, among others, in Turkey, India and the United States), which can eventually undermine their independence.

Yes, We Are Probably All Japanese Now - Jacob Funk Kirkegaard (PIIE)

This paper argues that the euro area has in recent years shared the same unfortunate concurrent systemic economic/financial crisis and demographic turnaround to an outright declining working age population that Japan suffered in the early 1990s. This combination will continue to depress euro area inflation dynamics for the foreseeable future, making it imperative that new fiscal policy initiatives, including public climate related investments, complement the ECB's ongoing monetary policy stimulus.

- Inflation dynamics are today subdued throughout the advanced economies. In Japan, however, this situation is not new, but started 25 years ago in the mid-1990s, following the country's dramatic economic boom-and-bust in the late 1980s and early 1990s. From 1995 onwards, Japan in addition reached its long-term demographic turning point, as its working age population began to decline inexorably. The combined effect of these two developments exposed Japan to intense deflationary economic pressures.
- The decade-long zero-interest-rate-policy and asset purchase policies and extraordinary fiscal stimulus pursued by the Bank of Japan and the Japanese government respectively since the mid-1990s have not managed to restore Japanese inflation levels to the targeted levels.
- The euro area has in recent years suffered the same twin effects of a concurrent systemic economic crisis and its demographic turnaround and a declining working age population since 2009. This will subject the euro area to dramatic deflationary pressures for the foreseeable future.

- Ageing and a demographic turnaround negatively affect all three component drivers of long-term economic growth: potential workforce, capital accumulation and productivity. Fewer potential workers reduce economic growth prospects. Lower growth depresses profitable investment opportunities, and ageing workers carrying more of the financial responsibility for their retirement themselves will save more. The retirement of increasingly well-educated generations leads to slower future educational attainment advances, lack of financial pressure on unproductive firms from low cost of capital, and an ageing related decline in entrepreneurship and business start-up rates are all effects likely in the long run to adversely affect productivity growth.
- Japan's example of ineffective macroeconomic policies in the face of downward demographic pressure on inflation dynamics makes it clear that the euro area is unlikely to escape persistently subdued prices, unless a more integrated fiscal and monetary policy response is implemented. This could see euro area (and EU) governments commit fiscal resources, supported by the ECB, to an investment-led strategy to reach Europe's ambitious climate change goals.

Subdued Inflation, Targets and Monetary Policy Cooperation - Andrew HUGHES HALLETT (Copenhagen Business School)

This paper examines the case that there has been a structural change in the determination of inflation in the EU (and elsewhere) that has led to a low real-wages, low inflation, slow productivity growth regime. In fact, there appears to have been no structural change. Instead, there has been a marked convergence between the performance of those variables in national economies. The implication is that there is little scope for greater monetary coordination in the conventional sense, or adjusting the monetary rules (e.g., targets), since this uniformity is the origin of the low inflation problem. Outcomes can be improved with better coordination of monetary policy with non-monetary variables. There are two lines of attack. One is a short term approach using conventional instruments (monetary-fiscal, structural or labour market reforms, improving policymakers' credibility). The other is a long term approach based on improved income distribution, a better distribution of the gains from productivity growth, and stabilisation by means of an external anchor (exchange rate).

- The question posed in this paper asks us to examine whether the unrelenting persistence in low euro area inflation, and the low real wages and very slow growth in productivity observed during the slow recovery since the great recession, now represents a permanent state of affairs (a "new normal"). If so, what can be done to generate better outcomes? Is a new monetary policy stance from the ECB warranted, based on greater coordination?
- To do this, authors test formally if the persistence in the inflation rate is transitory; or whether it constitutes a structural change that might be expected to continue indefinitely at current rates and ultimately settle at or above the ECB's 2% inflation threshold that could automatically trigger a change in policy.
- In such an exercise, it is important to be sure that any shift in inflation is a) significant statistically, b) likely to be sustained into the medium-term and prove durable thereafter, and c) be evenly distributed so that the low inflation economies are not unfairly penalised by the measures taken to help those who have caused the inflation.
- Evidence and simple statistical tests show that there was a brief acceleration in inflation in 2016 towards 2%, but this flattened out in early 2017 and the proximity to 2% was lost. Inflation since

then has been constant at 1.5%. Moreover, core inflation was constant at 0.9% throughout, which demonstrates that inflation itself was mostly generated externally, not structurally by the recovery.

- What accounts for the weak price dynamics? It appears that low growth in real wages has led to substantial increases in (mostly) low skilled employment. That then implies weak investment, slow productivity growth, and consequently, slow output growth and inflation.
- Authors find that this model fits the data rather closely, down to poor labour productivity and low total factor productivity. This model also implies that advanced economies have been substituting cheaper labour for the excess capital stocks of the past.
- As a result, some of the inefficiencies caused by excessive capital are being worked off, which will help the euro area economies in the long term if this process is allowed to continue. It is also true that the euro area is not alone in this situation; the same process has been unfolding in all the advanced economies (although the euro area is not among the better performers in this regard). This may be cold comfort, but it is some comfort.
- What really matters is coordination with instruments beyond monetary policy. Hence the real risk is that policymakers get stuck in their own bubble and fail to investigate coordination with alternative policies. These alternative policies may include structural and labour market reforms to restore market flexibility, and a more flexible/coordinated use of fiscal policy. The link between employment, wage growth, and competitiveness are also often mentioned as a real possibility but have seldom been implemented seriously. Rebuilding the credibility of the policymakers is another useful support mechanism. But what won't work is more globalisation or conventional monetary coordination (Carney 2017).
- More interesting perhaps are the non-traditional approaches outlined in Section 6. Changes in the distribution of income and productivity gains may have a big impact in size if history is anything to go by, but be very slow to take effect. One easy and practical solution is to set up a clear and easy to track exchange rate mechanism to encourage productivity improving investments. This appears not to have been considered but could make a difference.