

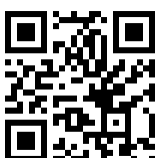
IN-DEPTH ANALYSIS

Requested by the ECON committee

Monetary Dialogue Papers, September 2021



What About Policy Normalisation?



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Monetary Dialogue Papers
September 2021

Abstract

As the ECB follows the time-honoured inflation targeting strategy, it runs the risk of, once more, failing to normalise its policy in time for the next unexpected shock. With interest rates at their lower bounds and facing historic uncertainty that undermines its policy effectiveness, a strong case can be made for developing a Plan B.

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CONTENTS

LIST OF FIGURES	4
LIST OF ABBREVIATIONS	5
EXECUTIVE SUMMARY	6
1. INTRODUCTION	7
2. FISCAL VS. FINANCIAL DOMINANCE	9
2.1. Fiscal dominance	9
2.2. Banks vs nonbank financial institutions	10
3. MONETARY POLICY NORMALISATION VS. MARKET TURMOIL	12
4. ECB RESPONSES	14
4.1. Clarity of objectives: Good and bad unwinding of monetary policy	14
4.2. Fear of taper tantrum	15
4.3. Macroprudential policies	16
4.4. The communication challenge	17
4.5. Hazy forecasts: COVID-19 is special and inflation targeting is questionable	18
5. CONCLUSION: TOWARD PLAN B	19
REFERENCES	21

LIST OF FIGURES

Figure 1:	Public debt in the euro area (% of GDP)	9
Figure 2:	Share price indices (monthly: January 2000-June 2021)	16

LIST OF ABBREVIATIONS

APP	Asset purchase programme
ECB	European Central Bank
ESRB	European Systemic Risk Board
FOMC	Federal Open Market Committee
OMT	Outright Monetary Transactions
QE	Harmonised index of consumer prices
PEPP	Pandemic emergency purchase programme
QE	Quantitative easing
TLTRO	Targeted longer-term refinancing operations

EXECUTIVE SUMMARY

- **Much as the pandemic is an exceptional historical event, the exit from the economic policies raises a number of unusual issues.** Policymakers must move out of their comfort zones to respond to the associated challenges.
- **The debates about fiscal and financial dominance illustrate concerns that central banks in the developed economies may be tempted to follow the easy way.** Over the last decade, both governments and financial markets have grown accustomed to interest rates at their lower bounds and to ample liquidity. Ending ultra-loose monetary policies will greatly affect highly indebted countries and could seriously hurt the financial markets. Fiscal and financial dominance lead to inaction in the name of prudence.
- **Yet, prudence is one thing, inaction is another one.** Central banks will have to normalise their policies if they want to avoid being caught again with rather ineffective instruments when the next shock arises.
- **The central banks face a new trade-off: policy normalisation vs. the continuation of the inflation targeting policy.** While the inflation targeting strategy has been highly successful in normal conditions, it cannot be the single guide under current conditions.
- **Winding down the current policy stance is unlikely to have a significant contractionary effect.** The standard and nonstandard instruments have proven to be weak, at best, to trigger solid growth and to bring inflation to the target rate. They are likely to be weak the other way round, when the stance is reversed.
- **Anyway, fiscal policy can make up for any contractionary effect of monetary policy winding up.** The ECB should encourage governments to act in this way. It can do so by clarifying its intentions and by being ready to restart its outright monetary transactions (OMT; "Whatever it takes") programme.
- **Historic uncertainty requires a historic response.** It is impossible to make valid forecasts based on historical patterns that do not include pandemics like the current one. A key challenge for the ECB and other policymakers is to respond to this acute difficulty.
- **This paper argues in favour of a Plan B.** This is a natural way to deal with the current level uncertainty. Plan B recognises the trade-off between Plan A – lower interest rates for longer and more quantitative easing – and the need to normalise monetary policy before the next shock. Plan B further admits that there is too much uncertainty to solely rely on inflation targeting. It also offers a reassurance that the ECB will not accept fiscal and financial dominance.

1. INTRODUCTION

From the early-1980s to 2008, central banks in the advanced economies and several emerging market countries have operated under a clear framework. Their mandate was to maintain price stability (however defined), they used the short-term interest rate as their key instrument, they were guided by inflation forecasts two to three years ahead and they transparently communicated their views and intentions. The results have been superb, leading many central bankers to claim that the two-decade long period of the "Great Moderation" – low and stable inflation along with sustained growth – was a result of the new monetary policy framework:

"My view is that improvements in monetary policy, though certainly not the only factor, have probably been an important source of the Great Moderation. In particular, I am not convinced that the decline in macroeconomic volatility of the past two decades was *primarily* the result of good luck". Bernanke (2004)

Then, following the global financial crisis, the framework evolved quickly. Interest rates were brought to their effective lower bounds, leading to the use of nonstandard instruments like large-scale asset purchases called quantitative easing (QE) and to forward guidance (promises of keep interest rates for long) backed by efforts to guide long-term interest rates. These efforts were successful, but they signalled that monetary policy is not just about aiming at stable prices. Financial stability has become an additional responsibility. The COVID-19 pandemic has led to the extensive use of these nonstandard instruments, in further efforts to maintain financial stability in the midst of a historic recession. In the euro area, the 2010-12 debt crisis had seen the European Central Bank (ECB) recognise that it is a lender in last resort to governments, a highly controversial view. The pandemic emergency purchase programme (PEPP) of 2020 has confirmed this shift.

These momentous adaptations of the monetary strategy show that central banks have been able to build on the inflation targeting strategy once "good luck" turned into "massive disasters". With insight, the former Governor of the Bank of England wrote in 2005:

"Is inflation targeting the last word in monetary policy? Almost certainly not. Twenty-five years from now, I am confident that one of my successors will be able to look back and explain [...] the great improvements that took place between 2005 and 2030. But I like to think that the inflation target framework has the ability to serve us well over that period". King (2005).

Yet, all is not perfect in the world of central banking. Two (at least) major issues remain unresolved. First, since 2009, central banks have essentially lost control of the inflation rate, which has been too low. Until then, price stability meant preventing too high inflation, and inflation targeting was the answer. Apparently, central banks have no answer to too low inflation, despite massive efforts with the standard and nonstandard instruments. Second, they also seem hesitant, possibly unable, to roll back these instruments. When the COVID-19 pandemic struck, ten years after the global financial crisis, interest rates still were at, or close to their effective lower bounds and the sizes their balance sheets were a multiple of what they used to be beforehand. Both issues are not new, they were already present in Japan since the mid-1980s.

Central banks now face these two challenges. As the economies re-start, the extra-loose monetary policy stances will have to come to an end and quite possibly to be reversed. Inflation targeting and financial stability will drive central bank decisions, but will it work? Decisions will have to be made in a difficult and highly uncertain environment.

This paper examines these new challenges. It starts with the question of whether central banks risk losing *de facto* independence as they face grave concerns in public finances and in financial markets. Fiscal dominance, a concept long considered as irrelevant, is now actively being discussed, for good reason. The paper starts by clarifying what dominance is before examining the very difficult choices that central banks will have to make in 2022 and 2023, focusing on the importance of normalisation. It then describes this unusual level of prevailing uncertainty. The concluding section brings these considerations together by outlining an example of what the ECB's strategy could be during the most difficult period ahead.

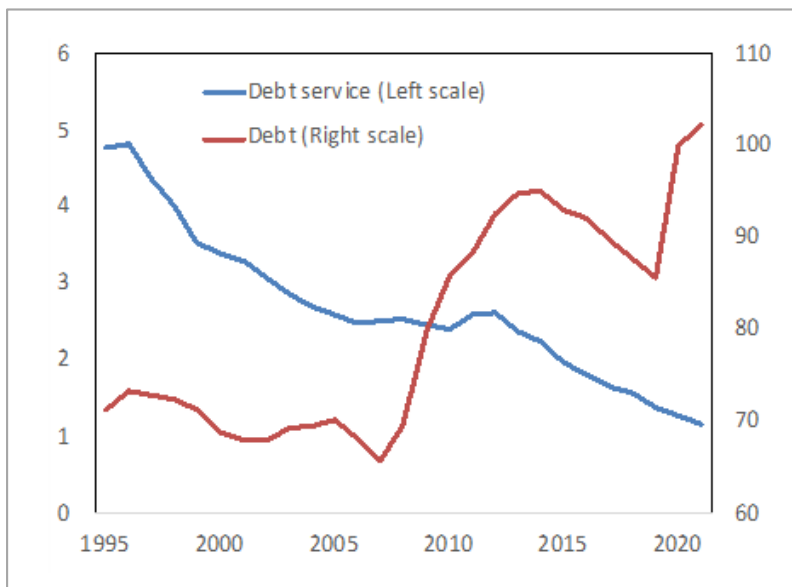
2. FISCAL VS. FINANCIAL DOMINANCE

As its name indicates, fiscal dominance concerns the case when monetary policy is subject to constraints imposed by fiscal policy. A very different concept is financial dominance whereby monetary policy is constrained by concerns about financial market stability. In both cases, the constraints reflect fears that a tightening of monetary policy may endanger the stability of financial obligations¹.

2.1. Fiscal dominance

Most governments are indebted, with the average public debt around a quasi-peace-time record of about 100% in the euro area. When the interest rate is low, debt service is comparatively limited. Indeed, Figure 1 shows that debt service as a share of GDP has more than halved since 2008 in the euro area while the debt ratio has increased by 150%. Should the ECB bring its interest rates up to 2008 levels, the debt service would be much larger. Highly indebted governments would of course face a serious impact. Short of being able to cut public spending or raise taxes, the result would be an increase in the deficit, which could well alarm the financial markets and trigger a new public debt crisis.

Figure 1: Public debt in the euro area (% of GDP)



Source: AMECO online, European Commission.

Over the coming couple of years, many governments are likely to strongly oppose any interest rate increase. Fiscal dominance would occur if the ECB, even if it is formally independent, would not raise its interest rates even though it would wish to do so for the sake of its monetary policy objectives. It might be concerned about hurting governments and it might also be loath to trigger a public debt crisis for which it would be blamed.

The discussion about a potential case of fiscal dominance reflects the fact that we do not know now what will happen when the time to raise interest rates comes. These discussions are not limited to the euro area, they concern many advanced countries as well. At stake is not just the lifting of policy interest rates from their current effective lower bounds but it also concerns QE and forward guidance that affect longer-term interest rates.

¹ The distinction between fiscal and financial dominance is presented in Brunnermeier (2020).

Central banks assert that they will not let their hands tremble when action becomes necessary. The experience since 2009, however, illustrates the fact that economic conditions are not always black-and-white. The recovery from the 2009 recession was generally lukewarm and inflation was below target, leading central banks to maintain a generally expansionary stance. As a result, when the COVID-19 crisis hit, the interest rates were already at their effective lower bounds. A decade of highly expansionary monetary policies, with all instruments standard and nonstandard in place, failed to generate adequate growth and desired inflation rates. This remains to be fully explained.

One interpretation is that fiscal policies had become restrictive, undermining the expansionary impulses from monetary policies. This was certainly the case in the euro area after 2012, as suggested by Figure 1, which shows a steady decline in public debt. Under this interpretation, the ECB felt that normalising its policy was uncalled for. In this case of fiscal dominance, the central bank maintains its expansionary policy stance for far longer than it anticipated because it needs to counteract the impact of contractionary fiscal policies.

Very low interest rates, which central banks commit to keep in place for a long period of time, mechanically boost asset prices. This has led to misleading assertions that the financial markets are disconnected from the real economy. It is true that investors reap large capital gains when stock and bond prices rise while the economic situation is sufficiently weak to justify an expansionary monetary policy, which may seem both inconsistent and unfair, but it is not illogical. Indeed, high asset prices is one channel through which an expansionary monetary policy is expected to generate more activity and to raise inflation. Historically, this has been the norm.

When and if the central bank starts preparations to reverse its policy stance, the mere indication that a change is forthcoming is likely to lead to declines in asset prices, which is contractionary. If the central bank signals its intentions too early, it risks derailing the recovery. This is what happened in 2013 when the Federal Reserve indicated that it will eventually taper its QE asset purchases. The result was the famous "taper tantrum", which led the Fed to backpedal. Yet, the initial taper statement, vague in the intended timing, was in fact an effort to calm what the Fed saw as market exuberance. The intention also was to avoid a surprise change that could lead to a damaging precipitous market crash.

Financial dominance occurs when central banks delay the removal of expansionary policies for longer than desired in order to avoid market turmoil. For obvious reasons, the financial investors stand to suffer capital losses when the stance changes. They know that this change is unavoidable, they prepare for it but hope that "the party" will last a bit longer. Central bankers may be reluctant to assume responsibility for a sharp fall in asset prices. The resulting delays are undesirable from a general point of view.

2.2. Banks vs nonbank financial institutions

Fully assessing the financial dominance issue requires going into further details. As noted above, the eventual fall of share and bond prices is inescapable if the monetary policy stance must cease to be expansionary. It simply is the mirror image of the price increases generated by the expansionary policy phase during a period of weak or negative growth accompanied by below-target inflation. Why, then, should a central bank be subject to financial dominance?

A distinction must be made between banks and non-bank financial institutions or, roughly, the financial markets. Both can be hurt by a monetary tightening, but the implications for the economy are very different. Turmoil in financial markets affect investors and may lead some non-financial institutions to fail. Investors, however, are or should be aware that they are taking risks. In good times, they reap rewards but they can face large, possibly devastating losses.

Bank failures are different because they affect depositors who are usually unaware that deposits may be at risk. Bank deposits are guaranteed by mandatory insurance up to a ceiling. Most deposits are below the ceiling but, even then, depositors may temporarily lose access to their monies that they use for everyday activities. Bank failures stand therefore to deeply disrupt the economy, often with dramatic consequences for large numbers of people. They also stand to break trust in the banking system, which underpins the day-to-day functioning of an economy.

Banking crises, therefore, are much more dangerous than financial market crises. The attendant risk of financial dominance is magnified by the fact that banks are also often quite influential. To reduce this risk, several possibilities exist and have been developed overtime:

- Mandatory deposit insurance limits the costs of a bank crisis.
- Regulations limit the amount of risk that banks can take as they strive to enhance returns.
- The resilience of banks can be increased by requiring that they build up a shock-absorption capacity through a large capital base.
- Bank supervision allows the authorities to acquire real-time information about individual banks. Coupled with the possibility of applying tighter rules and prudential requirements.
- When banks fail, the relevant authorities intervene to protect depositors. This resolution process can be tailored to impose large losses on shareholders and bondholders as well as large depositors, with a view to enhance their role in calling for limited risk-taking.
- Macroprudential policies tighten up regulations and requirements in periods when risks are rising.

3. MONETARY POLICY NORMALISATION VS. MARKET TURMOIL

As noted above, since 2009 most central banks have not normalised their policies. Interest rates have remained close to their effective lower bounds and their balance sheets have not been significantly reduced following QE. There are many good reasons for the lack of effective normalisation over a decade, including restrictive fiscal policies.

The central bank challenge is now to normalise when the COVID-19 pandemic is finally brought under control. Should the speed of normalisation depend first and foremost on the evolution of inflation? The patient wait-and-see approach adopted by most central banks in the mid 2010s was justified by the fact that inflation remained subdued during the decade that preceded the pandemic. The need to build some policy space for the next economic slowdown was well understood, but action was delayed by the inflation targeting rule that we must first observe inflation increases toward the targets.

What is not clear is the role played by fiscal and financial dominance, a case of observational equivalence. Observational equivalence is arising when distinct causes simultaneously lead to the same outcome. Fears that an early normalisation could trigger pressure on public debt and financial market instability cannot be distinguished from fears of slowing the economy down by forcing governments to tighten their budgets and by reducing access to funding by firms and households.

The really difficult question is how can central banks deal with conflicting objectives. Formally, the easiest response is to formally state that the main objective is price stability, with secondary objectives being sustained growth and financial stability, all of which call for keeping the current stance. This was the strategy adopted after 2012.

However, the current situation is very different. Financial crises, especially those that involve banks as in 2009, have long-lasting effects. In addition, the financial markets are currently in a strong position and banks have been shielded from the health crisis. The world is awash with liquidity so that it is unclear what a continuation of QE is adding beyond its signalling effect. The very low interest rates are not encouraging spending by firms and households, whose savings have strongly increased thus reducing the need to borrow. Instead, spending is constrained by the sanitary situation. Developed countries have now achieved respectable levels of vaccination and governments are trying hard to reach a situation where COVID-19 will become as irrelevant as flu. Of course, the likelihood that more dangerous variants appear is a serious concern, in fact the source of deep uncertainty. Relative to this level of uncertainty, the interest rate could be higher without becoming the limiting factor.

In addition, fiscal policies are now expansionary in most developed countries, actually very strong in the United States. These policies are well adapted to the current situation. Partly, they compensate for losses suffered because of the distancing measures taken in response to the pandemic and partly, they represent direct spending by government and hence do not rely on whether firms and households still fear threatened by the virus. Of course, governments will be eager to cut their large deficits when the pandemic stops being a vital danger and private spending is returning to its normal pattern, enhanced by accumulate savings. However, if they know that they cannot rely on central banks to support the recovery as was the case a decade ago, their incentives to bring deficits down as soon as possible will be lessened.

Thus, a case can be made that monetary policy normalisation will not seriously dent the recovery. The benefits from normalisation accrue in the long term as the ability to effectively use the instruments is recovered. In the short term, they are nearly useless. Building up space for later use should therefore be an important objective in the years to come. During the period 2009-2019, central banks were satisfied with continuing with expansionary policies. This professed patience was justified by the belief

that waiting for better times called for delaying normalisation. As we know, this belief proved invalid when a massive shock occurred. Of course, it was hard to imagine that a lethal pandemic would unexpectedly surge. This admittedly rare event has taught us that shocks occur and must be factored in policy strategies. A leaf could be taken from the military: it is essential to be prepared as if a conflict could happen tomorrow. Again and again countries have been poorly prepared for the next conflict because of the same mistaken belief that it is most unlikely.

Of course, early normalisation is not be devoid of risks. As noted above, the chief concern is that normalisation stands to hit the financial markets and banks. However, the financial markets have fared well over the last 10 years: the Standard and Poor index has quadrupled and the Dax has doubled, for instance. Straight investors could suffer significant losses without being badly hurt, even if they reaped much higher returns so far. Highly leveraged investors, of course, could suffer much more and many could be bankrupted, but this is the rule of the game. It is not a central bank purpose to protect investors and financial institutions. Placating financial markets should not stand in the way of monetary policy normalisation.

As previously explained, it is not either a central bank responsibility to protect banks, but consumer protection is a state responsibility. The role of central banks is to contribute to this task. Depending on national arrangement, central banks may tighten banking supervision and macroprudential rules at this particular juncture when risks are rising and the possibility of financial dominance is surfacing. It can also help stabilise the situation in the event of bank failures by acting as lender of last resort in conjunction with the resolution authorities. Banking turmoil can be limited by early precautionary measures and adequate resolution procedures. In short, these concerns are valid but should not be an argument for delaying normalisation.

4. ECB RESPONSES

The current position of the ECB is that the recovery is far from complete and that monetary policy still has a role to play in supporting it. This sounds right, but it falls short in view of the many complications that are unique to the pandemic. Furthermore, it does not seem to factor in the situation inherited from the previous financial and debt crises when the pandemic hit. While the ECB clearly does not want to muddle its message, it needs to prepare actively for the next phase, which stands to be highly challenging. Streamlining communication is one thing, planning for this challenge is another thing.

4.1. Clarity of objectives: Good and bad unwinding of monetary policy

Inflation is now close to the 2% target but current forecasts do not anticipate a lasting overshoot. Growth is brisk but the GDP level remains below what it was in 2019. Changing the monetary stance is therefore not called for, but what is the medium-term strategy? Barring another surprise, it is important that the ECB envisages to move the interest rate up and to stop and then reverse QE. Its planning is evidently complicated by the high level of uncertainty, explained in Section 4.5.

The financial markets are well aware of these considerations. In fact, this is one reason why they are highly sensitive to signals from the central banks. The ECB should address their concerns without making commitments that they may come to regret. Over recent weeks, the Fed has started to address these concerns publicly, sometimes through conflicting statements from members of the policy-making committee – the Federal Open Market Committee (FOMC). These statements do not reassure the markets, but they provide useful insights into the FOMC's internal debates. As the recovery in the euro area lags behind that in the US, it may be too early now to start that conversation, but the time will come, and the ECB's Governing Council is not known for conveying its internal debates effectively. Some early thought is required.

The challenge is to adequately unwind the expansionary stance of monetary policy. This in turn calls for a strategy that deals with the issues raised in Section 3. The ECB claims that its instruments are effective, but the evidence is limited. Most of the favourable results come from studies carried out in central banks, but academic research is more cautious, as observed by Kempf and Pastor (2020). Importantly, the favourable evidence concerns financial stability, not the other key macroeconomic objectives of monetary policy, growth and inflation. One way of taking stock of the empirical evidence is that the ECB's expansionary effects on the macroeconomy are too modest to be found in the data, while they are helpful in terms of financial stability.

Concluding her summary of the Governing Council meeting on 22 July 2021, President Lagarde stated: "Our policy measures, including our revised forward guidance, will help the economy shift to a solid recovery and, ultimately, bring inflation to our two per cent target". Such unconditional assertions are constantly repeated by the ECB but they stand in contrast with the evidence. Yet they drive the current strategy, which President Lagarde described as follows: "The key ECB interest rates [are] to remain at their present or lower levels until we see inflation reaching two per cent well ahead of the end of our projection horizon and durably for the rest of the projection horizon, and we judge that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term. This may also imply a transitory period in which inflation is moderately above target".

This strategy would be totally noncontroversial in normal times. But, following a decade of interest rates stuck at their lower bounds alongside considerable cash injections, the strategy effectively ignores the issue of normalisation. Blind faith in the effectiveness of monetary policy instruments already led to the lack of normalisation before the pandemic while waiting for the same growth and

inflation outcomes as we hope today to see coming. This left the ECB without little or no power to help with the pandemic-induced recession. As stated, the strategy stands to deliver the same outcome when the next adverse shock will occur, following the current recovery.

The reason for the current ECB strategy is easy to understand. In its strategy review, the ECB merely chose to better specify its inflation objective. This clarification was helpful if not surprising. But it did not address the deeper shortcomings of a strategy, formulated in 1998 when it prepared to operate in a radically different environment. The strategy remains driven by the principle of inflation targeting. There is nothing wrong with inflation targeting in normal time; quite to the contrary, it has been very successful². However, over the last decade, it has failed once the interest rate was brought to its lower bound, where it still lingers.

In the current circumstances, the ECB must trade off a realistic evaluation of the effectiveness of its instruments against the need to normalise in good times. This difficult challenge is likely to determine whether the unwinding of the current stance will have been correctly managed.

An alternative would accept that an early lifting of interest rates is unlikely to seriously dent the recovery. In the immediate future, the recovery is driven by private dissaving and strongly supportive and effective fiscal policies based on public spending. Over time, private dissaving will vanish. The governments should withdraw their support slowly enough to keep the broadening recovery on track, rather than relying on an ineffective monetary policy. By announcing early on its intention to normalise, the ECB will provide crucial information to governments.

4.2. Fear of taper tantrum

Central banks well remember the 2013 taper tantrum in the US and are mindful not to generate again a negative financial market reaction. This should not be an argument against normalisation. Instead, it calls for a careful signalling of medium and longer-term intentions. The ECB does not do so probably for two reasons.

First, it strongly resists accepting publicly that its policy is currently weak, for fear of further weakening it. Yet, it is unclear why that would be the case. It is concerned that such an admission would undermine its forward guidance, but the credibility of unconvincing statements is limited, at best. Forward guidance in the years preceding the COVID-19 crisis was clearly not enough to trigger higher growth nor to bring the inflation rate up to target.

Second, the policy stance helps stabilise the financial markets, an effect that is well documented. The financial markets may well expect that the nonstandard policies will come to an end sometime in the future. The question is: when? Central bank statements that the time is so far off that it cannot be specified until later increases the risk of a taper tantrum. Markets easily price in long-term events while they strongly react to immediate changes. In contrast, for a while now, the Fed has started to mention possible dates and, recently, has indicated that the date could be brought forward. As previously note, each time such statements have been made – usually not officially by the Chairman but by other members of the FOMC – the markets have reacted, but these reactions have been moderate and usually short-lived, posing no serious threat to the macroeconomy.

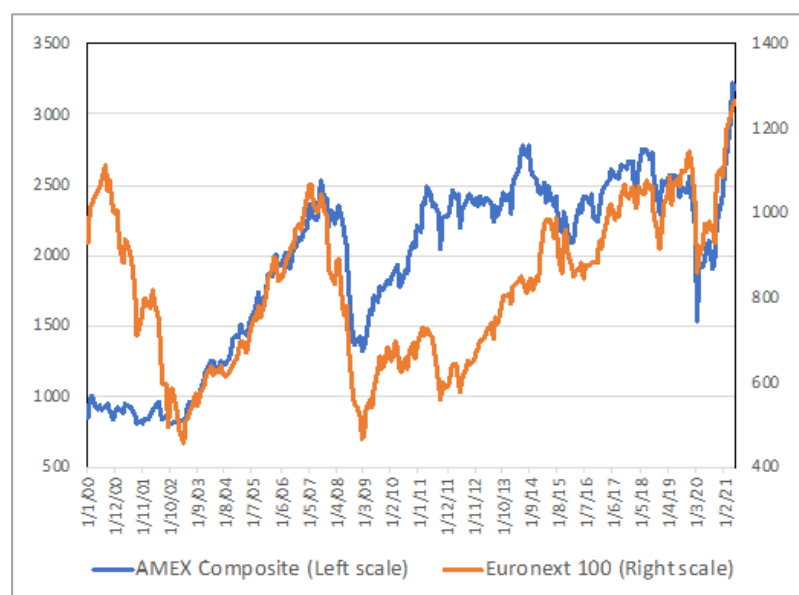
Of course, no one knows when the time will be ripe, and the ECB cannot be asked to make announcements about future decisions based on highly uncertain developments. Still, the ECB could share its reasoning and assumptions, making it clear that precise implications cannot be drawn at this

² For a discussion of the strategy review, see Wyplosz (2021).

stage. It could, for example, admit that the macroeconomic effects of monetary policy are weak and that normalisation is an important objective, letting the markets grapple with the range of possible implications. Adverse reactions are possible but, as long as the nonstandard policies are in place, financial stability is not really under threat. Short run panics cannot be ruled out but the effects on the macroeconomy stand to be limited. When normalisation starts, the market reactions may be stronger. Accepting financial dominance is not the solution, now and later.

Financial market losses are expected anyway. Figure 2 presents the evolution of two share price indices (AMEX Composite and Euronext 100) for the US and Europe. Two features are relevant here. First, wide long-lasting fluctuations are common and large declines often follow large increases. Second, the 2020-21 increase is unusually strong and both indices have now reached historical highs; the rise has been unusually strong, even taking into account the collapse of March 2020, which reflected the realisation that a historical pandemic was under way. A significant decline in the future would merely return share prices to less unusual levels. It is only to be expected that monetary policy normalisation will lead to a normalisation of asset valuations. Anyway, share prices stand to be "corrected", one way or another. The ECB would definitely escape financial dominance by accepting to help with this correction.

Figure 2: Share price indices (monthly: January 2000-June 2021)



Source: Yahoo Finance.

4.3. Macroprudential policies

While financial market stability should not be a valid reason for delaying normalisation, it is crucial to avoid a new banking crisis. Fortunately, regulations adopted after 2008 have reduced banks' risk-taking and enhanced their ability to absorb adverse shocks, especially shocks that originate in financial markets. Supervision is now carried for the whole euro area by the ECB, which is less susceptible than national authorities to succumb to misguided temptations to protect their own banks. Indeed, the ECB is regularly conducting reasonably tight stress tests and to warn weak banks. These tests should now routinely explore the potential impact of monetary policy normalisation.

Another innovation is the possibility to carry out macroprudential policies. This is indeed an additional instrument that can be used when risk increases temporarily call for more careful actions by banks and financial institutions, without involving monetary policy proper. Importantly, it is meant to be pre-emptive, designed to avoid inaction bias, as argued by Draghi (2019). This bias can be seen as a manifestation of financial dominance whereby the authorities hesitate for too long to impose tighter regulations as risks grow. The experience so far has been encouraging. The policy has been used in reaction to high and rising prices of housing and commercial real estate and it has been successful in slowing down, even in reversing price increases.

However, the institutional setup in the euro area remains unsatisfactory. The European Systemic Risk Board (ESRB) – which operates under the ECB in its capacity as single supervisor – can issue warnings and make recommendations regarding banks, and it has done so when needed. However, the implementation of macroprudential regulations remains in the hand of national governments, which may or may not respond to the ESRB's request. This is where the inaction bias may resurface because financial dominance remains prevalent at the national level. Much like bank resolution, the ESRB should be given more power over national authorities, as suggested by De Guindos (2021).

4.4. The communication challenge

Central banks tend to consider forward guidance as an additional instrument, part of the nonstandard policy toolkit. This can be misleading and even counterproductive. Forward guidance consists for a central bank to indicate what it intends to do in the future. In principle, this is a good idea but, as always, the details matter.

To start with, the intentions must be truthful. For example, the promise to keep the interest rates at the current level over a long horizon must be eventually validated by subsequent action. If not, the credibility of forward guidance will be undermined.

Forward guidance statements may well convey what the central bank currently thinks, but subsequent events may require a reassessment. As well explained by the intertemporal inconsistency literature, in this case the central bank will have to choose between two unpalatable options. It may decide to act differently from what it announced, which could be good macroeconomic policy but it would amount to reneging on previous commitments, or it can stick to its announcements and carry out a poor monetary policy. In other words, when uncertainty about future developments is high, forward guidance is inherently hazardous.

Finally, what is the proper horizon for forward guidance? Clearly, it must cover the period until the policy stance will be changed. Uncertainty, however, often means that the horizon is unknown. Two main solutions have been tried. One solution is to specify a date, not necessarily very precise. Another solution is to list conditions that will trigger the policy change. Both are problematic because conditions may change unexpectedly, making either solution inapplicable. This is why the horizon often remains undefined, as when interest rates are announced to remain "low for long". Such vagueness does not just limit the usefulness of forward guidance, it also keeps the financial markets on edge and potentially opens the door to financial dominance.

The ECB currently announces that it will pursue its stance until inflation reaches its target, while keeping an eye on financial stability. In line with its revised strategy, it accepts that it could move late and tolerate a temporary and limited overshoot of the target. Its insistence on claiming that monetary policy remains effective justifies this classic messaging. Yet, the post-pandemic situation is unique – we have no modern experience with pandemics. This situation probably requires a more open communication strategy, which explicitly recognizes the high level of prevailing uncertainty, the

limited macroeconomic effectiveness of monetary instruments and the need to normalise. This is all uncharted territory. The ECB will need to move out of its comfort zone.

4.5. Hazy forecasts: COVID-19 is special and inflation targeting is questionable

Like most other central banks, the ECB is relying on its models to produce forecasts and to evaluate possible policy actions. These models are built to reproduce key aspects of the economy as observed on past data. However, past data do not include a pandemic. Lockdowns have shut down parts of the economy, public support has sustained incomes of inactive people and of closed businesses. Fear of contagion has radically affected people's behaviour. When the pandemic ceases to be a major threat, these policies will be withdrawn, but it is not yet clear how and when. Past experience tells us close to nothing about how people will return to normalcy. In fact, commentators love to predict that the new normal will be vastly different from the old normal, without any evidence to justify – or contradict – these assertions, and even less to quantify the putative effects. In addition, mutations of the coronavirus predictably occur, with occasional deeply disturbing impacts that instantly make previous forecasts outdated.

It is fair to say that we never have faced such momentous uncertainty since World War II. It is distressing that forecasters keep making forecasts as usual and that policymakers, including central banks, keep working on the basis of these forecasts. The usual justification is that we have nothing better to rely upon. That is undoubtedly true but not the correct answer. Proper forecasts always require explicit mention of the margins of confidence, even if this is too rarely done. In the present situation, it is impossible to evaluate the margins of confidence. This massive amount of Knightian uncertainty is pervasive and must be accepted.

The case of inflation is especially important to central banks. There is an intense debate about whether the current sharp increases in inflation rates throughout the developed countries are a temporary phenomenon, driven by the specificities of the exit from the acute economic phase of the pandemic, or the beginning of a new era of higher inflation rates. The dominant monetary policy strategy, inflation targeting, is highly vulnerable to surprises. Over the last decade, central banks have been surprised repeatedly by the sluggishness of price increases; this is one reason why they have found it nearly impossible to normalise. At the current juncture, surprises are likely to be much larger and could be in either direction, up or down. Inflation targeting has become highly impractical.

The implication is that the ECB should indicate that its provisions are fragile and it should explicitly consider alternatives to its current stance, which remains driven by inflation targeting. The ECB is likely to consider that an alternative approach could destabilise the financial markets, which indeed have grown accustomed to inflation targeting. That is a distinct possibility but the ECB's claim that it is set on a definitive course of action is not credible and may be ultimately dangerous. Financial stability cannot be pursued on the basis of forecasts that are deeply uncertain. It is tempting to try and reassure markets by projecting an image of steadiness, but it really amounts to shielding the markets from the underlying uncertainty, which is not the mission of the ECB.

5. CONCLUSION: TOWARD PLAN B

The main argument of this paper is that the ECB needs to acknowledge that its instruments currently have little or no impact on inflation and growth and that it needs to normalise its policies before a new shock occurs unexpectedly. The risk is that it unduly delays normalisation, as has been the case in the mid-2010s. At the same time, all central banks face unusual uncertainty, which calls for an open mind and readiness to envisage a variety of options. Communicating this approach, in turn, is challenging.

The present paper has discussed a wide range of issues raised by these considerations. Rather than restating these points, it may be helpful to illustrate the practical aspects of the analysis by briefly outlining a Plan B.

The alternative strategy starts with the recognition that the current monetary stance has no material impact on the macroeconomy when the interest rate is at the effective lower bound and that the financial markets are awash with liquidity, a situation that has already lasted several years. It concludes that a key objective for the coming couple of years is to escape this liquidity trap. These considerations are far from certain, however. Three risks are prevalent.

First, shifting the monetary policy stance may have some adverse effect on growth, after all. The last year has shown that fiscal policy can be powerful when well targeted. A continuation of supporting fiscal policies, adapted to the evolving situation in order to allow the recovery to widen, should easily make up for whatever negative impact the normalisation of monetary policy imparts.

Second, interest rate increases and liquidity withdrawal may raise suspicions that some countries' public debts are unsustainable, precisely at a time when fiscal policy must remain expansionary. Debt sustainability, however, is not determined by a few years of deficits; it depends on (very) long-run fiscal discipline (Debrun et al., 2029; Wyplosz, 2020). Over the shorter-run, the central bank can widen the fiscal policy space, as explained by Bartsch et al. (2021). The best instrument is not QE as with the PEPP but the OMT programme, better known as "Whatever it Takes". Indeed, the unique power of a central bank is to make limitless intervention commitments, which usually requires no further action. A new OMT commitment, will not only protect public debts, it will also provide incentives for governments to continue supporting the recovery.

Finally, ending and then reversing QE may endanger hard-won financial stability. Stock prices are currently beefed up by QE and may well fall when it ends. This is not a matter of public policy unless it endangers the banking system. In the absence of a fully-fledged banking union, national authorities must stand ready to resolve failing banks to protect depositors. The ECB should prepare to intervene as lender in last resort by working out agreements with governments in case it suffers losses. Any negative impact on the macroeconomy is to be offset by fiscal policy.

What about inflation? Whether the current surge of inflation is temporary or long-lasting is the object of intense debates. These debates are bound to remain inconclusive for quite some time because of the uniqueness of the situation. Instead of supporting the optimistic view that the surge is temporary, the ECB should remain agnostic. Instead, it should indicate its readiness to deal with whatever outcome materialises. Plan B is well adapted to both views. The speed of normalisation can be varied depending on the evolution of inflation. What is not adapted is the "low for long" mantra.

Plan B is also dealing effectively with fiscal and financial dominance. The OMT programme is not subject to fiscal dominance. It provides relief to highly indebted governments during a most uncertain period, but it is strictly temporary. It should be eventually lifted when the recovery has firmed up. Focusing on banking stability while expressing benign neglect regarding asset prices indicates that the ECB is not subject to financial dominance again.

Finally, communication must shift from endlessly repeating the same outdated strategy to openly tackling uncertainty. This is the purpose of spelling out a Plan B. The financial markets, which always try to have the central bank absorb risks, may not like it but they exist in part to deal with risk. Their losses are a private issue, up until they have macroeconomic repercussions as examined earlier.

These proposals may not amount to an ideal Plan B. They merely aim at showing that there exist alternatives to the ECB's only plan.

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As the ECB follows the time-honoured inflation targeting strategy, it runs the risk of, once more, failing to normalise its policy in time for the next unexpected shock. With interest rates at their lower bounds and facing historic uncertainty that undermines its policy effectiveness, a strong case can be made for developing a Plan B.

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