Macroeconomic policies in the short term and the medium term

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ABSTRACT

This is the panel contribution by Philip R. Lane, Member of the Executive Board of the ECB, at the Lámfalussy Lectures E-Conference 2021 organised by the Magyar Nemzeti Bank on 25 January 2021[1].

The current configuration of macroeconomic policies around the world is striking. The large-scale-but-temporary nature of a pandemic calls for an outsized fiscal response that takes account of the shortfall of income for many workers and firms; the asymmetric effects across industries (depending on their reliance on physical proximity to customers); and the compelling case for smoothing the financing of the cost of extensive fiscal support over a very extended period. The optimal contribution of monetary policy in a pandemic is also analytically straightforward: the ample provision of liquidity to protect credit supply and the stabilisation of markets, in combination with an accommodative monetary stance to counter the negative pandemic shock to the projected inflation path which is generated by the large drop in activity levels compared to the pre-pandemic path of activity.

We consider that the best way for us to achieve our monetary policy aims is to preserve favourable financing conditions throughout the pandemic period[2].

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[1] Source: ECB
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[2] For a more complete elaboration, see Lane, P.R. (2020), “Monetary policy in a pandemic: ensuring favourable financing conditions”, speech at the Economics Department and IM-TCD, Trinity College Dublin, 26 November.

Our commitment to preserve favourable financing conditions stabilises markets, supports financial intermediation and reassures potential borrowers, since the extended presence of the central bank limits the scope for the type of real-financial doom loop that might otherwise be triggered by an adverse shock in the current environment. It also anchors the monetary policy stance: the amount of slack in the economy and the low levels of inflation expected in the latest macroeconomic projections make it essential to avoid any loss of confidence and crowding-out of economic activity that would be generated by unfavourable developments in financing conditions.

In overall terms, the ECB supports favourable financing conditions through: (i) the already-low level of the policy rate (the deposit facility rate); (ii) the forward guidance on the future path of the policy rate; (iii) our array of liquidity-providing refinancing operations (most prominently, the targeted longer-term refinancing operations (TLTRO) programme); (iv) asset purchases, with the steady contribution of our asset purchase programme (APP) (which is buttressed by the forward guidance that net purchases under the APP will only end shortly before we lift the policy rate); and (v) our pandemic emergency purchase programme (PEPP).

In terms of policy implementation, the Governing Council of the ECB routinely looks at a wide range of measures to gauge the state of financing conditions for all sectors of the economy, with a prominent focus on the conditions facing customers who depend on bank-intermediated credit, as well as the conditions facing sectors which seek to obtain funding in bond markets. In a similar vein, a wide array of models and empirical methods is employed to assess the role played by financing conditions in determining the evolution of the economy and inflation dynamics.

Naturally, the focus on credit conditions in the banking system on the one side and the bond markets on the other is consistent with the main methods used by central banks in steering financing conditions, namely through the various types of operations with banking system counterparties and through outright securities purchases which primarily focus on bond markets. Other financial indicators also feed into the staff macroeconomic and inflation projections and are incorporated into the Governing Council's regular assessments of the appropriate monetary stance.

The PEPP plays an especially important role, given that it is expressly designed to respond to the pandemic shock. Thanks to its scale and flexibility, it both underpins the crucial market stabilisation role of monetary policy (which was urgent in the initial months of the pandemic in the spring and summer of 2020) and is a substantial contributor to the ample monetary accommodation required to counter the negative impact of the pandemic on inflation dynamics. The PEPP is a particularly effective and efficient programme for ensuring that the critical middle and long-end segments of the yield curve component of overall financing conditions remain appropriate: the most recent macroeconomic projections suggest that

any premature steepening of the yield curve would not be conducive to countering the negative pandemic shock to the projected inflation path. More generally, our commitment to employ the PEPP to preserve favourable financing conditions throughout the pandemic period represents a significant easing of the monetary policy stance (and thereby boosts inflation expectations) through the forward guidance it provides. Finally, the revisions to the TLTRO III programme have also played a central role in easing bank funding conditions in a manner that protects the supply of credit to firms and households.

There is considerable uncertainty about pandemic dynamics: the recent intensification of the pandemic in many countries (and the associated containment measures) represents a significant downside risk and also requires the prolongation of various fiscal support measures. At the same time, the launch of vaccination campaigns is a milestone in the eventual resolution of the pandemic health crisis, even if there is only cloudy visibility of the calendar towards sufficient immunity to enable the restoration of normal economic activity. Under these conditions of high uncertainty, standard Poole analysis suggests that the preservation of favourable financing conditions calls for a two-sided and flexible approach to the total scale of asset purchases under the PEPP: if favourable financing conditions can be maintained with asset purchase flows that do not exhaust the envelope over the net purchase horizon of the PEPP, the envelope need not be used in full. Equally, the envelope can be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation[3].

Looking beyond the pandemic period, the future orientation of macroeconomic policies will need to meet several challenges. In thinking about the new steady state, the implications of low equilibrium real interest rates for fiscal policy and monetary policy is a first-order issue. In relation to fiscal policy, this applies both to reviewing the conditions for fiscal sustainability and the appropriate role of fiscal policy in macroeconomic stabilisation[4].

In relation to monetary policy, the decline in the equilibrium real interest rate is a central topic in our ongoing strategy review.

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[3] See Poole, W. (1970), "Optimal choice of monetary policy instruments in a simple stochastic macro model", The Quarterly Journal of Economics, Vol. 84, No 2, pp. 197-216.

[4] Relevant recent contributions include Blanchard, O. (2019), "Public Debt and Low Interest Rates," American Economic Review, Vol. 109, No 4, pp. 1197-1229; Furman, J. and Summers, L.H. (2020), "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates," mimeo, Harvard University; and Orzag, P., Rubin, R. and Stiglitz, J. (2021), "Fiscal Resiliency in a Deeply Uncertain World: The Role of Semi-Autonomous Discretion," Policy Briefs, No 21-02, Peterson Institute for International Economics.