

Monetary Policy in the times of corona: many unknown unknowns

Maria Demertzis, Marta Domínguez-Jiménez

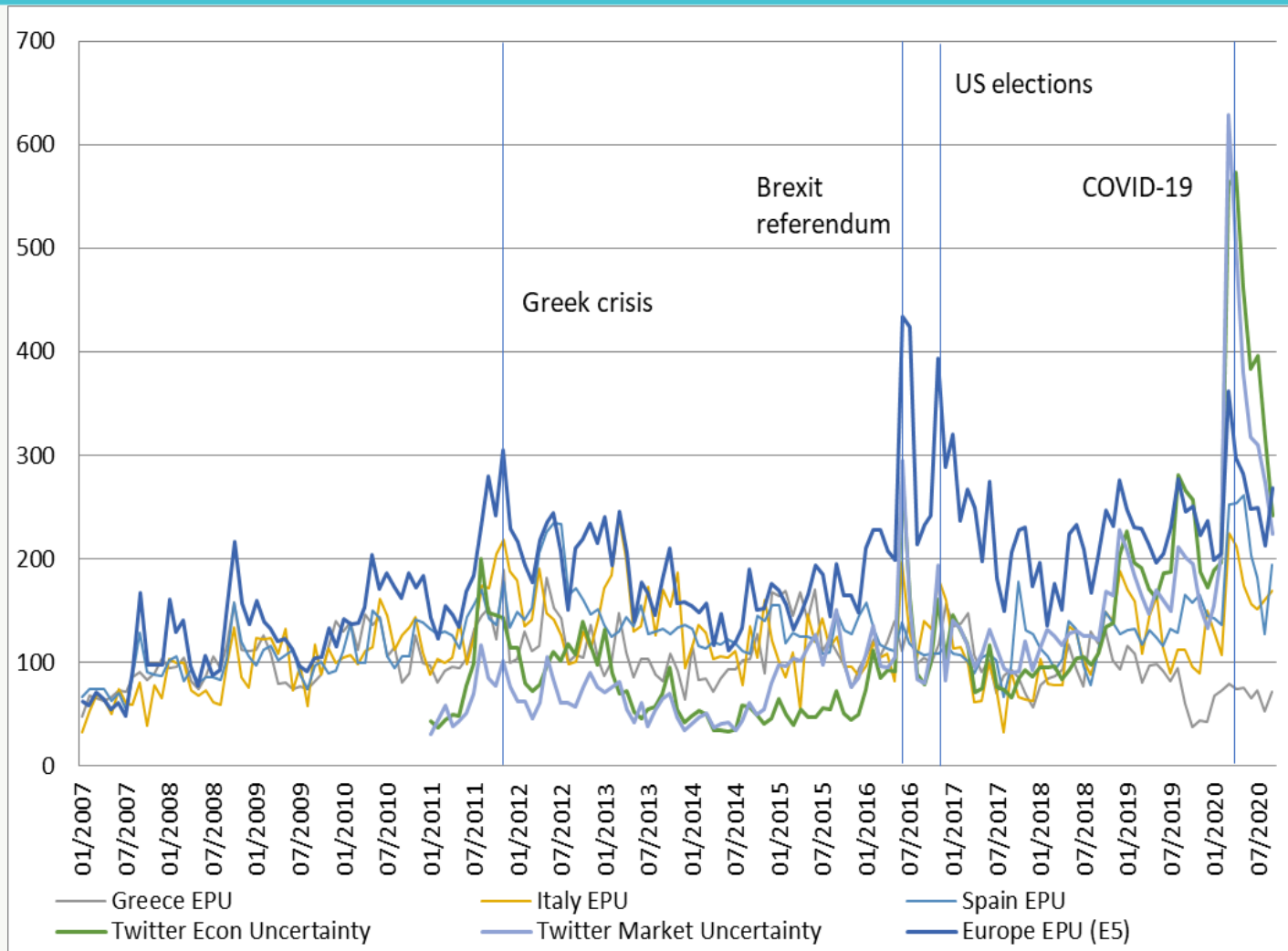
26th October 2020

The questions we are asked

- Relevant measures of economic uncertainty
- What are the short and long run effects of this uncertainty on economic outcomes?
- How do you design policy under such circumstances?

Measuring Uncertainty?

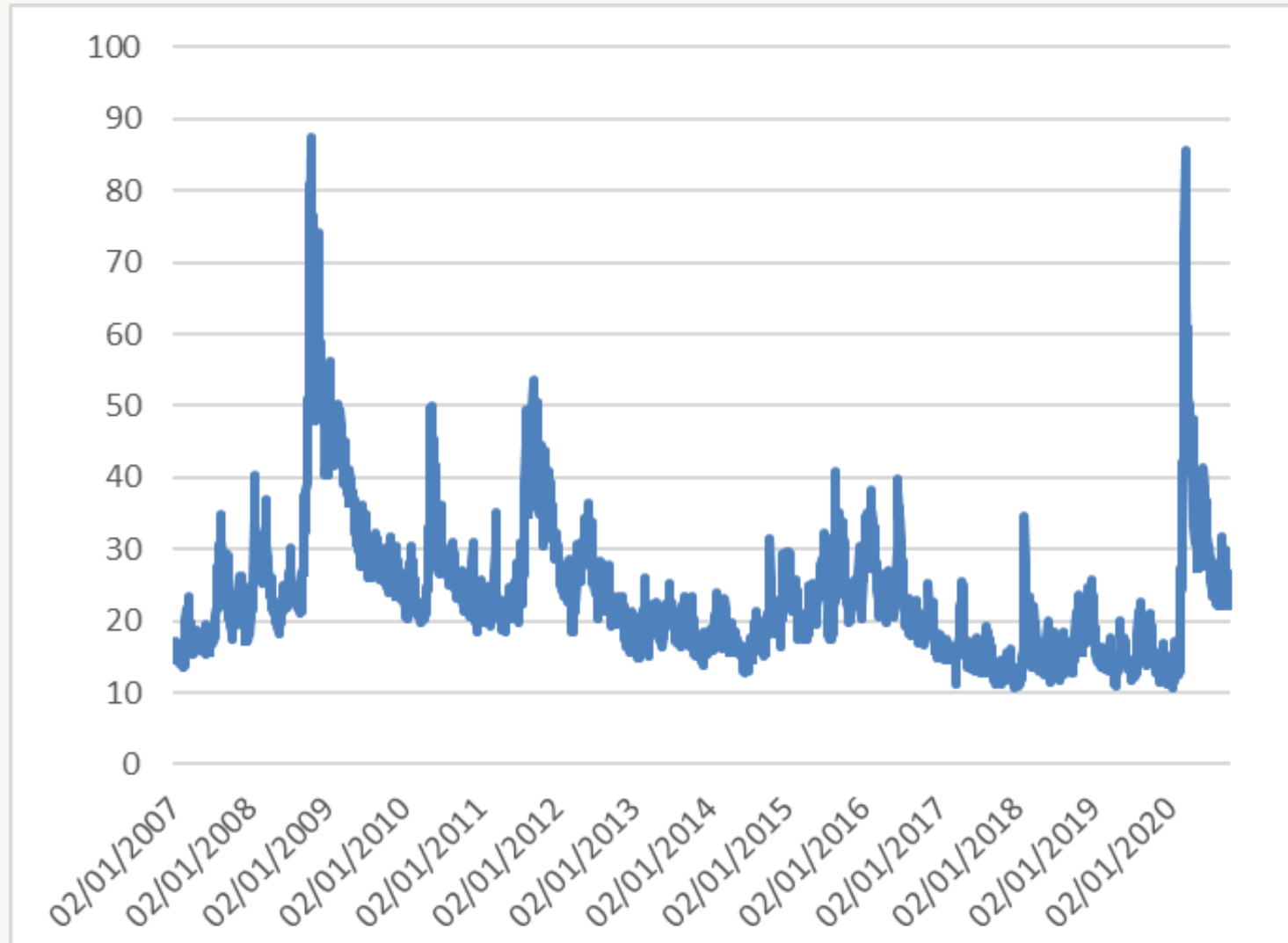
Economic Policy Uncertainty –press and twitter



Source: Baker, Bloom and Davis (2016), Hardouvelis, Karalas, Karanastasis and Samartzis (2018); Ghirelli, Perez, and Urtasun (2019); Renault, Baker, Bloom and Davis (2000)

Measuring Uncertainty?

VSTOXX – market perceptions of uncertainty

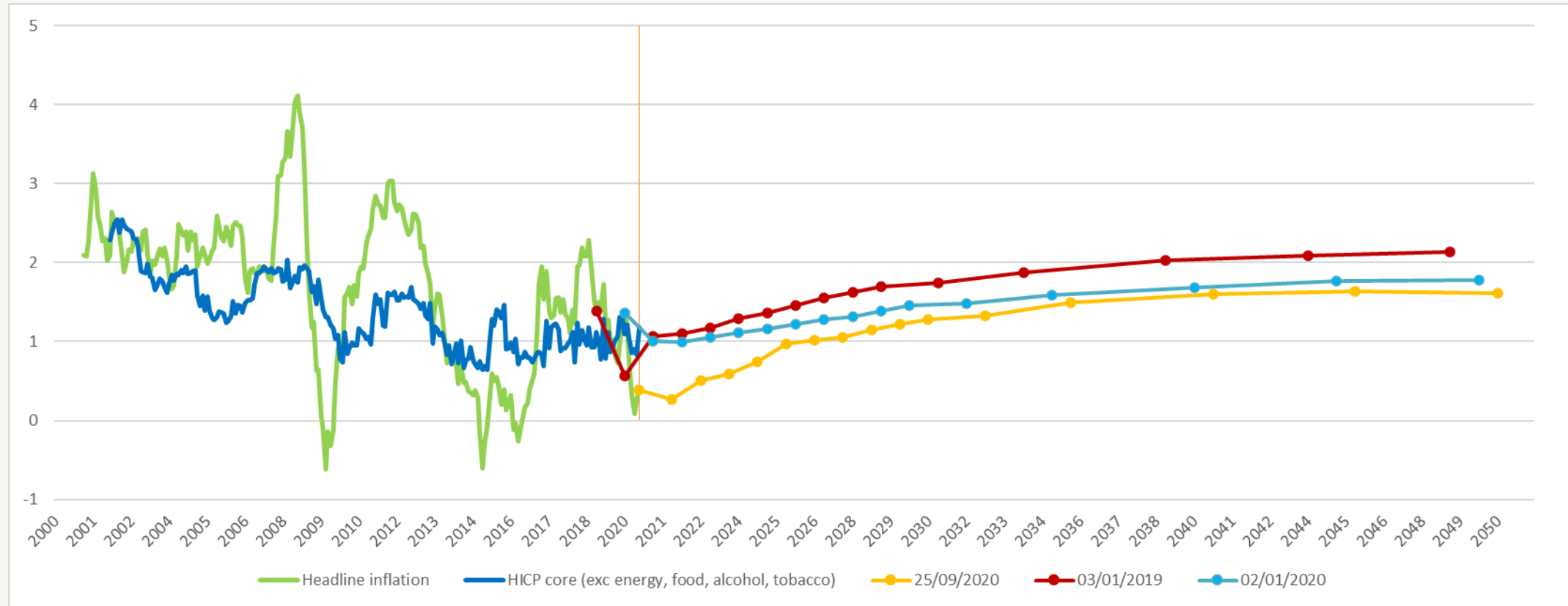


Source: Bloomberg

Outline

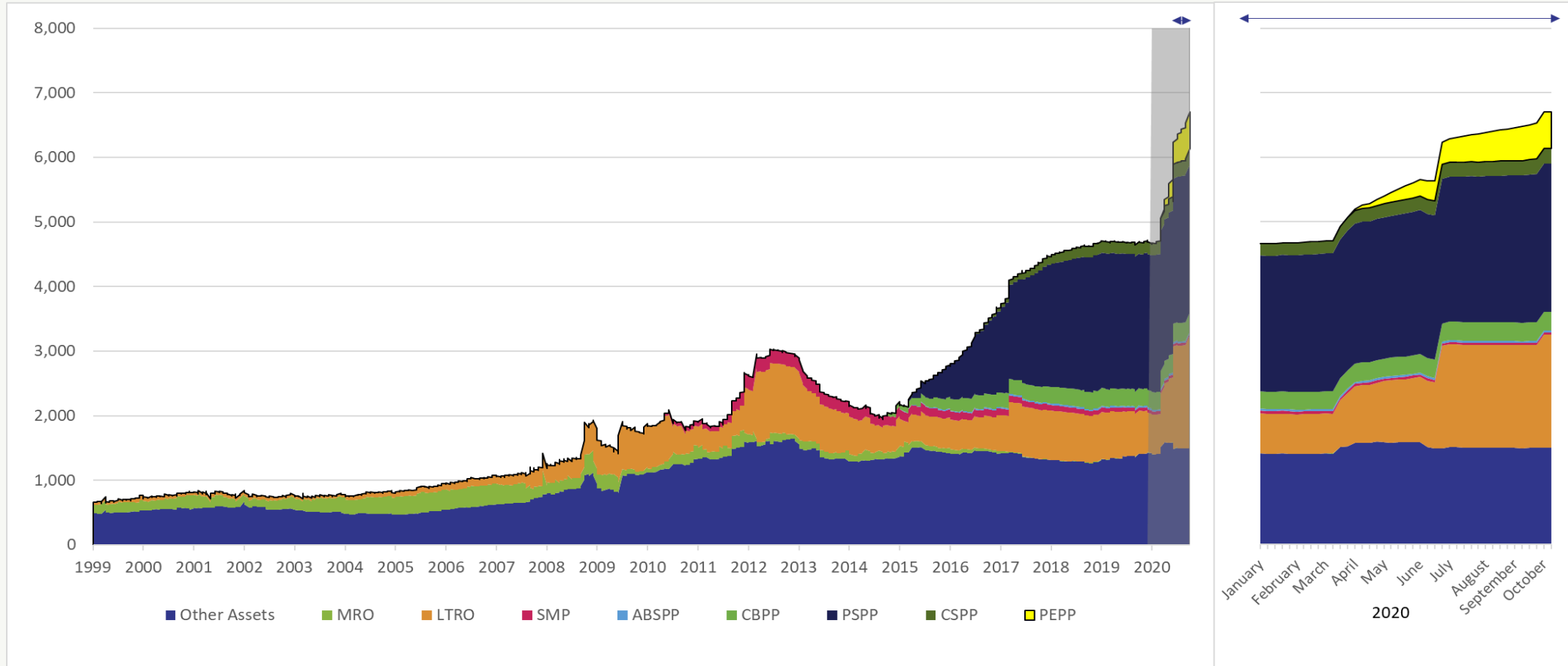
1. ECB actions and effects
 - Inflation and Covid19
 - More QE to suppress the spreads?
2. Monetary policy and dealing with long-term challenges
 - Interest rates: negative for ever?
 - Forecasting is difficult, particularly about the future
3. Implications for policy

Inflation and Covid19



Source: Bloomberg

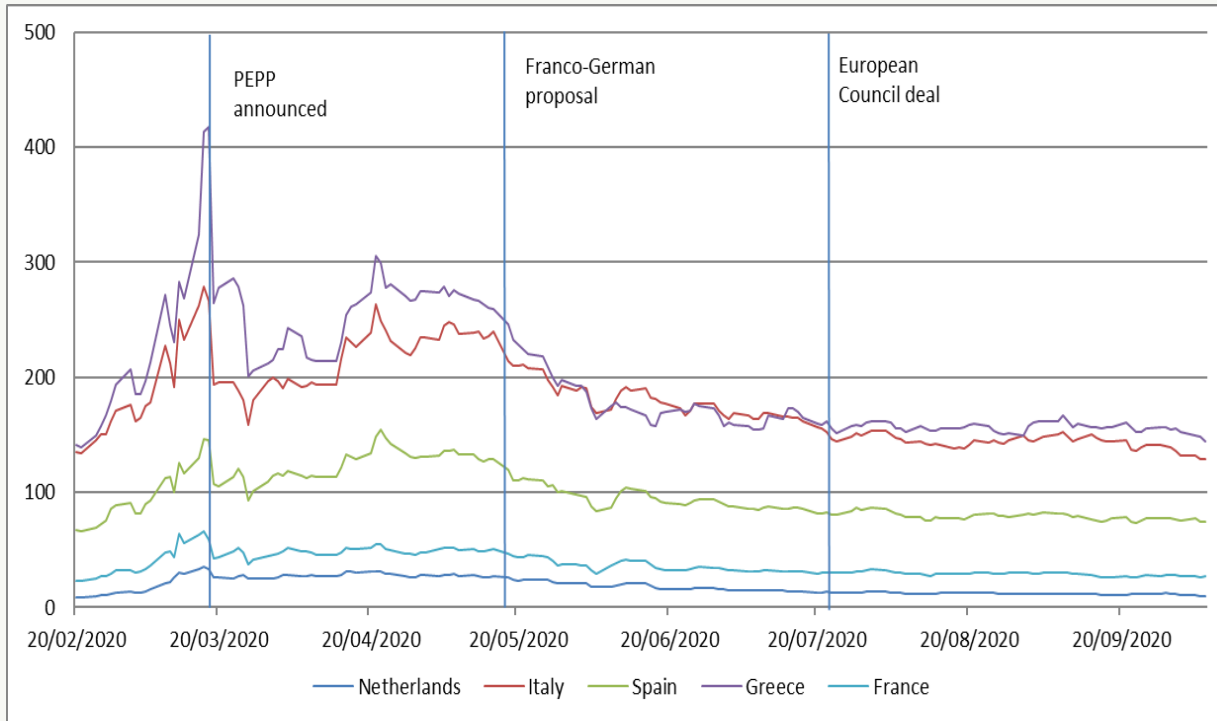
The ECB's balance sheet



Source: Bloomberg

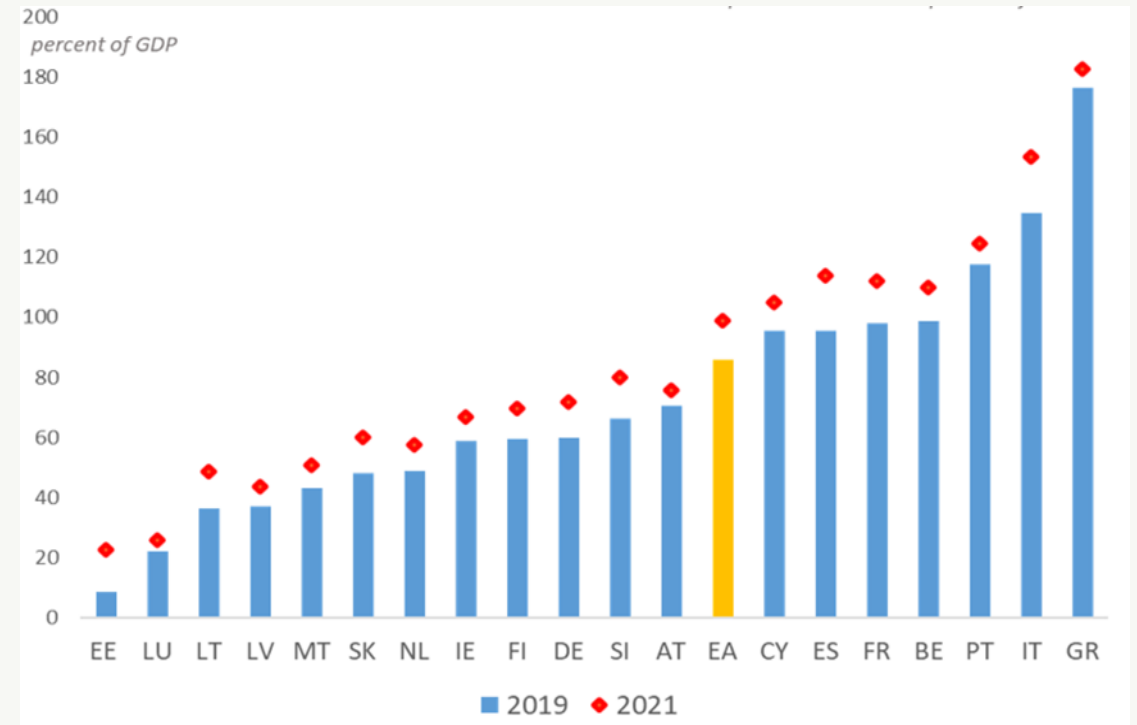
Falling spreads, Growing debt

Sovereign Spread (10Y) to DE



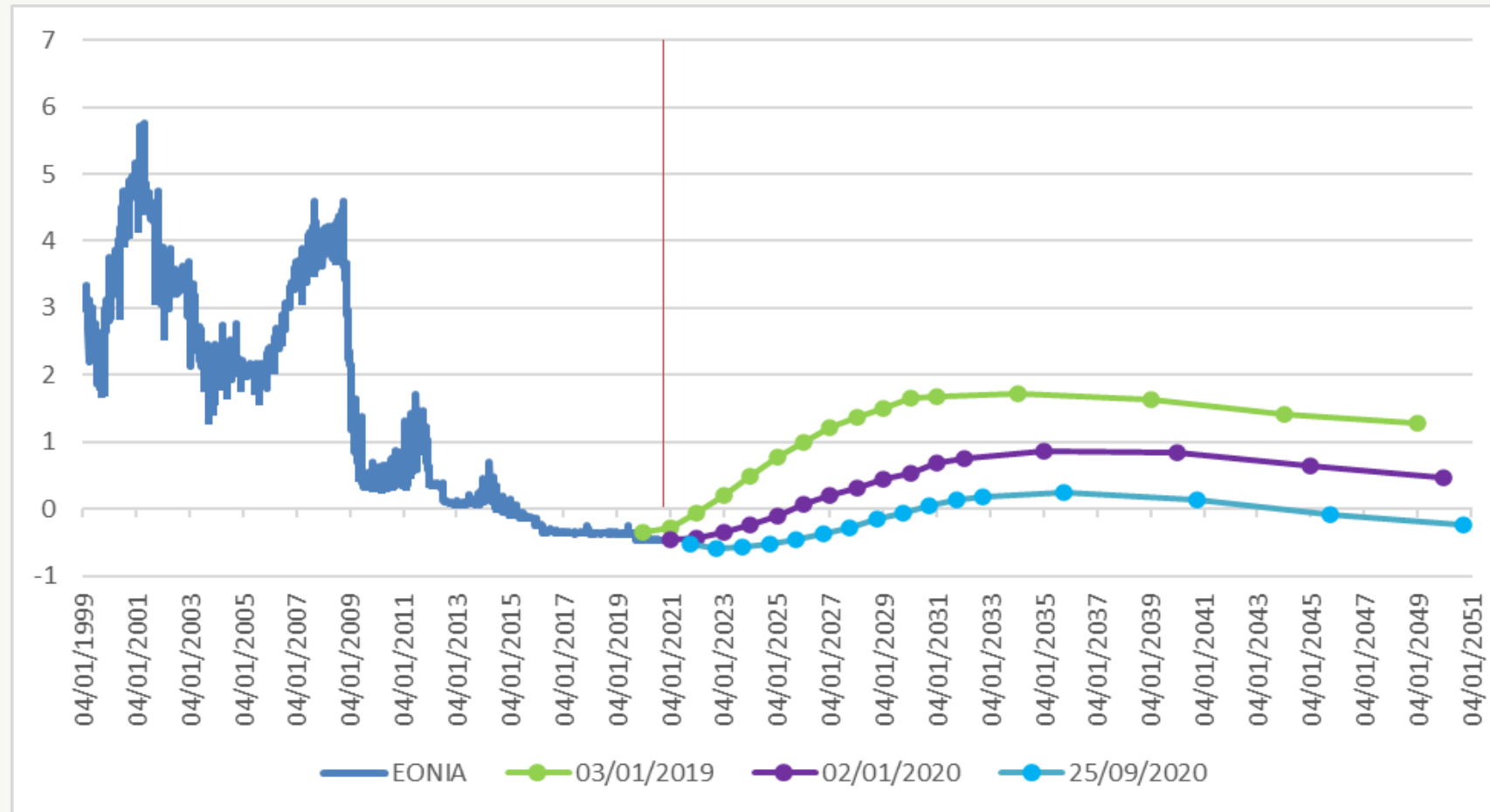
Source: Bloomberg

Public debt (2019 vs 2021 projections)

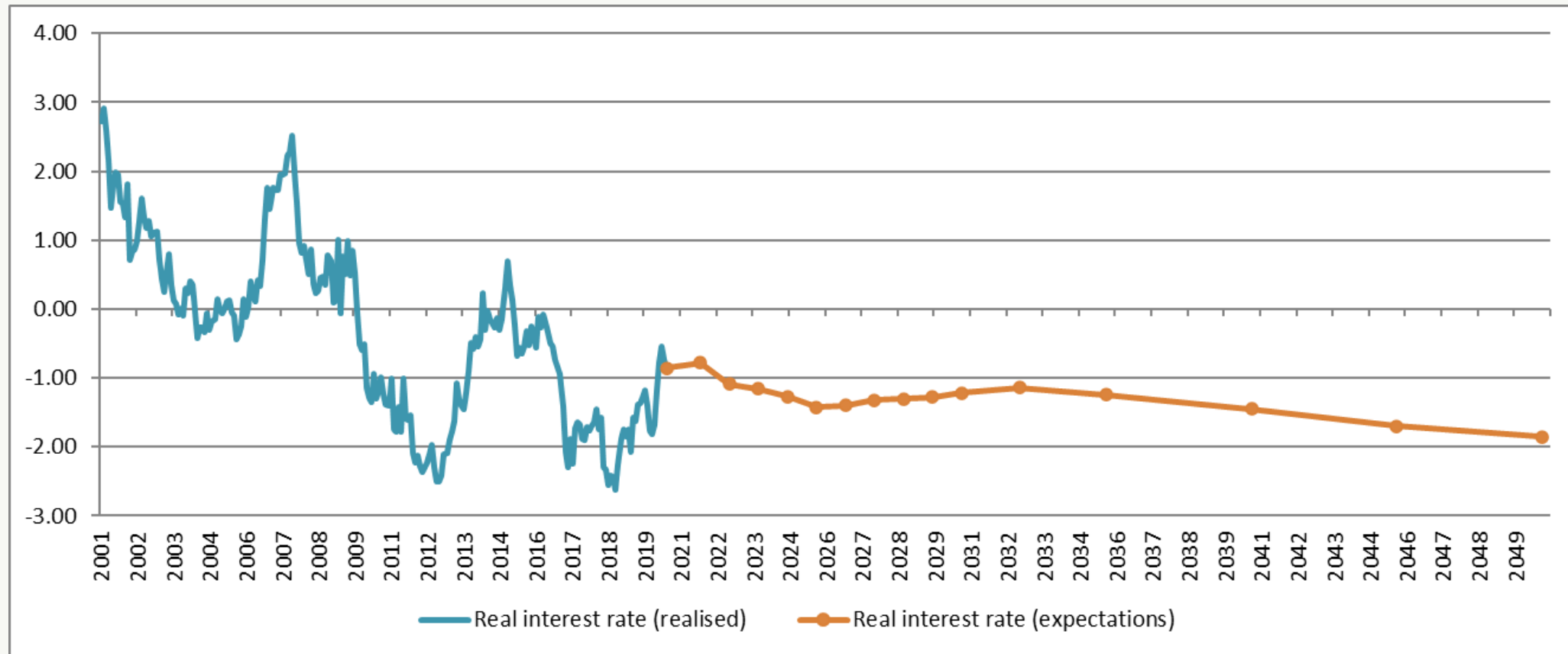


Source: European Commission, April 2020 forecast

Interest rates: too low for ever?

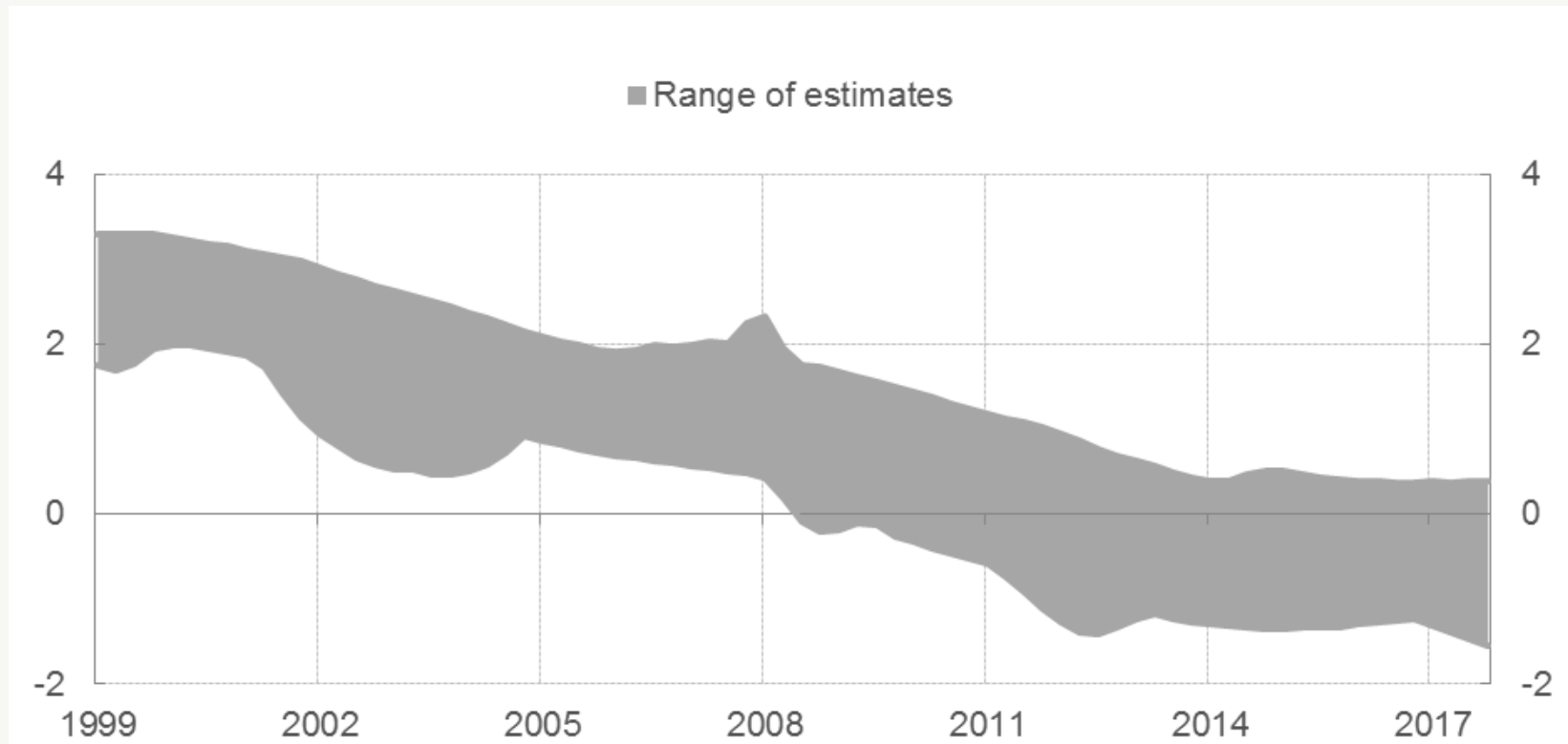


Real interest rates: negative in equilibrium?



Source: Bloomberg

Estimated equilibrium rates: declining



Source: Philip Lane, Remarks, Dublin, 28 November 2019. Notes: The grey-shaded area reports ranges of point estimates of r^* for the euro area, as estimated in Brand, C. and Mazelis, F. (2019), "Taylor-rule consistent estimates of the natural rate of interest", Working Paper Series, No 2257, ECB. Corresponding individual point estimates are reported in Brand, C. et al. (2019), op. cit. Sample period: 1999 Q1 to 2017 Q4.

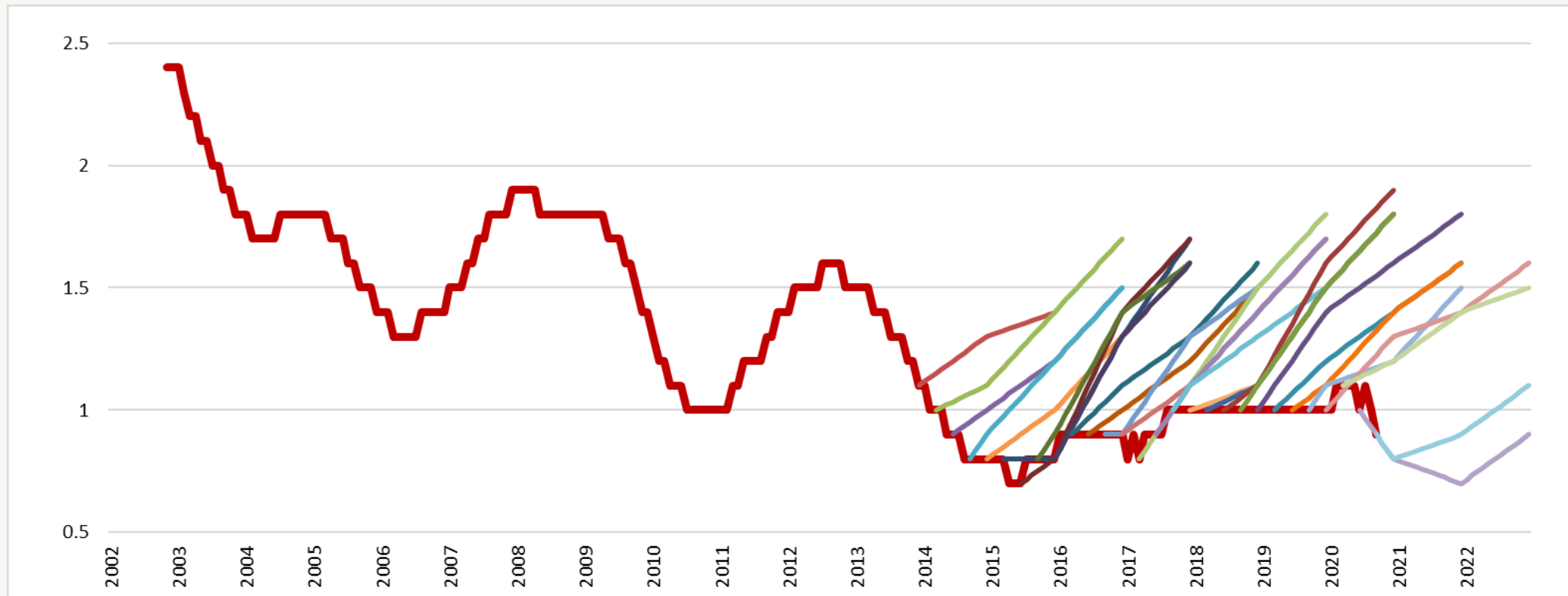
Forecasting is difficult...

$$i_t = \pi^* + r^* + \alpha_\pi(\pi_t - \pi^*) + \alpha_y(y_t - y^*)$$

$$i_t - r^* = \pi^* + \alpha_\pi(\pi_t - \pi^*) + \alpha_y(y_t - y^*)$$

- π^* is the inflation target
- r^* is the equilibrium interest rate.
- $y_t - y^*$ is the output gap.

Mean reversion – inherent in models

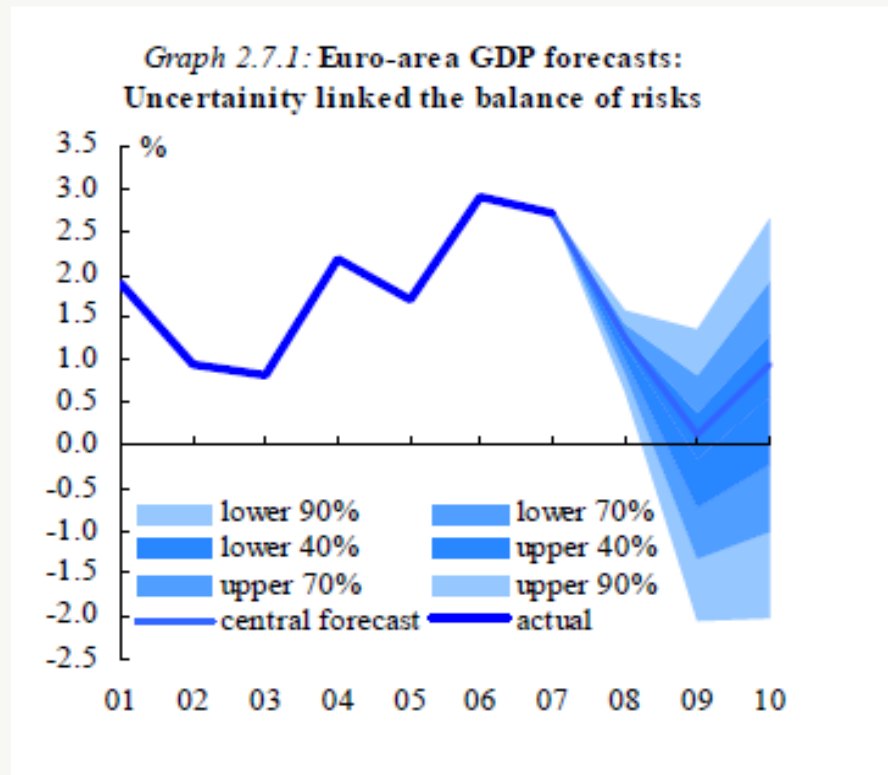


Source: Darvas (2018), ECB staff macroeconomic projections for the euro area, core inflation (moving 12-month average rate of change)

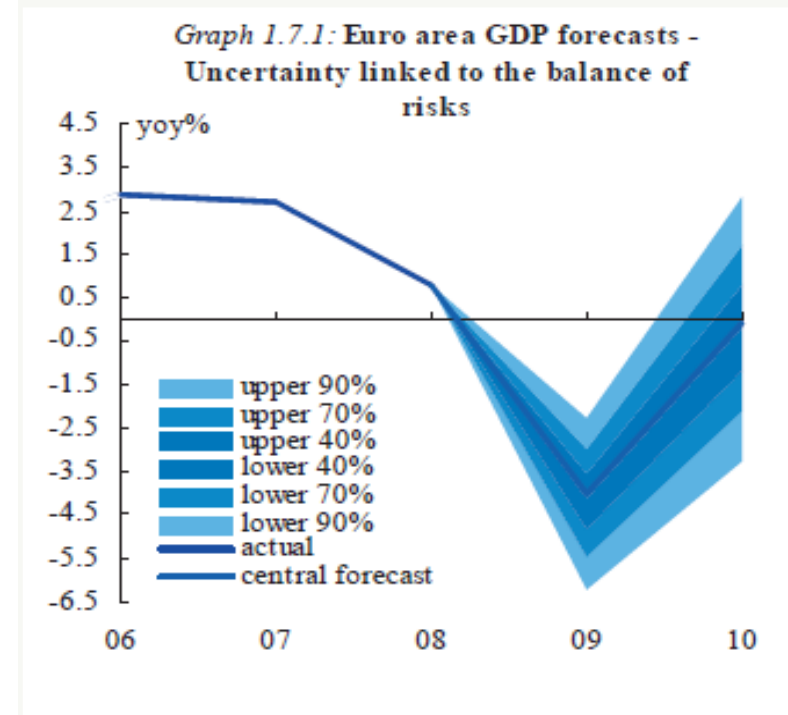
False confidence

Figure 11: European Commission, *Economic Forecasts* report, euro-area GDP predictions for 2009

Autumn 2008

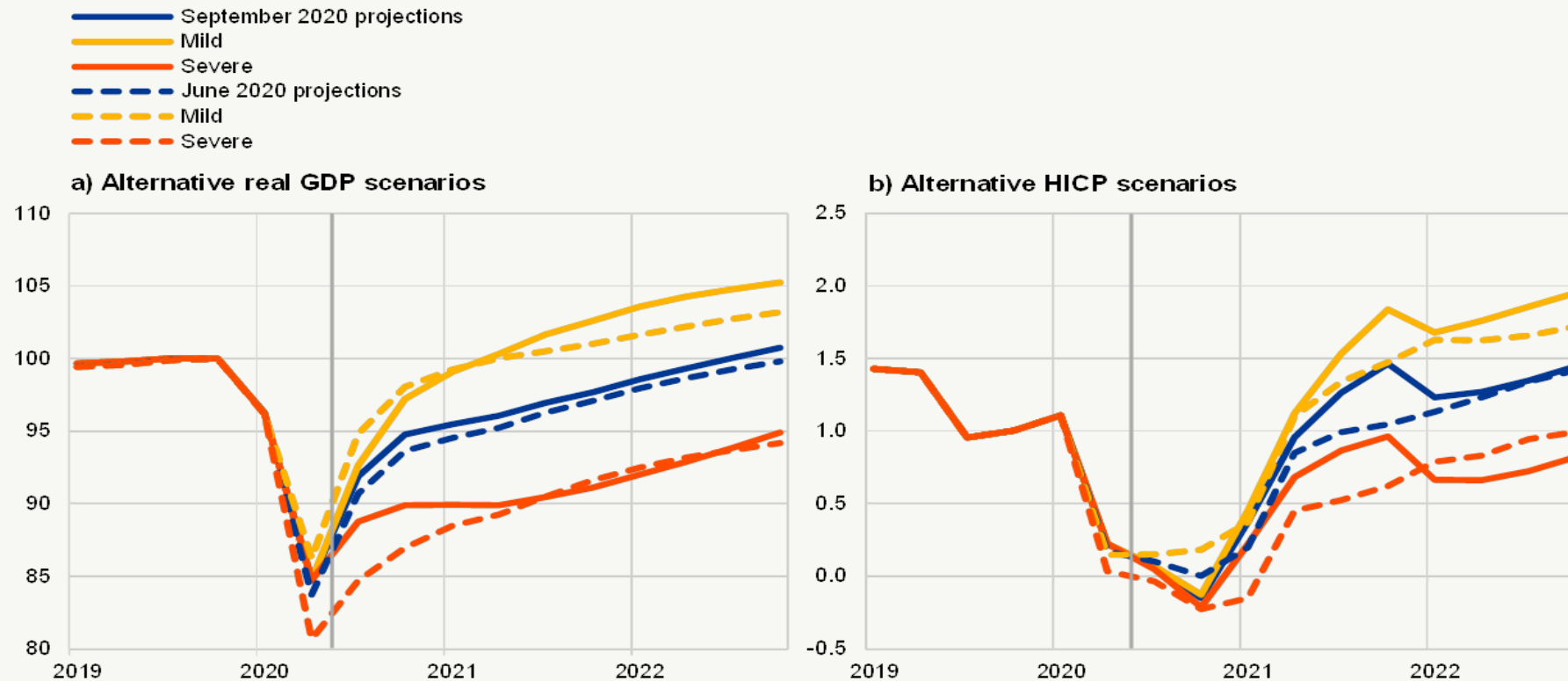


Spring 2009



Confidence without probabilities

Figure 12: ECB Staff macroeconomic projections and alternative scenarios for real GDP and HICP inflation in the euro area (September and June projections 2020)



Policy Implications: 2 (+1) quick wins

- The definition of price stability should be a **focal point** (this has to do with communication) 2%
- Precise versus predictable inflation outcomes: tolerance bands around it. But what width (0.5% to 3.5%)
“In times of uncertainty it is more useful to be predictable than precise.”
- With heightened uncertainty, communication is less about what will happen, which by definition is less known, and more about what the reaction should be if alternative scenarios would happen.

Thank you!