

**Reza Moghadam**

***Bruegel round table on the ECB strategy review***

At the outset I would like to make two brief observations and then turn to the specifics of the Strategy Review.

Observation 1: market inflation expectations of future inflation are at their lowest since the euro was established. Inflation expectations are more depressed now than during and after the euro crisis – despite the fact that Europe is viewed as having had a much more coherent and coordinated response to this crisis than the last one. By contrast, US inflation expectations have recovered strongly.

Observation 2: one has to accept that the ECB should not be the only game in town in terms of generating growth and inflation. The response to the pandemic and efforts to reduce economic scarring matter and importantly fiscal policy also matter a lot. In fact, market focus is now more on fiscal policy than on monetary policy.

Nonetheless, I think the ECB has an opportunity to reset and raise inflation expectations in the context of the Strategy Review. But it needs to be more ambitious and go further than the current consensus view.

**I will focus on three areas where the emerging consensus on the Strategy Review risks disappointing the market and economists more generally.**

**First, the choice between a symmetric vs. Average Inflation Target (AIT)**

There is broad consensus that the ECB should move formally to a symmetric 2 percent target, and that AIT in Europe would be a mistake. I will argue for AIT.

Why the reluctance about AIT in Europe?

- (i) **Objection #1: Structural inflation.** Inflation has fallen for structural reasons (demographics, technology, etc) and trying to push it up beyond 2% is futile.

**Yes, structural factors have brought down inflation.** But that doesn't mean that inflation itself is structural: **there is no "natural rate of inflation"**. Europe like the US needs a minimum amount of inflation to counteract the effect of downward wage and price rigidities and allow real interest rates to go as low as they need to go. This is **doubly true in Europe**, which is an incomplete monetary union (without a common fiscal policy) where low inflation – in the face of unequal price/wage flexibility – would slow down relative price adjustment across members.

- (ii) **Objection #2: Bygones are not bygones.** AIT may have the advantage of allowing looser monetary conditions to exit a recession, when inflation is still low, but it forces tighter policy as you enter a recession because of the burden of high inflation from the past.

**But this is not a problem without a solution.** Just as flexible inflation targeting was a solution to the tyranny of pure inflation targeting in the face of temporary shocks, AIT too can be made flexible – as the Fed has indicated it will do – without bringing down the whole superstructure of credibility.

- (iii) **Objection #3: Credibility.** The ECB has been unable to deliver even 2% inflation – so how can it credibly promise 2 plus percent?

Yes, this is a problem, and the ECB will have to work harder than it has in the past in overcoming the voices constantly warning about runaway inflation. **That is the whole point of the strategy review: to make it your mandate to not shy away from needed monetary easing** The Fed has managed to push inflation expectations to pre-pandemic levels and I think AIT has played a role here.

In sum, there are **good reasons not to give up on AIT. Even if it is not ready to embrace the full AIT framework, the ECB must not just signal but commit to tolerate above target inflation to help lift inflation expectations. Otherwise, it will be seen as perpetually more hawkish than the Fed, forced into a cycle of currency appreciation and ever more unconventional policies.**

## **Second, on rethinking the monetary toolbox of QE and credit easing**

I do worry that a focus on sovereign spreads (via PEPP and APP) and on bank credit (TLTROs) which have shown some success may not be enough to turn around inflation expectations. Let me offer 3 brief thoughts:

- (i) The ECB should signal that it would be prepared to purchase a wider range of private assets such as ETFs or pools of bank debt, to lend credibility to its ability to engage in asset purchases.
- (ii) Further monetary easing requires a **better solution to the zero bound** problem than QE. To me, this means more negative rates – which requires pushing down the reversal rate. Dual rates can help but cannot be the only lever. Another way would be to replace the bulk of cash with a digital euro, the return on which can more easily be made negative than with zero yield cash. Yes bankers don't like the idea but a central bank needs to do what it must to deliver on its mandate.
- (iii) Finally, I would not totally dismiss YCC, as many in Europe do. Yes, there are 19 different yield curves the issuance of a common bond for the EU Next generation will soon create a euro yield curve as a reference point around which spreads should not be allowed to widen. That has to be the long-term goal.

**Finally, a word on the green agenda: should the ECB move away from market neutrality in its monetary operations?**

There seems to be increasing consensus that central banks should require much greater degree of transparency about the impact of climate change on financial assets. There is however, much less agreement on whether central banks should move away from market neutrality in their own operations.

However, there is a curious inconsistency here: central bankers cannot argue that there is a market failure because climate change is not appropriately priced in financial assets and then say we as central bankers will remain market neutral in our operations and let the market adjust by itself.

There are few policy issues in Europe where there is a political consensus. However, combating climate change is one of them. Given the ECB's mandate clearly states that it should support EU policies, I think there is a case to move away from market neutrality and actually favour green assets in ECB operations. **This is also an attractive means of monetary-fiscal cooperation.**

And on that note,

Thank you