Ignazio Visco: Should the current monetary policy framework be adjusted to meet (new) post-crisis challenges?

Remarks by Mr Ignazio Visco, Governor of the Bank of Italy, at the conference "The ECB and Its Watchers XVII", debate on "Should the current monetary policy framework be adjusted to meet (new) post-crisis challenges?", organised by the Center for Financial Studies, Frankfurt am Main, 7 April 2016.

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1. I will comment on three issues. First, is the (below but close to) 2 per cent objective still appropriate? Second, why does inflation remain low? Do global forces dominate, and is monetary policy still effective? Third, should financial stability considerations interfere with monetary policy?

Is the (below but close to) 2 per cent objective still appropriate?

2. The 2003 evaluation of the ECB's monetary policy strategy considered three arguments,[1] which appear all the more valid today. All of them suggest that price stability must be achieved and preserved through timely and effective action.

3. First, the risks of deflation and of policy rates hitting the lower bound have been shown to be a serious issue, more than we thought in 2003. For more than one year now we have had negative or barely positive inflation and a short-term nominal interest rate close to its lower bound, a condition that in 2003, when we assessed our monetary policy strategy, was considered to be very unlikely.

4. Second, there is still need to "grease" the adjustment of relative prices in the euro area, within and especially across countries. Price and nominal wage rigidities still exist, notwithstanding the reforms in the goods and labour markets that have been implemented in recent years; structural differences across countries remain considerable.

5. Third, as to the upward bias in the measurement of consumer prices, if anything, there is more reason today to believe that this is an issue that deserves attention. Let me quote as an example a recent article in *The Economist* (March 19, 2016), reporting interesting evidence on a 'digital price index' that Adobe is developing with the help of two academics (Pete Klenow of Stanford University and Austan Goolsbee of the University of Chicago). The index (which is based on anonymised sales data collected from websites that use the Adobe software) suggests that official statistics are likely to measure the price dynamics of certain goods incorrectly, in particular consumer technology, and, as a result, might significantly overestimate inflation.

6. Let me also add that we should pay attention to the interactions among these (and other) conditions. A very relevant aspect is that too low inflation for too long makes it more difficult to deal with public and private debt. Related to this, as shown by recent research, the interaction of falling inflation and nominal interest rates at the ZLB with nominal debt and downward nominal rigidities can lead even favourable transitory supply shocks (such as a reduction of the price of oil) to have negative effects on economic activity.[2]

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[1] "*The outcome of the ECB's evaluation of its monetary policy strategy*", ECB Monthly Bulletin, June 2003.

[2] Neri, S. and A Notarpietro, "*The macroeconomic effects of low and falling inflation at the zero lower bound*", Banca d'Italia, Temi di Discussione (Working Papers), No. 1040, 2015.

Why does inflation remain low? Do global forces dominate, and is monetary policy still effective?

7. Low inflation certainly has a global dimension. It reflects developments in oil prices; deflationary pressures coming from the Chinese economy; possibly technological change. But it also reflects domestic developments that should not be underestimated. Domestic factors operate both via expectations and via economic activity, and in both respects conditions in the euro area differ from those in other main advanced economies.

8. Although declining inflation expectations has been a global phenomenon, since the end of 2014 the risk of a de-anchoring has increased particularly in the euro area, where expectations have reached lower levels than in other advanced economies.[3] A measure of this risk can be inferred from the probability that large changes in short-term expectations will be passed on to long-term expectations.[4] This indicator climbed from October 2014 until mid-January 2015 in the euro area, while no increases were recorded in the U.S. or the U.K. over the same period (Figure 1). After the extension of the APP to include public sector securities the indicator decreased sharply, but remained volatile and above the historical average.

9. Let me also point out, in this respect, that the importance of expectations of low inflation in determining wage outcomes, and thus giving rise to second-round effects, may be increasing. In Italy, in some recently signed collective contracts it was agreed that parts of future pay rises will be revised downwards in the event that the inflation rate falls short of current forecasts; according to our simulations, a generalised adoption of this type of contract would significantly decrease the rate of growth of wages and this would in turn be reflected in the dynamics of consumer prices.

10. Very low inflation in the euro-area also depends to a large extent on the persistence of economic slack and high unemployment. In the euro area the negative correlation between unemployment and core inflation or the rate of growth of negotiated wages is very evident even from a simple descriptive analysis (Figure 2). Supporting growth and employment is thus crucial to bringing inflation back to target. Indeed, ongoing work carried out at the Banca d'Italia based on micro-data suggests that after the crisis nominal wages became more reactive to unemployment in Italy, France and Spain; in Italy a reduction of unemployment by 3 percentage points would result in an increase of wage inflation in a range of 0.5–1.0 percentage points.

11. But is monetary policy still capable of supporting inflation and activity? The short answer is yes. Although we are not happy with the current outlook for inflation (and we are also only moderately satisfied with the growth outlook) there is no doubt that the counterfactual would have been much worse and could have led to a deflationary spiral with severe consequences both for the real economy and the financial sector.

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[3] For a comprehensive description of the APP, its impact and remarks on the evaluation of possible unintended consequences see: Ignazio Visco, "Global Monetary System: Our Currency, Your Problem?", Remarks to the Monetary Policy Panel, UBS European Conference, London, 11 November 2015.

[4] The indicator is based on the probability of co-movement of long-term and short-term inflation expectations. Technically, it is calculated as an odds ratio over a rolling window of 250 working days and ranges from zero to infinity; an increase indicates a closer link between sharp decreases in short-term and in long-term expectations; low values indicate that long-term expectations are better anchored. For details on how the indicator is constructed see F. Natoli and L. Sigalotti, "*An indicator of inflation expectations anchoring*", Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

12. Constructing counterfactuals is always difficult, but estimates by Banca d'Italia staff (which do not consider possible non-linear effects) show that in the absence of the monetary policy measures adopted between June 2014 and December 2015, both annual inflation and GDP growth in the euro area would have been lower by about half a percentage point in 2015–17. The expansion of economic activity in 2015 would have been slightly below 1 per cent, against an observed 1.6 per cent; inflation would have been negative, at about –0.5 per cent, against 0.0.[5] These estimates are consistent with those of the Eurosystem and the ECB staff.[6] Regarding Italy, the effects are estimated to be somewhat stronger: absent the monetary impulse, the Italian recession would have ended only in 2017; inflation would have remained negative for the whole three-year period.[7]

13. The commitment to pursuing the objective of price stability shown by the Governing Council has been essential for stemming the de-anchoring of expectations and maintaining the ECB credibility, which is crucial to avoiding the risk of a deflationary spiral. When inflation remains far from target for a prolonged period, the risk of de-anchoring may be compounded by economic agents revising their expectations for future inflation to take account of surprises registered in the past, to an extent that also depends on the share of agents that lose their trust in the central bank's objective.[8]

14. In order to bring inflation back to target, it is essential to support aggregate demand. The unconventional measures adopted by the Governing Council of the ECB are contributing to increased spending on consumption and investment goods. And I am confident that the effects we have observed so far will be strengthened by the new decisions we took on 10 March: the strengthening of the APP and the inclusion of corporate bonds, together with the introduction of new targeted refinancing operations, will contribute to a further decline of the cost of borrowing in the private sector.

15. A recent debate has centred on the notion of "helicopter money". Obviously this is a "very unconventional" policy, targeted at directly affecting consumption and investment by households and firms. Such an extreme measure would undoubtedly be subject to operational and legal constraints; the redistributive implications and the close ties with fiscal policy would all make it very complex, all the more so in the euro area given its institutional framework. As recently noted by President Draghi, and reiterated by Benoît Cœuré and Peter Praet, helicopter money is not currently part of the discussion in the Governing Council, although no policy tool within our mandate can or should be dismissed a priori.

16. This discussion is noteworthy, not much per se, but because it underlines the concern that monetary policy is left to act in isolation. Indeed, the fact that monetary policy is still effective does not mean that it can support macroeconomic stability on its own. In order to achieve satisfactory growth, it needs to be complemented by budgetary policies aimed at creating appropriate macroeconomic conditions, as well as by further reforms aimed at increasing potential output growth. In the past years of crisis, monetary policy has bought time for the decisions in other spheres of policy

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[5] See Locarno, A., A. Notarpietro, and M. Pisani, "*Sovereign risk, monetary policy and fiscal multipliers: a structural model-based assessment*", Banca d'Italia, Temi di Discussione (Working Papers) 943, 2013).

[6] Mario Draghi, "*Global and domestic inflation*", speech at the Economic Club of New York, 4 December 2015; Vítor Constâncio, "*In defence of monetary policy*", 11 March 2016.

[7] Estimates computed using the Banca d'Italia Quarterly Model.

[8] F. Busetti, G. Ferrero, A. Gerali and A. Locarno, "*Deflationary shocks and de-anchoring of inflation expectations*", Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), No. 252, 2014.

making, but beyond a certain limit such a role would inevitably run into unintended consequences.

Should financial stability considerations interfere with monetary policy?

17. My reading is that it is important to consider the implications of monetary policy for financial stability, but that financial stability depends on adequate nominal growth. It is thus dangerous if monetary policy fails to pursue its own targets. As highlighted in the latest (November) *Financial Stability Review* of the ECB, banks' profitability and debt-sustainability continue to be challenged by a weak economic recovery.

18. Are concerns for financial instability – due to the very accommodative monetary policy – currently justified in the euro area? It does not seem so. Indicators of imbalances in housing and credit markets do not point to increasing vulnerabilities in the euro area as a whole: estimates of over-valuation of residential property prices do not signal widespread risks (Figure 3), and the financial cycle is still negative (Figure 4). Of course, aggregate data may mask heterogeneous developments across and within countries. But in the event of risks in specific sectors and/or countries, appropriate macroprudential measures can be implemented to limit their accumulation.

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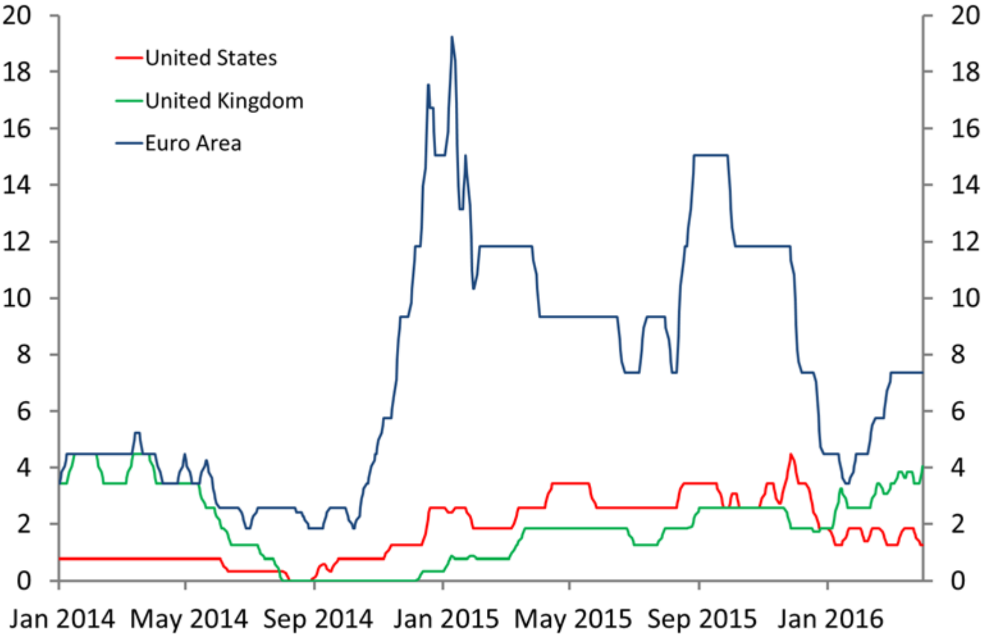
19. A protracted, very accommodative monetary policy involves risks which need to be monitored carefully, and low or negative nominal rates for too long may hurt some institutions. But the current low level of interest rates in the euro area is not a bizarre choice of the Governing Council of the ECB; rather, it reflects the slack in the economy and dangerously low actual and expected inflation. A less accommodative monetary policy in the current circumstances would be harmful to everyone. The only sustainable way to raise nominal rates is to strengthen growth and job creation. These are necessary conditions for bringing inflation back to target and preserving price stability in the interest of all euro-area citizens. And this is why we need to be ambitious in our decisions. The stronger our actions today, the sooner these conditions will be fulfilled.

Figure 1

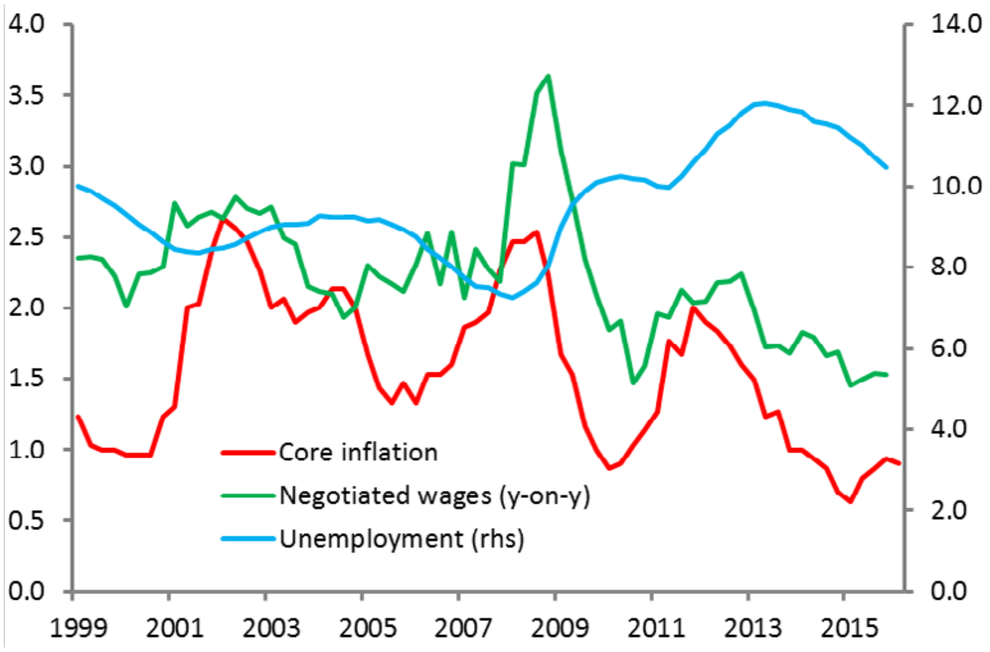
Indicator of co-movement between short/long-term inflation expectations for extremely negative variations



Note: The indicator is based on the probability of co-movement of long-term and short-term inflation expectations. It is calculated as an odds ratio over a rolling window of 250 working days; an increase indicates a closer link between large reduction in short-term and long-term expectations. See F. Natoli and L. Sigalotti, "An indicator of inflation expectations anchoring", Banca d'Italia, Temi di Discussione (Working Papers), forthcoming.

Figure 2

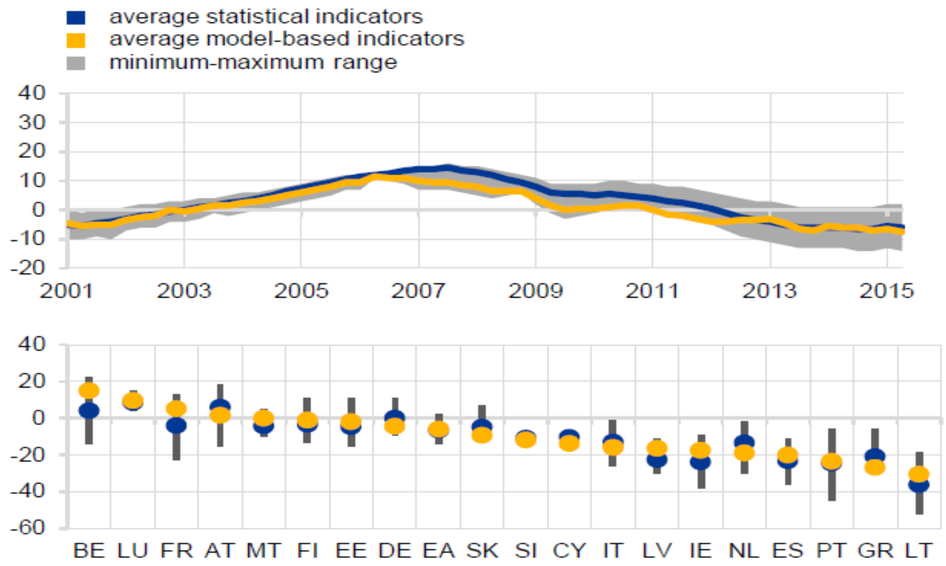
Core inflation, negotiated wages and unemployment in the euro area



Source: European Central Bank and Eurostat. *Note*: core inflation excludes energy and unprocessed food.

Figure 3

Over/undervaluation of residential property prices in the euro area

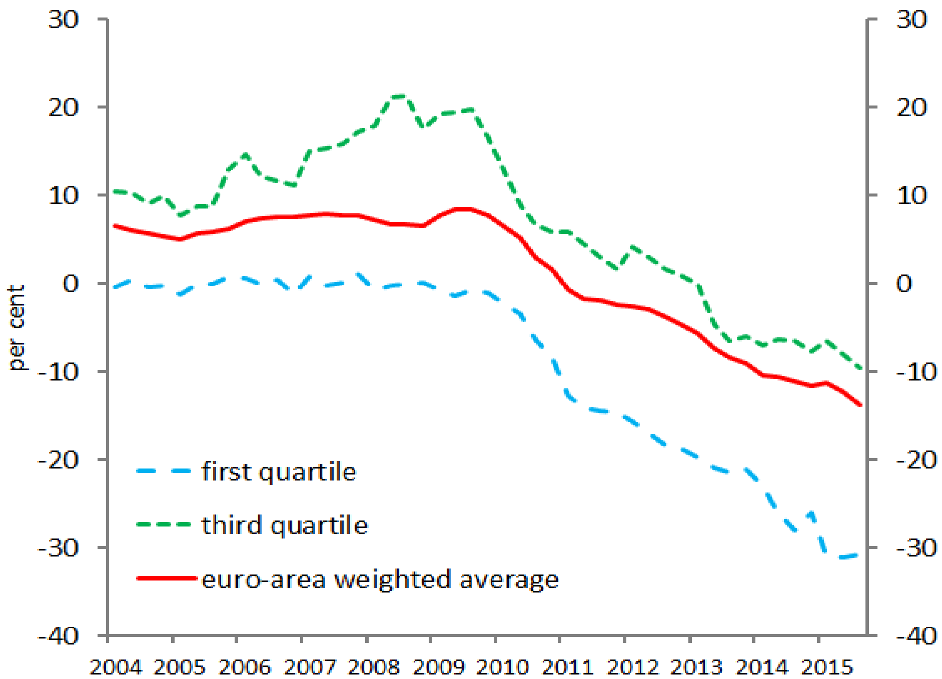


Source: European Central Bank, Financial Stability Review, November 2015.

Note: over/undervaluation estimates are based on four different methods, two statistical and two model-based. A positive figure indicates overvaluation, i.e. prices above long-term average (in the case of statistical models) or fundamental values (in the case of economic models).

Figure 4

Domestic credit-to-GDP gap in the euro area



Source: European Systemic Risk Board and Banca d'Italia's calculations.

Note: the credit-to-GDP gap is calculated as the deviation of the ratio of total credit to nominal GDP from its recursive one-sided Hodrick-Prescott trend. GDP-weighted average of euro area country gaps.