# John Iannis Mourmouras: Monetary policy and global markets

Speech by Professor John Iannis Mourmouras, Deputy Governor of the Bank of Greece, on the occasion of the launch of his book entitled "Speeches on Monetary Policy and Global Capital Markets, 2015-2017", OMFIF City Lecture, London, 6 December 2017.

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Your Excellency, Ambassador Tziras,

Sir Christopher, Professor Pissarides,

Distinguished panellists,

Ladies and Gentlemen,

Let me first of all thank David Marsh and the OMFIF team for the organisation of the event and today's strong panel: two distinguished Governors, former President of Deutsche Bundesbank Ernst Welteke and former Governor of the Czech Central Bank, Miroslav Singer, two renowned Professors, policy makers and market gurus, Charles Goodhart, LSE Professor and former Monetary Policy Committee Member at the Bank of England, and Vittorio Grilli, former Italian Minister of Economy and Finances and Chairman of JP Morgan EMEA, for kindly accepting the invitation and taking the time to speak today. I am truly honoured by their presence, I thank you all and each one personally, and I am also very grateful to all of you for being here today.

I will restrict myself today to offering brief remarks on the global outlook for 2018 and the risks ahead, as well as current developments in terms of global monetary policy and the prospects for capital markets, the latest on Europe, including my own country, Greece. There is evidence which makes me feel optimistic, after the 8-year Greek saga, and I would like to share my optimism with you today.

## 1. Introduction

The upswing in global economic activity has continued well into the second half of 2017, and the upturn has become more synchronised across countries. The recovery is supported by significant increases in trade, investment and industrial production, along with strengthened business and consumer confidence. The short-term risks are broadly balanced, but medium-term risks are still tilted to the downside. Furthermore, wage growth has been disappointing, keeping inflation at low levels. According to the IMF's latest forecasts, global GDP growth is expected to accelerate to 3.6% in 2017, and reach 3.7% in 2018, while global inflation will reach 3.1% this year and 3.3% in 2018.

## 2. The eurozone's current economic outlook

In the eurozone, we can say with confidence that we are going through a solid economic expansion.

Indeed, GDP has risen for 18 straight quarters. The increase in growth in 2017 mostly reflects acceleration in exports in the context of the broader pickup in global trade and continued strength in domestic demand growth supported by accommodative financial conditions amid diminished political risk and policy uncertainty. Overall, growth is expected to average 2.2% in 2017 to the highest level since 2007. The positive momentum will continue going forward mainly because the drivers of growth are increasingly endogenous, rather than exogenous, which used to be falling oil prices and accommodative monetary policy. Now, there are indicators that growth is "feeding on itself", that is, spending multipliers and endogenous propagation are once again supporting economic activity. This is most evident in private consumption, which has remained robust even as oil prices have risen by about 30 dollars since the start of 2016. Consumption is being supported by a virtuous circle between rising labour income and rising employment. Employment in the euro area has reached its highest level ever, while unemployment has fallen to its lowest rate since January 2009. As consumption has strengthened and spending multipliers have taken hold, investment has also followed with a lag. Since 2016, investment has contributed almost 45% to annual GDP growth, compared with under 30% in the two years previously.

However, inflation developments across the euro area still remain subdued. Indeed, annual HICP inflation decelerated to 1.4% in October 2017, down from 1.5% in September, while core inflation fell to 0.9% in October from 1.1% in September. Two indicators are important for assessing the durability of inflation. The first is the outlook for growth, since this helps us assess whether inflation will continue to rise. The second is underlying inflation. This assesses whether inflation will stabilise around the ECB's target of 2% once the effects of volatile factors, such as oil and food price swings fade away. As I already mentioned, the growth outlook is now solidly improved (1.8% in 2018), but the underlying inflation trend remains subdued. A key issue here is wage growth. Since the trough in mid-2016, growth in compensation per employee has risen, recovering around half of the gap towards its historical average. But overall trends still remain subdued and are not broad-based mainly because the effects of past low inflation are continuing to weigh on wage growth while the relationship between wage growth and traditional measures of slack has weakened in the post-crisis period. Hence, the outlook for inflation based on Eurosystem staff projections has been revised downward, to 1.5% for 2017 and 1.4% for 2018 and 1.6% for 2019.

In sum, the inflation target cannot be restored without the ECB's accommodative policy and as ECB President Draghi stated recently "an ample degree of monetary stimulus remains necessary" for underlying inflation pressures to build up and support headline inflation over the medium term.

## 3. Global economic outlook

The largest economy in the world, the US economy, has been expanding for eight years in a row, which is one of the longest periods on US record. Output growth is projected to reach 2.4% in 2017 and 2.1% in 2018 (1.6% in 2016), much lower than the Trump administration's plan to get the economy growing at 3%, while CPI inflation is projected by the Federal Reserve (Fed) at 1.6% in 2017 before increasing to 1.9% in 2018.

In the United Kingdom, Brexit is having a negative effect on growth via both weaker consumption (thanks to the FX-induced rise in inflation) and heightened uncertainty negatively affecting investment. On the inflation front, the UK is one of the few developed countries where inflation has surprised on the upside at around 3% in the current quarter as a result of past falls in the sterling's value. UK growth is expected to stand around 1.5% in 2017 from 1.8% in 2016 and 1.7% in 2018 with downside risks on the back of the slow progress in Brexit negotiations. According to the Bank of England, inflation should remain elevated to 3% in 2017, before falling back to 2.4% in 2018.

In Japan, real GDP growth is projected to decelerate to 1.0% in 2018 from 1.5% in 2017. As far as inflation is concerned (as you know Japan is an outlier in terms of persistently low inflation despite its full employment), core inflation is projected to stand at 0.8% for 2017 and 1.4% for 2018 and that is why the Bank of Japan, among all other central banks from developed countries, is likely to maintain its quantitative easing policy for the longest period.

Finally, with Brazil and Russia exiting recession and China stabilising at growth rates above 6%, emerging economies real GDP is projected to be expanding roughly near to 4.6% in 2017 from 4.3% in 2016 and to 4.9% in 2018.

## 4. Potential risks ahead

Among the major downside risks I would like to focus on the so-called “trade risk”, namely how a shift towards protectionism driven mainly by the new US administration could disrupt global supply chains reducing trade and cross-border investment flows harming global growth.

The decision to pull the US out of the Trans-Pacific Partnership and threats to leave NAFTA are signs of a fierce protectionist stance by one of the world’s major trading blocks that could have a destabilising effect on the WTO and world trade relations in general.

At his speech before the United Nations General Assembly last September, US President Trump repeatedly argued in favour of “strong sovereign nations”, attacking globalism and putting allegiance to the national state ahead of international institutions. The Chinese and US policy appear to converge in this regard against a “one-size-fits-all universal order”. This stance also finds followers among the lines of “international nationalists” or anti-globalists also include leaders such as Vladimir Putin, Viktor Orban in Hungary or Duterte in the Philippines. The argument goes that strong sovereign nations should be the basis of a stable, international order that cuts back on the excesses of globalism, which is seen as elitist.

Another risk that is not so probable, one that I would like to take a moment to mention nonetheless: A bad revival of Reaganomics of the 1980s, for which I will simply remind you that during President Reagan’s first administration, loose fiscal policy collided with a tight monetary stance by the Fed under Chairman Paul Volcker, in an effort to squeeze inflation out. This combination resulted in a seriously overvalued dollar, which for many analysts is the primary cause that sunk a large number of Latin American economies into a decade of stagnation. Underlying vulnerabilities remain for some large emerging markets still today. High corporate debt, weak balance sheets and thin policy buffers mean that these economies are exposed to tighter global financial conditions and capital flow reversals. A closer look at the numbers may provide some reason to be slightly apprehensive: today we are experiencing a stronger dollar than in the strong dollar period of the eighties. Indeed, the US dollar’s annual rise over the last two years was 11% annually, compared with 7% in the 1980s between November 1978 and March 1985. It would be extremely interesting if Vittorio Grilli, either with his professorial hat or in his current position as J.P. Morgan Europe Chairman, could share his views on whether he considers this dollar overvaluation is a real possibility, and more importantly, if we face it, how long it would last. A repeat of the eighties?

Other risks include exogenous shocks such as geopolitical tensions, political turbulence and large-scale involuntary migration especially from Africa.

## 5. Central banks’ monetary policies: A cautious transition to a less expansionary monetary policy

### *European Central Bank goes for a dovish tapering in 2018*

In my own turf of central banking now, at the October Governing Council, the ECB has decided the official start of QE tapering by a combination of the following decisions:

- The ECB has, on the one hand, decided to scale back its purchases of new securities (from €60 billion to €30 billion per month) and, on the other hand, to extend the horizon of purchases until the end of September 2018 and beyond, if necessary. Up to now, the ECB has bought around €2.2 trillion under the APP programme.
- The ECB also decided to strengthen its forward guidance on the reinvestment of already purchased securities “for an extended period” after the end of net QE purchases and “in any case for as long as necessary” and will publish the monthly profile of reinvestment flows twelve months ahead, which means a rough amount of €120 billion, or 12 billion per month.

This means that the ECB's gross purchases over the period until September 2018 will average €41 billion per month.

- In this context, during the period of net asset purchases, PSPP principal redemptions will be reinvested in the jurisdiction in which the maturing bond was issued. As regards the private sector programmes, there is no strict allocation of the total volume to jurisdictions, but purchases are broadly oriented towards market capitalisation of eligible securities, while also paying due consideration to market conditions. Therefore, for the private sector programmes, the maturing amount in a jurisdiction in a specific month does not necessarily determine the amount to be purchased in this jurisdiction during the month, leaving ECB with flexibility and degrees of freedom to intervene in the euro area's bond markets in case of any absurd movements domestically.
- The ECB's monetary policy tends to influence long-term yields through both its main components: by compressing the term premium, and by anchoring the expected path of policy rates in the future.

By accumulating a portfolio of long-duration assets, the central bank can compress term premia by extracting duration risk from private investors and thus lowers term premia and yields across a range of financial assets.

Asset purchases do matter also for the signals they entail about the path of future policy rates: the so-called "signalling effect". In the euro area, this effect is reinforced by the sequence in which our instruments are ordered.

Specifically, the length of the horizon of our net asset purchases, and the forward guidance that our policy interest rates are expected to remain at their present levels "well past" the end of those net purchases (but they are unrelated to the time guidance on reinvestments), mechanically affect the time of the first expected rate hike, anchoring the path of expected policy rates over the lifespan of the APP and beyond.

The positive evidence from the ECB's QE programme can be found in many areas, including the growth rate of loans, the decline in bank lending rates including the growth rate of loans, the cross-country heterogeneity in bank lending rates, which implies a less fragmented banking sector, a compression of intra-euro area spreads and a flattening of yield curves across all markets.

In my keynote address in Valencia at the BBVA Annual Congress last spring (Chapter 11 of my book), I tried using a Taylor rule framework to provide tentative answers on a number of important future ECB monetary policy issues including timing and sequencing. In addition, I then raised and tried to answer there a number of pending issues like, for instance, should the scaling back of a national central bank's balance sheet be discretionary or rule-based?

It would be extremely interesting to hear the views on the policy dilemma about sequencing, namely rate hikes first and then the start of tapering or vice versa, of Professor Goodhart, the best monetary economist in Britain and continental Europe.

It is fair to say that for many years to come, bonds will remain in central banks' balance sheets. How quickly central banks reduce their bond portfolio will depend on macroeconomic and financial developments over the next several years. In such expanded balance sheets, central banks have to resolve the following growing maturity mismatch: on the asset side, one can find long-term items like government bonds as a result of the QE programme, while central banks liabilities have remained of very short maturity, typically bank reserves, currency and government deposits.

Clearly, the fundamental question that has to be addressed by macroeconomists and central bankers is how durable the existing environment of low and stable inflation and low real interest rates will be. Let me elaborate a bit on this. With a Nobel laureate and leading macroeconomist in the audience, Professor Pissarides, by whom I had the privilege to be taught graduate macroeconomics, I can't resist the temptation to say one word on this. We all see that the link between the economic cycle and inflation is rather weak; if you like, inflation is not behaving the way our economic models predict in the short run. We don't see stronger wage and inflation dynamics when the average unemployment rate falls from 9% to 6% (and the numbers are real). Instead, we witness that inflationary pressures are largely absent and inflation expectations are subdued because there is more slack, as some claim, in the economy? Or is it at the end of the day, an inflation measurement issue, and that's it? (quite convenient!) There is a large body of academic literature on both disputed issues of low inflation and low real interest rates, but unfortunately there is no strong consensus on the findings to the extent that these could be adopted straight away by monetary policy makers. More academic research is needed here as I strongly believe that this sort of research will be useful and have a forceful impact on real-world monetary policy making.

### *US monetary policy*

In terms of US monetary policy, the Fed has signalled its intention to carry out the third hike of the year at next week's meeting (and by the way, the Bank of England has, for the first time in a decade, raised its base rate from 0.25% to 0.5%) and there is consensus in the market to expect two more rate hikes in 2018 in the US. The Fed's new Chairman, Mr. Jerome Powel, for the first time a non-economist, is facing a number of challenges including: shrinking the Fed's balance sheet, the classic dilemma coming from a buoyant labour market in the US (4.1% unemployment rate), which might warrant a faster pace of tightening, versus modest wage growth and inflation that has been below target for 5 years, but also new ones like, for instance, how the Republicans' tax reform bill (approved with a slim majority by the US Senate following its approval by the House of Representatives), which could affect the projected interest rate path, particularly if it stimulates faster economic growth.

## 6. Prospects for global capital markets in 2018

A few words now on prospects for global capital markets in 2018 based on our own predictions at the Bank of Greece.

### *Bond markets*

Starting with the bond markets, the four-decades-long bull market seems to be coming to a close, and we expect interest rates to continue rising at the short and, to a lesser extent, at long ends, resulting in a flattening yield curve (this is especially true for the US). Hence, 10-year Treasury note yields may gradually rise to 2.7% by end-2018 [today 2.3%]. In the eurozone, the hunt for yield will remain strong, and alternatives to core government bonds, such as corporate debt, high-yield and European periphery bonds, should remain in big demand. We expect the German 10-year Bund to yield around 0.7% at the end of 2018 [today 0.33%].

### *Foreign exchange markets*

The story of 2017 so far has been the weak US dollar versus a strong euro, as the euro area's economy picks up, the ECB winds down its QE programme and political risks subside. However, US higher budget deficit, the prospect of accelerating growth and inflation and consequently further monetary tightening by the Fed, would favour a stronger dollar, most likely in the first months of 2018. Nevertheless, as soon as the ECB probably terminates its bond purchase programme towards the end of the year and possibly give rise to more formal talks about rate hikes, market participants could assume that the ECB will pursue a more restrictive monetary policy. As a result, the euro will pick up against the dollar towards 1.22 (today 0.88) by the end of the first half of 2018.

Finally, an expected range for the exchange rate of the sterling pound against the US dollar is between 1.26 and 1.36, while the euro against the sterling pound should be between 0.86 and 0.96 and against the yen could climb towards 140.

## 7. The dynamics of European integration

Moving on to the situation in Europe now (Part II of my book), December 2017 marks 18 months since the referendum on the UK's exit from the EU and 18 years since the introduction of the single currency, the euro. These two milestones have drastically altered the dynamics of the European Union. However, my belief is that eurozone membership will remain unchanged at 19 countries in the foreseeable future, as I do not see a possible entry, say, of Poland or the Czech Republic, Governor Singer, my good friend Miroslav, I hope you agree, but there are also slim chances today of an exit referendum in a eurozone country because the political message from recent key elections for instance in the Netherlands and France shows a straight defeat of the populist, anti-European political forces (I refer to Marine LePen's defeat in France, the win of Mark Rutte in the Netherlands, the Italian Five Star Movement has mitigated its anti-European rhetoric, while in Spain the Catalunya issue seems to have been addressed and Prime Minister Rajoy has come out stronger). This is not to deny an escalation of the anti-euro sentiment in Europe in the near future triggered perhaps by another turn in the migrant crisis, which remains dormant at the moment.

In Germany, growing euroscepticism is reflected in the unusual political instability following the recent general elections. Probably you are aware it was indeed on a European issue – the issue of extending the powers of the European Stability Mechanism (ESM), the EU's rescue fund – that Merkel's coalition talks with FDP liberal leader Christian Lindner stumbled. I hope this deadlock is resolved sooner rather than later.

The best hope for getting serious EMU reform back on the agenda is a successful conclusion for the talks Christian Democrats and the Social-Democrats. A "Grand Coalition" between Germany's two largest parties would be the most stable and market-friendly outcome, as opposed to the other two scenarios: a minority government or another general election in Germany. However, if such a "Grand Coalition" is formed, then the main opposition party at the Bundestag will be the fiercely eurosceptic Alternative for Germany (AfD).

In the United Kingdom, and in particular on the Brexit front, there is cautious optimism that a December summit breakthrough is still possible, as the UK accepts EU financial settlement demands, removing one of the biggest obstacles to a Brexit divorce settlement.

In France, modernisation is at the forefront of President Macron's agenda, who has put forward proposals for reforms that will reshape the EU. Of course, Macron needs to establish his credentials as a reformer first in his own country. An initial successful step was taken with the reform of France's labour law, which must now be followed by the tricky reforms of France's taxation and vocational training system.

In parallel, President Macron has placed deepening the European project at the heart of his agenda. His address on Pnyka Hill last September, as part of his visit to Athens, his first ever official trip abroad as France's President, but also his speech at Sorbonne University a few weeks later were intended to send a clear message about France's European ambitions, covering everything from common defence to harmonisation of tax policy, including a Finance Minister for the eurozone.

As a Southern pro-European myself, I strongly believe that the urgency in Europe is not to be complacent and leave the populists dictate the agenda. Southern European countries must stick with reforms (including the mother of all reforms, namely the privatisation agenda), and, on the other hand, leading eurozone countries must make sure to build the missing pieces of the EMU incomplete architecture, including a financial union among eurozone countries through the completion of the Banking Union – I have no doubt that there will be another European compromise on the long-mooted proposal for a European deposit insurance scheme (EDIS) – and the Capital Markets Union. There is also the recent proposal in the field of fiscal policy from the European Commission on a European Safe Bond (ESB), which is also the subject of a study by a high-level group at the ECB, chaired by Bank of Ireland Governor Philip Lane. The idea is that sovereign debt across the eurozone could be bundled into a new financial instrument, the ESB, and sold, if you like, as a European brand, to investors. This is a different idea from pooling national government debt issuance, known as the common Eurobond, which, I know, remains a political taboo in Germany. And I want to assure the esteemed President of the Deutsche Bundesbank, Mr. Welteke, that I make no personal value judgement on this.

As ECB President Mario Draghi rightfully said two weeks ago at the annual European Banking Congress in Frankfurt, this is the right moment for the euro area to address the remaining gaps in the institutional architecture of the EMU and, if I could add, that would help the benefits of growth in Europe reach not only the countries of the North, but also the countries of the europeriphery.

## 8. Greece

Finally the latest on my own country (Part III of my book). This is a fortunate moment for Greece. After 8 years of economic hardship, we can say with confidence that there is light at the end of the tunnel for the Greek economy. This is not the right place to ask what went wrong in Greece or put the blame. What is important today is to look forward. Based on this year's economic performance, namely a solid primary budget surplus of 2.5%, a growth rate of about 1.5%, albeit modest and cyclical, it is the highest over the last 10 years, quite necessary to stabilise expectations. The country also recorded a current account surplus of 0.4% and an unprecedented 30 million tourists visited Greece this year, and, in light of the above evidence, next year's prospects are even more promising, with official forecasts of 2.5% economic growth rate and a primary budget surplus of 3.8% of GDP.

On top of that, two more signs make me really optimistic about the future: Firstly, there is evidence of the rebalancing of the Greek economy towards the external sector: a 9% increase in the share of export of goods and services as a percentage of GDP (up from 19% to 28%). Secondly, a tentative but successful return to international capital markets through a €3-billion bond issue last July and a €30-billion voluntary bond swap last week aiming at building a proper sovereign bond yield curve and providing depth into the Greek secondary bond market. The take-up reached 86% of bondholders, with more than half of participants being international investors.

I conclude here with one final remark about the state of Greek banks and two further points or messages, if you like, addressed at several recipients. After three recapitalisations during the last 5 years, the financial position of the Greek banking sector is progressively stabilising. As Greek banks are the outlier on the non-performing loans' European map, efforts must be stepped up beyond the existing performance targets set by the Bank of Greece. Moreover, new stress tests as part of a pan-European exercise next spring are widely expected not to hold any negative surprises for the capital position of Greece's systemic banks. A gradual return to normal bank funding conditions, less dependence from the Eurosystem and a steady increase in deposits will ultimately encourage new bank lending to healthy businesses, restoring Greek banks' profitability, thus allowing Greek banks to face the modern-day challenges, together with their European counterparts, such as green financing, smart technologies, including fin-tech and cybersecurity, etc.

I turn now to the two messages I promised earlier.

Message #1: Firstly, a permanent return to international capital markets and a drastic drop in the cost of sovereign borrowing, comparable to that of Portugal are within reach, after the timely completion of the Third Adjustment Programme in August next year, subject to one or two preconditions. There is so much liquidity out there and the hunt for yield never stops. Greece can offer right now government bonds with high yields and safety. May I also remind you that four-fifths (4/5) of Greece's public debt now lies in the hands of the official sector, with a very low cost of servicing (1-1.5%), with long maturities and indeed long-deferred amortisation payments. One such necessary, but not sufficient, precondition is the following: a cash buffer of €15 billion for the first year after the end of the programme, which requires three new timely bond issues (with 7-, 3- and 10-year maturities) during the first half of next year, worth €6 billion in total, plus another €9 billion from the ESM, agreed already, to be followed of course by some sort of conditionality (others might include: entry to ECB's QE, some further debt relief and one or two credit rating upgrades, etc.).

My second message is more political and is addressed to various competent stakeholders, starting with the imperative of political stability and continuing with no complacency, no slackening of effort, and a requirement to stick to reforms and indeed to the mother of all reforms, namely the privatisation agenda for a slim and efficient public sector.

The above are all prerequisites for incentivising foreign direct investment (FDI) but also domestic investment, which are the key drivers behind sustainable growth and indeed job creation, which should be the ultimate objective.

Thank you very much for your attention.