John Iannis Mourmouras: Monetary policy and global capital markets - an update

Address by Professor John Iannis Mourmouras, Deputy Governor of the Bank of Greece, at the launch of the second edition of his book at the NYU Stern School of Business, New York City, 28 September 2018.

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Introduction

Dear Vice Dean,

Dear President Barroso,

Dear Governor King,

Distinguished panellists and esteemed Professors of NYU, Yale and Princeton,

Ladies and Gentlemen,

I am very delighted to be here at NYU. I would like first of all to thank Stern Business School for hosting my book launch event and all the team who worked and made this happen. I am truly honoured by the presence of Prime Minister Barroso, a true European statesman with a long tenure as President of the European Commission, the government of the European Union, who left his mark on Europe in unprecedented and difficult times. He personally worked hard to keep my country within the eurozone, quite often at a personal cost for him against stiff opposition by a number of core European countries. President Barroso, the whole Greek nation, including myself, will always be grateful to you for this.

The presence of such a strong panel is a great honour for me as a central banker and academic. Professor the Lord King, one of the world's leading central bankers of modern times, among only a handful, still sets the standards high for all those involved with global monetary affairs, well-known also for his passion for cricket! Both these two distinguished gentlemen, Barroso and King, have something in common: their common feature, although one was in politics and the other in central banking, is, by pure coincidence, that they both held the top position in their field for two full successive terms, a total of ten years each, Barroso from 2004 to 2014, and King from 2003 to 2013, in the same turbulent period. History pays tribute not only to achievements, what one has done after all during one's tenure, but also to the longevity of one's time in office.

I would also like to thank Professor Robert Engle for finding time to be here with us, a leading figure in finance, a Nobel laureate who has rightfully gained a place in the pantheon of great men and women in Economics for his work of modelling time-varying volatility, his famous ARCH model is used extensively not only by academics, but also by analysts of financial markets who use it in asset pricing and in evaluating portfolio risk.

And of course, I am very grateful to the two colleagues, one from finance and one from economics, Professor Richardson and Professor White, both distinguished experts in their respective fields, for being here today.

I will focus only on monetary policy and capital markets. I fully subscribe what President Barroso said in his opening remarks on European developments. He said it all! Instead, I will make a short reference to my own country, Greece. This is a fortunate moment for my country. After 8 years of hardship and 3 adjustment programmes, Greece is emerging with renewed optimism from this difficult time and is finally returning to European normality.

A. Monetary policy

Global economic activity in advanced economies has expanded in a robust manner in recent years, however, due to a persistently low inflation, most of the unconventional tools of monetary policy are more or less still in place, especially in Europe. To give you an idea of the extraordinary circumstances that we experienced since 2008, in Britain, the Bank of England's base rate had historically remained above 2 per cent for 315 years, from its foundation in 1694 until 2009. It was in response to the severity of the crisis that Governor King had to cut the base rate below 2 per cent and to take it even to the level of half a percentage point in March 2009 in an MPC meeting which also launched the BoE's QE programme (amounting to $575 billion or 22% of the UK's GDP).

Today, although much of the excitement comes from the uncertainty surrounding the timing of the expected rate hikes by the Fed, and developments in emerging economies (Argentina, Turkey, etc.), I propose to focus, as a Eurosystem central banker, on ECB's monetary policy.

The global monetary policy outlook continues to diverge. At one end of the spectrum is the US Federal Reserve, which is likely to continue to tighten policy (only two days ago we had another quarter rate hike) ; at the other end, is the People's Bank of China, likely to keep gradually easing monetary conditions, and the Bank of Japan, which is expected to stick to its yield curve control for the foreseeable future. At the same time, the European Central Bank and the Bank of England are somewhere in the middle. Both seem to want to normalise policy gradually.

In the euro area, following 21 consecutive quarters of expansion, including the last five with vigorous GDP growth, economic momentum moderated in the first half of the year. The euro area is expected to grow at a modest rate of 2.1% this year (down from 2.4% in 2017) and to moderate to 1.9% in 2019.

Headline inflation is forecast to an average of 1.7% over both 2018 and 2019. Core inflation is estimated to remain around 1%. Recent Phillips curve analysis by the IMF indicates a strong backward-looking element in the euro area inflation process, suggesting significant sluggishness in the face of what will be a positive euro area output gap.

At the Governing Council in Frankfurt two weeks ago, the ECB continued its enhanced forward guidance towards normalisation of its monetary policy and confirmed that it will reduce the monthly pace of its net asset purchases to €15 billion starting next month and until December 2018, and then end them. Up to now, the ECB has bought around €2.5 trillion under the APP programme. It is estimated that the APP purchases will rise near 23% of euro area's GDP in December 2018 [this compares to the quantitative easing programmes of the US Fed: $4.2 trillion or 21% of GDP, of the Bank of Japan: $5 trillion or 97% of GDP, and of the Bank of England: $575 billion or 22% of GDP].

So the excitement most likely left for the Governing Council meeting on 25 October, where it is widely expected that the so-called QE reinvestment policy will be discussed and announced.

Here are my own insights on the ECB's reinvestment policy. QE reinvestments have already started in the euro area. In 2017, the ECB re-purchased about €47 billion this way. With the ECB conducting only reinvestments, its gross asset purchases will fall from €465 billion in 2018 to €165 billion in 2019.

The ECB has clarified that during the period of net asset purchases, principal redemptions of public sector securities will be reinvested in the jurisdiction in which the maturing bond was issued. An open issue remains – and this is my own personal view – that is, whether the ECB would **reinvest maturing bonds introducing a new twist while respecting the capital key?**

Let me explain. Maintaining a high maturity would ensure that the term premium and yields for longer-dated bonds stay low. By investing cash from maturing bonds into bonds with a maturity of, say, at least ten years, such an operation twist could be potentially useful during the reinvestment period, since it can be used as a vehicle for differential stimulus across countries. This fine-tuning of the maturity of assets is nothing unprecedented. In 1961, the Fed sold short-term T-bills and replaced them with longer-dated government bonds, while in the period between September 2011 and December 2012, the Fed replaced $667 billion in securities with maturities below three years with longer-dated assets.

In terms of challenges ahead, beyond the reinvestment period i.e. beyond 2020, let me focus on a pivotal issue.

Question: Is there an optimal central bank's balance sheet size?

An important issue is how long it will take for the ECB to reduce the balance sheet to its original – or another predetermined – level. My personal view is that there is no need for the ECB to rush to reduce the size of its balance sheet, as one needs to take into account the uncertainty created among market participants and to avoid any potential market disruptions. There are other (conventional) tools to use if tightening is deemed necessary, including: raising interest rates even with a large balance sheet, increasing reserve requirements, using reverse repo operations to drain excess liquidity. What is important is to make sure predictability is safeguarded by presenting a normalisation sequencing roadmap, which allows the balance sheet to shrink passively by holding the assets purchased to maturity. There are pros and cons of a large central bank balance sheet (from the standard monetarist argument that points to excess liquidity originating a rapid inflation to financial stability considerations). No matter what this optimal size is, it is important for the central bank to communicate with the markets what will be the new 'normal' balance sheet size. In other words, central banks should define clearly the framework, in which they intend to implement monetary policy at the end of the normalisation period.

Let me now briefly turn to developments in and prospects for financial markets.

B. Global markets

Our Research and Financial Operations Department and the Asset Management Committee, which I chair, at the Bank in Athens, share the widely held view that the US dollar will remain strong in the months ahead [by midyear about 6% above its low point against other currencies in February], vis-à-vis other major global currencies, while in the fixed income, again the US will continue to offer one of the highest interest rates in the developed world. For example, US 2-year Treasury yields are the most attractive among the G10 economies, a situation highly unusual and unprecedented since the turn of this century. The main driver behind this is US economic policy, which – if you allow me to use a catch phrase– may be described as follows: "Fed up, with tariffs", plus of course the drop in tax rates.

In the eurozone financial markets, the normalisation of ECB's monetary policy remains the main driver of the still fragmented euro area government bond market. The core euro area countries form a rather homogeneous group; the europeriphery, by contrast, is less homogeneous. The diversity is due to recent developments in Italy, headed by a fragile, populist coalition government. Indeed, as a result of the latest political turmoil over immigration and the budget debate, the Italian 10-year yield has reached 3% and remains in this area since August. Other peripheral countries such as Spain and Portugal remain resilient and contagion remains limited.

Italy is not Greece. It is too big to ignore, as the eurozone's third largest economy and the world's third largest, after the US and Japan, sovereign debt market with total public debt of more than €2.3 trillion, of which more than 36% is held by foreigners, and the political uncertainty could generate severe spillover effects to the global sovereign markets. There is a nightmare scenario which I do not share, of which markets are of course aware and already factor it in. This political tit-for-tat between the populist government of Italy and Brussels may escalate into a genuine diplomatic war (for some people, what is at stake here is the next Italian Prime Minister) and this would lead to a downgrade of Italy's credit rating (currently at BBB), and a potential loss of its investment grade, which would force the ECB not to accept Italian bonds as collateral for the provision of liquidity and to stop buying Italian government bonds under its PSPP. Taking into account that QE ends next December, borrowing costs in some euro area countries could surge to more than 5%, near 2013 levels. The worry then would be that this could perhaps trigger the next eurozone crisis: a remote, unthinkable scenario. Enter Italy's most famous personality after Julius Caesar (as you know, famous for his quote "veni, vidi, vici"), with his world-famous quote, "whatever it takes"; it is far from clear that the "only game in town" WOULD be enough to save the euro ***this*** time.

Before closing with my comments on my country, Greece, only a very brief comment on populism. Next May's elections for the new European Parliament are going to be a big test of populist strength in Europe. If populist/nationalist parties do well next year, they might be setting the agenda in European politics as an unofficial alliance against pro-European forces. Populism may have disastrous effects for independent institutions and civil peace.

The rise in populism might have significant effects on growth, as populists opt for protectionist and anti-market measures and less prudent economic policies having the potential to lead to slowing or backtracking of growth-promoting reforms. Lacking the pragmatism of mainstream parties, populists risk shifting away from the pro- business, pro-market policies towards some form of "big government".

C. Greece

Greece, last month, exited successfully an 8-year strict surveillance period, during which it has received about €240 billion from our European partners and the IMF in the context of three adjustment programmes. During this period, Greece experienced a dramatic fall in output (more than 25% in GDP), the unemployment ratio almost tripled from 9% in 2008 to 26% in 2015, a huge fall in the standards of living and valuations of assets (real and financial) and another mountain of private debt had been built up (around €220 billion in 7 years). This is not the venue and time to ask what went wrong in Greece. I have written extensively on this topic with my two previous hats.

What is more important is that the country is finally out of the woods and we have to make sure that past mistakes are not repeated and to create the conditions so that the Greek people are in a position to look into the future with optimism.

Now that expectations have been stabilised and public debt dynamics are under control, it is important for the Greek authorities to focus on the agenda to achieve a sustainable return to capital markets. I have recently proposed elsewhere ***what*** could make such a return feasible in the near future.

Briefly, (a) No return to the markets can be permanent and hence credible with capital controls still imposed on the economy. The full lifting of capital controls, signalling also the end-date (which could be Q1 next year) would be the catalyst for the full recovery of trust of depositors, but also boost investor confidence in the prospects of the economy.

(b) Regaining the investment grade held in 2008 is as important as ensuring debt sustainability. This should be at the top of Greece's policy agenda over the next year or so, we are only two notches far away. Its significance is comparable to meeting the Maastricht nominal criteria that allowed the country to enter the euro area.

(c) Given the prolonged fiscal consolidation and private disinvestment that took place (2007: investment was 27% of GDP, today it is 11% of GDP, the lowest level since 1960), the country needs an investment shock. Reviving domestic and foreign investment is crucial to supporting the economic recovery. That is why it is important for the government to speed up the privatisation agenda, not so much as a revenue exercise, but as a great opportunity to attract FDI in key sectors of the economy, such as transport, energy, logistics and tourism.

I would recall a proposal I made in the summer of 2014, which links reduced primary surplus targets with a drastic gradual reduction of corporate tax rates in line with the fiercely competitive corporate tax rates applied by Greece's neighbours in the Balkans.

If such steps are taken and there is no slackening of effort, no reform fatigue, no complacency, etc., I am pretty confident that my country will soon no longer bean outlier of the eurozone and become a normal south European country.

Thank you very much for your attention.

I am really honoured to be here today among such clever people!