

SPEECH

Unconventional fiscal and monetary policy at the zero lower bound

Keynote speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Third Annual Conference organised by the European Fiscal Board on “High Debt, Low Rates and Tail Events: Rules-Based Fiscal Frameworks under Stress”

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One of the greatest conundrums and policy challenges of our times is the coincidence of persistently low real long-term interest rates and low inflation.

Even before the coronavirus (COVID-19) pandemic, inflation across many advanced economies had been falling short of central banks' aims for nearly a decade. In the euro area, hopes that inflation would sustainably recover to levels closer to 2% have been repeatedly and persistently disappointed, despite highly favourable financing conditions.

Years of subdued price pressures have raised the spectre of low inflation becoming entrenched in people's expectations. Considering that financial markets believe that real interest rates will remain in negative territory for the foreseeable future, private investors appear to harbour serious doubts about the capacity of the euro area economy to chart a sustainable path towards higher nominal growth.

In my remarks this morning, I will argue that the experience of the past decade requires us to think differently about the optimal policy mix in the vicinity of the effective lower bound. In particular, whether low

inflation will prevail in the medium term will depend not only on monetary policy but also on the decisions made by fiscal policymakers, including on the structural side.

Monetary policy implications of persistent supply-side shocks

Before the pandemic, the global economy enjoyed a period of benevolent growth. Slack was gradually disappearing, output gaps had closed and unemployment had declined to record low levels in many advanced economies (see slide 2).

Even broader measures of slack, including, for example, the number of people working part-time involuntarily, signalled growing scarcity in labour markets (see left chart slide 3).

Yet, inflation in advanced economies did not show any signs of acceleration. Since 2012, there has not been a single year in which inflation for a group of advanced economies as a whole exceeded 2% – the level that is widely considered to be consistent with price stability (see right chart slide 3).

At first sight, these developments seem to point to a weakened relationship between economic slack and inflation. ECB staff analysis for the euro area, however, suggests that while the slope of the Phillips curve is flat, it has not changed in any statistically significant manner in recent years (see left chart slide 4).^[1]

Instead, Phillips curve models point to other factors putting persistent downward pressure on underlying inflation in recent years (see right chart slide 4).

Research suggests that these factors include slow-moving secular forces, such as demographic change, the decline in productivity growth, the impact of globalisation and digitalisation on prices, profits and the

bargaining power of workers, as well as far-reaching changes in energy production and consumption, also due to climate change.^[2]

The coincidence of low inflation with a persistent decline in real interest rates corroborates the view that structural factors are likely to have played an important role in recent years (see left chart slide 5).

With more savings chasing fewer investments, low and stable inflation today is consistent with real short and long-term interest rates that are much lower than even a decade ago. Available estimates of this “equilibrium” rate of interest suggest that nowadays stable inflation is likely to require a negative real short-term interest rate (see right chart slide 5).

The implications of these developments for monetary policy are twofold.

First, since monetary policy is acting on the demand side, it has less traction in countering persistent structural shocks to inflation. In the absence of supply-side policies, inflation can then diverge from central banks’ aim for a protracted period of time.

Adaptive expectations raise the costs of such divergences. If firms and households expect inflation to remain at very low levels, it becomes even harder for central banks to achieve their inflation aim (see left chart slide 6).

Second, the decline in real interest rates limits the extent to which monetary policy can stabilise the economy in the wake of demand-side shocks.

The pandemic is a case in point. Despite the unprecedented severity of the crisis and the large shortfall in aggregate demand, the ECB did not cut its key policy rates. Although there is some room left to reduce short-term rates further, the benefits and costs of deeper negative rates need to be weighed carefully.

To circumvent the effective lower bound, central banks have resorted to unconventional monetary policies. For example, in response to the pandemic, the ECB launched a new asset purchase programme – the pandemic emergency purchase programme (PEPP) – and a new series of targeted longer-term refinancing operations (TLTRO III).

Such tools are powerful in directly influencing the relevant borrowing conditions of the private sector, and they have been instrumental in stimulating growth and inflation during the pandemic.

But after many years of continued monetary expansion, the risk-free yield curve in the euro area has become very flat – much flatter than in the United States (see right chart slide 6). As a result, there is less scope for asset purchases to further compress term premia and thus long-term yields.

Moreover, academics and the central banking community increasingly acknowledge that, even if real rates could be pushed lower, the effects on growth and inflation may be limited as aggregate demand may become less sensitive to interest rate changes when rates are very low, or when they have been low for a long time.^[3] The result could be a “macroeconomic reversal rate”, at which the costs of further easing, especially in terms of financial stability, could outgrow the benefits.^[4]

The euro area policy mix before and during the pandemic

The implication is that, in a world in which monetary policy is constrained and in which inflation is not solely determined by demand-side policies over a policy-relevant horizon, it will be difficult for monetary policy alone to stabilise the economy satisfactorily.

A key lesson from the literature is that, in these circumstances, monetary, fiscal and structural policies are needed to jump-start and reflate the economy.^[5]

The failure of inflation to accelerate more forcefully in the euro area over the past decade may, in fact, be less of a conundrum when considering the response of public spending to even sizeable changes in interest rates: before the pandemic hit the euro area, the primary balance was positive and growing in the years after 2014 (see left chart slide 7). Public investment fell rather than rose (see right chart slide 7).

The lack of public investment might also have hampered private investment. For the euro area, there is evidence that public investment tends to crowd *in* private investment, rather than *out*.^[6]

A public sector that is largely insensitive to interest rate changes significantly reduces the effectiveness of monetary policy, in particular in the euro area, where governments account for nearly half of total spending. An unresponsive fiscal authority disregards the broad empirical evidence that fiscal policy is particularly effective at the lower bound.^[7]

Fiscal restraint was, of course, not without reason.

In many countries, years of cyclical upswing before the global financial crisis had not been used to build sufficient fiscal buffers. Elevated debt levels carry a particularly high vulnerability in a decentralised currency union, where the absence of a fully consolidated public balance sheet exposes governments to a higher risk of self-fulfilling debt crises.^[8]

Fiscal policy, then, faces a difficult trade-off between business cycle stabilisation and debt sustainability, in particular in a situation with high legacy debt. This limits the extent to which governments can commit to sizeable expansionary fiscal policies, even if such policies would be optimal for society as a whole.

The pandemic has been a stark reminder of this trade-off. Risk premia on lower-rated sovereign bonds sky-rocketed in March last year, impairing the transmission of both monetary and fiscal policy.

Two decisions were necessary to break this vicious circle.

First, the launch of the PEPP concentrated market expectations around the good equilibrium. Sovereign spreads in Greece, for example, had fallen by 150 basis points before we even bought a single bond. The backstop function of the PEPP prevented private cross-border risk-sharing from collapsing more permanently, as it had done in past crises, thereby complementing efforts to increase public risk sharing (see left chart slide 8).^[9]

Second, the European Commission lifted state aid requirements and decided to invoke the escape clause, and the launch of the EU Recovery and Resilience Facility pooled risks, thereby reducing pressure on national budgets. For the first time, a euro area-wide instrument was created with the specific aim of ensuring that the aggregate euro area fiscal stance is appropriately countercyclical.

Together, the PEPP and the Recovery and Resilience Facility created the conditions for national fiscal policies to mitigate the dramatic social and economic costs of this crisis. The experience of the past year suggests that, in the presence of both facilities, all national government bonds are, in essence, considered safe assets by private investors.

Indeed, never since the global financial crisis of 2008 has the spread between the GDP-weighted 10-year sovereign yield and the euro area risk-free rate been lower than today, despite the sharp rise in nominal debt and deficits (see right chart slide 8).

The policy response to the pandemic is a remarkable showcase for the power of monetary and fiscal policy interaction to boost confidence, stabilise aggregate demand and avoid a persistent destabilisation of medium to long-term inflation expectations.^[10]

Macroeconomic stabilisation in the future

Both facilities, however, are temporary and linked to the pandemic, while the effective lower bound is likely to remain a recurring constraint in the future.

ECB staff simulations suggest that, at current levels of the real equilibrium interest rate, the lower bound may become binding one-quarter of the time – about twice as often as estimated when the euro was introduced.

The question, then, is how to ensure effective macroeconomic stabilisation in the euro area in the future.

The pandemic holds two lessons, one for monetary and one for fiscal policy.

First, monetary policy has to enable sustainable private and public spending.

Low rates do not mean that monetary policy no longer has a role to play. On the contrary, monetary support will remain an important pillar of macroeconomic stabilisation. But, in the vicinity of the lower bound, the central bank needs to weigh more carefully the evolving balance of the benefits and costs of lowering short- and long-term rates further.

In this environment, when financing conditions are at a level that incentivises all sectors of the economy to consume and invest, monetary policy can best support the economy by shifting its focus away from instrument activism – that is, from the intensity with which it uses the available array of instruments – and towards the duration of policy support.

By credibly promising to preserve favourable financing conditions for as long as needed central banks underscore their unwavering commitment to the achievement of their mandate and ensure that monetary

policy does not itself become a source of uncertainty, both with respect to its short-term reaction function and the potential vulnerabilities that too negative yield curve constellations could create in the future.

The horizon of policy support will then depend on the extent to which the private and the public sector make use of accommodative monetary conditions. The intensity of policy support, in turn, will evolve endogenously with the economic recovery.^[11]

This means that changes in nominal rates have to be monitored closely and interpreted in the light of their driving forces. For example, a rise in nominal yields that reflects an increase in inflation expectations is a welcome sign that the policy measures are bearing fruit. Even gradual increases in real yields may not necessarily be a cause of concern if they reflect improving growth prospects.

However, a rise in real long-term rates at the early stages of the recovery, even if reflecting improved growth prospects, may withdraw vital policy support too early and too abruptly given the still fragile state of the economy. Policy will then have to step up its level of support.

A policy of preserving favourable financing conditions includes a second element.

To ultimately empower fiscal policy as a transmission channel of monetary policy, the ECB needs to provide liquidity when risks of self-fulfilling price spirals threaten to undermine stability in the euro area as a whole.

As was the case during the pandemic, this may require temporary flexibility in the use of instruments. Being clear about this upfront reduces the emergence of destabilising dynamics in the first place and minimises the extent of interventions when they are needed.

In such situations, risks of moral hazard should not condemn the central bank to a course of inaction. These risks should be governed by other institutions outside crisis times.

The lesson for fiscal policy is that, in lower bound episodes, it has to become more responsive to downturns.

This requires fiscal tools that are specifically designed to provide macroeconomic stabilisation, ideally at the euro area level, but at least at the national level. Put simply, unconventional monetary policy needs to be complemented by unconventional *fiscal* policy.

The concept of unconventional fiscal policy is not yet well established.^[12] A simple Google search, for example, returns more than 700,000 results for unconventional monetary policy but only about 8,000 entries for unconventional fiscal policy.

In essence, unconventional fiscal policy comprises measures that go beyond traditional automatic stabilisers, which tend to be too small to offset the effects of an adverse demand shock at the lower bound. These unconventional measures are only activated when the economy heads into a deep recession.

In the United States, for example, the length of unemployment benefits automatically increases as soon as the unemployment rate exceeds a certain threshold. The use of job furlough schemes in large parts of the euro area in response to the pandemic is another powerful example of how unconventional fiscal policies can stabilise household incomes to avoid risks of long-term scarring.

Similarly, theoretical and empirical evidence suggests that budget-neutral policies that work through the revenue side – for example, by engineering a specific path for consumption and labour taxes over time –

can effectively support the efforts by central banks to boost inflation expectations and consumer spending at the lower bound.^[13]

Creating a framework for effective stabilisation in the euro area

Refocusing stabilisation along these lines requires an institutional framework that reliably creates space for fiscal policy in good times and allows this space to be used in bad times to provide a policy mix that best protects the euro area economy against downturns.

In 2019, the European Fiscal Board concluded that the current framework remained insufficient to deliver a more countercyclical fiscal policy stance.^[14] It also recommended focusing on a single operational indicator – an expenditure rule – and a single target, a debt anchor.

There is broad agreement that these proposals go in the right direction. Because most expenditure components are insensitive to business cycle variations, an expenditure rule can measurably help reduce the procyclicality of fiscal policy and thereby also support monetary policy.

An intense debate has emerged, however, about the appropriate level of the debt anchor, and the EU's 60% reference value in particular.^[15] Not few observers point to the benign implications of the sharp decline in real and nominal interest rates for debt sustainability. Despite much higher debt, interest rate expenses as a share of euro area GDP have declined from more than 5% in 1995 to 1.6% today (see left chart slide 9).

Rates can, of course, rise again in the future if required by the price stability mandate of the central bank even if depressed equilibrium interest rates will make monetary policy restrictive at much lower interest rate levels than in the past.

History suggests, however, that it would be a mistake to project the present environment into the indefinite future. Interest rate growth differentials have fluctuated widely in the past. Periods with negative “r-g” have often been followed by periods with positive “r-g”.^[16]

It would be imprudent to assume that governments face no intertemporal budget constraints. A credible debt anchor remains an important pillar of a stability-oriented policy framework and central bank independence.

Yet, there is a case for reflecting on the appropriate pace at which this debt anchor should be reached over time.

Two considerations are most relevant for monetary policy.

First, ECB staff analysis suggests that, under the current rules, requirements to reduce debt in excess of the 60% threshold risk creating a vicious circle between monetary and fiscal policy when inflation is below our medium-term aim – which is precisely at a time when fiscal support is most needed.^[17]

Correcting fiscal adjustment requirements for deviations from the ECB’s inflation aim would help break this circle. Simulation analysis suggests that such a “nominal” cyclical adjustment would significantly smooth adjustment requirements (see right chart slide 9).^[18] It would create fiscal space and support price stability without endangering debt sustainability.

Second, the medium-term pace of adjustment should strike a sensible balance between the benign effects of the decline of real equilibrium interest rates on debt sustainability and the importance of a credible debt anchor for market expectations.

Take the pandemic as an example.

A mechanical application of the current rules could imply fiscal adjustment needs in some euro area economies that would be severely damaging from a societal, economic and monetary policy perspective.

Evidence shows that austerity does not pay off at times of weak growth, even if debt is already high.^[19]

Targeted fiscal support will improve rather than harm future debt dynamics by reducing the scars that the pandemic will leave.^[20]

There is one further reason why a too mechanistic return to lower debt levels may be misguided: expenditure cuts often affect investment the most.

Reducing public investment further from already low levels would be a costly mistake. New research shows that many investments, in particular in education and infrastructure, pay for themselves at much higher real interest rates than the ones currently prevailing.^[21]

The responsible use of the Recovery and Resilience Facility is crucial in that respect. It provides sizeable funds to promote investment in future technologies. But EU funds should not be taken as an excuse to reduce the investment component of national budgets.

Public investment and structural policies hold the key to a higher sustainable growth path and higher interest rates. Monetary policy must take the equilibrium interest rate largely as given. Fiscal policy can help raise it.

Conclusion

My conclusion is therefore that the current era of low inflation and low interest rates – which is unlikely to change in the near term in light of the pandemic – forces us to reconsider how monetary and fiscal policy

should complement each other to protect the economy from large downturns and to minimise risks of long-term scarring.

Effective macroeconomic stabilisation in the vicinity of the lower bound requires both unconventional monetary *and* fiscal policies. Central banks need to establish and preserve a level of financing conditions that enables sustainable private and public spending. Fiscal policy, in turn, needs to recognise its role in the transmission of monetary policy in a low inflation, low interest rate environment.

Achieving this policy mix requires an institutional framework that creates the tools and the space for fiscal policy to support the efforts of the central bank when inflation is below its aim and that recognises the existence of a budget constraint in the long run.

Thank you.

Annexes

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Slides

 ENGLISH

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