Gediminas Šimkus: Post-pandemic economic recovery - realities and perspectives

Speech by Mr Gediminas Šimkus, Chairman of the Board of the Bank of Lithuania, at the high-level conference „Post-pandemic economic recovery: realities and perspectives", organized by the National Bank of Moldova, 4 June 2021.

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CHECK AGAINST DELIVERY

Dear Governors, Central Bankers and Colleagues,

It is a great honour to address you on this momentous occasion. The National Bank of Moldova (NBM) is currently celebrating its 30th anniversary. Over the past three decades, the NBM has achieved a great deal: from banking sector rehabilitation to delivering on price and financial sector stability – and much besides.

I wish to highlight, if I may, the word "maturity". The NBM has matured into a central bank with solid capacity and expertise, resilient governance, autonomy, policy credibility and a strong standing within the international central banking community.

This maturity is reflected in the topic chosen for our first session today – the role of central banks in the post-pandemic recovery. This is a topic of strategic importance and long time horizon. It is only fitting that we are having this discussion on such a notable occasion.

My brief intervention today will focus on two groups: first, advanced economy central banks, and second, central banks in the emerging markets.

Let me begin with the advanced world.

A strong fiscal impulse, alongside a highly successful vaccination campaign, will put the US economy above its potential already this year. The euro area will continue to operate with a negative output gap.

By 2022, it is very likely that the US will have caught up with its pre-pandemic growth trend. There is little chance of that happening in the euro area in the foreseeable future.

A heated debate is taking place on the possibility of the US experiencing a surge of inflation. Such an eventuality would not allow for synchronised tightening across the advanced economies. Managing such desynchronisation may prove to be challenging.

At the same time, we should not rush to conclusions. The environment in which monetary policy operates has changed in recent years.

The natural real rate of interest has declined to 0 % or even lower over the past two decades in both the US and Europe. Phillips curves have become considerably flatter in this period. Several structural factors underlie this diminished relation between inflation and economic activity. The first is globalisation, which has limited inflation in traded goods – and even certain services. A second factor is automation, which, through productivity gains, has kept higher wages from being passed through to prices.

Moreover, research shows that real equilibrium rates tend to fall following pandemics. The pandemic will likely reinforce "secular stagnation" trends, magnifying the savings absorption problem and its effects on the persistently low inflation.

In the euro area, the aggregate unemployment rate is higher compared to the US or Japan.

Current tendencies in the labour market – such as the emergence of the gig economy and the absence of stronger labour unions – are leading to a diminishing power of European labour. This in turn makes it increasingly difficult to build wage pressures that could raise inflation.

The evidence we have on the table, then, indicates that a sustained surge of inflation is an unlikely event – be it in the US, Europe or elsewhere. For the same reason that inflation did not drop significantly when output gaps were large and negative during the global financial crisis, inflation is unlikely to increase to worrisome levels now. Of course, centrals banks need to stay vigilant and closely monitor inflation developments, so that sudden reactionary policy does not put the brakes on economic recovery.

In light of all this, the implications of low natural real interest rates will remain a first-order issue for advanced economy central banks in the post-pandemic period.

Fiscal policy is the first tool in line, along with structural reforms, to affect conditions shaping the current low interest rate environment. Here I would recall the well-known maxim: monetary policy cannot be the only game in town.

Indeed, one explanation for the superior inflation performance of the US relative to the euro area over the recent decade is the greater alignment of monetary and fiscal policies in the former. Accordingly, the key risk in the post-pandemic period is that poor coordination between monetary and fiscal policy leads to a continued and pronounced undershooting of the inflation objective.

But central banks can also play their part. This is why the decline in the natural real interest rate continues to be a central topic in our ECB strategy review. The review was postponed due to the pandemic and is now set to conclude in the second half of 2021.

Our reaction function will likely evolve on the basis of this review exercise. For instance, a stronger emphasis on the symmetry in our inflation target is vital given the new realities. However, that step might not suffice to convince markets and agents in the real economy that we are serious about reaching the inflation target. Allowing for a period of above-target inflation to compensate for a sustained undershoot might be an additional tool to increase inflation expectations. Crucially, we must maintain our flexibility in order to ensure that we continue to effectively carry out our mandate.

Beyond monetary policy, the importance of macroprudential policy will only grow in the low interest rate environment – especially considering the current level of monetary accommodation and the possible side effects of the non-standard measures. The time is coming when policy-makers will need to consider tightening selected macroprudential policy tools to tackle pockets of elevated vulnerability.

For instance, throughout the COVID-19 crisis the demand for housing continued to increase in many countries, drawing attention to risks in the residential real estate sector. These include a possible house price overvaluation, elevated household indebtedness and high residential real estate exposures of banks.

Let me now turn to the emerging markets.

During the peak of the pandemic crisis, capital outflows from emerging market economies (EMEs) were unprecedented in scale and speed – but also short-lived. EMEs, including Moldova, shed their “fear of floating” and allowed the exchange rate to move and absorb the shock.

In sharp contrast to previous crises a full one-third of EMEs have employed quantitative easing (QE). In the past, EMEs generally tightened monetary policy to avoid rapid capital outflows and the inflationary effect of exchange rate depreciations. The current crisis has seen EME policy reaction being more in line with that of advances economies, with QE being launched even

before reaching the zero lower bound on policy rates.

Financial markets mostly responded favourably to the QE announcements. Central banks successfully communicated that they stood behind their sovereign should fiscal expansion undermine investor confidence. Long-term interest rates decreased in response, while exchange rates did not move significantly.

How can we explain this EME resilience? Of course, large-scale injections of new liquidity by the Fed and other systemic central banks have eased global financial conditions and redirected investors to EMEs in the quest for better-yielding asset classes.

Let us not underestimate, however, the progress achieved by the EMEs themselves. In recent years, a number of EMEs have strengthened their monetary policy frameworks, anchored inflation expectations and further developed local currency sovereign debt markets. This enabled them to step into terra incognito with asset purchases when the crisis hit.

Such experience confirms that strong fundamentals constitute the first line of defence for EME central banks against potential shocks. As the emerging market sell-off in 2018 or the 2013 taper tantrum tells us, capital flows to EMEs are vulnerable to advanced economy central bank policy movements, particularly by the US FED.

Therefore, now is the time for EMEs to further strengthen their monetary policy frameworks – and build on their hard-won monetary policy independence.

International institutions, such as the IMF, are there to assist countries through programmes or capacity- development. IMF programmes for emerging markets often stress the need to safeguard central bank independence and strengthen monetary policy frameworks, which can substantially support EMEs under stress.

Moving forward, we can see the contours of what needs to be done to prepare for the post-pandemic economy. But this brave new world may look different than we currently imagine. Some have suggested that we are entering uncharted waters, which may require novel ideas and bold action. I thus hope that we can return to this topic and continue our dialogue.

Meanwhile, I wish you an enlightening and enjoyable conference.