Flash Economics

N° 10
August 2nd, 2024

Theoretical debates on the ECB's monetary policy

We review here the main theoretical debates concerning the ECB's monetary policy. These are:

- The relevance of a 2% inflation target when inflation is likely to be permanently higher and the importance of investment needs (for the ecological transition, for the relocation of strategic industries) leads to desire low real interest rates;
- The weight of the objective of financial stability, which is currently weak, as shown by the repeated excessive increases in asset prices and the constant increase in the debt ratio;
- The likely irreversibility of money creation policies through quantitative easing;
- The existence or not of fiscal dominance mechanisms, i.e. the extent to which monetary policy decisions take into account the need to ensure the sustainability of public debt;
- The relevance of introducing incentive mechanisms linked to the energy transition into monetary policy instruments, for example a differentiation between "brown" and "green" debt for the interest rates on refinancing operations;
- The possibility of the ECB remaining independent if it has to coordinate its policy with other economic policies (fiscal policy, environmental policies, etc.);
- And of course, the effectiveness of monetary policy in fighting inflation.

All in all, the greatest difficulty will be to reconcile the possibility of investing much more with the defence of financial stability and low inflation.

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First theoretical debate on the ECB's monetary policy: the relevance of a 2% inflation target

The problem arises **if inflation spontaneously exceeds 2% in the future** (**Chart 1A**), which could be the case with the cost of the energy transition (higher depreciation of capital, intermittent production of renewable energies), with demographic ageing, and with the stagnation of productivity since 2017 (**Chart 1B**).

Chart 1A
Euro zone: Inflation (HICP, Y/Y as %)

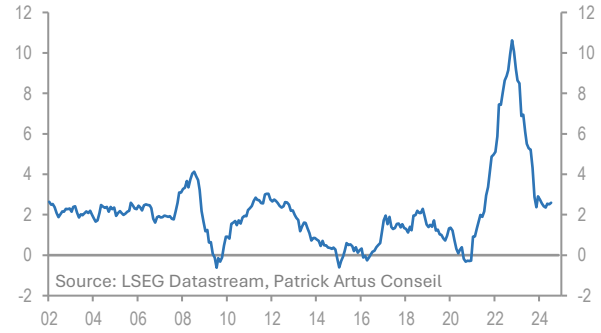
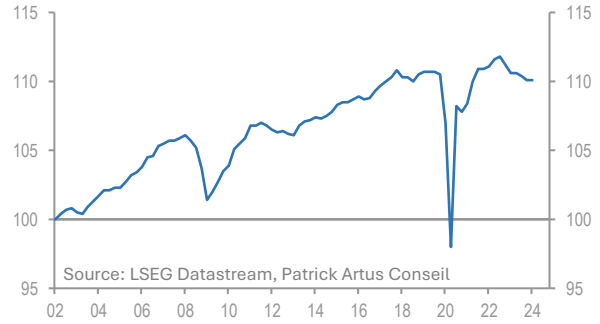


Chart 1B
Euro zone: Productivity per person (100: 2002.Q1)



If inflation is spontaneously higher than 2% in the future, bringing back inflation to 2% will require the introduction of high real interest rates. Such a scenario conflicts with executing the investments crucial for the energy transition. Increasing the inflation target would avoid this major drawback.

Second theoretical debate on the ECB's monetary policy: the weight of the objective of financial stability.

Monetary policy normally has two objectives: to ensure price stability and to ensure financial stability.

Regrettably, it has neglected the second objective, as shown by **the repeated increases in asset prices** (**Chart 2A**), **or the increase in the overall debt ratio** (**Chart 2B**).

Chart 2A
Euro zone: House price index and Euro Stoxx
(100 : 01.01.2005)

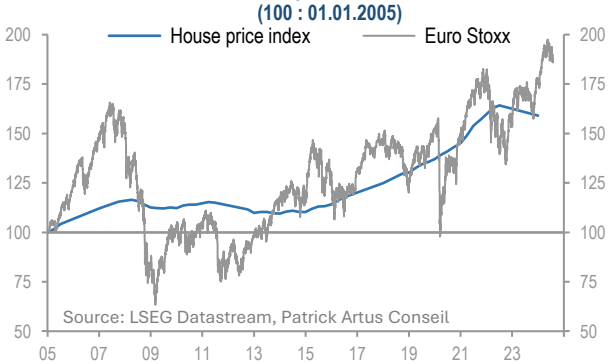
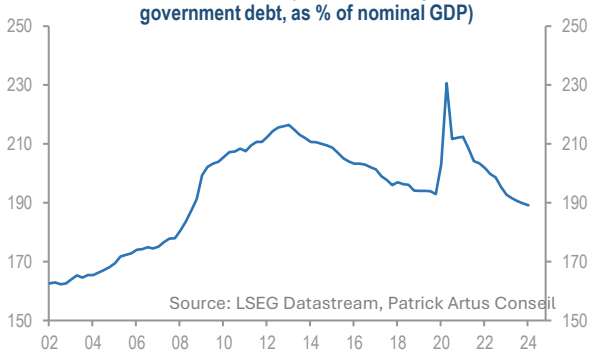


Chart 2B
Euro zone : Total debt (household, corporate and government debt, as % of nominal GDP)



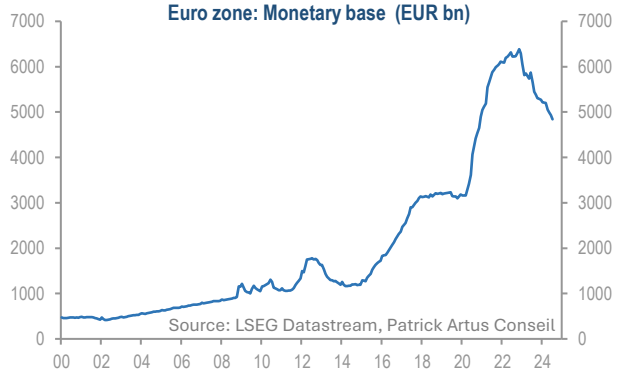
The problem is the conflict of objectives that very often arises between price stability and financial stability: maintaining financial stability would most often require raising interest rates more than is necessary to ensure price stability.

The solution is probably a more intensive use of macroprudential policies: adjustment of the ratios of required reserves or of the capital required from banks, stricter use of maximum debt standards, taxation of capital gains when asset prices rise too rapidly.

Third theoretical debate on the ECB's monetary policy: the irreversibility of quantitative easing policies

It has been observed that, on various occasions, after a period of quantitative easing, **the creation of central bank money that was carried out during the period of quantitative easing has largely persisted in the period of growth recovery** (**Chart 3A**).

Chart 3A
Euro zone: Monetary base (EUR bn)



This result from the central banks' desire to avoid a decline in asset prices, particularly illiquid assets, which would be associated with a sharp downward correction in the amount of central bank money outstanding.

This irreversibility leads to the irreversibility of the money supply created during quantitative easing (**Chart 3B**), and generates **a lasting upward bias in asset prices and a lasting downward bias in long-term interest rates**: the more often this bias has appeared in the past, the more likely it is that asset price bubbles will persist.

Chart 3B
Euro zone : Money supply (M3, as % of GDP)



The use of quantitative easing is therefore incompatible with the pursuit of financial stability.

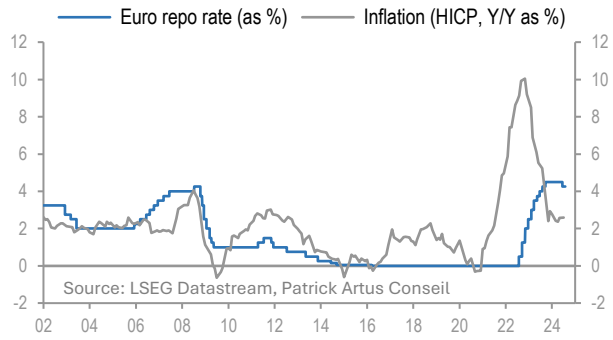
Fourth theoretical debate on the ECB's monetary policy: is there fiscal dominance?

Fiscal dominance is **a situation where the central bank is forced to ensure the sustainability of public debt.**

One can think that there is fiscal dominance if monetary policy allows inflation to exceed the central bank's target in order to stabilise the public debt ratio.

Chart 4 shows that the only period where one can think that fiscal dominance may have appeared is the period from mid-2021 to the present day.

Chart 4
Euro zone: Euro repo rate and inflation



Fifth theoretical debate on the ECB's monetary policy: the introduction of a climate objective in the objectives of monetary policy

The ECB is likely to introduce a climate objective into its monetary policy, perhaps in the form of **a different interest rate applied to the refinancing of "green" and "brown" debt**, or preferential purchases of green debt.

The debate focuses on the relevance of using monetary policy to guide the financing choices of the economy, when these choices can probably be more effectively guided by other policies (CO_2 price, decarbonization subsidies, etc.).

Sixth theoretical debate on the ECB's monetary policy: the possibility for the ECB to be independent

In theory, a central bank can be independent if there is no need to coordinate monetary policy with other public policies. This is the case, for example, if there is monetary neutrality: monetary policy only has a long-term influence on inflation, not on the level of production or other variables in the real economy.

This leads to the realization that a central bank that decides on monetary policy also to support investment, in particular investment in the energy transition, or to ensure the sustainability of public debt cannot be independent, and must coordinate monetary policy with other public policies.

Seventh theoretical debate on the ECB's monetary policy: the effectiveness of monetary policy in fighting inflation

Estimates made by the ECB show that the more restrictive monetary policy it has pursued since 2022 has reduced current inflation in the euro zone by more than 2 points. **But one can doubt these estimates, since**:

- Wages and unit labour costs are still growing very rapidly (more than 5% year-on-year for unit labour costs, **Chart 5A**);
- Service prices are still rising by more than 4% per year (**Chart 5B**);
- And if industrial product prices have slowed down sharply (**Chart 5B**), this is due to the decline in import prices and in industrial raw materials prices (**Chart 5C**).

Chart 5A
Eurozone: Labour compensation per employee and unit labour costs (Y/Y as %)

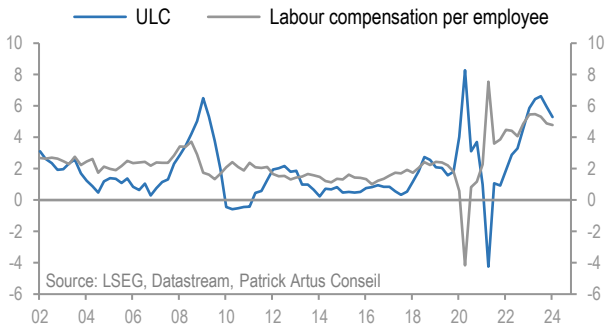


Chart 5B
Euro zone: Consumer price indices of services and nonenergy industrial goods

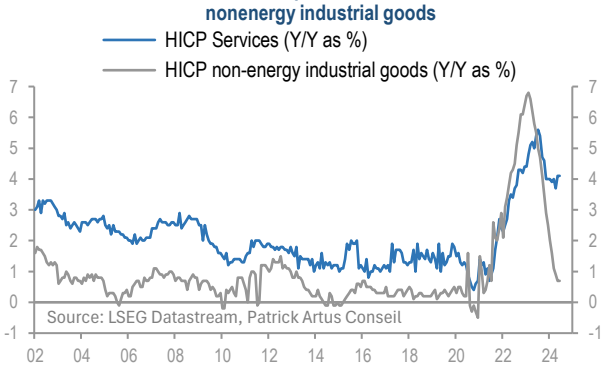
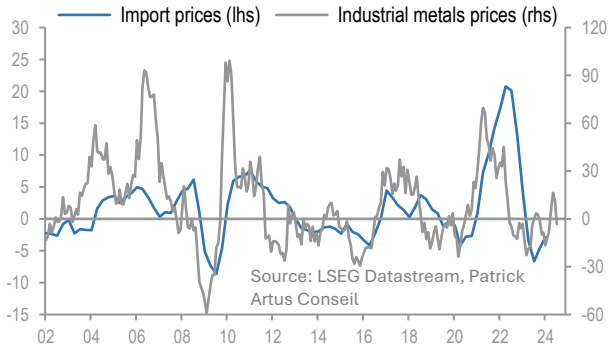


Chart 5C
Euro zone : Import prices and industrial metals prices (Y/Y as %)



Summary: what conflicts between the objectives of monetary policy?

We have examined the theoretical debates on various aspects of the ECB's monetary policy:

- Relevance of the 2% inflation target ;
- Weight to be given to the objective of financial stability;
- Irreversibility of quantitative easing policies;
- Existence of fiscal dominance;
- Relevance of including climate objectives in monetary policy;
- Possibility of maintaining the independence of the ECB;
- Effectiveness of monetary policy in fighting inflation.

It is interesting to consider the conflicts that can arise between the different objectives of monetary policy.

It is clear that the inflation objective and the objective of massive investment linked to the energy transition may come into conflict, particularly if the ECB's inflation target is not raised; the same applies to the objective of financial stability (which requires a sufficiently restrictive monetary policy) and the objective of massive investment (which requires an expansionary monetary policy causing asset prices and debt rates to rise).

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