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Sustainable Architecture for Finance in Europe

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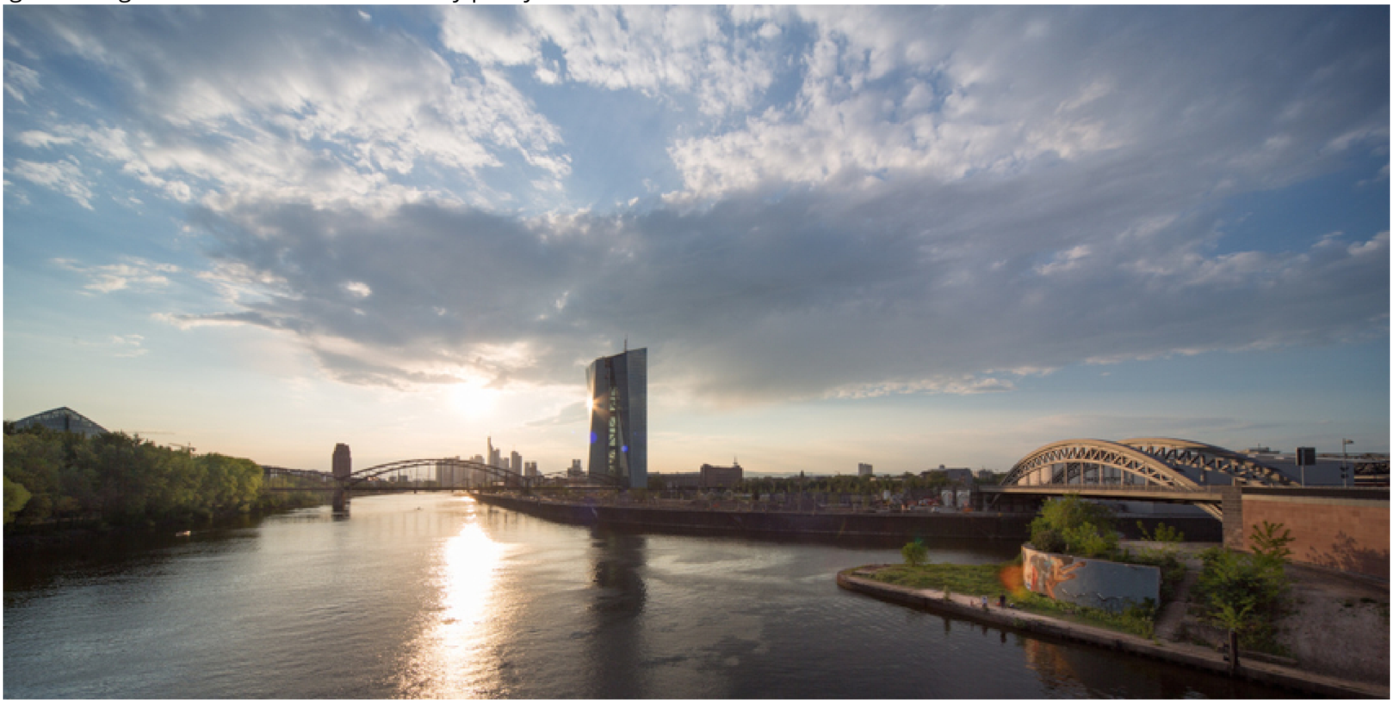
Sailing out of the Covid crisis with the ECB's compass

Ignazio Angeloni: The course of monetary policy should deal with the Corona crisis now but be sustainable later



Mervyn King, former governor of the Bank of England, once said that monetary policy should be "boring". By that he meant predictable, without surprises. A policy in which the central banker executes a predetermined playbook known to all, without running the risk of losing its reputation, or of gaining one.

By that standard, euro area monetary policy is all but boring these days. By all indications we are close to a turning point, when the Covid-induced recession comes to an end and gives way to a recovery. A tricky moment, in which the central banker cannot afford to make mistakes. Not only should policy moves be right, but also their timing and related announcements.

The first wave of recession, related to Covid-19, and the lockdown measures in the second quarter of 2020 were followed by a brief pause, and then by the second wave of recession in the fourth quarter. Since the beginning of this year, several factors contribute to make the eurozone situation more complex. Manufacturing production indicators have started to rise again, but the service sector, more directly affected by the restrictions, remains in recession. The health situation also shows contradictory aspects. European countries still struggle in lockdowns, each in its own way. But the vaccination process is gaining momentum, generating expectations that the pandemic crisis may head to a solution sometime during the summer months.

Rising interest rates should be contrasted by monetary expansion

In the United States, President Joe Biden has announced that every adult citizen will have a vaccine by May. This is a powerful sign of a new start. The service sector's indicators are there already at historic highs. In the financial market, the yield curve has shifted upward: a reliable signal that an economic recovery is approaching or already ongoing. Yields have also risen in the eurozone, but how should this be interpreted? The first buds of recovery are visible here as well, but interest rates are also influenced by what happens in the US.

The monetary policy standard handbook prescribes two options. If yields indeed reflect the prospects of an upswing, monetary policy should allow a gradual rise in yields (which are now negative or extremely low anyway), helping stabilize the cycle in the long term. If, on the other hand, they convey a false or premature signal, their movement must be counteracted. Unfortunately, this prescription does not untangle the two ends of the dilemma. ECB Chief Economist Philip Lane said in a recent speech that "financing conditions" must be the central bank's "compass." A hint that rising interest rates should be contrasted by maintaining or even intensifying monetary expansion.

President Lagarde can no longer rely on the handbook, but only on her experience, instinct, and the skills of her staff. Three aspects seem particularly important.

A little more inflation could temporarily help

First, manage communication. Conflicting signals transmitted by different policymakers, systematically amplified by financial market economists who may have conflicting interests, risk increasing volatility and limit the President's room for maneuver.

Second, keep options open while new information flows onto the desks and into the computers of central bank analysts. This is precisely what was conveyed at the ECB's press conference in the second week of March 2021. President Lagarde indicated that the recent lower-than-average asset purchased will be reversed but did not announce a change in policy or that financing conditions (the "compass") will necessarily be brought back to where they were. The next few weeks will bring plenty of incoming information. Actions and signals by the central bank must accompany this information, not precede it.

Third, keep in mind that the risks of the current situation are fundamentally asymmetrical. The Covid recession in the eurozone has already had two crashes and should not experience a third. By contrast, inflation risks seem low – and in any case, a little more inflation could temporarily help overcome certain past imbalances. In the longer term, however (hopefully a matter of months, not years), a return to positive market returns is desirable and should not be resisted.

This means keeping in check now the "hawks" (those who stand for a more restrictive policy early on) and later the "doves" (those who advocate a semi-permanently looser monetary policy). Not an easy task, and certainly not a boring one, on which the President is staking her reputation.

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