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1st plennary session: From the ECB's 2021 strategy review to the possible return of inflation, what is the macro-economic outlook for European investors? Speaking points

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Outlookfor the eurozone economy post-Covid

- We are currently witnessing a **strong recovery of economic activity** in the euro area, as the economy continues to reopen following progress in vaccination campaigns. According to the last ECB staff macroeconomic projections, euro area real GDP is expected to surpass its pre-pandemic level by the end of this year. Going forward, strong growth is expected also for next year, at a pace of 4,6%, before falling to slightly above 2% in 2023.

- At the same time, we are seeing a **sharp increase in euro area inflation**, which reached 3.4% in September according to the flash estimate. These are levels last seen back in 2008. There is an ongoing debate on whether this high inflation is transitory or not, and in fact we will most likely discuss this issue later on, but let me offer now a preview of what I think. My own view is mostly aligned with that of the ECB, according to which this high inflation largely reflects **transitory factors**, such as supply bottlenecks, energy price increases, and the reversion of the VAT tax cut in Germany. Therefore, part of this inflation should be reabsorbed in the medium run. This is also the view of the ECB staff, which sees inflation exceeding 2% on average this year, before falling to 1.7% in 2022 and 1.5% in 2023, a level clearly below our 2% inflation target.

- This being said, this baseline scenario is of course **subject to risks**. A worsening of the pandemic, due for instance to new strains of the virus, could slow down the economic recovery. On the inflation front, if supply bottlenecks prove to be more persistent than expected, then high inflation could end up feeding into new wage agreements and thus reinforce itself through **second-round effects**. And of course, we still have to see how the crisis of Evergrande unfolds, because a hypothetical disorderly collapse could have an adverse impact on global financial markets.

- Finally, from a longer-term perspective, I think a successful deployment of the **NGEU fund** will be critical in order for the euro area economy to grow sustainably in the years to come. This of course requires that member states make a good use of those funds, by selecting growth-enhancing investment projects that make the most of digital technologies and are also environmentally friendly.

Impacts of the Covid crisis and the policy mix implemented during the pandemic on potential growth and inflation.

- In my view, the question of how the pandemic will affect potential growth is very challenging as there are still many uncertainties to be clarified. I see all sorts of effects going in different directions. Some of the sectors that have been hit hardest by the pandemic might not recover ever their pre-pandemic dynamism. I am referring to the retail sector because the online shopping rates have rocketed during the pandemic or the business travels due to the more intensive use of technology to set meetings. I don´t think they will disappear for good, but our way of life changes and the pandemic has accelerated somehow this process. On the other hand, I see the NGEU –a policy initiative that would not have happened without the pandemic- as an excellent opportunity for raising the UE's growth potential. In the end, it will all depend on how these different opposing forces play out.

- A different question is how inflation will evolve in the aftermath of the pandemic. For that, the relevant concept is not potential growth, but actual growth relative to potential, or more precisely the actual GDP level relative to potential –what we call the *output gap*. In a context of economic reopening and rapid growth in demand such as the current one, and given that supply cannot adjust at the same pace, it is normal for the output gap to rise and hence for inflation to rise too. This is essentially what we are seeing right now. But eventually this strong demand growth will stabilize and supply will also adjust, so this increase in the output gap should recede to some extent. This should in principle bring inflation back down over the medium run.

- That does not mean of course that things could not evolve differently. If these supply bottlenecks last longer than anticipated, then high inflation could eventually feed into new wage agreements, which would increase firms' production costs and could eventually lead to higher prices. Through these **second-round effects**, the high inflation we are now seeing could become very persistent. This is a scenario that we cannot discard at all.

- But I would like to end with a positive note. During the last decade we have learned that, for central banks in advanced economies, it is very difficult to fight against low inflation, because of the constraint on monetary policy posed by the **lower bound** on nominal interest rates. But the fight against *high* inflation does not face this limitation, because central banks can in principle **raise their interest rates as much as needed** in order to rein in inflation. This, together with the fact that the ECB has a clear 2% inflation target, makes me confident that the current high inflation we are currently experiencing will not become persistent in the future.

- Now, I am aware that high public debt levels raise issues of possible **fiscal dominance**, according to which central banks might refrain from raising interest rates as much as needed to control inflation. But I honestly do not see this concern as a relevant one for the ECB. The ECB has a wide set of tools that can be optimally combined and flexibly used in order to allow interest rates to rise as much as needed without causing turmoil in sovereign debt markets.

Optimal policy mix going forward. Will central banks be ever able to raise rates again?

- On the first question, in my view monetary and fiscal policy need to keep on **working together for as long as the pandemic lasts**. This means monetary policy needs to continue maintaining favourable financing conditions, and fiscal authorities need to continue supporting firms and households, although as the economy reopens this support needs to become more and more targeted.

- A much complex question is how the **scaling back** of monetary and fiscal support should be done once the pandemic crisis is over. In my view, one of the few things that is clear is the need to **avoid cliff effects**. When the time comes to unwind policy support, this should be done in a **gradual and predictable** manner. Monetary authorities should **communicate** their decisions clearly, explaining to investors and the general public that their removal of policy support responds to the improvement in the economic situation and/or the inflation outlook.

- On the second question (“Will central banks be ever able to raise rates again?”), my answer is a clear yes. In the long run, nominal interest rates should converge to a level that is the sum of the **natural real interest rate** and the central bank inflation target. As you know, the natural rate is not observable and can only be estimated with a high degree of uncertainty. But even so, most estimates of the euro area natural rate, are in the range of 0 to –2%. Given the 2% inflation target, this means that in the long run nominal rates should converge to a level in between 0 and 2%. Given that the current policy rate is at –0.5%, this means that policy rates could eventually lift off from current levels and converge towards levels that are, most likely, low but *positive*.

Impact of the greening of the monetary policy on financial markets

- I am firmly convinced that, in the process of greening their monetary policy frameworks, central banks can act as **catalyst for a green transformation in financial markets**.

- Take for instance the **ECB action plan** for incorporating climate change considerations in its monetary policy framework, announced last July together with its revised monetary policy strategy. The plan has several action points, all of which will allow the ECB to play that incentive role. But let me just mention two of them.

- One of the key elements in the plan is the commitment to introduce **disclosure requirements** for private sector assets as a new eligibility criterion or as a basis for a differentiated treatment for collateral and asset purchases. That is, corporate issuers would need to disclose environmental information in order for their debt instruments to be purchased by the ECB’s corporate sector purchase program or to be accepted as collateral in Eurosystem refinancing operations, or at least to receive a better treatment in both areas. This requirement should be a game changer in environmental disclosure practices among corporate issuers.

- Also, the ECB will adjust the framework guiding the **allocation of corporate bond purchases** to incorporate climate change criteria. This will foster the alignment of issuers with, at least, the EU legislation implementing the Paris agreement through climate change-related metrics. Again, this modification should create strong incentives for corporate issuers to adopt environment-friendly practices and policies