Monetary Policy in the times of corona: many unknown unknowns

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The questions we are asked

• Relevant measures of economic uncertainty
• What are the short and long run effects of this uncertainty on economic outcomes?
• How do you design policy under such circumstances?

Source: Baker, Bloom and Davis (2016), Hardouvelis, Karalas, Karanastasis and Samartzis (2018); Ghirelli, Perez, and Urtasun (2019); Renault, Baker, Bloom and Davis (2000)
Measuring Uncertainty?
VSTOXX – market perceptions of uncertainty

Source: Bloomberg
1. ECB actions and effects
   • Inflation and Covid19
   • More QE to suppress the spreads?
2. Monetary policy and dealing with long-term challenges
   • Interest rates: negative for ever?
   • Forecasting is difficult, particularly about the future
3. Implications for policy
Inflation and Covid19

Source: Bloomberg
The ECB’s balance sheet

Source: Bloomberg
Falling spreads, Growing debt

Sovereign Spread (10Y) to DE

Public debt (2019 vs 2021 projections)

Source: European Commission, April 2020 forecast

Source: Bloomberg
Interest rates: too low for ever?

Source: Bloomberg
Real interest rates: negative in equilibrium?

Source: Bloomberg
Estimated equilibrium rates: declining

Forecasting is difficult…

\[ i_t = \pi^* + r^* + \alpha_\pi (\pi_t - \pi^*) + \alpha_y (y_t - y^*) \]

\[ i_t - r^* = \pi^* + \alpha_\pi (\pi_t - \pi^*) + \alpha_y (y_t - y^*) \]

- \( \pi^* \) is the inflation target
- \( r^* \) is the equilibrium interest rate.
- \( y_t - y^* \) is the output gap.
Mean reversion – inherent in models

Source: Darvas (2018), ECB staff macroeconomic projections for the euro area, core inflation (moving 12-month average rate of change)
False confidence

Figure 11: European Commission, *Economic Forecasts* report, euro-area GDP predictions for 2009

Autumn 2008

Spring 2009
Confidence without probabilities

Figure 12: ECB Staff macroeconomic projections and alternative scenarios for real GDP and HICP inflation in the euro area (September and June projections 2020)
Policy Implications: 2 (+1) quick wins

• The definition of price stability should be a **focal point** (this has to do with communication) 2%

• Precise versus predictable inflation outcomes: tolerance bands around it. But what width (0.5% to 3.5%)

  “In times of uncertainty it is more useful to be predictable than precise.”

• With heightened uncertainty, communication is less about what will happen, which by definition is less known, and more about what the reaction should be if alternative scenarios would happen.
Thank you!