Analysis

The ECB: the fine line between stimulus and exuberance

- *Economic conditions and prospects in the euro area have improved*
- *Markets are exuberant, and the ECB expects the pickup in inflation to prove temporary*
- *Soon however the ECB will have to consider when to start 'leaning against the wind'*

Introduction

The ECB is maintaining its expansionary stance for now …

Progress with vaccination campaigns and global economic recovery have significantly improved both the macroeconomic environment and prospects in euro-area countries, and this is reflected in the ECB's upwardly revised projections for GDP growth and inflation, both for this year and next.

Nevertheless, largely because it expects inflation soon to return to well below its target, the ECB is maintaining its expansionary monetary policy stance – at least for now. The terms of its recently reconsidered and revised strategy have not expressed change in this intention, and the central bank does not see the time as yet having come for debate about exit and a tightening of policy.

The matter however stands to assume increasing urgency as the year progresses.

Inflation may not prove temporary

… foreseeing euro-area inflation at below-target in 2021

In the ECB's judgement, the faster growth of the aggregate price level in recent months has been due to causes that will in large part prove temporary. Thus, while it has increased its inflation projections both for this year and for 2022, the ECB still sees a rate of euro area CPI inflation of only 1.5% in the coming year, which is below its target value.

This may prove to be a somewhat moderate forecast, however.

While the inflation rate in the euro area is much lower than in the US, the mechanisms driving it are the same: energy price increases and broad-based increases in raw material prices; supply bottlenecks for intermediate products; high transport costs (including importantly container freight rates); very low inventories and strong increases in demand, prospectively also for services. Together these stand to keep inflation high for consumers, quite possibly pushing it above 3% in the second half of this year.

Aggregate demand in H2 however may well be quite strong …

Over time, bottlenecks and supply constraints will be overcome, and the pent-up demand for services will also subside. However, given the large amount of money saved in the euro area in the wake of the pandemic, much of which is likely to be used for pent-up consumption, aggregate demand may well be quite strong well into 2022.

… and so might be pressures for wage increases

What happens to inflation – and in particular whether it quickly falls below 2% again – will depend in large extent to what happens to wages. Wage earners have experienced significant losses in purchasing power, while corporate profits have risen sharply. And meanwhile shortages of labour have emerged in many areas. In this environment, pressure for higher wages, and indeed rising wage settlements, are only to be expected.

Hence while inflation may well moderate somewhat, whether later this year or into next, it seems unlikely to subside as much as the ECB at present apparently considers likely.

This has implications for the future course of monetary policy.

Monetary stance

While no indication has yet been given of a change in stance …

The ECB has so far given no indication regarding possible corrections of its expansionary policy stance. Importantly, it is continuing its bond purchases under the PEPP program (Pandemic Emergency Purchasing Program) unabated. Moreover, it argues that the time has not yet come to discuss exit from its extremely loose policy stance: rather, it continues to underline the importance of securing and maintaining favorable monetary conditions.

Certainly there has been quite a bit to be said for this strategy in the wake of the Corona-crisis. It has brought, and continues to bring, strongly rising (real) real estate prices; high stock market valuations; extremely low risk premia in many financial market segments; and a surge in the amount of money in circulation in the private sector.

For financial market participants this is a kind of assurance that the ECB would oppose significantly rising yields on government bonds and deteriorating financing conditions for companies. In the wake of a strong economic recovery, the odds are for further rising valuations of equities and real estate, notwithstanding the high levels that they have already reached. All of this has been good for the recovery.

The risk

… remaining loose for too long risks medium-term growth

However, if monetary conditions remain too loose for too long, there is a risk not only of generating undesirably high inflation expectations, but also of increasing exaggerations in the financial markets. Both can pose a threat to growth over the more medium term.

This risk is pointed to frequently by the International Monetary Fund in its analyses. And it is all the greater, the more that exuberance in financial markets is accompanied by strong credit growth in the private sector.

Two events in just the past two decades have exemplified this: the dotcom bubble at the beginning of the millennium; and the subprime crisis 13 years ago. Both showed how great the losses in growth and prosperity can be when blatant excesses on the financial markets are corrected.

In the interests of maintaining sustainable growth over the longer term, therefore, there is an increasing case for the ECB to consider starting to 'lean against the wind': and such arguments for reducing monetary policy stimulus seem likely to arise increasingly in the coming months, particularly with regard to a scaling back of the large-scale bond-buying programs. And more generally, it can be important to lean against the wind in the face of financial market euphoria, and not to rely on bank regulation alone to preserve financial stability.

The recent review of the ECB's monetary policy strategy contains a number of nuances: but it does not seem to herald major changes to its practical policies:

- The analysis of monetary and financial developments will no longer be analysed in a second pillar (next to inflation), but in an integrated manner.
- But there is no indication that changes in money supply and credit growth, for example, will become more important as a systemic factor in policy decisions.
- Moreover, the reformulation of the inflation objective, a symmetrical 2% target, can be seen as a reconfirmation of the ECBs present stance of very high policy accommodation.

Conclusion

Discussion on monetary tightening will have to start soon

Monetary policy always involves balancing opportunities and risks. At present, the ECB apparently considers the opportunities of a continued expansionary policy to be greater than the risks and side effects that may result in terms of higher inflation and further risks on financial markets.

However, the debate about reducing monetary stimulus, which is well underway in the US, will not be long in coming to the euro area too. There, too, the first step is likely to be a scaling back of the large-scale bond-buying programs. That may provoke criticism and possibly adverse market reactions. But arguably, in the interests of stable economic and financial market development in the medium term, it should nevertheless take place.■

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