The Future of Europe

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Union Investment Institutional GmbH Risk Management Conference

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A macro view on the euro area through the lenses of quantitative models

Outline of the talk

A. Where are now in the euro area and where have we come from?
   Risk appetite, liquidity and real data
B. Does monetary policy work? The ECB view
C. But why is inflation so low?
D. Political challenges for the monetary union
Euro area data

• Slowdown since 2017q3
• Very recent positive but modest signals
What are recent data telling us? Follow the news! Thinking ....
Evolution of Now-Casting predictions for the EA

Quarterly GDP growth – QoQ%

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Evolution of Now-Casting predictions for the EA

Quarterly GDP growth – QoQ%

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24 October GDP now-cast 0.26 QoQ % Q4'19

25 October GDP now-cast 0.13 QoQ % Q4'19
Combining macro signal with financial data

*Macro factor and risk appetite*

Risk Appetite Index and Now-Casting Index, standardised

Sources: CrossBorder Capital, and Now-Casting Economics
Same picture for the US and the world

Risk Appetite Index and Now-Casting Index, standardised

Sources: CrossBorder Capital, and Now-Casting Economics
But where are we coming from?
Euro area – longer trends in asset allocation
Assets/GDP increased after 2000 and then declined after the crisis. Since 2012 market risk appetite has been increasing.
But where are we coming from?

• Since the 2008 crisis financial assets/GDP trending down
• 2008-2012: flight to safety
• Since 2012: equity / fixed income increasing – renewed confidence in the euro?
Liquidity and ECB policy

• Pro-active ECB policy - easing liquidity conditions 2015-2016
• More liquidity reduces the demand for safe assets and hence drives an improvement in risk appetite
• Let us look at Cross-border capital liquidity indexes (essentially ‘normalised’ growth rates) ....
Liquidity and long term interest rates possibly anticipating risk appetite and business cycle

Since 2017 liquidity down as a consequence of ECB decline in growth of balance sheet size and holding of government debt + decline in growth of banks’ excess reserves

Source: CrossBorder Capital
Remark on data/indicator

CrossBorder Capital indicator which tracks data on credit spreads, credit growth and leverage, available funding, cross-border flows and Central Bank interventions.

• It is an indicator of credit quality and capital capacity
• It corelates with asset prices not inflation – as liquidity index up, risk appetite increases
• More comprehensive of monetary statistics - Traditional ‘money’ or ‘means of settlement’ is too narrow : it comprises only Bank Deposits
Summarising

• Weak growth associated with declining cyclical risk appetite
• Increase in trend of safe assets relatively to equity mitigated by OMT and QE
• Liquidity conditions anticipate risk appetite/business cycle

➢ But how should we interpret ECB policy today?
➢ Why is inflation so low?
Understanding ECB policy

Four instruments:

- Negative interest rate policy (NIRP) ➔ Level of the term structure
- Asset purchase programme (APP) ➔ Slope of the term structure
- Forward guidance (FG) ➔ Rate expectations
- Targeted longer-term refinancing operations (TLTRO) ➔ Bank lending rates

Index of financial conditions (financial prices) ➔ Aggregate demand ➔ Phillips curve ➔ Inflation
ECB view: APP most effective on spreads

Propagation to sovereign yields

Impact of ECB non-standard measures on 2-year, 5-year and 10-year sovereign yields over 2014-2018 (percentage points per annum)

Source: Rostagno et al, 2019
ECB view: 1% effect on GDP, .7% effect on inflation

Source: Rostagno et al, 2019
But data show GDP growth is slowing-down and inflation is flat

Two views:

1. *More aggressive policies needed*
   
   Question is: monetary or fiscal or both?

2. *Something is wrong in the ECB estimates of the transmission*
   
   a) Effect of financial conditions on investment is lower than estimated because of pervasive risk aversion [see trend towards safety]
   
   b) Phillips curve is flat
   
   c) Issue is trend growth possibly related to point a)
The debate on the Phillips curve

Alternative hypotheses:

i. Flat Phillips curve and large negative output gap
   *Demand management needed but small effect on inflation*

ii. Both output gap and trend output are moving
   *In this case even if the Phillips curve is steep inflation does not move much*
   *The question is open as to whether a combination of monetary and fiscal policy can affect trend growth positively but we should expect inflation to remain low in this case*

What follows will give some evidence on ii
The now-casting view then and now
Vox article – January 2018

“The forecast of different components of inflation in the Eurozone points to a high probability of inflation remaining below 1.6% in 2019. This prediction is based on the assessment that trend expectations will remain at the level of the last ten years, that oil price pressures will remain subdued, and that the economy will start slowing down in the second part of 2018 and possibly be in recession by the second part in 2019.”

• We made the point that the ECB forecast for inflation in 2019, at that point at 1.6%, was too high
• Our forecast at the time was 1.5% for 2018 and 1.1% for 2019. Today the data show that we were right
• In September the monthly year-on-year inflation was 0.85% while the average over the year was 1.26%
Vox article, euro area January 2018 forecast HICP

HICP inflation

- Data
- Forecast
- CI, 68%
- CI, 90%
- ECB
- ECB, SPF
- Breakeven π, GER
- Breakeven π, FRA
- Breakeven π, ITA
Two years later ... recent forecasts of HICP

Our forecast for this year is in line with what we predicted two years ago and points to 1.48% for Q4-2022. This is close to what the ECB projects for 2021.
Cyclical decomposition of HICP

gap positive but declining consistent with decline in growth
Output gap
Our view is that the gap is positive and larger than other forecasters estimate.

Output gap as a percentage of potential GDP

- TC Model (median)
- CI, 68%
- CI, 90%
- Bloomberg
- IMF
- EC
... since we estimate that potential output has been declining historically.

GDP vs potential output growth

- GDP growth (annualised)
- Potential output growth (median, annualised)
- CI, 68%
- CI, 90%
Inflation expectations have been declining since 2014 – this is the trend!

Comparison with the US
Conjectures/evidence

• Trend in output and trend in inflation have moved down
• Even if the Phillips curve is steep (our calculations) inflation does not move much
• A combination of monetary and fiscal policy can affect trend growth
Political challenges for the monetary union

Today too much weight on monetary policy with respect to fiscal

Two views:

i. Okay as long as price stability is respected

ii. Not okay because this implies an implicit subsidy for high debt countries with the danger of “moral hazard”

Some truth in both arguments – need to go beyond this discussion
My view

• We are in a new world characterized by high demand for safety and risk aversion. The main danger is low growth, not inflation
• Central banks have multiple instruments and need to use them at the zero lower bound
• New policies seems to be effective although uncertainty on the transmission mechanism
• Possibly quasi-fiscal effects – divisive in a monetary union
• Need to accept the new reality and coordinate between fiscal and monetary policy
• For this, we need new institutions at the euro area level such as a central fiscal capacity whose actions would be legitimized by governments and ultimately taxpayers