Panel on Post-Pandemic Monetary Policy and the Effective Lower Bound

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Today, I wish to focus on three points. First, the current accommodative mix of monetary and fiscal policies has power to stabilize the economy and is needed for a prolonged period.[1] Second, in these circumstances, it is important for fiscal policy to both lock in low interest rates and uses the available fiscal space. Third, we need a credible framework for monetary, fiscal and structural policies to ensure low interest rates and resulting fiscal space.

Let me begin by presenting a view on the economic monetary and fiscal landscape that we now face. The macroeconomic outlook is very challenging. We now live in a 90-95 economy where labor and capital reallocation has not yet begun. The combination of accommodative monetary and fiscal policies is appropriate in the current circumstances and will need to continue in order to support labor and capital reallocation over coming years. Consequently, public debt and monetary policy will be strongly interlinked, in part as a large share of government debt is likely to be held by central banks.[2]

This equilibrium is fragile and can only work if agents believe that it can last and fiscal policy and monetary policies are efficient. Let me explain some of the risks.

The main risk for monetary policy is fiscal dominance. The current situation is sustainable for as long as the difference between interest rates and nominal growth–the so-called *r-g*–remains sufficiently negative. Thus, unless growth improves significantly, it will be difficult to move away from the effective lower bound (ELB) in the future, as rising interest rates would weigh on interest payments. For instance, with gross debt of 100% of GDP and the effective interest rate paid on debt of 0.5%, interest payments are only a small share of output–0.5% of GDP. However, if the effective interest rate goes up to 2.5%, interest payments would increase by 2% of GDP. For some levels of the primary balance and nominal economic growth rates, and even with a delayed pass-through of market interest rates to effective debt servicing costs, such a deterioration in the overall budget balance could add to the debt-to-GDP ratio. Thus, governments would face two choices: either let public debt increase or tighten the fiscal stance sufficiently to prevent the increase in debt. The higher debt, the lower primary balance and nominal growth and the shorter remaining debt maturity, the more daunting these challenges will be. At this juncture, we cannot afford a repeat of the fiscal tightening seen in the aftermath of the global financial crisis.[3]

This equilibrium is also fragile if not all countries can implement fiscal measures with the strength necessary in the current circumstances. Countries that have announced the largest support measures are those that believe they have enough fiscal space. The U.S. policymakers feel the fiscal space is large enough because of the safe haven status of the United States and the history of using the fiscal tool in a generally efficient countercyclical way. In Europe, Germany was able to announce very large measures because debt was low and budget balance strong prior to the COVID-19 crisis. However, Italy and Spain were more restrained because, in their own and market perceptions, fiscal space was low. The fact that these two countries relied more on guarantees rather than on direct spending[4] demonstrates that they could not spend as much as what the current situation and the future outlook required.

Fiscal support in the euro area has been facilitated by ECB actions and by new EU fiscal support measures.[5] The ECB–among other things–announced the Pandemic Emergency Purchase Programme, involving purchases of public and private securities up to 1.35 trillion euros, and introduced Pandemic Emergency Longer-Term Refinancing Operations to provide ample and cheap funding to banks to encourage their lending to the private sector. The EU has recently agreed the Next Generation EU recovery plan, amounting to 750 billion euros. This multiyear plan includes non-repayable grants and the bulk of the resources is expected to support public investment. [Some support can also be expected from low-cost loans to fight high unemployment under the EU Support to mitigate Unemployment Risk in an Emergency (SURE) program.]

Overall, the efficacy of current "optimal" policy-mix is dependent on monetary policy capacity to keep interest rates low, and on using the resulting fiscal space.[6] Without sufficient fiscal stimulus, low interest rates may not be enough to stimulate private demand. For instance, low interest rates may not encourage households to decrease savings or to borrow for consumption or investment when job prospects are very uncertain. Similarly, stimulation of business investment may be weak due to high hurdle rates, high uncertainty about future demand, and corporations' preferences to borrow to buy back equities or to purchase financial assets. Besides, with prolonged recession and low interest rates, transmission of monetary policy could become impaired by weaker bank profitability and balance sheets.

Let me reiterate two points. First, monetary support is key for fiscal space. Second, higher debt leads countries to restrain fiscal support and this, in turn, may diminish the efficacy of monetary and fiscal policy implicit coordination.

Let me now briefly turn to inflation risks. I want to mention this aspect because sustaining low interest rates will be difficult with persistently rising inflation. In the longer term, I do think that there is a risk of inflation because of a possible declining influence of globalization, growing threats to central bank independence and the risk that the public starts believing that the central bank's key objective of keeping interest rates low is a reduction of government borrowing costs rather than maintaining price stability.[7]

With limits to lower *r* below zero, fiscal policy space can be boosted by higher nominal GDP growth, *g*. Higher productivity growth is not a given and we know that productivity growth has been trending downward for decades despite technological innovation. Raising the rate of growth will not be easy at a time when a signification reallocation of resources is needed and the capacity of the economy to reallocate appears impaired. Aggregate productivity growth has declined as only a few frontier firms have boosted their productivity and the vast majority of firms have been lagging.[8] This outcome is associated with increasing market concentration. Policies that have been implemented to protect capital and workers during the temporary shutdown, such as job retention schemes and credit support for firms, need to evolve. Failure to do so could further reduce the capacity of our economies to reallocate capital and labor.

Monetary and fiscal support cannot alone boost employment and structural reforms are needed in order to encourage efficient reallocation. Technology adoption by laggard firms should be promoted and competition policy should be updated to meet the digital age requirements.[9] Labor mobility across jobs and firms should be enhanced by reducing barriers and making it easier for employees to switch to more productive firms.[10] For example, we have shown in the OECD work that the increase in occupational licensing has impeded labor mobility.[11] Research has shown also that one of the main ways young people can escape the income scarring effect of a recession is to boost their wages by switching firms.[12]

Let me end by quoting Mario Draghi who spoke at Jackson Hole in 2014.[13] He said, "Without determined structural reforms, aggregate demand measures will quickly run out of steam and may ultimately become less effective. The way back to higher employment, in other words, is a policy mix that combines monetary, fiscal and structural measures." This is even more urgent than it was in 2014, and not only in Europe.

Endnotes

[1]OECD. 2020. *OECD Economic Outlook*, Volume 2020 Issue 1, OECD Publishing, Paris, *https://doi.org/10.1787/0d1d1e2e-en*

[2]Ibid.

[3]Boone, L. 2019. "Institutional Architecture and Policies: A Critical Assessment of the First 20 Years of the Single Currency, in 20 years of European Economic and Monetary Union," Conference proceedings, ECB Forum on Central Banking, *https://www.ecb.europa.eu/pub/pdf/sintra/ecb.forumcentbank201911~e0dd97f2c0.en.pdf*

[4]Boone, L. 2020. "The State of the Union," European University Institute, *https://stateoftheunion.eui.eu/sou2020- session-2/*

[5]Lane, P. 2020. "The ECB's Monetary Policy Response to the Pandemic: Liquidity, Stabilization and Supporting the Recovery," *https://www.ecb.europa.eu/press/key/date/2020/html/ecb.sp200624~d102335222.en.html*

[6]Landau, J. 2020. "Money and Debt: Paying for the Crisis," *https://voxeu.org/article/money-and-debt-paying-crisis*

[7]Reis, R. 2020. "The Central Bank and Policy Interactions Post Pandemic," *https://www.bankofcanada.ca/wp-content/uploads/2020/08/2020-ITR-Workshop-Presentations-Session-2-Ricardo-Reis.pdf*, at Towards the 2021 Renewal of the Bank of Canada's Monetary Policy Framework (2020), *https://www.bankofcanada.ca/2020/08/towards-the-2021-renewal-of-the-bank-of-canadas-monetary-policy-framework*

[8]Andrews, D., Criscuolo, C., and Gal, P.N., 2015. "Frontier Firms, Technology Diffusion and Public Policy: Micro Evidence from OECD Countries," *http://www.oecd.org/economy/growth/Frontier-Firms-Technology-Diffusion-and-Public-Policy-Micro-Evidence-from-OECD-Countries.pdf*

[9]Ibid.

[10]McGowan., M.A., Andrews, D., Criscuolo, C., and Nicoletti, G. 2015. "The Future of Productivity, OECD," *http://www.oecd.org/economy/growth/OECD-2015-The-future-of-productivity-book.pdf*

[11]OECD. 2020. "OECD Economic Surveys: United States 2020," OECD Publishing, Paris, *https://doi.org/10.1787/12323be9-en.*

[12]Andrews, D., Deutscher, N., Hambur, J., and Hansell, D. 2020. "The Career Effects of Labour Market Conditions at Entry," Treasury Working Paper, Australian Government, The Treasury, *https://treasury.gov.au/sites/default/files/2020-06/p2020-85098-202006.pdf*

[13]Draghi, M. 2014. "Unemployment in the Euro Area," [online] European Central Bank. Available at*: https://www.ecb.europa.eu/press/key/date/2014/html/sp140822.en.html*