



OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Current Monetary Policy Challenges for the ECB

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Agenda: Current Monetary Policy Challenges for the Eurosystem

Transformational shocks for Europe and the world – the „New Normal“?

1. COVID-19 shocks
2. Russian aggression shocks
3. Climate shocks

Challenges in uncertain times – „Way Forward“

1. Geopolitics
2. Monetary Policy

Exogenous shocks and central banks

The foundation of central banks and their reforms are mostly the result of exogenous shocks

- Swedish central bank Riksbank (foundation 1668) – “to maintain the domestic coinage at its fair and right value” in response to the Thirty Years‘ War and Swedish imperial ambitions
- Bank of England (foundation 1694) – to finance the war of the Spanish Succession
- Banque de France (foundation 1800) – to finance Napoleonic ambitions
- OeNB (foundation 1816 „privilegirte oesterreichische National-Bank“) – for stabilization purposes in response to the Napoleonic Wars
- FED (foundation 1913): A severe financial panic in the US in 1907 resulted in bank runs that wreaked havoc on the fragile banking system and ultimately led Congress in 1913 to write the Federal Reserve Act

Objective of Central Banks

- Maintain price stability – price stability is essential for economic growth

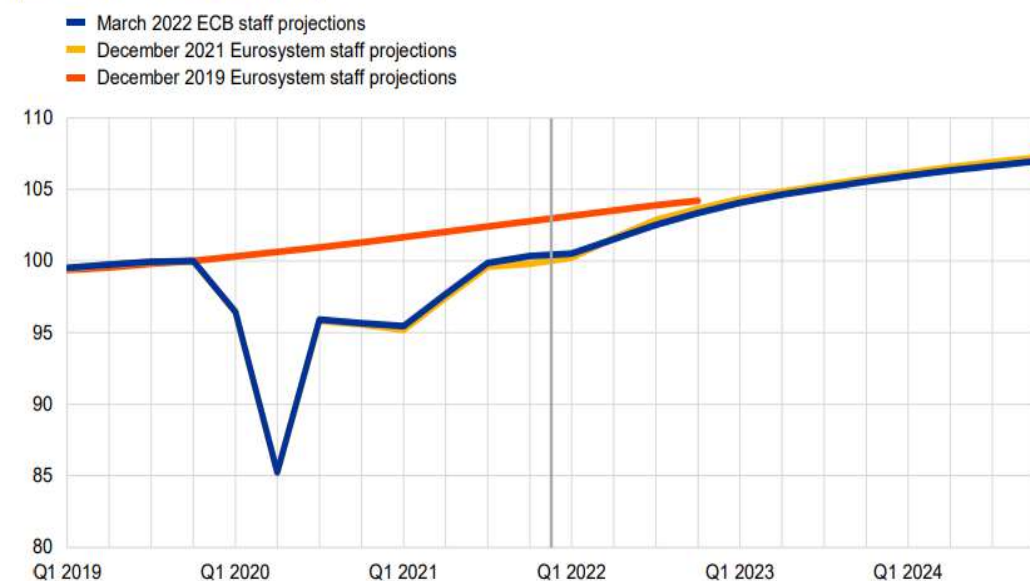
TRANSFORMATIONAL SHOCKS FOR EUROPE AND THE WORLD: 1. COVID-19 SHOCKS

COVID-19: demand shock (lockdowns) turning to supply shocks (supply chains)

Deepest recession in post-war history

Euro area real GDP

(chain-linked volumes, Q4 2019 = 100)



Notes: Data are seasonally and working day-adjusted. Historical data may differ from the latest Eurostat publications due to data releases after the cut-off date for the projections. The vertical line indicates the start of the current projection horizon.

Source: ECB staff macroeconomic projections for the euro area, March 2022.

Quick recovery due to swift policy reaction

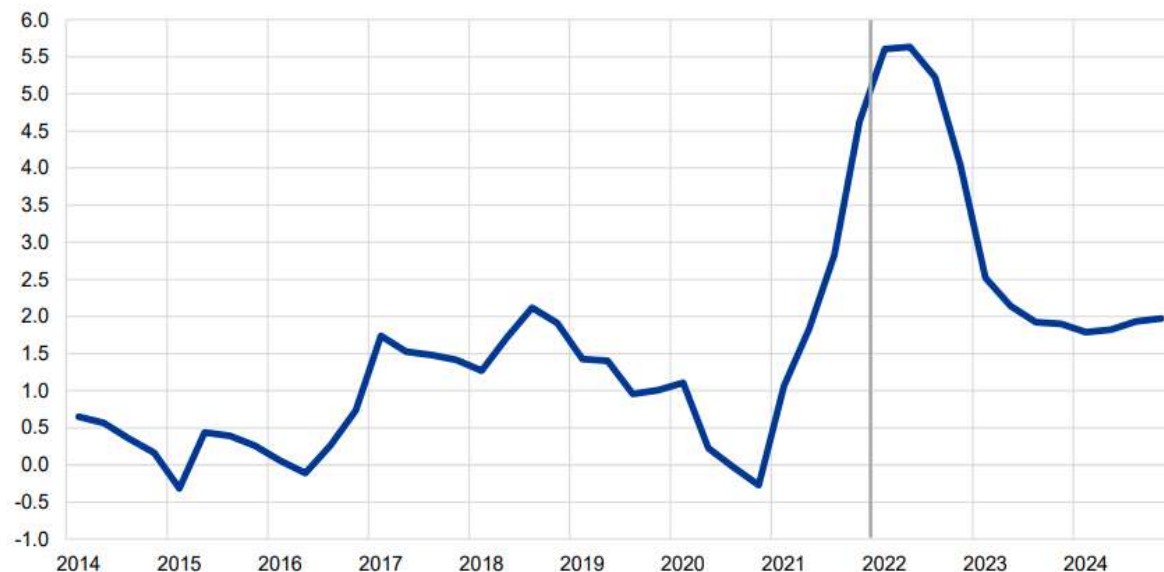
- **ECB**
 - **PEPP** – pandemic emergency purchase programme
 - **TLTRO III** – targeted longer-term refinancing operations
 - **Liquidity provisions** to CESEE: **swap** and **repo lines**
- **EU countries**
 - Various **transfers** and **subsidy programs**
- **EU**
 - **NGEU** – Next Generation EU fund
 - **RRP** – national resilience and recovery plans
- **Banks** – part of the solution

COVID-19 legacy: increasing inflation and public debt as well as fiscal and monetary policy challenges

Inflation at record highs

Euro area HICP

(annual percentage changes)



Note: The vertical line indicates the start of the projection horizon.

Source: ECB staff macroeconomic projections for the euro area, March 2022.

Inflation driven by

- Initial strong **recovery** and **fiscal policy**
- **Energy prices**: demand-supply mismatch in gas (and oil) as part of the transition (China)
- **Supply chain disruptions**
- **Demand shifts** – from leisure to products

Challenges due to

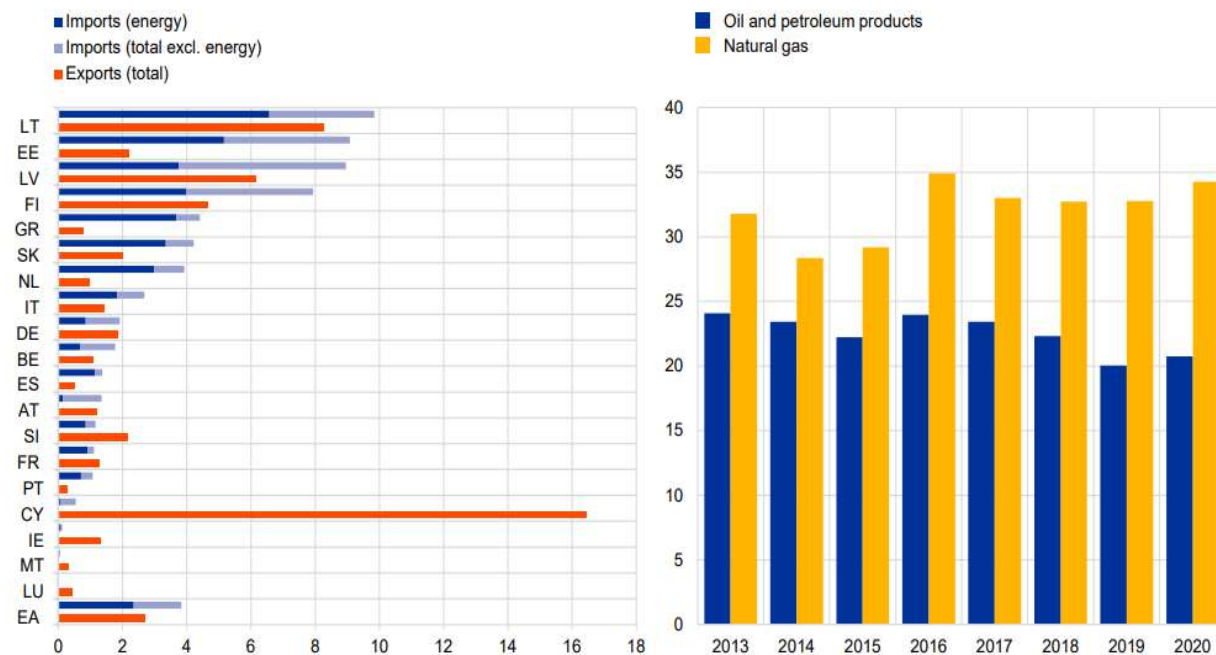
- **Public debt** (14 pp higher)
- **Fragmentation risk**
- **Fiscal dominance**
- **Shifts in inflation expectation – de-anchoring**

TRANSFORMATIONAL SHOCKS FOR EUROPE AND THE WORLD: 2. RUSSIAN AGGRESSION SHOCKS

Russian aggression shock hits Europe particularly hard ...

Euro area trade with Russia (left-hand panel) and euro area dependence on Russian energy supplies (right-hand panel)

(left-hand panel: percentage of total trade in goods and services; right-hand panel: percentage of imports)



Sources: ECB, Eurostat and ECB staff calculations.
 Note: Imports of natural gas include those of liquefied natural gas.

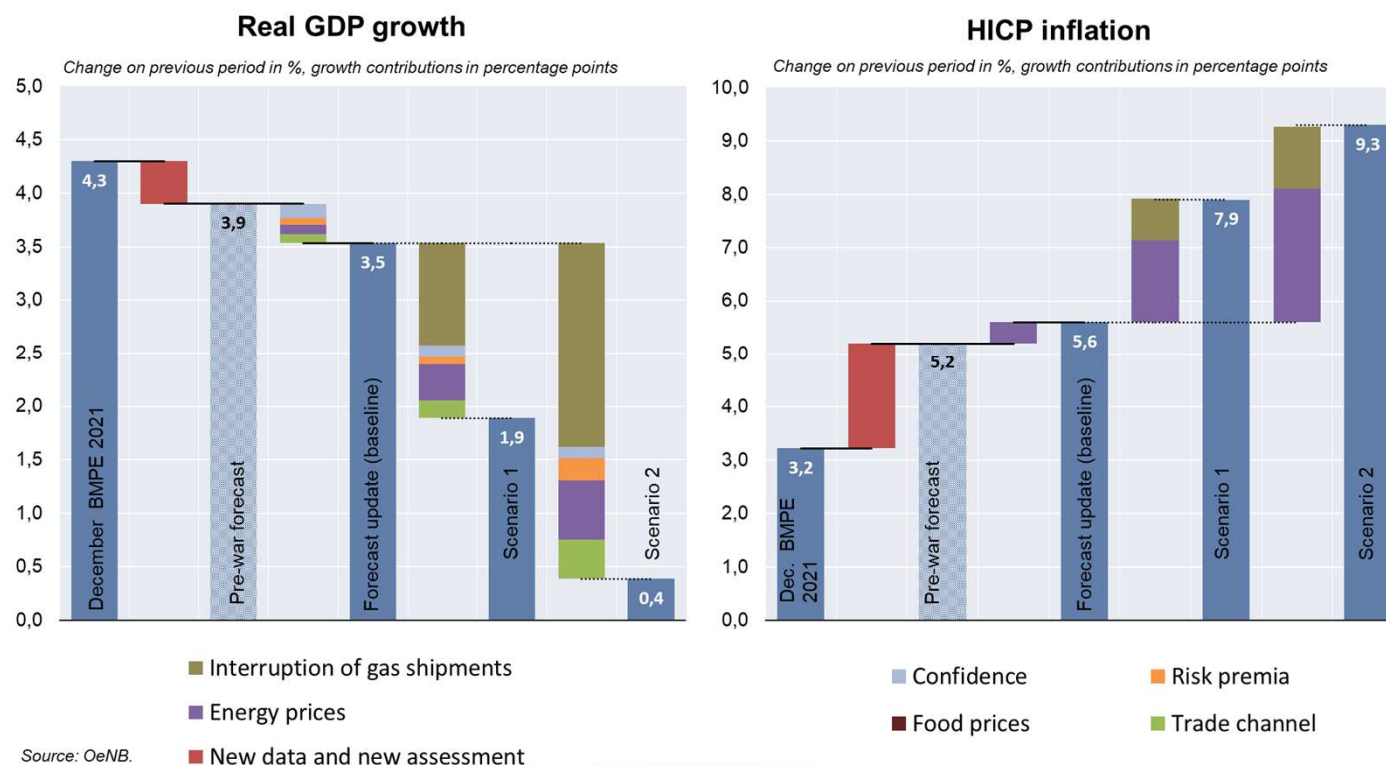
Epochal shift from the world we knew before

- **Membership in NATO** may not substitute for **weaknesses of EU** of **lack in central government** anymore
- **Resilience of EU** will be seriously tested
- In the **short term** new **supply** and **demand shocks** with unpleasant **trade-offs** between **inflation** and **growth**
- In the **medium term** the **conflict resolution** will determine further development (baseline, adverse or severe scenario)

... with impacts on Austrian economy

GDP forecast update March 2022 & Inflation forecast update April 2022

Austria: forecasts and scenarios for 2022



Source: OeNB.

- **Forecast update:** timely end of the war (GDP March, inflation April)
- **Scenarios:** protracted and escalating hostilities, intensified sanctions and also possible disruptions of gas shipments from Russia:
 - **S1:** disruption of gas shipments from spring to fall (-15% gas)
 - **S2:** disruption of gas shipments from spring to year end (-30% gas)

Key assumptions

- Stable international financial markets
- No change of power in Russia

... with slowing growth expectations and rising inflation

GDP forecast update March 2022 & Inflation forecast update April 2022

GDP and HICP forecast for Austria

	GDP and HICP scenario results			Difference to December 2021		
	2022	2023	2024	2022	2023	2024
	<i>Change to previous year in %</i>			<i>Difference in percentage points</i>		
GDP, real	3,5	2,2	2,0	-0,8	-0,4	0,2
HICP inflation	5,6	2,9	2,2	2,4	0,6	0,1
	Scenario 1					
GDP, real	1,9	2,3	2,4	-2,4	-0,3	0,6
HICP inflation	7,9	3,4	2,2	4,7	1,1	0,2
	Scenario 2					
GDP, real	0,4	2,3	2,5	-3,9	-0,3	0,7
HICP inflation	9,3	4,2	2,3	6,0	1,9	0,2

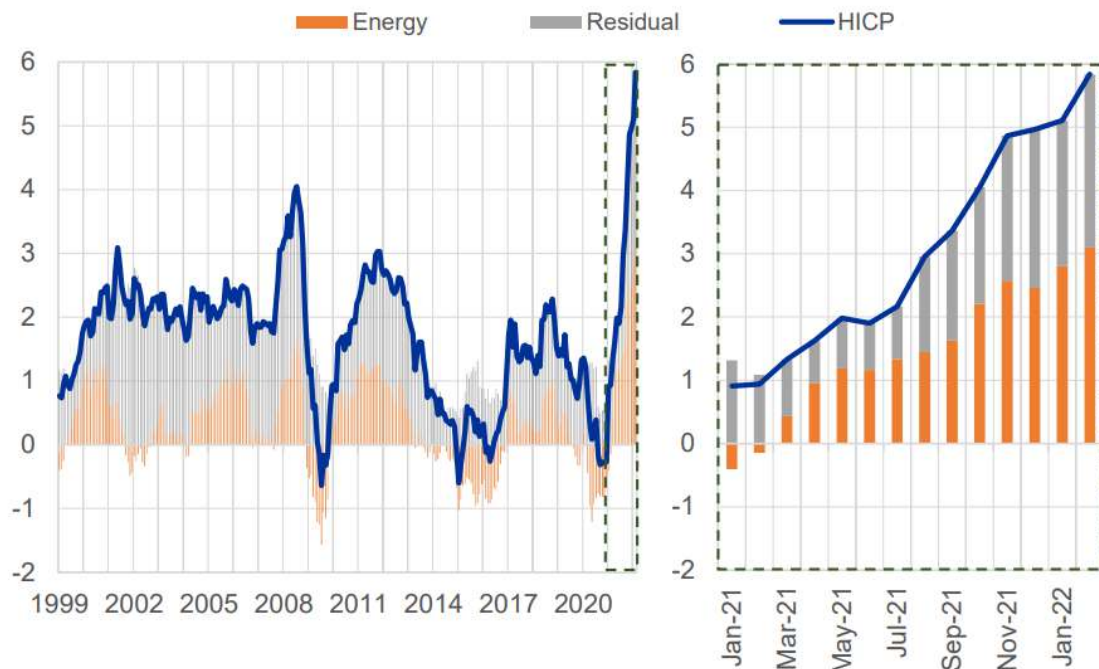
Source: OeNB.

- **OeNB forecast update** and **two alternative scenarios** (GDP March 2022, Inflation April 2022)
- **Forecast update** shows **weaker GDP growth** and a **significant rise in inflation** for 2022
- **Alternative scenarios** include **disruptions of gas shipments** in 2022 and lead to strong **GDP** and **inflation effects**

TRANSFORMATIONAL SHOCKS FOR EUROPE AND THE WORLD: 3. CLIMATE SHOCKS

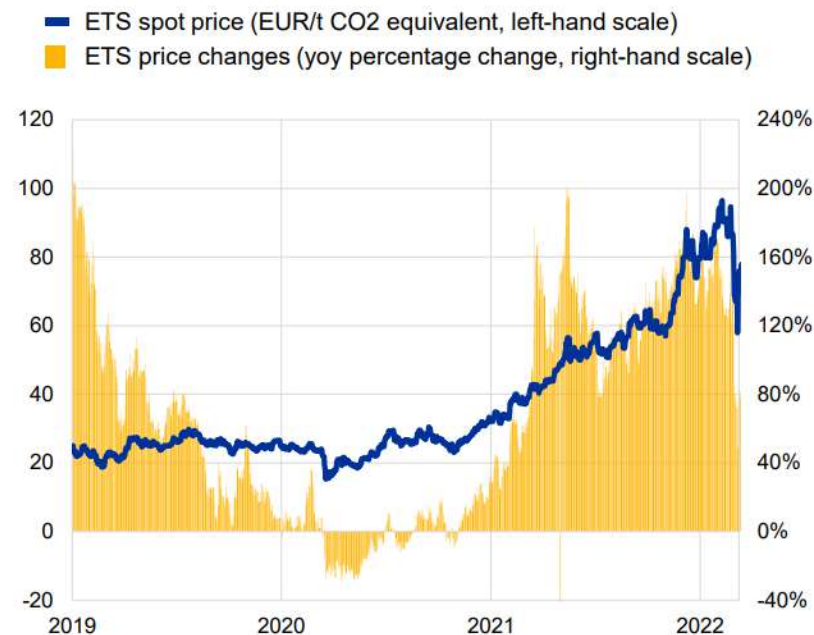
Climate shocks: energy drives 50% inflation – carbon prices play minor role ...

Energy contribution to HICP
(annual percentage changes; percentage point contributions)



Source: Eurostat and ECB staff calculations.
Last observation: February 2022.

**Emissions Trading System (ETS)
spot price developments** (units in legend)

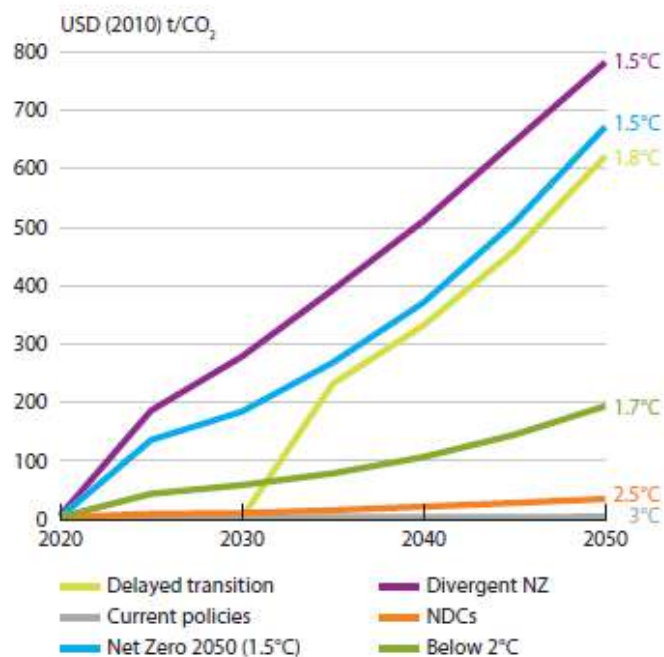


Source: Eurostat and ECB staff calculations.
Notes: Daily observations. Last observation: 15/03/2022.

... but climate policies likely to be inflationary for some time

NGFS Scenarios 2020-2050

Carbon price development



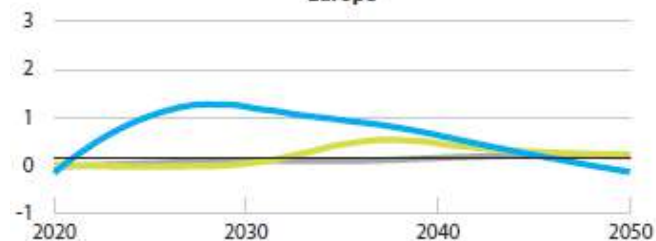
Source: IIASA NGFS Climate Scenarios Database, REMIND model. Carbon prices are weighted global averages.

Investment demand drives inflation

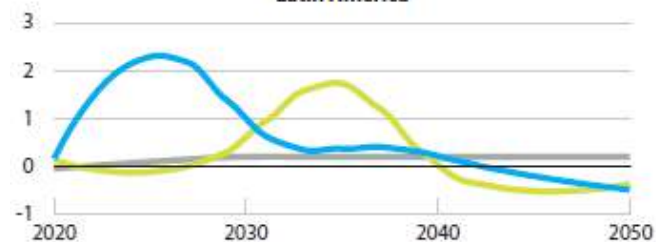
Inflation

Percentage point change

Europe



Latin America



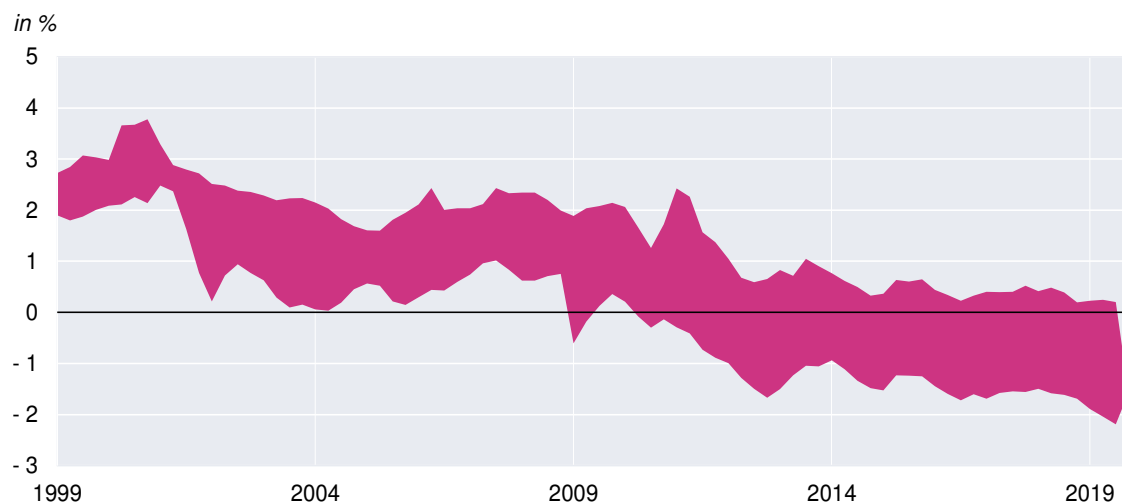
Legend: Delayed transition (yellow), Current policies (grey), Net Zero 2050 (1.5°C) (blue)

Results have been smoothed as a 5 year centred average.

Source: IIASA NGFS Climate Scenarios Database, NiGEM based on REMIND, IAM data and damage estimates from Kalkuhl & Wenz (2020).

... and the equilibrium real interest rate limits monetary policy leeway

Chart 1 Range of point estimates of r^* in the euro area obtained from econometric models



Source: "The natural rate of interest: estimates, drivers, and challenges to monetary policy"; OP, No 217; Ajevskis (2018); Brand, Goy, Lemke (2020); Brand, Mazelis (2019); Fiorentini, Galesi, Pérez-Quirós, Sentana (2018); Geiger and Schupp (2018); Holston, Laubach, Williams (2017); Jarocinski (2017); Johansson and Mertens (2021).

Notes: Ranges span point estimates across models to reflect model uncertainty and no other source of r^* uncertainty. The dark shaded area highlights smoother r^* estimates that are statistically less affected by cyclical movements in the real rate of interest.

Latest observation: 2019Q4

- The equilibrium real interest rate - also known as the natural rate or r^* - has **declined** worldwide **over the past 30 years**
- Estimates of the equilibrium real interest rate in the **euro area** are currently **just under zero percent**
- Without a **rebound of r^*** , **no return to conventional monetary policy and real positive interest rates** is possible
- Various factors explain this development:
 - **Decline in productivity**
 - **Population aging**
 - **Excess of savings over investments**
- Is r^* **endogenous** and **amenable to economic policy**?

Three requirements (shocks) to a low-carbon world economy

Creative destruction a la Schumpeter

- Effective measures will have to be disruptive and comprehensive
- Disruption and sustained productivity gains is the USP (Unique Selling Proposition) of capitalism and market economy
- Promises to offer higher productivity growth, high natural interest rate and return to conventional monetary policy

Protracted period of investments required

- Investment needs are largely unknown but likely to be higher than anticipated
- Investment demand may drive inflation up by additional 1-2%
- May require change in inflation and monetary policy stance

Requires return of global North-South capital flows

- Sustainable energy solution expected from sun, wind etc., and hydrogen as energy carrier required
- Provision and efficient production will be in the South (and mostly not Europe)
- Calls for major investment in Sahara, Patagonia and other places

WAY FORWARD – GEOPOLITICAL & MONETARY POLICY CHALLENGES

Geopolitical challenges

1. **Shock** from the **pandemic largely**, but not completely, **overcome**
 - **Risk of new mutations** and **insufficient access** to **vaccination** and **medication**
2. **Russia-Ukraine war**
 - **Duration** and **intensity** of the **war** – possibly (much?) **longer** than expected
 - **New bipolar world order?**
=> New Iron Curtain/ **Western alliance vs. Eastern alliance**
 - **Impact** on **globalization**, **international economic** and **financial systems**
Europe's autonomy particularly affected
3. **Fight** against **climate change** – **green transition**
 - Consistent **taxation** of **CO₂** in a **heterogeneous world**
 - Development of **new production** and **consumption networks**
 - Financing **climate change investments** in an **uncertain world**

Monetary policy challenges

1. Elements, sequence and pace of monetary policy normalisation

- **Purchase programs** (net purchases/sales), **credit programs** (interest rates, repayment, availability), **interest rates** (deposit and loan)
- **Guideline for interest rate setting**: equilibrium real interest rate and inflation dynamics
- **Flexibility in scaling back purchase programs** to eliminate **fragmentation risk**

2. Dilemma of monetary policy

- Assessment of **instruments, scope and timing: too early** (hampering recovery) vs. **too late** (de-anchoring of inflation expectation)

3. To normalise monetary policy an **increase** in the **equilibrium real interest rate** is **necessary** – monetary policy is not responsible for possible policy approaches regarding a rebound

4. **Economic transformation needs are greater than expected** – how to adjust models to better reflect e.g. the impact of global trends, energy prices, inflation, ...?

Danke für Ihre Aufmerksamkeit

Thank you for your attention

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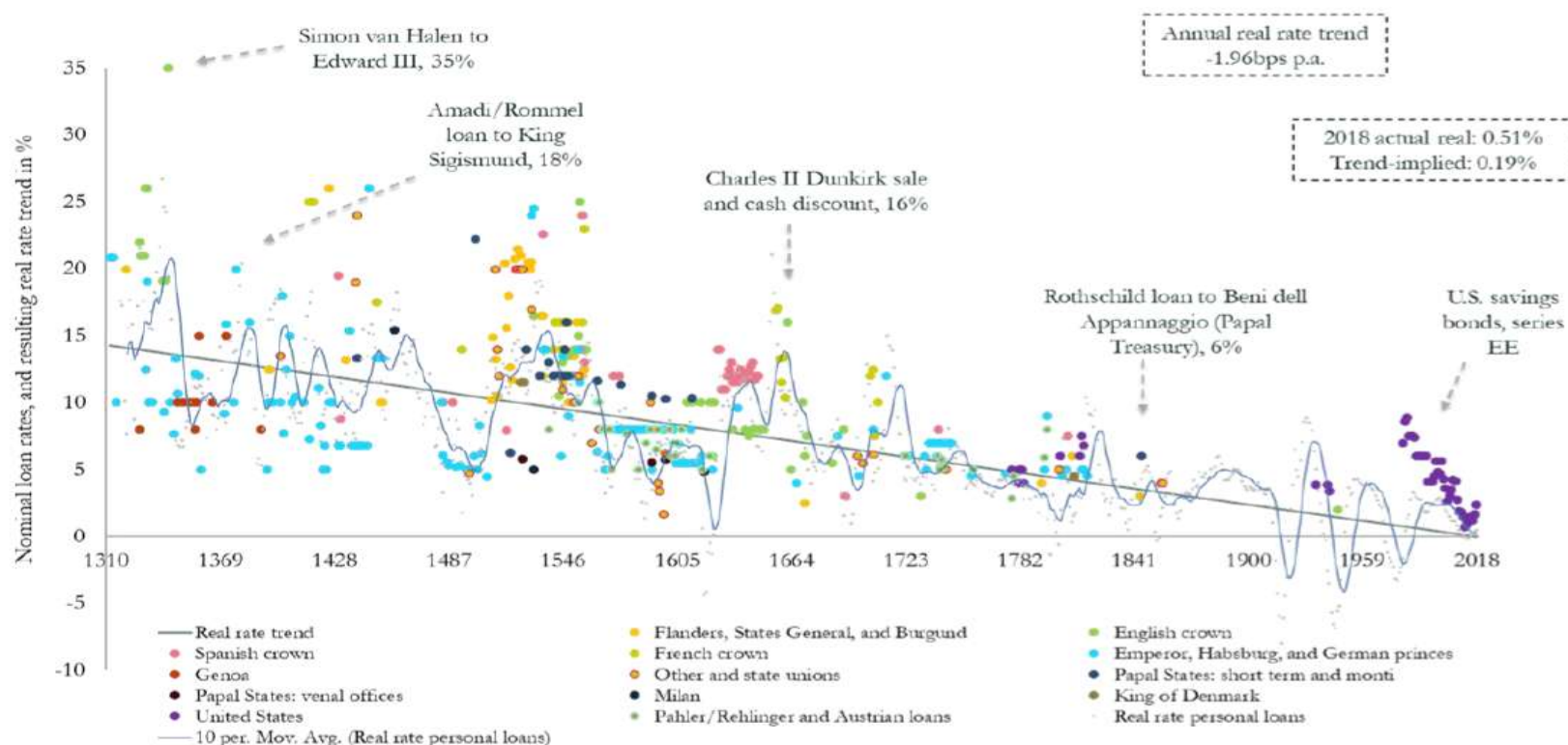
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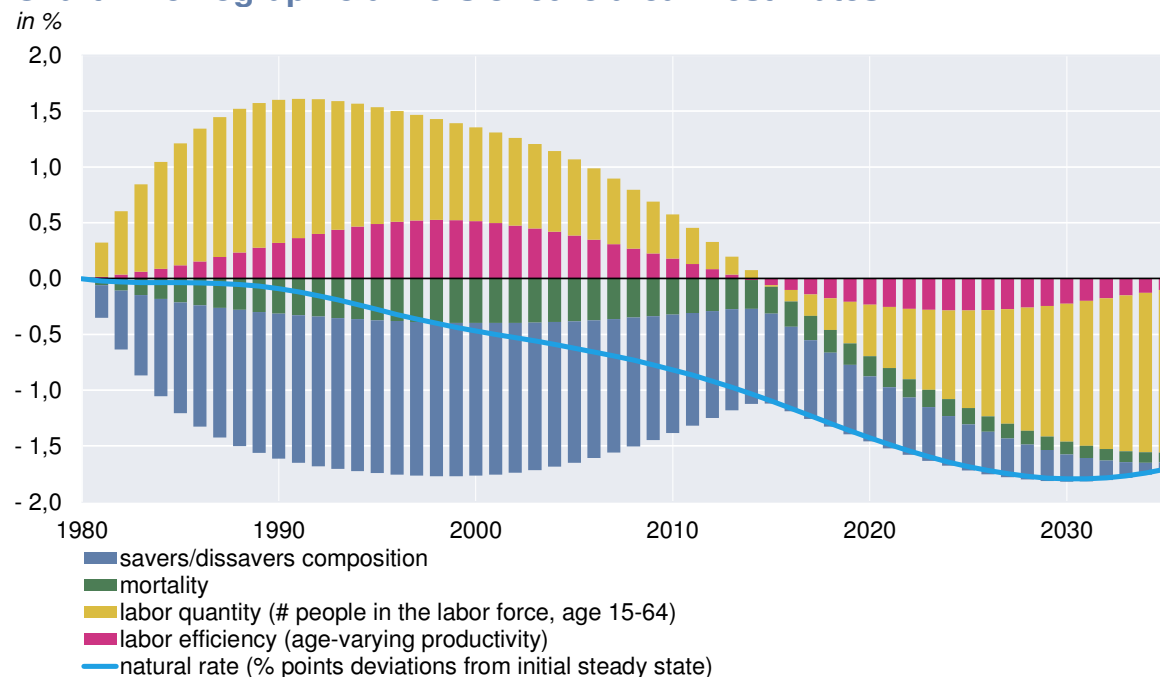
The equilibrium real interest rate, its secular decline and the economic policy options for its rebound



Quelle: Bank of England.

Demographic transition influences the equilibrium real interest rate

Chart 2 Demographic drivers of euro area r^* estimates



Source: Papetti (2018).

- **Increasing savings** for retirement **dampen equilibrium real interest rate**
- **Declining labor force** due to **low population growth** pushes equilibrium real interest rate further **down** → **falling productivity**
- The **positive effect** of **declining saving rates** in old age is **offset** by the **negative effects**
- **Unconventional** monetary policy measures **necessary**