ECB Listens online survey

Responses by Sustainable Finance Lab, The Netherlands

This response is the product of discussions on the ECB's monetary policy framework amongst the members of the Sustainable Finance Lab and reflects broad agreement among its participants. This does not imply agreement of every member with every specific observation or nuance. Members participated in their personal capacity, and their participation does not imply the support or agreement of their respective public or private institutions.

Section 1 – What does price stability mean for you?

The main contribution central banks can make to improving people's welfare is to maintain price stability. You may have heard about our recent measures to help counter the economic impact of the coronavirus pandemic. These have the overall aim of keeping prices stable. If the rate of inflation (the rate at which consumer prices increase on average from one year to the next) is positive, low and stable, this situation is consistent with price stability. We currently aim at an inflation rate below, but close to, 2% over the medium term.

1.1 How do changes in general price levels affect you/your organization and your members?

Central banks have decades ago, rightly, set their aim at maintaining inflation at positive, but low levels. The main challenge for central banks at that time was generally seen as to keep inflation from rising excessively. However, times have changed. Now we have deflationary pressures rather than inflationary ones. Deflation can be a drag on economic development. It is even more so for economies that are burdened by high debt levels, as is the case in the eurozone. Too low inflation therefore is now the most clear and present danger to society.

Some of the drivers of low inflation in the eurozone are structural and external like automation, globalization, demographic ageing and the decreasing power of labor unions. However, some authors see a shift in these factors, with the global reservoir of working population decreasing and inflation returning (Goodhart & Pradhan, 2020). In general, high liquidity (excessive cumulative money growth) and asset inflation do have the potential to quickly turn around inflation dynamics.

1.2 Are you concerned about either deflation or inflation being too high?

Even before the Covid-19 crisis deflation was more of a concern than high inflation. Eurozone economies have been in deflation in four episodes in the last 11 years.[1] This is worrying, if deflationary expectation become well anchored, it could lead to a deflationary spiral.

Deflation is especially harmful given that it entails wealth transfers from debtors to creditors. Given the already high wealth inequality this is all the more disconcerting. Moreover, wealth inequality also cuts through demographical lines, with older populations predominantly holding wealth, while younger generations usually are asset-poor. Deflation clearly exacerbates pre-existing social fault lines and inequalities that are already hampering economic development and human flourishing, contributing to political tensions.

The accompanying low interest rate environment also creates a future debt issue, both for governments and for the private sector. It puts us in a catch 22, or in fact two: there is indeed no need to have contractionary fiscal policy now, but the higher the stock of debt becomes, the more difficult it will be to go back to higher interest rates without a debt crisis. Also low rates help to keep the interest payments low, and low rates stimulate debt growth which raises interest payments. The current low-rates, high debt growth regime is not sustainable.

1.3 For which types of goods and services do you feel the effects of price changes most?

The low inflation of the broad price indicators poses, as we explained above, macro economic problems. However, whereas prices in the real economy have remained stagnant over the last decade, this has not been the case for asset prices, like those for stocks and real estate. In these markets we have seen strong price rises. These price rises are supported not only by falling interest rates, but also by the instruments used by the ECB and other central banks, especially its policy of quantitative easing, its asset purchase programmes.[2] These price rises further increase wealth inequalities and thus increase political tensions in society.

A proposal is to remove energy prices from the HICP index as a shift towards low-carbon economy requires carbon taxes which would raise energy prices. The worry is that should the ECB act on increase in energy prices due to the rising HICP by raising interest rates, that could choke off the economy.[3] We do not think such a structural solution is needed for what essentially is a temporary phenomenon that monetary policy makers can look through. Rising energy prices because of carbon taxes probably are a temporary issue, which – when interpreted correctly by the central bank should not be weighed very heavily, similar to large shifts in value added tax that disappear from inflation measures after a year. Because energy prices have plummeted in the COVID crisis, there actually is plenty of room for carbon taxes now.

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[1] https://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=122.ICP.M.U2.N.000000.3.ANR
[2] https://www.economy.com/economicview/analysis/255221/QE-Could-Fuel-Housing-Bubbles-in-Europe
[3] https://www.project-syndicate.org/commentary/ecb-strategy-review-must-change-price-stability-target-by-helene-rey-2020-10

1.4 When you think about inflation, how relevant do you find the increase in the cost of housing?

Increase in the price of housing, and the ECB's role in it, is discouraging for several reasons. Firstly, as mentioned, assets are unequally divided in our societies, with older populations typically holding most wealth. Rising house prices thus favor those in upper age distributions, and disadvantage young people. This makes it more difficult for them to get on the housing ladder and start building wealth – houses being the main source of wealth for the middle classes.

Secondly, an increase in mortgage lending has a strong pro-cyclical effect, increasing the chances of another financial downturn. Banks lend disproportionately for buying existing assets at a cost to investments in productive activities.

It is thus imperative that central banks recognize the 'doom loop' of monetary policy and high housing costs: long-lasting expansionary monetary policy leading to increasing house prices; these in turn leading to bursting of the bubble and bank defaults, further negatively impacting financial stability and possibly again requiring bank bail-outs.

The ECB's measure of inflation (HICP) excludes the costs of housing for house owners. This way the ECB keeps no track of one of the most relevant price changes for Europe's citizens. It is assessed that had the ECB included owner-occupied housing, HICP would be some 0.3% higher than it is now (Gros, 2018). We admit it is difficult to construct one index that mixes consumer prices and asset prices. We recommend that the ECB periodically reports and comments on asset price trends, to highlight its importance; and to take the harmful and dangerous effects of asset price booms into account in its policy decisions.

Section 2 – What are your organization's expectations and concerns?

We conduct monetary policy to make sure that the euro holds its value over time. To make our monetary policy as effective as possible, we want to better understand your expectations, as well as your economic concerns.

2.1 What economic concerns are you/your organization and your members facing?

The Corona crisis has brought uncertainty, destabilization and economic devastation not seen in recent memory. Many millions have already lost, or are forecasted to lose employment. Companies (usually SMEs) will irrevocably close. The ECB's role in stemming this tide has been commendable, but insufficient. Fiscal policy will have to play the largest role in the recovery. The ECB's role is to accommodate this by monetizing deficits as necessary, and by calling upon governments to use their fiscal space, as it has done in the past.[4]

[4] https://www.centralbanking.com/central-banks/economics/7696386/lagarde-calls-on-governments-to-prolong-fiscal-support

The euro area has never been able to deliver on the promise of the Maastricht Treaty of economic convergence. The last eurocrisis has increased the problem of divergence, as the South was forced to do most of the austerity leading to investment levels falling much stronger in the South. The current pandemic further exacerbates this as the South experiences the biggest economic impact and has the highest borrowing costs. The common Recovery Fund of the European Commission is indeed a step towards the common fiscal policy instrument needed for a monetary union. However, its size of 5% of GDP, to be spent over 3 years, is small compared to the actual fiscal needs. Fiscal needs that will further rise now that a second wave of covid-19 is hitting the eurozone.

Introduction of PEPP and the broadening of TLTRO programmes are steps in the right direction. These give fiscal policymakers and banks extra room to stimulate the economy. Having monetary and fiscal policy working in the same direction.

Our concern is that monetary policy cannot solve these problems on its own, and that on the fiscal side not enough will be done, by individual euro member states, but especially at the level of the European Union. For that reason we think the most important topic for the ECB Review is the question what instruments it can effectively use to achieve its price stability objective, rather than a discussion on the inflation objective itself.

While some voices call for a reduction in inflation target[5], we believe this to be misguided as this would reduce monetary policy buffers even further, constrain leeway for action, and even force some weaker Eurozone countries into deflation.
For this reason the inflation target should be increased rather than decreased. However, given the current low inflation and lack of instruments this may be a rather symbolic gesture. Despite this, it could be helpful to signal that a temporary overshoot of inflation will be tolerated.
We however argue against introducing a symmetric goal akin to the recent policy shift at the Federal Reserve as this will not be a credible target in the longer run. For example, when past inflation has been too high in a boo period and the ECB would then be forced to create a deeper recession when the economic cycle turns.

On the instruments, our point of departure is that it is important to align central monetary policy and central fiscal policy to deal with big problems such as euro area divergence (asymmetries) and climate change. However, the key problem is that the euro area has design flaws from the start with respect to the lack of (partly) centralization of fiscal policy. This needs a fiscal solution. Monetary policy can be accommodative to this, keeping the costs of fiscal action low.
However, highly indebted governments may be too cautious borrowing now, fearing that the interest rate will rise sharply when the ECB starts to diminish its support. Therefore the ECB needs to signal its willingness to keep rates low, also when inflation moderately exceeds the current target of 2%, and use additional instruments like the PEPP that can deviate from the capital key to keep the interest rate low for all euro countries.

[5] https://www.reuters.com/article/us-imf-worldbank-ecb-austria-idUSKBN1WX1ZR

2.2 How have changing economic conditions affected you in the last decade and especially in the current economic crisis caused by the coronavirus pandemic?

On the one hand, the years before the Covid crisis have shown falling unemployment levels and moderate economic growth, NPLs have been decreasing and dispersion of growth across the Eurozone has decreased. On the other hand, wage growth has stagnated, government debt levels have increased above the SGP mandated limits, all in spite of unprecedented monetary stimulus (van Tilburg & Simić, 2020).

This has led to high levels of divergence both between and within member states. Northern countries have benefitted disproportionately more from the introduction of the euro. Moreover, income inequality has grown within states, leading to increasingly polarized societies, radicalized politics and erosion of the support for European cooperation and integration.

The pro-cyclical fiscal restrictions in the Stability and Growth Pact have been damaging to economic growth in general and the state of the public sector in particular in many member states.

2.3 How do low interest rates and monetary policy in general affect you/your organization, your members and the overall economy?

As mentioned, protracted low interest rates influence asset prices, most poignantly housing and stock prices which are booming even in a deep recession. This leads to further social and economic divergence. Furthermore, long term expansionary monetary policy contributes to the creation of zombie firms, thus reducing Schumpeter's 'creative destruction' and hence the growth of productivity. In addition, low-for-long monetary policy reduces the viability of the traditional banks' business model, forcing them to pass-through negative rates to consumers.

Section 3 - what other topics matter to your organization?

The ECB's main task, its "primary objective", is to maintain price stability in the euro area. However, once price stability is guaranteed, it is the ECB's task to support the general economic policies of the European Union. These include, for example, the sustainable development of Europe based on balanced economic growth, a highly competitive social market economy aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment.

3.1 Do you think the ECB should give more or less attention to these other considerations and why?

The EU Treaty is clear: the ECB should contribute to the secondary policies of the Union if it can without prejudice to its primary objective of price stability. Until now the ECB has however focused exclusively on price stability. In particular, the ecological sustainability of the economy is a secondary objective that the ECB should contribute more actively to. The reasons for this being:

1. That the ECB through its unconventional policies has become such an influential market player. With this influence comes responsibility for the effect it has on the economy and wider society. Through its programmes (APP, TLTRO) the ECB is affecting relative prices, and currently it does in a more carbon intensive way than the rest of the market (APP) (Matikainen et al., 2017) or it is bringing forward lending (through its refinancing operations like the TLTRO) that needs to be less carbon intensive in order to be in line with stated policy objectives (van ’t Klooster & van Tilburg, 2020).

2. Risk perspective: the ECB should recognize the importance of climate risks for its balance sheet and the financial system in general. In supervision the ECB recognizes bot physical and transition risks from climate change. In its prudential policy the ECb requires banks to take these into account and mitigate the risk, for instance through transitioning off brown assets and holding more green loans. This raises the question why the ECB is not taking transition risks into account in its own bond purchases and bank refinancing operations? Something that can be done for instance through tilting its purchases (Schoenmaker 2019) and greening the TLTRO (van ’t Klooster & van Tilburg, 2020).

3. Amongst the secondary objectives, climate change and biodiversity stand out. First because these are not political objectives that may change with the next election. Rather, they are part of global commitments and international treaties and goals have been set that stretch into 2050.

4. Also, unlike other objectives, like employment, there seems to be no trade off with the inflation objective (Schoenmaker, 2019). Actually, climate change and biodiversity loss are themselves a clear threat to price stability in the medium to long term.
Climate change, and biodiversity loss, are an existential threat to many species on earth and thus to the economy. The severity of this threat and its permanence is what separates it from other considerations enumerated in the secondary mandate. In the medium-term, a changing climate may even be one of the largest risks to price stability. Many authors have compared the economic effects of climate change to that of the world wars of the 20th centuries (Stern 2007), both periods of high and hyperinflation. Given the nature of climate change only a precautionary approach can be effective. Acting when its effects materialize may not possible given the time lag between emissions and their effects.
This effect of climate change on price stability may not materialize within the next years. The time horizon of monetary policy is currently around 2-3 years. However, the EU Treaty does not state such a short time horizon for the objective of price stability. Arguably, central bankers are expected to look ahead, something they can do given their independence from everyday politics. It is for this reason that also in order to achieve its primary target of price stability the ECB can and should use the instruments at its disposal.

3.2 Are there other issues not mentioned above that you think the ECB should be concerned with when setting its policies?

As mentioned in the secondary mandate, the ECB has a duty to bolster the sustainable economic development of the Eurozone countries. However, as previously mentioned, the divergence between the Northern and Southern countries of the Eurozone is obvious. This inequity is, and will be, further exacerbated by the impact of the Covid crisis. Given the high government debt levels of the South, this divergence may prove to be an existential threat to the euro.

What is missing is deeper coordination between monetary and fiscal policies. While many ECB board members repeatedly emphasized the necessity of more fiscal firepower, it is for various reasons not forthcoming. Nevertheless, it is in the arsenal of central banks to meet fiscal authorities half-way.

There is a variety of proposals on the table on how this could be managed. For instance, the ECB could increase the purchase of (green) bonds of the European Investment Bank or the European Commission, which could target green and digital infrastructure spending in the Southern countries (van Tilburg & Simić, 2020, Benink & Boonstra 2015).[6] Another proposal put forward by several reputable central bankers puts forward the ideas of financing shovel-ready projects pre-agreed by the executive powers until the inflation goal is achieved (Bartsch et al., 2019).[7] Another would be tweaking the currently existing TLTRO programme, giving it a 'green twist'. According to this proposal, banks in the Eurozone would be incentivized to lend specifically for the European Commission's Taxonomy-aligned projects by giving them preferential funding rates (van 't Klooster & van Tilburg, 2020)
Other set of policies relies on the handling of sovereign debt by the ECB. One strain of the literature relies on issuing perpetual bonds.[8] Others, like Paul de Grauwe[9] and Vesa Vihriälä[10], suggested converting some of the existing government debt already held at the ECB into coupons in order to give Member States more fiscal space for recovery.
Lastly, many proposals touching upon direct transfers from central banks to either governments or citizens have been put forward. Willem Buiter and Sony Kapoor argued for the former, claiming that these would not be in violation of the TFEU.[11] A similar claim has been made by François Villeroy de Galhau, governor of the Bank of France.[12] 'Helicopter money' proposals rely on the direct crediting of citizens' bank accounts by their central banks. This was a proposal first put forward by ~~an~~ Oxford economist John Muellbauer[13], and more recently updated to fit the Covid-19 crisis (Jourdan, 2020).

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[6] For similar proposals by Harald Benink and Wim Boonstra see https://www.mejudice.nl/artikelen/detail/hoe-de-ecb-en-europese-investeringsbank-europa-vlot-kunnen-trekken. Paul de Grauwe proposed a similar idea here: https://www.socialeurope.eu/green-money-without-inflation

[7] A similar, but more extreme thinking is offered by an Israeli economist Eran Yashiv, who proposes forming a new committee with politicians and central bankers working together to decide how much new money would be created and for which purposes. See https://voxeu.org/article/political-economy-covid-motivated-helicopter-drops

[8] https://www.project-syndicate.org/commentary/finance-european-union-recovery-with-perpetual-bonds-by-george-soros-2020-04

[9] https://www.mo.be/interview/als-we-de-komende-tien-jaar-weer-moeten-besparen-het-omdat-we-daarvoor-gekozen-hebben

[10] https://voxeu.org/article/make-room-fiscal-action-through-debt-conversion

[11] https://voxeu.org/article/fight-covid-pandemic-policymakers-must-move-fast-and-break-taboos

[12] https://www.ft.com/content/c60a3bab-9229-48d7-8da5-574f8b0b9df6

[13] https://voxeu.org/article/combatting-eurozone-deflation-qe-people

3.3 How will climate change have an impact on you/your organization, your members and the economy?

While climate change has both economic costs and benefits, on a global scale the costs are expected to dominate the benefits by a large margin. The costs of physical changes in the climate result from decreased production capacity, negative impacts on workforces (heat stress and increased disease-burden), write-offs of existing assets, increased operating costs, increased capital costs, reduced revenues from lower sales/output, increased insurance premiums, and reduced availability of insurance on assets in "high-risk" locations (TCFD, 2018). Droughts, decreased crop yields, floods and extreme weather conditions can drive large migrations.

The Stern Review further shows that if no new mitigation is undertaken the overall costs and risks of climate change will be equivalent to losing at least 5% of global GDP (Stern, 2007). Wider estimates of damage yield costs of 20% of GDP or more. It should be kept in mind that 'socially contingent' impacts, such as migration and conflict, were not quantified in this study.

After the Stern review many other studies emerged that tried to quantify the effect of climate change. A report by the Dutch Environmental Assessment Agency (PBL) shows economic damage ranging from 10% to 47% of global GDP (Hof et al., 2014). Like the physical consequences of climate change, the impact on the economy is not spatially uniform.

4. How can we best communicate with your organization?

We know that understanding how monetary policy works helps people make decisions about how to spend, save, invest or borrow money. We would like to find out how successful we have been in explaining what we do and why we do it.

4.1 To what extent do you feel well informed about the ECB/your national central bank, for example, concerning the recent measures taken in response to the coronavirus crisis?

The ECB has done a good job responding to this crisis, not only in terms of monetary policy response, but the outreach as well. The decisions for introducing PEPP, the new TLTRO expansion and PELTRO, and swap lines to non-Eurozone countries were well argued for and clearly explained in the media. Furthermore, Mr Philip Lane's blogs have been useful to further explain Mme Lagarde's previous communications as have been speeches from ECB-board members.

Nevertheless, these pronouncements and explications remain limited in scope in terms of its audience. Unfortunately, it is usually the (financial) press that follows and understands these events, with the less informed public remaining in the dark. If the ECB is to work in the spirit of an open, democratic, European institution, it should extend its outreach beyond press conferences, newspaper and other media interviews, and its online presence. The public deserves to have a better insight into the intricacies and the influence of the workings of monetary policy.

4.2 How could the ECB/the Eurosystem improve the way it explains the benefits of price stability and the risks of inflation being too high or too low?

Central banks, in general, have a reputation for opaqueness in the general population, which often leads to misunderstandings and misinterpretations. While the ECB goes out of its way to explain the benefits of price stability and the workings of its monetary policy, more can be done in that area. It is especially disheartening to see, for example, that the average citizen believed the inflation to be 5%, while the actual value was closer to 0,3% (Lagarde, 2020).

Furthermore, it should explain better how the financial system works in general, and how money creation works in the banking sector in particular (McLeay & Radia, 2014). Lastly, the ECB should do more to underscore why central bank independence is relevant and how the ECB works in the common good, as a public institution at the EU level.

4.3 What could we do to improve your understanding of the decisions we take and how they affect you?

In general, the ECB's outreach is often limited to the financial sector and financial (rubrics of the) press. Given that central banks play ever more important roles in economies, a development that we do not see change any time soon, this surely should change.

ECB members should appear more frequently in front of national and European parliaments, and thus show more accountability to elected politicians and the public. This is one of the larger lessons of the episode with the Karlsruhe Constitutional Court. Furthermore, this would not limit ECB's independence and would contribute to its image and credibility. After all, it is a custom followed by other central banks, without showing any signs of jeopardizing their independence (Tucker, 2018).

We commend the effort that the ECB has put in in consulting with the public, and more specifically the civil sector, with regards to its policy review process. However, there is no reason why that openness cannot be extended to various fora and events on a more regular basis. ECB is a democratic institution and would benefit from taking in more feedback from the academic, public, civil and other expert circles.