

Central Banks / Global Economy

Sintra, beyond the tweet of Trump

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Central banking forums are particularly interesting, providing as they do an environment where one can take a step back from the volatile present and, even more importantly, take perspective and ask oneself where it is that we are heading.

The focus a few weeks ago was on the United States, where there have been long and drawn-out discussions around the challenges surrounding the strategy and communications of the Fed against a backdrop of low interest rates and inflation, and with the margin of "traditional" monetary policy being greatly reduced. The Federal Reserve has given itself a few months to digest all of this and, eventually, present its conclusions and smoothly translate them into a redefined inflation target.

Recently, attention has been on Sintra, where, under the title "20 Years of European Economic and Monetary Union," there has been reflection on monetary policy, with a broader focus on Europe, because, twenty years after it was first created, there continue to be weaknesses in the European architecture that greatly limit the ability to respond to new shocks that we may have to address in the (perhaps not so distant) future. And here in Europe, the challenges and debate remain far greater than in the United States. In that sense, Sintra hasn't disappointed.

Draghi could not have been clearer when he stressed that the ECB's great challenge will be to ensure the anchoring of inflation expectations to the target from low levels (in complete contrast to what it had to do in the first decade after it was founded, when inflation was above the target and it had to converge to lower level). If there was any doubt about the commitment to this goal, he went on to literally say that inflation will have to be over 2% for this goal to be achieved. The big question, however, is how to achieve it taking into account the perception that in Europe, unlike in the United States, there is no monetary policy margin. Draghi firmly defended that they still have room of maneuver and, one by one, listed the available instruments.

The ECB will surely, sooner rather than later, use "forward guidance" to strengthen its commitment to keeping rates low as long as necessary until inflation expectations increase. Interest rates could be lowered somewhat further (although the room quite limited). Moreover, there is also the option to resume the asset purchase program (the ECB has the flexibility to further increase its balance sheet). Furthermore, it would be desirable, unlike in the more recent past, to align the messages from the Governing Council members in order to strengthen the communication channel. Last, but not least, he openly defended that fiscal policy should play its role. Europe needs fiscal capacity. It is a way of implicitly acknowledging that, in an environment where Europe may have to address a new shock (caused, for instance, by a trade war), monetary policy will very likely not be sufficient.

And this links into another of the most interesting topics that was addressed in Sintra. Blanchard, who focused on the "architecture of macroeconomic policy". While the ECB has transformed and adapted its instruments, there are significant weaknesses concerning the rest of Europe's architecture, the European framework being far from optimal. A key aspect is the lack of a European Treasury, which makes it very complicated to coordinate fiscal policy and monetary policy to deal with adverse situations. Another aspect that remains unresolved, and which according to Blanchard will recur, is the lack of relative price adjustment and the persistence of current account imbalances in the countries.

Finally, the "anecdotes" chapter of the Sintra 2019 story will contain President Trump's tweeted declaration that the ECB is seeking "unfairly" to depreciate the euro in order to improve the competitiveness of the European economy. It is slightly concerning that the delicate issue of the currency war has popped up on the radar at such a delicate juncture, but we hope that the tweet is not a warning and remains nothing more than an anecdote.

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