Memo to the President of the ECB.

Even if main mandate (inflation target) has been missed, ECB has done a great job

Came in aggressively when markets were disrupted

Has gone beyond duty to sustain demand and activity

- Question: Where does it go from here?

Three environments

- Dislocated markets. Sudden inflows/outflows, not information related
- Secular stagnation plus ELB. Policy rate at zero minus epsilon
- Normal (olden?) times. Enough room for policy rate.

- First: ECB (and others) did well. Lesson: Fill all the holes.
- Third: There will be time to think about it…
- Focus on the second. Central issue: Combination of fiscal and monetary policy

Both fiscal and monetary policy are needed to meet inflation/output targets

Fiscal been off and on. Austerity, then Covid spending. Worries about post-Covid . Return to rules?

Has forced the ECB to do a lot (still not enough. Missed mandate). Gone from policy rate to spread reductions.

During Covid, the two have roughly found the sweet spot. What's next?

Three issues. Division of labor. Coordination. Fiscal stance.

Division of labor. Spread reductions.

False labelling? "Market stabilization", "improving transmission mechanism"

ECB and national banks taken risk. Not catastrophic, but who should take it?

Fiscal backstop, or fiscal entirely: direct subsidies, conditions for countries

Optimal arrangement? ESM-OMT light + ECB at high frequency?

Coordination. QE and debt management

QE: Buy long maturity, issue floating rate reserves. Decreases spreads, increases interest rate risk

Treasuries: Issuing long maturity. Increases spreads, decreases interest rate risk

If think of the consolidated balance sheet (ECB + governments), the two largely offset (distribution effects across countries, deviation from key…).

Fiscal stance. Less of an advice to the ECB than to the Treasuries.

But ECB must push. A fiscal partner, not 19. Appropriate EU fiscal rules?

If you don't do enough, the ECB must do too much. Creating credibility risks.

Other issues, but I see them as more tactical than strategic:

Inflation target.

No-brainer. Go to a straight 2%.

More: No credibility in announcing a higher target now. But keep door open if and when inflation is back at target

Affecting expectations. Whose expectations? Investors, or wage and price setters?

The second, which matter for inflation, are sticky, unaffected by smart schemes.

The first: Average inflation targeting: Hard to do credibly. Yield curve control more straightforward.

Rebuilding the Global Economy

A series outlining policy priorities and solutions

PIIE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Memorandum to:

President of the European Central Bank

From: Olivier Blanchard

December 11, 2020

Key priority: Clarify the relative roles of monetary and fiscal policy

Division of labor.
Tools
Coordination

The rest matters less.