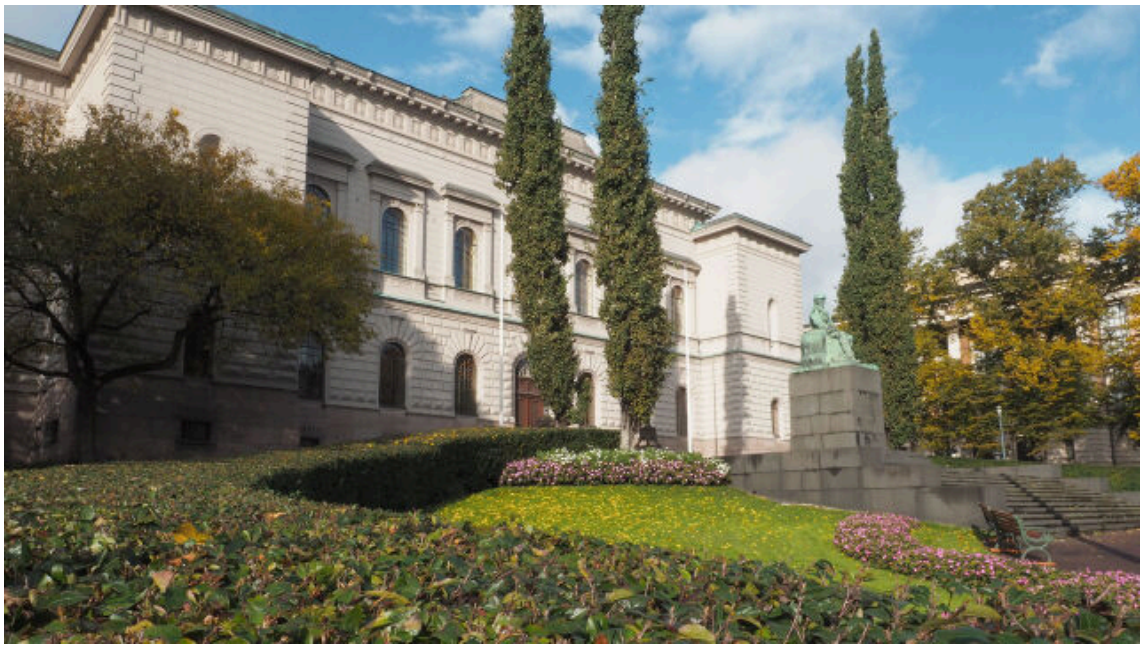
Editorial

How can we avoid a negative equilibrium of low growth and low inflation?

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Global economic growth began to moderate in early 2018. Industrial confidence has waned worldwide and global manufactures trade has seen its growth stall this year. Financial markets have avoided disruption for the time being, but the widening trade war has already slowed the expansion of the global economy.



In the euro area, growth has decelerated to about 1% and is not forecast to meaningfully pick up in the immediate years ahead. Recession has been avoided thus far, but the persistence of uncertainties – relating to geopolitical factors, rising protectionism and vulnerabilities in emerging markets – is sustaining a balance of risks that is tilted to the downside.

Inflation in the euro area will similarly remain subdued for the immediate years ahead. The ECB's latest forecast projects that inflation will remain at about 1% in 2020 and increase to 1.5% in 2021. Core inflation, which reflects the medium-term price pressures within the economy, has remained at about 1% for six years now, but is projected to gradually rise to 1.5% in 2021. The weakening of the economic cycle and shortfall in inflation expectations will maintain low inflation in the euro area.

At its meeting in September, the Governing Council of the ECB substantially increased its monetary accommodation in response to the continued shortfall of inflation with respect to the ECB's target and recent data indicating weak economic growth in the euro area. In addition, the downside risks to growth have persisted, and the inflation outlook is projected to remain subdued well into the future. With this decision, financing conditions will remain accommodative for an extended period and will contribute to the euro area's growth outlook, both short-term and long-term. If monetary policy remains accommodative for a prolonged period, this will raise the need to examine its impact on the financial system, so as to avoid any potential unforeseen negative effects.

The discussions concerning a review of the ECB's monetary policy strategy have progressed over the year, and a broad consensus has emerged regarding its implementation. The ECB's incoming president Christine Lagarde has announced that she will conduct a strategy review. This will allow for a thorough and analytical debate on the operating environment for monetary policy, on the definition of price stability, and on the instruments of monetary policy. Successful implementation of the strategy review will deepen the research-based knowledge underpinning the monetary policy strategy and thereby strengthen the the common understanding on policy within the Governing Council. The review process will therefore contribute to better monetary policy decision-making and support consistent communication.

Key questions to be addressed in the strategy review might include the following. How will remaining in an environment of negative interest rates and low inflation for a prolonged period affect the monetary policy framework? How will the effective lower bound on interest rates limit the scope for monetary policy in the future, and how should this be factored into the policy framework? What is the effectiveness of non-standard monetary policy measures when interest rates are near the zero lower bound?

The strategy review, in keeping with the ECB's mandate, might clarify both the definition of price stability and the medium-term inflation aim as well as the monetary policy reaction function.

The relationship between different policy areas is also of material importance. Is monetary policy reconcilable with financial stability, and how might fiscal policy and structural reforms that facilitate growth, employment and productivity share the burden borne by monetary policy?

The shortfall in inflation and the stubborn decline of inflation expectations are key challenges for monetary policy. We should take care to avoid the sort of profoundly harmful equilibrium that might arise from prolonged low inflation and zero interest rates, as this would significantly undermine the effectiveness of monetary policy, fasten economic growth below its potential and hinder efforts to boost employment.

To steer clear of this equilibrium, it will be necessary to draw on an array of both monetary and other economic policy tools. Fiscal measures should be actively pursued, particularly towards the financing of public investment in countries with the fiscal space to do so. Structural reforms need to be harnessed to boost productivity and the economy's growth potential and to reduce structural unemployment. In this division of labour, monetary policy needs to bring about a rise in inflation expectations and ensure that they remain well anchored with the price stability objective. It is our ambition that as a result of our actions, we will eventually see a rebalancing of the euro area economy and the normalisation of interest rates.

Recent studies, such as those looking at the experiences of Japan over the past decades, demonstrate that declining inflation expectations can become permanently stuck at low levels. This can lead the economy into a prolonged period of low inflation, where monetary policy has little room for manoeuvre. Consequently, a powerful monetary response is needed in situations where inflation expectations have become depressed for a protracted period, so as to prevent a scenario where inflation expectations become anchored at too low a level. This was one key reason for the ECB's decision to further ease financing conditions on 12 September 2019.

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