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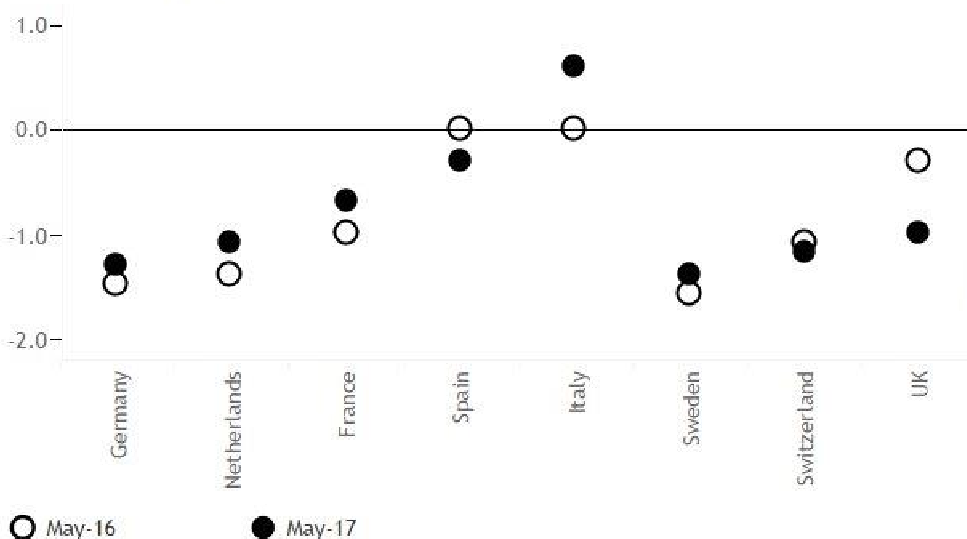
Draghi's monetary policy predicament

Blog post by Chief Economist Gregor Irwin, 18 May 2017

If you want to understand the predicament facing ECB Governor Mario Draghi you need look no further than estimates of long-run real interest rates for the major eurozone economies.
Real interest rates are estimated by taking the yield on long-term government bonds and deflating this by the expected rate of inflation over the same period. Fig. 1 shows 10-year real interest rates for the five biggest eurozone economies plus the UK, Sweden and Switzerland.
Several messages emerge. First, real interest rates remain exceptionally low by any standard. In normal times, real rates should roughly equal the trend growth rate of the economy. But even the most pessimistic forecaster would not conclude that Europe's major economies are facing a future in which trend growth is below zero.
The explanation is we are still far from normal times. Many countries (not all) still have large output gaps and unorthodox monetary policies have succeeded in keeping long-term rates at exceptionally low levels. The chart is a reminder that when those policies change and monetary conditions are 'normalised' this will involve significant shifts in asset prices, with all the potential disruption this implies for corporate and household balance sheets.
Second, while real rates have edged up over the past year in most countries, they have fallen in Spain and the UK, but for different reasons. Rates have increased in most countries as financial markets judge the moment when the normalisation of policy begins is getting closer. Spain has bucked the trend because the economy has performed better than expected, reducing the risk premium on Spanish sovereign debt. In the UK, the dominant factor is Brexit. The sharp fall in real rates may reflect a combination of pessimism about the long-term potential growth rate, policy easing following the referendum and a reduced likelihood that policy will begin to normalise soon.



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Third, and more directly related to Draghi's predicament, is the widening of the spread in real rates among the major eurozone economies. While real rates have mostly edged up, the gap between the lowest and the highest has increased, with Italy now looking more exposed.
The dispersion in real rates reveals a structural weakness in the eurozone. It is those states that have the largest output gaps and which are struggling most, that have the highest real rates. The differences are not trivial. Real rates in Italy are 1.9 percentage points higher than in Germany. It took the ECB almost two years to raise its policy rate by a similar amount in 2006 and 2007. And over the past year, the gap has grown.
Fourth, while the Germans and the Dutch may grumble about monetary policy being too loose and savers being punished by low interest rates, they appear to be in respectable company. There is nothing exceptional about real rates there when compared to Sweden, Switzerland or the UK. This suggests that if anyone has grounds to complain about ECB policy not serving their interests, it is the Spanish and Italians.
Draghi's predicament is when to begin the long process of normalising monetary policy. The gap in real rates across the major eurozone economies suggests he will be unable to please everyone. In theory, that should not be his concern. In practice, it will be and the widening of the gap will worry him. For now, he appears to be in no hurry. Whatever he does, he should expect to come under ever more intense political pressure from all sides.

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