

Recent Policy Challenges through the Lens of Economic Forecasts†

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This short paper outlines some thoughts about the policy challenges we have experienced over the past two or so years through the lens of economic forecasts. More specifically, the paper traces recent events and policy by looking at the evolution of recent forecasts of the euro area economy prepared by euro area professional forecasters and published quarterly by the European Central Bank.

Study of the history of central banking suggests that monetary policymakers must always be ready to face difficult challenges, and that sometimes they need to quickly map an appropriate response even when precise guidance from historical experience may be lacking. In late 2007, as Cyprus was preparing to adopt the euro, it was already clear that possible challenges on the horizon would pertain not only to the banking system of Cyprus but also to the economy and monetary policymaking of all the euro area. However, it was hard to imagine that the euro area would be confronted with challenges so extreme as the ones encountered over the past two or so years.

In broad terms, the euro area macro economy has faced two very different challenges over the past two or so years. The first was an inflationary threat, an adverse supply shock, associated to a large extent with a sharp increase in energy costs and the prices of other key commodities. The acceleration of oil prices from the beginning of 2007 until the summer of 2008 was so dramatic as to bring back bad memories from the 1970s, specifically the painful experience we associate with the oil shocks of 1973 and 1979. Subsequently, though, this inflationary threat subsided and

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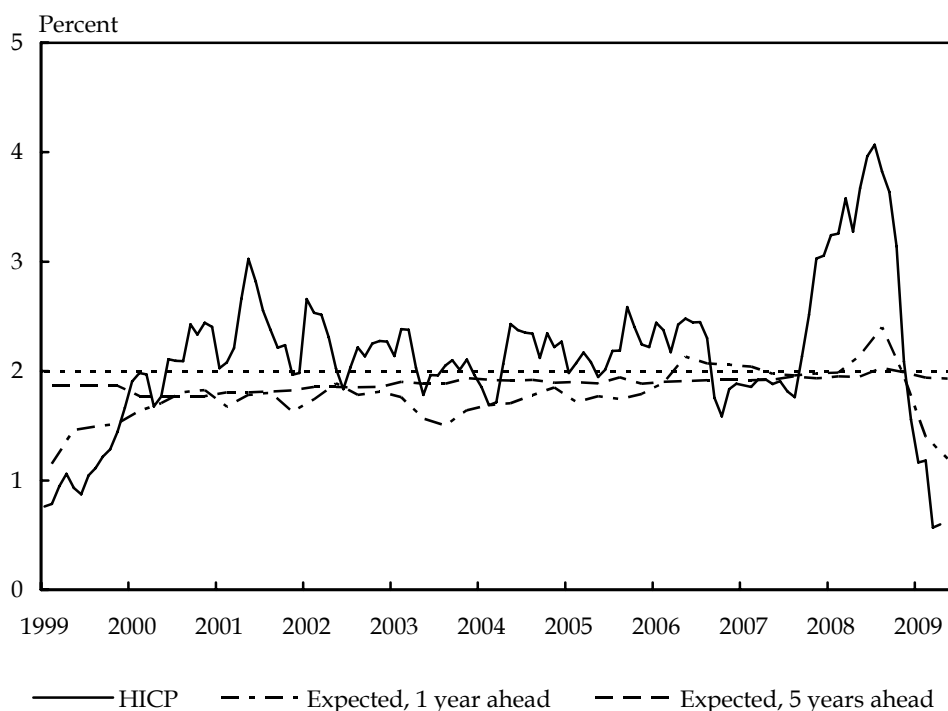
indeed we have experienced a reversal of much of the earlier increase in energy costs.

But it was the second challenge that proved more vexing and more threatening for the worldwide economy. This challenge initially manifested itself as a financial turbulence that erupted suddenly in August 2007, and continues to this day. Although it threatened our financial system, prompt policy action initially contained the impact of this turbulence on the real economy until September 2008. Unfortunately, following the collapse of Lehman Brothers in the United States in the same month, this turbulence evolved into a full blown international crisis, one so severe that it eludes comparison with anything experienced worldwide in the post-World War II era. This crisis had a severe adverse effect on confidence worldwide, and evolved into a synchronized severe economic downturn, causing an unprecedented collapse in industrial production and world trade. For several months following September 2008, there were concerns about a developing adverse feedback loop with the financial disturbance and a worsening real economy reinforcing each other in a downward spiral for a time. The second major policy challenge this paper focuses on, is precisely this financial crisis we have experienced since September 2008.

The rollercoaster ride of the past two or so years can be described in numerous ways and is evident in many financial indicators and data. The macroeconomic environment has been associated with extreme uncertainty and poor visibility, a most unfriendly environment for anyone daring to forecast the future. As a pertinent illustration one can highlight the wild swings we have experienced in inflation over the past two years in the euro area, with HICP inflation registering both its highest and its lowest readings recorded in the ten-year history of the euro area (Figure 1). Following several years of relative stability, when HICP inflation fluctuated within just a few tenths of a percentage point around 2 percent, we have experienced over the past year a new peak exceeding 4 percent last July and a new low at 0.6 percent in the past two months, and cannot exclude negative readings in the months ahead. Comparing the path of actual inflation shown in Figure 1 against the one year-ahead forecasts shows how difficult it has been of recent to forecast inflation, even by professional forecasters.

Just how difficult has it been to forecast inflation during these times? The last year-ahead forecast that can be evaluated with available data is the forecast made in the 2008Q2 survey for the 12-month period ending in March 2009. The mean forecast was 2.1 percent while the actual inflation reported was 0.6 percent, a difference of 1.5 percentage points.

FIGURE 1
Inflation Expectations in the Euro Area



Sources: Eurostat and ECB.

Figure 1 also presents the evolution of longer-term inflation expectations from the survey, specifically the expected rate of inflation five years ahead. Despite the unprecedented challenges in the economic environment and unusually violent swings in inflation over the past two years, long-term expectations have remained remarkably stable and in line with the ECB objective of keeping HICP inflation close to but below 2 percent over time.

This evidence is a confirmation of the credibility of the ECB in achieving its mandate even under the challenging circumstances experienced over the past year or two. Well-anchored inflation expectations are of the essence not only to facilitate attainment of the ECB's primary objective to maintain price stability but also to allow the flexibility that monetary policymakers can have to alleviate the adverse effects of financial disturbances as well as shocks to the real economy.

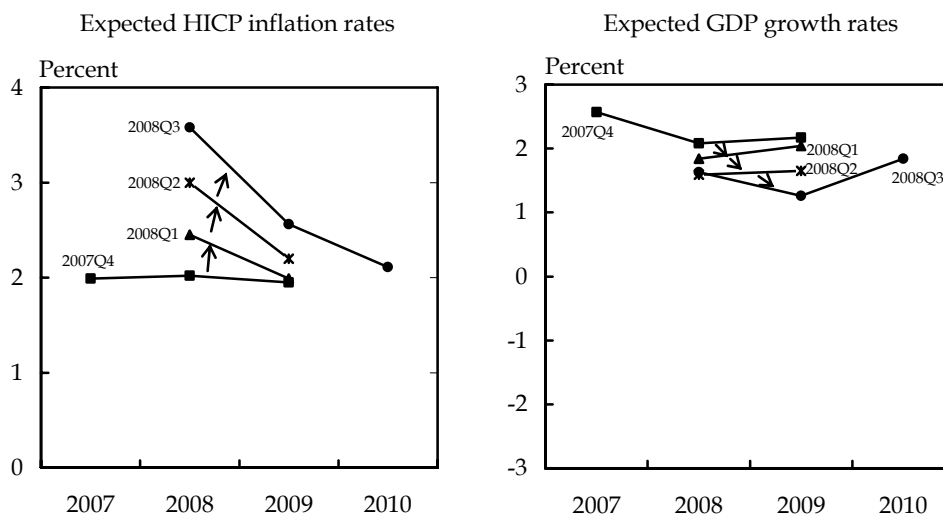
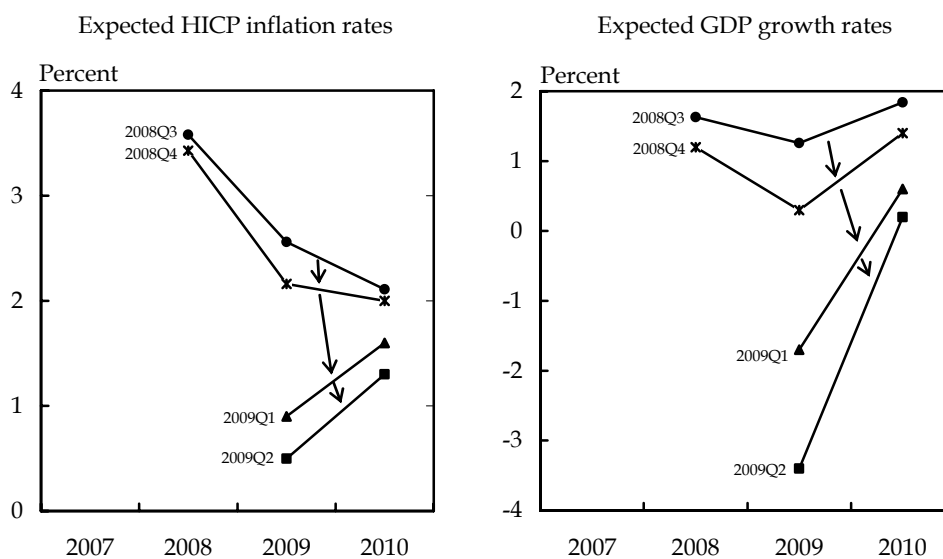
Economists sometimes find it useful to decompose economic disturbances into "aggregate demand" and "aggregate supply" shocks. This decomposition is also useful for understanding differences in how policy

might respond to different challenges. Recognizing the risk of oversimplification, it may nonetheless be instructive to categorize the two challenges mentioned above in this manner. The first challenge, could be seen as an adverse supply shock. Adverse supply shocks tend to put upward pressure on inflation while also dampening aggregate demand. The policy response is not straightforward and depends on a number of factors. If inflation expectations are well-anchored and there is no threat that second round effects on inflation could potentially materialize, then monetary policy could ease slightly, thus dampening the drop in economic activity. But if threats of second round effects on inflation appear on the horizon, then a tightening of policy is appropriate to ensure that inflation expectations will not become unmoored. In this manner, monetary policy secures price stability over time and the sustainable growth in economic activity that comes with it.

The experience with the evolution of short-term forecasts of the euro area during the second half of 2007 and the period prior to the Lehman collapse in 2008, suggests the pattern of an adverse supply shock. As can be seen in the top two panels of Figure 2, in successive quarters from 2007Q4 to 2008Q3, the outlook for inflation deteriorated, with inflation projected to exceed significantly 2 percent, while at the same time growth prospects also deteriorated somewhat in successive forecast rounds. But expectations beyond the very short-term horizon remained well anchored and the ECB Governing Council decided it was appropriate to adjust monetary policy only very slightly during this period, a 25 basis points increase in its policy rate on 3 July 2008. As shown in Figure 1, for the longer-term forecasts, and confirmed by the pattern of convergence towards the ECB's definition of price stability shown in the forecasts in the upper left panel of Figure 2, this slight policy adjustment succeeded in maintaining inflation expectations well anchored in the medium and longer-term.

The effects of the second challenge on the economy, that is developments associated with the financial crisis since the collapse of Lehman in September 2008, could be seen as an aggregate demand shock---indeed, a massive demand shock of unprecedented size in the post-World War II era. Adverse demand shocks tend to put downward pressures on inflation, while also dampening aggregate demand which tends to reinforce further downward pressures on inflation. Unlike the case of adverse supply shocks, in this case the policy response is quite a bit clearer. Policy easing is required so as to avoid a severe depression in economic activity since such an outcome could threaten price stability by increasing the risk of deflation.

FIGURE 2

*Evolution of Euro Area Forecasts**2007Q4 – 2008Q3 surveys**2008Q3 – 2009Q2 surveys*

Note: The forecasts shown are taken from successive vintages of the ECB's Survey of Professional Forecasters. Each line connects the forecasts collected during the quarter noted next to the line. For example, in the upper left panel, the red line shows the forecasts for HICP inflation made in 2007Q4 for 2007, 2008 and 2009.

The experience with the evolution of short-term forecasts of the euro area since the second half of 2008, suggests this pattern of an adverse demand shock. As can be seen in the two bottom panels of Figure 2, forecasts for both inflation and growth prospects were revised significantly downwards as the crisis evolved. The sharpest downward revisions could be seen in the forecasts from the survey for the first quarter of 2009, when the sharpness of the downturn started to become more clearly evident. Some further downward revisions can be seen in the most recent survey, but these revisions are not as large as those recorded in the previous quarter. The deterioration in the forecasts over the past two quarters has been unprecedented in the history of the survey. Note that the pattern of forecasts in the Survey of Professional Forecasters is not significantly different from that of forecasts by other organisations.

Looking more closely at the most recent survey results from the 2008Q2 survey, it should be noted that although the inflation forecast for 2009 is well below the ECB's price stability objective, forecasters expect a sizeable pick-up in inflation for next year. In addition, inflation expectations five-years ahead remain at 1.9 percent, which is in line with the ECB's definition of price stability. It is important to monitor closely inflation expectations going forward. A protracted period of inflation below our definition of price stability could risk unmooring inflation expectations on the downside, with all the associated adverse consequences.

Seen in the light of the deterioration in the economic outlook experienced over the past several months, it is easy to understand why the Governing Council of the ECB thought it was appropriate to proceed with a series of decisive monetary policy easings. Since October 2008, the main policy rate has been cut drastically, with last week's decision bringing it down to an all-time low level of 1 percent. Similarly, the interest rate on the deposit facility is at a historic low of 0.25 percent.

It should be kept in mind that when policy rates are close to the zero lower bound, they may no longer suffice as the best indicators of the monetary policy stance and of how expansionary monetary policy may be. In these circumstances, non-standard policy measures acquire an elevated role. To evaluate policy, it is important to look at the complete policy package, accounting both for standard and non-standard policy easing. In this light, it should be recalled that since October 2008 the Governing Council has implemented a series of non-standard policy easings.

In closing one cannot avoid but reiterate the extreme uncertainty about the economy during this episode and the need for policymakers to remain alert and ready to react appropriately to incoming information. Needless

to say, continued monitoring of the evolution of forecasts remains of the essence towards that end.