NORMALIZING MONETARY POLICY

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The contribution of the new ECB's strategy to normalizing monetary policy

In July 2021, the members of the Governing Council of the ECB – including myself – agreed unanimously to a new monetary policy strategy. The most important change is the new definition of price stability aiming for a symmetric inflation target of 2% over the medium term. The charm of this new definition is its simplicity and clarity. We are confident that this improvement makes our target easier to understand. Moreover, it reflects better the symmetry already pursued by the ECB's Governing Council in recent years. We consider negative and positive deviations from this target over the medium-term as equally undesirable.

Currently, our projections – as many others from well-known international organizations – expect inflation rates in the euro area to hover around 1½% in 2022 and 2023, despite the fact that current inflation is higher. In our strategy we should see through these short-term increases and focus on the medium-term, and the forecasts for the medium term are clearly below our 2% target. Consequently, we will stick to our ultra-loose monetary policy stance until we see inflation reaching 2%. Yet, there is the possibility that we may be able to normalize monetary policy sooner than most financial market experts expect. I see potential upward price pressures coming from (1) persisting global supply bottlenecks, (2) mounting labor shortages in several sectors, (3) pent-up demand and higher savings triggering a stronger spending spree, (4) cost effects from effectively implementing climate change policies, and (5) last but not least, higher headline inflation getting entrenched into inflation expectations.

Let me emphasize that a persistent rise in inflation and inflation expectations towards the ECB's inflation target of 2% would be welcome. In accordance with our new monetary policy strategy, we will tolerate a transitory period in which inflation is moderately above target. This is also consistent with our medium-term orientation and this should contribute to re-anchor inflation expectations at 2% more persistently. However, the overshooting should be moderate and temporary, and more importantly we do not aim to compensate later with an undershooting, as would have been implied by an average inflation targeting regime.

Not losing sight of the side effects of our measures is an important contribution for normalization.

Our monetary policy measures will stay in place until the crisis is over and inflation is projected to reach our target. This may happen rather sooner than later if my view on inflation developments is correct. This does not mean that we will withdraw accommodation prematurely, but rather that accommodation will be needed for a shorter period than what markets expect.

I consider that not losing sight of diminishing returns, increasing negative side-effects as well as legal constraints and the proportionality of our non-standard measures is an equally important part of our strategy. These considerations could become more important the longer we keep this ultra-loose monetary policy stance, and therefore we should also avoid withdrawing monetary policy accommodation too late. Negative side effects include the build-up of financial imbalances, adverse distributional effects as well as long-term effects on capital allocation. Moreover, this can turn into a vicious circle if there are side-effects that hinder us in achieving our target. For example, low interest rates may exacerbate financial booms, rapid credit growth and the accumulation of debt, which distorts capital allocation through the banking sector by allowing for lax lending standards and low risk margins. The resulting high growth in debt, in combination with distorted production and investment decisions, might make it difficult to raise interest rates again without damaging the economy. Low interest rates risk becoming entrenched.

Additionally, due to low interest rates more low productive projects become profitable, facilitating their entry, while there is less pressure for unproductive firms to exit, which contributes to the misallocation of resources. Eventually, this could lead to the emergence of zombie firms. This slows down aggregate productivity growth by reducing the cleansing effect of the business cycle.

To be clear, the reason for these outcomes lies not only in low interest rates but are rather the product of the interaction with the institutional framework. For example, supervisory forbearance delays restructuring and could lower productivity growth. Also, the design of insolvency laws affects banks' attitude towards non-performing loans and the allocation of resources.

In any case, an ultra-loose monetary policy and a delayed withdrawal of monetary policy accommodation also carries risks and may hinder our target and delay normalization. We should keep an eye on these effects, try to understand better the interaction with the institutional framework and design our policies accordingly. If we consider more systematically the negative feedbacks from our policies, monetary policy normalization will happen sooner rather than later.

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Treading through policy normalization: navigating recovery and balancing risks

The Covid-19 pandemic has all the elements of a great Hollywood movie. First, there is a threat to end «the world as we know it». Then, there are heroes of the pandemic: scientists who rapidly developed vaccines and the pharmaceutical industry quickly scaling up the production.

And finally, there is a happy ending, as the swift pace of recovery continues to defy expectations throughout the recurring waves of the pandemic, with vaccines propelling economies further as populations in advanced countries are getting close to herd immunity. But vaccination efforts had powerful sidekicks: fiscal and monetary policies, which supported the global economy during the critical period.

Unlike the global financial crisis, when monetary policy was pretty much «the only game in town», a strong fiscal impulse was now concerted with an unprecedented monetary accommodation. Fiscal and monetary policies reinforced each other and fed into a virtuous cycle. Maintaining favourable borrowing conditions by central banks eased the financing of fiscal expansion, while government deficits strengthened the traction of monetary policy. Yet, despite the improving prospects, the recovery remains uneven within countries and across different parts of the world. Downside risks related to new virus variants and limits to vaccine availability, as well as to reluctance to vaccination, still loom large. Most policymakers in advanced economies are therefore in no hurry to wind down their exceptional policies.

For the first time since the start of the pandemic the improving prospects have opened room for discussion about the path to policy normalization. There is a broad consensus on the sequencing of monetary policy normalization: assets purchases will be the first to go away, followed by interest rate increases, with redemptions of government bonds, and maybe even outright sales, gradually reducing the size of the central bank balance sheets only at a later stage. But there is much less of a consensus on the timing and pace of policy normalization.

The central banks of the two largest economic blocs have so far avoided communication on the start of normalization, assuming that the mere discussion would amount to monetary policy tightening. But a batch of central banks from smaller advanced economies, such as Canada or Australia, has already announced tapering or even embarked on it. Even the Bank of Japan has stabilized the size of its balance sheet under the guise of yield curve control.

It is necessary to tread carefully through the recovery.

Some differences in the timing of actions between central banks can be explained by idiosyncratic fundamentals. However, different views on the balance of risks account for the bulk of divergence in central bank communications. The prevailing view in central banks of the largest economic blocs is that the current inflation surge is of a transitory nature.

The stabilization of energy and commodity prices as well as a gradual repair of overstretched production chains and resolution of mismatches in the labour market are considered sufficient to tame the inflationary pressures. Further on, inflation expectations appear to be firmly anchored – regardless of our preferred indicator of future inflation. Finally, erring on monetary policy with inflation on the upside is considered to be less costly than the premature tightening of monetary policy, as we possess adequate tools and knowledge to deal with excess inflation.

The leniency of central banks in major advanced economies towards the build-up of inflationary pressures is not unexpected. Inflation surprised us on the down-side many times over the last decade, so many times that constant inflation undershooting has instilled fear of deflation into the minds of central bankers. But the drivers of inflation may also work in the opposite direction, as we do not have a firm grasp on them.

The pandemic has cracked the globalization process, which may start unwinding disinflationary forces. This may also quickly alter the expectations – we know that consumers, businesses and participants in the financial markets are no better at forecasting inflation than central banks.

Following a prolonged period of exceptionally low interest rates, elevated public and private debts and stretched asset prices may induce surprising market reactions if central banks get forced into strong action.

Finally, recent tweaks to monetary policy strategies may also complicate matters, as new policy reaction functions are not yet obvious to markets, potentially forcing central bank actions even if there was no need for any.

To conclude, we need to tread carefully through the recovery, constantly re-evaluating the balance of risks and avoiding strategies that may force excessive reactions somewhere down the road.

MĀRTIŅŠ KAZĀKS
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Monetary and fiscal policy: independent, not unconditional alignment

Monetary policy has supported the economy during the Covid-19 crisis. So has fiscal policy, being able to provide targeted support to those most affected. Yet, none of them can resolve a health crisis, which needs medical solutions – comprehensive vaccination, effective and affordable treatment.

What are the lessons for monetary policy? First, the effectiveness of instruments is state-dependent. Second, a mix of instruments may yield a better result than a single instrument. Third, continued proportionality assessment is critical to assess appropriateness of policies and instrument choices.

The ECB has reviewed its strategy. Our target is 2% inflation symmetric over the medium term. We have committed to a forceful or persistent monetary policy action in the presence of effective lower bound (ELB), to avoid negative deviations from the inflation target becoming entrenched. The implementation of our monetary policy can result in a transitory period when inflation is moderately above target.

The strategy is supported by forward guidance on interest rates, i.e., to keep them at the current or lower levels until: we see inflation reaching 2% well ahead of the end of the projection horizon; inflation stays durably at this level for the rest of the projection horizon; we see sufficiently advanced progress in the observed underlying inflation.

Does this mean a longer period of negative interest rates than envisaged before? Our actions will be determined by the actual data, our projections and judgement on medium term outlook, and proportionality analysis. Yes, the hurdle for action in our policy rates has been raised. But the precise timing of the rate lift-off will be data driven. With now clearer inflation target and appropriate forward guidance, credibility can be improved, and the lift-off may well be brought closer rather than pushed further away.

For effective monetary policy and general policy mix, the former must preserve its independence.

The strategy allows for a forceful action, and we have instruments to achieve our target. But an interplay with other policies would help. With r*, the natural rate of interest, down to about zero and actual interest rates close to ELB, monetary policy space has narrowed. Fiscal policy is especially effective at ELB, its multipliers are higher. Bold fiscal and structural measures help close the output gap faster with less side effects from expansionary monetary policy. Quality (read: growth-friendly) fiscal spending complemented by structural reforms can boost productivity and r*, both sustainably raising living standards and increasing monetary policy space and its efficacy by reducing incidences of ELB. Low yields due to monetary policy do provide a unique opportunity to boost public investment, especially as investment activity over the past decade has been weak.

Currently, Covid-19 uncertainty is high, output gap is open, and supportive monetary and fiscal policies are warranted. Higher inflation is mainly driven by transitory factors and currently can be looked through. It won't stay so forever. Rates will rise. Accommodative monetary and loose fiscal policy are complementary during a crisis, but not when recovery roots in and inflation closes in on its target. Then tensions between monetary and fiscal policy are inevitable, especially when debt levels are high.

The Treaty puts price stability as the ECB's primary objective which the new strategy defines as 2% inflation symmetric over medium term. Phasing out support and raising rates is unpopular and ridden with economic risks. A central bank should reduce such tensions and risks by: (i) communicating clearly on economic outlook and its actions depending on economic developments, and (ii) moving carefully. For effective monetary policy and general policy mix, the former must preserve its independence and not allow for fiscal dominance. Monetary policy and fiscal policy should be independently aligned, not an unconditional alignment a la "till death do us part".

Thus, fiscal policy will need to come back to ensuring debt sustainability. When the output gap is closed, fiscal policy must be tightened accordingly. Such a countercyclical switch on and off model of fiscal policy to support a working and effective monetary and fiscal policy mix that is run independently and mutually complementary is a tough task. With fiscal policy still mainly at national level, the incomplete fiscal architecture is obvious. NextGen EU is a step in the right direction, but many more steps need to be made, including that of a sizeable common fiscal capacity.

Opportunities provided by such a painful crisis as the current one should be used to the full.

CYRIL ROUX

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Unconventional monetary policies weigh on insurers' profitability

Insurance companies are adept at managing diversifiable risk but they are no better suited than other economic actors to face systemic investment risks. On the contrary, because of their constrained liabilities, and the prudential and accounting regulations they operate under, insurers' fortunes are uncomfortably tied to the monetary policies which central banks now use to affect directly financial markets, such as assets purchase programs, on top of traditional channels of monetary transmission.

Investors should have little reason to complain today. Indeed, the fortunes of billionaires have famously ballooned since the beginning of the Covid-19 pandemic, thanks to the records reached by listed equity and real estate, two asset classes buoyed by unconventional monetary policies. Insurers, however, cannot emulate billionaires, family offices or even sovereign wealth funds with respect to their asset allocation. Notwithstanding their real economic and investment horizons, born out of their liabilities, insurers are bound by regulation to be mostly invested in sovereign and corporate credit markets and thus their fortunes are bound to follow those of these markets.

In recent years insurers have rightfully bemoaned the effect of negative interest rates on their business models. Because interest rates are still very depressed, by the massive use of conventional and unconventional monetary policies, it remains topical to recall the corrosive effects of such financial repression on insurance companies, despite the accompanying growth of the value of their fixed income assets. Let us count the ways.

First, life insurers have offered guaranteed returns (if only a zero return) to their policyholders ; depressed fixed-income coupons challenge their ability to honor those guarantees.

Second, as sellers of packaged fixed income returns, life insurers have seen part of their value proposition to individual savers dwindle or vanish.

Third, long tail non life insurance policies, such as those of liability insurance, are priced with some investment returns in mind – when these investment returns fail to materialize, this line of insurance business ends up unprofitable, years after having been sold.

Negative interests rates and benign neglect of inflation are detrimental to insurers and the economy.

Fourth, both life and non life insurers are structurally cash rich, due to the inversion of the production cycle of insurance, in which premiums are paid before claims. Because of this structural excess liquidity, insurers suffer from negative interest rates charged by banks on their cash holdings.

Finally, European insurers, operating under Solvency II, have to maintain solvency ratios calculated with regulation-mandated formulae which overstate their risk of ruin when computed using a negative interest rate curve. As a consequence, European insurers have had (i) to divest from equity markets and (ii) to issue debt for no other reason than to compensate for this model error.

Yet negative or zero interest rates on credit aren't any longer the only detrimental effect of monetary policies on insurance business. The recent increase of inflation may not be solely a monetary phenomenon- pace Milton Friedman. But it would be quite rich for central banks to argue it isn't at all a monetary one, wholly explained by the rebound from the economic suppression of lockdowns, production bottlenecks and generous unemployment payouts. An unexpected step increase of inflation is seriously detrimental to non life insurers, whose liabilities are paid in real, not nominal terms. Prior year developments will deteriorate under this scenario and can wipe out several years of underlying technical insurance margins.

Combined with depressed investment returns, an increased inflation rate can make the non life insurance sector durably unprofitable. Hence the benign neglect of 2021 inflation figures by central banks, the increase of which they explain away as transitory, and that they welcome at the same time as a boost away from the too low inflation figures of the recent past, is a serious concern for the insurance industry. As insurers cannot reprice policies already issued, they will have to try to pass on to their clients the burgeoning wage pressures and the extra costs of property and casualty claims which come from elevated hourly repair costs, rising health providers wages and higher prices of raw materials and replacement parts.

Together will the relentless increase in weather events, this will push non life insurers to become, willy-nilly, a new inflation transmission channel in the economy.

Negative interest rates and benign neglect of inflation are detrimental to insurers and the economy as a whole.

A return to a normalized monetary policy, ensuring subdued and stable inflation, anchored expectations, and positive returns on fixed income assets, commensurate with credit risks, would be a much more advisable regimen.

DINO KOS

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Normalizing monetary policy - when and how?

Mervyn King, former Governor of the Bank of England, recently said that unconventional monetary policy "tends to be deployed in response to bad news, but isn't reversed when the bad news ends." Indeed, central bank balance sheets have expanded massively since 2008. For example, the Federal Reserve's balance sheet has grown ten-fold in several stages, and attempts to shrink it or increase interest rates in the period since the global financial crisis (GFC) have all but been abandoned. In 2013 the Federal Reserve quickly reversed its messaging in response to the "taper tantrum"; stopped a tightening cycle after risk assets sold off in late 2018; and of course reduced interest rates to zero and resumed massive asset purchases when the pandemic arrived in March 2020. Looking back at the 13-year period since the GFC, United States interest rates have mostly been at or near zero, typically accompanied by some form of unconventional lending or asset purchase program.

The series of measures taken by the Fed, and other central banks, were "emergency" tools in response to crisis conditions. Arguably the "emergency" has passed, and fiscal policy has responded aggressively in this cycle, which should give central banks more flexibility. GDP is growing vigorously but alas the Fed has been unable to unwind (nor has it yet signaled a willingness to consider an unwinding of) its emergency measures.

The Federal Reserve is not alone in going through this experience. The Bank of Japan set interest rates near zero (and negative at times) for more than two decades. Several initiatives to normalize policy were introduced; in each case they were quickly abandoned, then reversed, and then ultimately supplemented with ever larger asset purchases, including acquisition of riskier assets such as equity exchange traded funds.

In both US and Japanese cases, the problem was not about "how" to normalize or what sequence of actions to take. Those issues have been well studied. The problem is the impact such a "normalization" will have on asset markets. Normalizing monetary policy such that (1) interest rates can move off the zero bound, and (2) asset purchases align with future growth of liabilities such as currency, implies that bank reserves would contract. Overall liquidity would also contract and long duration assets, such as equities, would fall – perhaps quite sharply. We saw glimpses of this in 2013 and 2018, when asset prices fell modestly, and the Federal Reserve quickly reversed itself.

The problem is not about how to normalize monetary policy.It's the impact this will have on markets.

To get a better appreciation of this dynamic one should go back to the origin of quantitative easing (QE). Recall the raging debate a decade ago on whether QE was "effective". Scholarly papers by central bank economists and others concluded that acquiring government bonds both reduced financing costs (and so spurred investment), but also increased the value of other asset markets by pushing investors out on the maturity and risk curves. Those higher prices would spur higher consumption by making consumers feel richer through the "wealth effect".

If that is the channel where central banks are buying, then the reverse should also apply. As interest rates rise and government bonds are either allowed to mature or sold outright, financial conditions will tighten, and high-priced risk assets will decline. Indeed, investors seem very conscious about the elevated valuations in both equity and bond markets. They will be sensitive to any hint of a reversal in policy and be ready to run through what will, no doubt, be a very small door.

Alas the central banks know this, and the Federal Reserve has been especially sensitive to asset markets - so much so, that it is now communicating its intention to keep policy steady even if inflation rises (which it recently has with easing of pandemic restrictions), so long as any uptick is "transitory". The Fed knows that a true "normalization" of policy would devastate markets and force another reversal. And so, it is stuck: it cannot and will not normalize policy pre-emptively and will only do so if forced by circumstances, which is to say by higher inflation. But if inflation really gets going then a tightening will happen "too late" and will not avoid the asset market cataclysm.

The bottom line is that full normalization will come - but much later than many expect - and when it does come the adjustment will be severe. Since central banks seek to push back that day of reckoning well into the future, investors will continue to take disproportionate risks while keeping one eye on that small exit door.

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The policy mix is not the only game in town

The economic crisis caused by the Covid epidemic has been contained thanks to the stabilisation policies implemented by governments and central banks. At the European level, the NGEU recovery fund, voted in the summer of 2020, became fully operational this summer. The first issues of common debt have met with great success with investors. The ball is now in the court of the governments who must respect their commitments and implement the promised reforms.

The challenges are multiple. On the economic side, potential growth is as low or even lower than before the crisis, while public and private debts are higher than before the crisis. Paradoxically, the Eurozone lacks investment, even though it has abundant savings. On the financial side, Europe's capital markets are still too fragmented and the system is over-banked, which limits the resilience of the Eurozone in the event of a new shock.

There is insufficient cross-border investment. On the environmental front, the «social demand» for change has increased further with this crisis across Europe. The probable breakthrough of the Greens in the next German elections (26 September 2021) will show once again that the lines are shifting. Finally, on the geopolitical level, Europe must strengthen itself more than ever in order to confront the two hyperpowers, the United States and China.

The NGEU, coupled with historically low real interest rates, offers a historic opportunity to get the EU back on track and meet these challenges. Improving Europe's position in the renewable energy sector, speeding up the digitalisation of entire sectors of the economy, enabling the economies hardest hit by Covid crisis to catch up and, ultimately, increasing potential growth, are all necessary conditions. The debt constraint is alleviated by low real interest rates, which increases the fiscal room for manoeuvre in the short term. But the mistake would be to believe that rates will remain at their current level indefinitely. Inflation could resurface at some point, putting the ECB in serious difficulty.

Looking ahead, the burden of macroeconomic stabilisation cannot rest solely on the policy mix. Negative interest rates and ECB asset purchases help governments cope with new spending but, at the same time, weaken the financial system as a whole, leading to a misallocation of savings. In a way, it can be argued that the expansionist policy mix is, at this stage of the cycle, the worst policy mix, except for all the others.

The expansionist policy mix is the worst policy mix, except for all the others.

Indeed, while it is far too early to normalise economic policy, it must also be recognised that the capacity for stabilisation cannot be reduced solely to the ability to mobilise fiscal and monetary levers. In particular, it is certainly not through fiscal policy alone that European competitiveness will be improved. It is not only a question of increasing external competitiveness, but above all of improving the attractiveness of the Eurozone for investment. Structural reforms are key.

The Eurozone is penalised by a financial architecture that is too fragile for foreign investors. The result is a form of "political risk premium" on European assets which are more affected by mistrust as soon as the situation deteriorates. It is therefore essential that the current expansionist policy mix be accompanied by an improvement in the financial architecture.

The Eurozone benefits from an excess of savings and paradoxically does not invest enough. It is thus necessary to encourage the circulation of savings within the zone. Households have a sub-optimal allocation of their savings, with excessive holding of debt securities. The financial education of savers should be strengthened and they should be encouraged to diversify their savings into riskier assets, including through cross-border European investments. Finally, the Eurozone is still over-banked and the authorities must therefore facilitate SMEs' access to capital markets. This is all the more important as banks are weakened by low interest rates and by holding their own sovereign debt (doom loop). Finally, progress needs to be made on the harmonisation of tax rules.

Since the Covid crisis, however, it must be acknowledged that no progress has been made in the capital markets union. European monetary union is often compared to the US when it comes to demonstrating the need for a common federal budget and debt instrument.

However, empirical work shows that risk sharing - much more than fiscal integration - is what allows the US economy to absorb asymmetric shocks. The resilience of the US economy comes in particular from the fact that companies finance themselves more on the markets. In Europe, a more integrated financial system will increase the resilience of the system to future shocks.

Europe's needs and challenges are clearly identified. The NGEU and the common European debt offer a historic opportunity to make a difference. But this is not enough. There is an urgent need to complete the European edifice with a process of further financial integration.

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Overburdening the ECB will hurt its credibility

The decisive and extensive interventions by the ECB were one of the lifesavers of the Eurozone when the Covid crisis hit. They prevented liquidity crunches in the markets at the peak of uncertainty and helped Euro countries to provide extensive fiscal support to protect individuals and businesses. It is fair to say that without the ECB's swift actions the Eurozone would have fared much worse in the peak days of the Covid crisis, would have faced a deeper recession as well as the destruction of economic and social capital.

Although the end of the crisis still is some time off with the appearance of new variants around the world, it is emerging consensus that Covid 19 is becoming manageable not least because of the acceleration of vaccination programs in Europe, the U.S. and elsewhere. Economic recovery, albeit very unevenly distributed, is now putting pressure on labour and commodity markets as well as supply chains. Some economies are on the verge of overheating, and inflation is expected to go beyond 5 percent year-on-year in Germany and the United States. We need to ask whether the actions of the ECB, as necessary and effective they have been a year ago, are still appropriate today and will be so in the medium-term.

On the one hand, the ECB's accommodative stance is clearly supporting those parts of the Eurozone economy that are still struggling and which require ample fiscal space to kick-start recovery and long-term structural reforms despite record-high debt levels. On the other hand, we see stock-market valuations that exceed pre-Covid levels, and real estate in many regions is reaching bubble territory. The ECB's actions at least do not stand against such overheating tendencies, and any moves of the ECB to counter these might suffocate the recovery in the more vulnerable Eurozone economies or may cause volatility and uncertainty in capital markets.

One might wonder how far the ECB can go in accepting these side effects, also as they pertain to politically sensitive issues like housing and retirement savings, the latter being obliged by law to hold a significant share of their portfolios in low-risk assets. While President Christine Lagarde has a point when saying „We Should Be Happier to Have a Job Than to Have Our Savings Protected" it is difficult to expand this argument to housing and pensions. Indeed, the ECB's policy toolkit is by design ill-suited to deal with divergences, also as constraints such as market neutrality and the capital key assume the existence of Mundell's „perfect monetary union" the Eurozone never was.

Effective post-crisis monetary policy requires the Eurozone to deal with persistent structural imbalances.

It is therefore good to see that fiscal policy is stepping up after President Mario Draghi's calls for governments to take on responsibility had gone unheard for all too long. This not only includes the NextGenEU initiative that establishes a one-off debt capacity at Eurozone level. Another example are the government-sponsored lending programs that governments were quick to introduce for Covid-related backstops such as grants and guarantees, and many Eurozone countries are working on follow-ons for the post-Covid area. These programs have done more to ease access to financing than comparable ECB measures such as TLTRO ever achieved. It is fair to assume that governments will not leave the stage anytime soon, although the jury is still out whether their support really fosters sustainable economic growth.

Still, one cannot ignore that the root cause of Eurozone divergences is deeply structural, and that it will take quite some time for them to narrow, if at all. After we have finally come to terms with the fact that the ECB cannot solve it alone we now need to have a discussion on how to deal with persistent structural imbalances in the Eurozone. Unfortunately, that difficult discussion is still in its early stages.

What will force the hand of policy makers is the elephant in the room: Inflation. We do all follow the debates on whether the marked increase of inflation is temporary or not. Convincing arguments are put forward by both camps, and I will not rehash them here. The track record of inflation forecasting by central banks, including the ECB, has been particularly weak over the last few years. It seems that the impact of structural shifts of society and the economy on inflation dynamics are only partially understood at this time. So it might be important to look at a few practical signs in the economy.

For example, in several markets we see labour shortages driving up salaries. Such raises do not only impact the most important inflation indicator – wages – but they are particularly sticky. And we must not forget that inflation is driven by expectations. If individuals and businesses believe that the relevant drivers are not of temporary nature, their expectations will change.

With many important Eurozone economies not having had experienced inflationary episodes for several decades, it is unclear how economic agents, public opinion and eventually political leadership will react to it – and central bank strategy statements might only have a limited impact on such dynamics. So we may well be reaching the point where the ECB needs to tighten, and the Eurozone policy framework then needs to come up with the right answer.

We should start looking at these answers now and do so – given the potential implications – in a transparent and open process. "Getting it right" is not only a question of monetary policy but might well determine the role and credibility of the ECB in a post-Covid Eurozone as well as the survival of the economic union as such.