NORMALIZING MONETARY POLICY

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How to keep inflation unnoticeable?

Central bankers know very well that the best level for inflation is when people do not notice it. We cannot always tell in advance where that point is, but we can certainly see with the benefit of the hindsight if inflation diverges too far from that level. Indeed, inflation has after a quite long period exceeded the point when it becomes palpable. This is largely due to prices of energy and food – components of inflation that are usually the most volatile, but also the least responsive to monetary policy. However, standard measures of core inflation – those that strip off volatile components out - are now also elevated across the globe. A consensus view attributes such developments largely to pandemic-related "supply chain bottlenecks" combined with increased consumer demand in reopened global economy, further boosted by switching of demand from high-contact services to goods. On top of that, we have also observed instances of severe weather conditions fueling food inflation, potential speculation in markets for some commodities, greening efforts and a touch of geopolitics in the area of energy prices.

Although analysts largely concur on diagnoses of economic forces behind the observed price swings, there is a remarkable lack of consensus on expected duration of current inflationary environment. To some extent at least, there is also a disagreement on the particular mix of economic shocks underlying it. The willingness of central bankers for phasing out QE ("tapering") and increasing policy rates to fight elevated consumer inflation crucially depends exactly on these "controversial" characteristics of the current inflation. Monetary authorities are usually reluctant to react when elevated inflation is driven by recessionary supply side shocks.

We need to constantly re-evaluate incoming data and weight risks to price stability.

Policy actions, in essence, depend on demand side shocks. In practice, however, separating between different types of shocks has proved awfully complicated. Take an oil price shocks for example. These shocks are often considered temporary supply side shocks for a net oil importing country, usually ignored by central banks. Recent literature, however, rather convincingly challenges these views and argues that most of the variation on real price of oil is in fact demand driven. Green transition may additionally complicate our ability to characterize drivers of oil prices properly – both in terms of sources and duration of underlying shocks – possibly asking for a different monetary policy reaction to swings in oil prices.

Prevalent view until recently was that elevated consumer inflation is only temporary in nature - energy prices are expected to stabilize this year, while easing of supply constraints would allow them to better align with growing demand. Under such a scenario, monetary policy tightening could be postponed – so called "looking – through" higher inflation. European central bank, for now, seems to be comfortable with such a wait and see strategy and is willing to tolerate a transitory period with inflation moderately above the target. On the other hand, FED has recently diverged from that narrative and adopted the view that inflation may last longer than initially expected, creating room for faster monetary policy normalization. These differences in policy actions are relatively well grounded in different economic conditions on the two sides of the ocean as cyclical recovery of the euro area is lagging behind that in the US at the moment, with muted wage growth leading to somewhat weaker inflationary pressures.

Duration of inflationary episode crucially depends on second round effects that operate through inflation expectation channel. Once consumer inflation remains elevated for an extended period of time, especially if prices of frequently purchased items, such as food or fuels for our vehicles, continuously increase, they may feed into inflation expectations and trigger self-fulfilling inflationary spiral. We need to take such a risk very seriously, even though inflation expectations remain anchored as well as at any time in past decades.

Over the last year we have seen a uniquely expedient recovery, but also reemergence of inflation that almost no-one saw coming. As emergence of inflation in itself was a surprise, we need to constantly re-evaluate incoming data in order to disentangle sources of shocks hitting our economies and weight risks to economic outlook. Our narrative needs to remain flexible in the face of those risks and adapt to changing circumstances. Likewise, our monetary policy guidance should be based on a specific set of conditions rather than fixed time-frames.

Only by acknowledging uncertainty and adapting to circumstances, we will be able to return in the least painful way inflation to the point where it is not high enough for people to notice.

ROBERT HOLZMANN
Governor - Oesterreichische Nationalbank and Member of the Governing Council of the ECB

Secular trends in interest rates - when and how of normalizing monetary policy

Secular trends in interest rates, and the when and how of normalizing monetary policy

Central banks are often charged that unconventional monetary policy is responsible for low interest rates. Savers certainly do not appreciate zero interest rates. Why are interest rates so low, what might climate protection imply for interest rates, when and how should monetary policy act in the shorter run?

Why are interest rates so low?

The key reason for low real interest rates is not central bank policy, but structural factors which have driven down equilibrium real interest rates over recent decades to or even below zero. Most probably, population aging, an overhang of savings over investment and declining productivity are responsible (Brand et al., 2018; Borio et al. 2017; Summers and Rachel 2019). In stabilizing output and inflation, monetary policy moves policy rates around this structurally determined natural rate of interest. Given the low level of this so-called r*, a "normalization" of monetary policy would not raise interest rates back to the high levels seen a few decades ago. At the same time, monetary policy rates should not persistently deviate from r*, as this can create asset price bubbles, accentuate wealth inequality, and damage productivity growth by facilitating the survival of unproductive, otherwise non-viable firms.

What might climate change imply for r*?

A key challenge of our time is climate change. The necessary transition to a carbon-neutral economy might help to reverse the trend decline in r* since it is the most fundamental transformation program since industrialization in the 19th century. If handled successfully, climate transition will bring forth new, innovative and fast-growing businesses – in line with the notion of "creative destruction" coined by Joseph Schumpeter.

> **The key reason for low real interest rates is an equilibrium real interest rate driven down to zero.**

Climate protection can trigger a gigantic economic investment and growth program. It has the potential to increase the demand for capital and to structurally increase r* over many decades. Climate protection avoids productivity losses from overheating; cheap renewable energy will in the long run provide a lasting boost to productivity, growth, and welfare.

The shorter-term: when and how should central banks act?

Corona has held the world in its tight grip for the past two years. In terms of growth and employment, the pandemic is almost over. The flip side: Inflation is back. While the ECB projects that the rise in inflation will be temporary, there is a risk that it may not decline as quickly and by as much as projected. So, when should we scale back the generous monetary stimulus? When should we not only scale down but stop net asset purchases? When should we start raising policy rates? When should we gradually scale back existing central banks' asset holdings? The answer is: "It depends".

Given prevailing uncertainties, monetary policy must keep its options open and "drive on sight". Many central banks, including the ECB, have reassured the public that inflation will soon fall back to or even slightly below target soon. But let us be humble given the repeated failure to anticipate the extent and persistence of the current surge in inflation. While many of the factors driving this surge are beyond central banks' control, they must also assure the public and markets that they will not allow inflation to get out of hand. Fighting inflation too late would be very costly.

Summing up

The secular trend towards low real interest rates is driven by fundamental factors. Reversing this trend requires big policy changes. These include (i) reforms to keep older workers in the labor force, making sure they stay healthy, skilled and engaged; (ii) a deep energy transition that offers productivity gains by drastically reducing clean energy prices and driving system transformation; and (iii) capital flows from the global north to the global south to fund infrastructure and green production.

In the short run, it will be for central banks to judge on time and correctly whether the current sharp rise in inflation is indeed temporary or more lasting. In the latter case, central banks must not shy away from acting fast and decisively to fulfil their primary mandate of preserving price stability.

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YANNIS STOURNARAS

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Lessons from Stagflation for Monetary Policy

"Stagflation" was popularised in the 1970s and early 1980s. It came to be identified with sustained periods of slow, or even negative, economic growth, high levels of unemployment and high inflation. Although central to the U.S. economy, this experience was mirrored in all other industrial economies.

The main causes of the stagflation episode were two successive waves of oil-price increases by OPEC. Those oil price shocks made life difficult for central banks because they were strictly supply-side phenomena. For almost 10 years, policy makers faced a dilemma. Tighten monetary policy to bring down inflation that would raise the unemployment rate further, or ease monetary policy to reduce the unemployment rate that would bring inflation even higher. Many central banks chose the latter.

Today's situation is very different. Oil prices have risen in the past year, but at a rate far below anything experienced in the 1970s. In fact, they are near or even below their levels of a decade ago. Moreover, today's economy is more service-based and less manufacturing-based than in the 1970s. Services require less energy than manufactured goods. Therefore, it would take a much larger oil-price change to have the impact on the economy observed during the 1970s.

Euro area inflation reached very high levels early this year, but is expected to come down as pandemic-related supply disruptions and product and labour shortages unwind. The combination of supply and demand shocks is expected to dissipate. Contrary to the 1970s stagflation, unemployment is at historically-low levels. Economic activity is expected to pick up again later this year and moderate at close to historical levels in 2023 and 2024.

Furthermore, during the 1970s most central banks had not established credibility, with few exceptions, like the Bundesbank. In the U.S. the main weapon to fight inflation was wage and price controls. In the mid-80s inflation had fallen to low levels but long-term interest rates remained high, because the Fed had still not earned credibility.

Today, despite the recent surge in euro-area inflation, the yield on the 10-year euro area benchmark bond stands near zero, indicating that the markets believe that this rise is transitory. The 5y5y forward inflation linked swap rate is anchored close to the 2 per cent target. Underpinning this situation is that markets expect that the ECB will deliver on its commitment to achieve 2 per cent inflation in the medium term. For the same reason, no second-round effects have been generated by rising prices; wages' growth remains rather contained. Unlike the 1970s, wage indexation schemes are largely non-existent today, as wage earners trust that the ECB will deliver price stability.

Today, inflation has risen but long-term interest rates have remained low because central banks, in our case the ECB, have earned credibility.

The ECB needs to assess whether the rise in inflation will be short-lived or persistent. Unlike the 1970s, there are good reasons to believe it will be short-lived. That is why medium-term indicators show that inflation will fall back to near – or below – the 2 per cent level.

It is essential that the ECB maintains its credibility, which brings me to the issue of the way forward for monetary policy.

Monetary policy faces high uncertainty, reflecting, in part, the erratic path of Covid-19, geopolitical tensions and the unknown impact of green transition policies on future inflation. Policy makers need to see through this cloud of uncertainty. Our objective is price stability, and our compass comprises the information, such as price expectations, that shows if that objective is achieved.

Presently, our compass tells us that a steady course is warranted. An abrupt tightening could lead to recession, damage credibility, especially in the aftermath of the too-low inflation outcomes in the previous decade, and trigger financial stability risks and fragmentation.

Therefore, the ECB's monetary policy stance should stay the course, as long as the available information points that inflation will remain below our target over the medium term. A gradual and cautious unwinding of the monetary policy stimulus over the coming period could continue to be pursued, based on the further improvement in the economic environment and the inflation outlook.

> **Monetary policy should learn from the lessons of the past**

However, the risk that current high inflation rates may become entrenched in long-term inflation expectations should not be overlooked. We have to remain vigilant and prevent that risk from materialising. If signs of a sustained presence of inflationary pressures emerge, we should act in accordance with our mandate.

Monetary policy implementation should learn from the past. It needs to see through price developments that are expected to be short-lived and focus on price stability in the medium term. It will thus maintain its credibility, continuing to support the smooth functioning of the economy in the euro area.

MĀRTIŅŠ KAZĀKS

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Monetary policy normalization in the euro area: better safe than sorry

The world economy has recently seen the return of inflation. After years of struggling with below target inflation, the policy challenge has shifted towards finding the right balance between "looking through" the pick-up of inflation that is viewed to be largely transitory, while keeping the underlying price pressures in check.

Almost all major central banks have revised their medium-term policy outlook. The ECB has decided to end the active phase of its emergency pandemic asset purchase programme (PEPP) in March, while the purchases in its more "traditional" asset purchase program are boosted slightly raised to smoothen the end of PEPP. With respect to possible changes to our current interest rate policy, no immediate commitments are envisaged for the time being. Which might beg the question – are there risks of the ECB falling behind the curve?

To some extent, this assessment will always be in the eye of the beholder. But it helps to have a common framework to evaluate the policy course. And in the case of the ECB, the forward guidance on interest rates (and implicitly on the remaining asset purchases) provides an explicit and clear guidepost.

Our forward guidance consists of three conditions that must be met before we decide to act on rates: inflation must be reaching our target well ahead of the end of the projection horizon; inflation must remain at this level durably for the rest of the projection horizon; and we should see sufficiently advanced progress in the observed underlying inflation. And we would not cherry-pick just one or two of these elements; all three must be met for us to act.

Inflation has recently exceeded our projections on a regular basis. We constantly update our projections, but even the most recent inflation forecast of December 2021, comes with upside risks. So, after years of undershooting our 2% target, the current inflation projections are close to it. And even though they come with a high degree of uncertainty, the probability of being at or above 2% over medium term has not been this high in a very long time.

> Forward guidance provides an explicit and clear guidepost – so, be ready and be prepared.

This does not mean downside risks to inflation have disappeared. High uncertainty equally implies future inflation may be lower than we anticipate. Moreover, if a significant part of the current inflation surge comes from rising energy prices and supply side bottlenecks, this can be seen as the evidence of high inflation for the wrong reasons, as it may dampen economic activity, and therefore also future inflation. So, the possibility of inflation falling below our target should not be discounted altogether.

Yes, forecasting inflation is complicated. Therefore, we do not rely entirely on a mechanical link between projections and policy, and we have deliberately included in our forward guidance the condition of advanced progress in underlying inflation, which requires using judgement as a complement to the more technical analysis.

The broader picture of the euro area economy shows us strong short-term price pressures, but also generally positive developments in the real sector. Labour market figures continue to be robust, with unemployment rates declining (which is one of the reasons we are not currently debating the stagflation scenario). But for a persistent inflation push we also need a robust wage growth, which is not there yet in the data. The Phillips curves for the euro area have been rather flat over the last years. This, of course, can change in the future, and wage growth may accelerate significantly, but we first must see it to believe it.

The long-term inflation expectations in the financial markets have not climbed above 2%. If anything, they still imply long-term inflation slightly below our target. So, if market expectations are for the ECB to raise rates soon, yet the long-term inflation expectations are below 2%, then this is clearly not consistent with the conditions we have laid out in our rate forward guidance. Unless the expectations are that inflation will fall back below 2% because of premature tightening. And this is exactly what we want to avoid!

The roadmap for central banks is much clearer when the inflation is high, as opposed to when it is persistently low and the risks of an effective lower bound are looming. This calls for a cautious approach to monetary tightening, and that is the idea behind our rate forward guidance. But it only works well when it is credible.

That is why we take the commitments embedded in our rate forward guidance seriously. It is clear on what needs to happen for us to change policy. We are getting closer to all three conditions being met, but we are not there yet. But make no mistake, when all three conditions are met, we will act without delay. We do not want to be behind the curve, nor do we aim to be ahead of the curve. We will be at the curve. So, be ready and be prepared.

BOŠTJAN VASLE
Governor and Member of the Governing Council of the ECB - Bank of Slovenia

Transition from crisis mode to a gradual normalisation of monetary policy

Less than two years into the pandemic, the euro area economy has returned to the pre-crisis level of activity, though the recovery has been incomplete in some sectors and countries. With a rapid and comprehensive response of monetary, fiscal and other policies to a once-in-a-lifetime shock, we prevented the free fall of the economy and helped to preserve financial stability and protect productive potential. As our interest rates were near the effective lower bound, the Eurosystem has resorted to unconventional monetary measures, launching tailor-made instruments to leave no one behind.

With the roughly simultaneous reopening of economies and relatively robust household incomes, backed by fiscal and other measures, regional and global demand rebounded strongly. This led to supply-chain bottlenecks and shortages of different goods, ranging from energy and construction materials to computer chips, and brought about soaring prices. The pick-up of inflation in the euro area and elsewhere was not unexpected, considering the low reference base in 2020 and the impact of pandemic-driven one-offs and other presumably short-term factors. In an effort to secure the uncertain recovery, we last year had good reasons to tolerate supply-driven spike of inflation - after a decade of it falling short of the target set.

However, Eurozone inflation prints kept surpassing our projections in recent months. Energy inflation and consequently headline inflation exceeded their highest levels since the introduction of the euro. Global supply chain disruptions have proven more sustained, while Europe also grapples with the energy supply crunch, aggravated by geopolitical developments and the EU's own climate-related policies. With the persistence of these factors, price growth has been gradually spilling over into a wider range of products, bringing core inflation rate on par with its previous 20-year peak.

We need to start rebuilding the monetary policy space to be ready for the next business cycle.

Elevated inflation is set to persist well into 2022, longer than previously expected. The development of the pandemic and thus the duration of disruptions in supply chains are still uncertain. At the same time, various structural policies and geopolitical disputes indicate no immediate relief in energy prices. Longer spell of higher inflation increases the danger of it becoming more entrenched and broad-based. Studies show that euro area economies tend to be at risk of price hikes leading to increased wage pressures. In addition, expectations of future inflation, an important determinant of inflation, are highly state dependent and tend to react strongly to current inflation. Higher inflation, even if caused by external factors, could therefore result in a feed-back loop through higher wages and increased inflation expectations. Our monetary policy focus should therefore be on identifying early signs of increased wage pressures or the de-anchoring of inflation expectations above our target.

In addition to the surge in consumer prices, some of the unintended consequences of our policies are also weighing heavily on our decisions. In a low-yield environment investors are seeking yields in risker segments of the markets, or are pushing the prices of some investment possibilities, like housing, into levels where abrupt repricing could pose a threat to the macroeconomic environment. Furthermore, our maintaining of favourable financing conditions across all sectors and jurisdictions during the pandemic has contributed to increased debt levels in these sectors, hence inducing refinancing risk. Macroprudential policies with capital- and borrower-based tools are an important line of defence, but they focus primarily on the banking sector and are not all powerful. The longer the highly accommodative policy is maintained, the more pronounced these risks become, and the more painful the normalisation process may have to be.

Given these considerations, the time seems right for our monetary policy to move out of crisis mode and start the process of gradual normalisation. With the return of economic activity to the pre-crisis level, looming labour shortages and in part structural pressures on energy prices, our monetary policy needs to start rebuilding its space to be ready to respond to the next business cycle. However, this has to be a gradual and predictable path, in order not to pull the rug from underneath a more complete recovery in the context of an enduring pandemic. The decisions at our previous monetary policy meetings have laid the necessary groundwork to implement such an approach.

TANATE PHUTRAKUL
Chief Financial Officer & Member of the Executive Board - ING Group

Inflation is ushering in a new and uncertain phase of monetary policy

A heated debate is raging about the causes of high inflation, and how persistent it will turn out to be. In short, I think we ended up in a sort of perfect storm, where a number of factors contribute to intensified price pressures. These include transitory factors such as clogged supply chains, stress on energy markets, and buoyant demand stimulated by government aid packages (particularly in the US).

If inflation is transitory, central bank action may not be needed and in any case is unlikely to help bring down inflation. A central bank rate hike won't move containers faster from Shanghai to Rotterdam, nor will it help making energy cheaper to come by.

But there is reason to at least be on the alert for more persistent inflation pressures. Labour shortages may be longer lasting, with a view to demographics and demand for specific labour skills needed for e.g. the energy transition. Inflation, transitory or not, may translate in higher wage demands. One round of wage increases doesn't make inflation structural, but central banks will be weary of a repeated back-and-forth between prices and wages.

I haven't mentioned one factor as possible cause of high inflation: monetary stimulus. Indeed central banks have been stimulating for many years already, while consumer price inflation only recently roared back to life. In that sense, a direct link appears implausible. Indeed, there is a broad consensus that negative rates and central bank asset purchases (Quantitative Easing or QE) have contributed to inflation not of consumer prices, but of financial and real estate assets. Wealth effects may have bolstered consumption, but the propensity to consume among households with financial assets tends to be relatively low.

So is there really no urgency to stop monetary stimulus in order to tame inflation? Well, let's look at this from another perspective. The economy is healthy, the impact of Covid-19 appears to be receding, unemployment is low, vacancy numbers are high. Inflation is running above the central bank's target. Is that an economy where you'd expect negative rates and asset purchases? Of course not. Indeed central banks have been changing their narrative. The Federal Reserve will conclude its asset purchases shortly and has signalled multiple rate increases for this year.

Is today's economy one where you'd expect negative rates and asset purchases? Of course not.

The ECB, too, has quickly rotated from warning against too-low inflation to warning against upside risks to price stability. Unlike the Fed, the ECB is not dealing with a potentially overheating economy warranting a strong rate hike cycle at this point. But with inflation running above the ECB's target, the case for asset purchases has all but disappeared. Tapering, followed by ending the negative ECB deposit facility rate would be a clear signal that the era of monetary stimulus is over. This would also be welcomed in the banking sector. Seven and a half years of negative rates and a flat yield curve are increasingly calling into question the sustainability of banking in the Eurozone. Maintaining negative rates and preventing the yield curve from steepening will weaken banks and impair their ability to lend. Given Europe's high dependency on banks for credit, this is a scenario to avoid.

But ending monetary stimulus is hard to do. For several years, the ECB conducted asset purchases targeting the longer end of the yield curve, thus helping to maintain price stability. But QE neatly also served to bring rest to the Eurozone's sovereign and financial markets. This happy concurrence of goals is breaking down, now that the economy no longer needs the ECB's asset purchases.

A big question mark has emerged how bond markets will respond to the phasing out of asset purchases (tapering). One major effect of asset purchases on financial markets has been the compression of risk premiums. Moreover, since the outbreak of the pandemic, the ECB has indirectly but effectively financed governments' (very welcome) deficit spending. It will be a precarious exercise to escort issuers and investors back to more normal market circumstances, where risk is adequately priced in absence of the ECB as the dominant buyer. At the same time, the ECB should not delay its monetary policy changes for fear of financial market reactions. It should avoid any impression of "fiscal dominance", a situation where the central bank's (in) action is guided by the effect it might have on governments' budgets.

In the end, the mandate of the ECB is about managing price stability in the real economy with risk-free rates as prime instruments. The mandate is not about financial markets or risk premiums.

DINO KOS
Special Advisor to Chief Executive Officer - CLS

Where does inflation go now?

The high inflation readings of 2021 caught everyone by surprise. At the beginning of the year, inflation looked well contained and some central banks – such as the Federal Reserve – were aiming for inflation that was "above target" to make up for earlier periods when prices rose less than the two percent target. As the year progressed and inflation rose, investors were reassured by the authorities that higher prices were "transitory". By year-end inflation rates were rising globally and the arguments of "team transitory" were ultimately abandoned even by some of the biggest proponents.

This evolution was not supposed to happen. Inflation targeting regimes – typically aiming for 2 percent – were thought to help anchor expectations at or near the target. For many years that seemed to work. However the combination or strong stimulus and resurgent demand has sent prices rising by 5 percent in Europe and even higher in the United States. Even excluding energy prices, eurozone inflation is running just below three percent, distant from the "below, but close to, two percent" target that has anchored the ECB's approach for many years.

Why did inflation rise so much? Three factors are at work. Firstly, fiscal policy loosened massively and stimulated demand almost everywhere except China. Secondly, central banks eased monetary policy further, including massive asset purchases that inflated equity and fixed income prices. So, consumers had more money from the government and felt wealthier from rising asset prices. Third, the pandemic disrupted supply chains that created shortages of some key components (e.g., semiconductors) and subsequent spikes in prices of those goods. In other words, as demand was rising, supply was being disrupted, creating a classic mismatch that could only be resolved with higher prices.

The troubling aspect was that higher prices began to feed into higher labor costs and the possibility that a "wage-price spiral", a term not common since the 1970s, could be unleashed. To be fair, we must acknowledge the impact of the pandemic and if it recedes in 2022, then inflation should start coming down as the COVID-related disruptions are corrected and supply chains once again rebalance.

As high inflation continues to rock global economies, how can central bank monetary policy control what may not just be a temporary trend?

However, there is no guarantee that will happen so neatly and quickly. In addition, the contagion of inflation from the supply chain to other parts of the economy is already happening. With real interest rates still deeply negative, central banks should carefully map out their strategies with a view to normalizing monetary policy. That implies both gradually raising rates and ending asset purchase programs. Even with that, monetary policy will still be deeply accommodative. Nonetheless, it would be a beginning of what is likely to be a long and uneven process. Not doing so risks a more serious inflation outbreak that would necessitate much harsher medicine later on.

That prospect of less friendly central banks already has the attention of global investors. During the first few weeks of 2022 many equity indices declined by 10 percent – a large amount given the short time frame. While geopolitics and COVID are factors, it is higher inflation and the risk of more aggressive tightening that is pushing investors to reprice valuations. It also raises the stakes for central banks to reassure markets that they will not permit inflation to get out of hand. That will require clear communications and a credible message that (1) real rates will need to rise, and (2) that inflation rates will be capped and then guided down gradually over time. For several years central banks were overly focused on inflation rates they viewed as "too low". Now they need to pivot to both safeguard their credibility and re-set investors' views that inflation will be contained, even if it means a period of higher volatility in asset markets.

ANDREAS DOMBRET
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Structural convergence, not more debt, is the key to success for the EU

Nobel laureate Robert Mundell defined the characteristics of an optimum currency area: It is all about factor mobility and risk sharing. Unfortunately, the Eurozone still is some distance away from meeting these criteria as defined by Mundell.

Firstly, labour mobility, the most important aspect of factor mobility, remains imperfect due to language and cultural barriers within the Eurozone. Fragmented social security frameworks also make it rather unattractive for workers to move.

Mobility mostly moves into one direction, i.e. from the economically weaker countries to the stronger ones, causing demographic and skill imbalances. The freedom of movement could be witnessed during the European sovereign debt crisis when young people from crisis-hit countries found opportunities in other EU member states.

More, but not enough progress has been achieved on capital mobility. The capital union has unified financial regulation across the Eurozone and created a common supervisory landscape. However, many differences remain. For example, insolvency frameworks remain highly fragmented, leading to challenges when dealing with legacy assets. Deposit insurance has been harmonized across the EU, but no mutualisation has been agreed. We lack truly European banks mainly for strategic considerations, but the current policy framework does not necessarily help either.

The third criterion, a fiscal risk-sharing framework within the Euro area, remains the elephant in the room. The Eurozone was created with the understanding that such a risk-sharing framework was not required as the Stability and Growth Pact (SGP) would prevent Euro area economies from diverging too far from each other.

In hindsight, the desired result has not been achieved. Neither was the SGP ever enforced nor did it prevent the European sovereign debt crisis. Unfortunately, the economies of member states have diverged rather than converged. Debt-to-GDP ratios in some member countries are well above SGP limits and will likely remain there for some time. Although everybody agrees that the ESM is hugely important for the Eurozone, it is predominantly a safety net in times of stress with limited power to address structural issues. The same is also true for the NextGenEU program.

> **Rather than increasing EU debt limits the ECB must be relieved of its role as „buyer of last resort“.**

The ECB stabilised the situation significantly as it kept borrowing costs low for all European member states. While the Eurosystem's balance sheet has more than quadrupled since 2008, the "cost" of doing so was limited as the extensive purchasing programs did not prevent the ECB from fulfilling its primary mandate: price stability. On the contrary, they played a key role in preventing the Eurozone from falling into recession.

This comfortable situation may now be a thing of the past. While current inflation is indeed partially due to temporary effects, structural factors could well constrain the ECB's room to manoeuvre should it not want to accept a protracted overshooting of its 2 percent target. The green transition, for example, is likely to exert continued upward pressure on energy prices.

With the ECB holdings of Eurozone sovereign paper approaching 40 percent and with the ECB continuing to buy a significant share of new Eurozone public debt, its actions largely determine the financing conditions within the Eurozone. The development of spreads in recent weeks shows which countries have more fiscal space than others.

The discussions on reforming the SGP have only started, but good ideas seem scarce. Simply lifting the debt limit is not sufficient, perhaps even premature and outright dangerous. While somewhat higher debt levels could indeed be sustainable in an interest rate environment substantially lower than when the 60 percent limit was defined, this would commit the ECB to keep rates low - whatever it takes.

It may make sense to approach the problem differently. While Eurozone leaders can raise debt levels, they cannot compel private investors to buy this debt. The ECB stepped in as the „buyer of last resort“, keeping interest levels low. To attract private investors, structural reforms are needed to increase competitiveness and productivity. Such reforms pay off only in the medium run and require political will. A revised SGP may put more emphasis on growth-enhancing reforms than purely on fiscal indicators.

The continued success of the Eurozone will depend on achieving the economic convergence that was always at the heart of the European project. Simply increasing debt levels cannot be the solution as it would only put more burden on the ECB. The times where the ECB was able to take on that burden without cost are coming to an end.

The future of the Eurozone is not to be determined in Frankfurt but in the European capitals and in Brussels.