Normalizing monetary policy in Europe: way forward against the threat of stagflation

The Chair underlined that monetary policy since the great financial crisis has been characterised by a very expansionary characteristic. Standard measures of core inflation are now elevated across the globe The panel discussed the causes and expected duration of the current inflationary environment as well as the priorities and the calendar regarding the normalisation of the ECB monetary policy.

1. There are many causes of high inflation

Inflation has risen sharply in many countries in recent months. The complex causes include lasting supply chain bottlenecks and supply and demand imbalances. The relationship between the growth rate of money supply and inflation was also discussed during the panel.

1.1 The acceleration of inflation reflects two supply-side shocks

A Central Bank official stated that the panellists mostly observe supply side inflation and the acceleration of inflation mainly reflects two interrelated supply side shocks. There was a series of pandemic shocks and then there was an energy shock. Finally, the confrontation over Ukraine is a supply side shock with stagflationary implications in the short term and deflationary implications in the long and medium term, depending on the resolution of the uncertainty.

With the reopening of economies and relatively robust household incomes, global and regional demand rebounded strongly. An excess of demand over supply was witnessed. This led to supply chain bottlenecks and shortages of different goods and caused soaring prices. This has happened not only in the euro area, but also in much of the world. The excess demand has pushed up the prices of energy products. Natural gas prices have also been significantly affected by the confrontation over Ukraine, and they are likely to increase in the future. It is not a coincidence that the oil price shock has occurred alongside the Covid shock.

1.2 The deflationary tendency that was witnessed for a number of years in the euro area before the pandemic has not turned into an inflationary one

A Central Bank official offered reassurance that the Governing Council will do whatever it takes to achieve its medium-term price objective. If it sees approaching inflation in the medium term, it will act in March or later, but it will review the evidence carefully. The ECB does not want to repeat the mistake of tightening too early and killing the recovery at its start. This is also true regarding the Ukraine uncertainty.

Secondly, it is impressive that the credibility of monetary policy is very high after so many years of quantitative easing (QE). Inflation expectations are 2% or below and labour wage contracts are very much consistent with the ECB's 2% inflation target. There is currently no question about the credibility of the ECB.

A Central Bank official stated that the ECB cannot control real interest rates. Central bankers cannot control real magnitudes. It is not advisable to forget where the equilibrium real interest rates determined by market forces are. Before the pandemic, the panellists all talked about negative R star. A Central Bank official is not convinced at all that fundamental forces have increased R star. Acceleration of inflation is due to a number of supply side shocks.

A Central Bank official noted that policy-makers in the widest sense are facing the issue of the need to normalise macroeconomic policy in Europe. The ECB cannot determine the movement in R star. Considering how to normalise macroeconomic policy is a fairly significant issue in the medium term for governments in particular.

1.3 Why did inflation rise so much?

An industry speaker explained that 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 due to rising asset prices. Thirdly, the pandemic disrupted supply chains, creating shortages of some key components such as semiconductors and subsequent spikes in the prices of those goods. Supply was being disrupted as demand was rising, creating a classic mismatch that could only be resolved with higher prices.

1.4 The causes of inflation are varied and complex

An expert emphasized that it is somewhat meaningless to declare that inflation is being caused by supply problems, which are temporary by nature and will quickly calm down. Firstly, there is the old problem of inelasticity of structural potential growth because of labour market rigidities, lack of qualified labour and poor productive investment behaviour over the last 20 years. Secondly, it is advisable to be careful not to underestimate the durability of high energy prices because moving to decarbonised, more expensive energy will push them up significantly. Thirdly, it is advisable to be mindful of the relationship between the evolution of money growth and inflation. In the central banks of the Fed and the ECB, not much attention is paid to the fact that inflation is also an inflationary monetary problem.

He added that pronouncements on the rapid elimination of inflation should be founded on careful economic and objective analysis. More action should not be delayed. If it does not happen the markets will act, and central banks will be behind the curve.

1.5 The relationship between the growth rate of money supply and inflation

A Central Bank official stated that the relationship with money supply is not stable and has broken in the past. Despite the very rapid rise in M3 or M0 in the last few years, inflation expectations have stayed below 2%. This is extremely important, but the Central Bank official does not belong to the class of economists who neglect the money supply. The economy is being governed by demand and supply forces. Money is part of the aggregate demand forces and sometimes matters.

The liquidity trap has been mentioned. There are cases of the effective lower bound under which money supply does not matter too much. The Mundell Fleming model is known, but there are different conditions under which money supply matters. A Central Bank official advised against being dogmatic. In the long term, inflation is determined by the money supply. However, the long term is very long.

Finally, it should not be forgotten that monetary tightening in the eurozone will start in June 2022 with the likely repayments of the targeted longer term refinancing operations (TLTRO). There are no delays.

2. Should high inflation persist longer than previously expected?

Many speakers, but not all, agreed that high inflation should last longer than expected.

2.1 Inflation should converge to 2% in the next two years

A Central Bank official noted that the supply disruptions will diminish as the end of the pandemic approaches. Combined with the envisioned style of fiscal stance, the excess demand has been eliminated slowly with a reduction in global excess demand. The second supply shock, which is the energy shock, is likely to subside depending on the resolution of the Ukrainian crisis. The ECB's projections and the forecasts of major financial institutions see inflation being reduced to 2% in the next two years. This is why forward measures of inflation such as the so-called 'five year-5-year inflation linked swap rate' as well as the euro area ten-year government benchmark bond yield are consistent with the 2% medium term inflation target.

Finally, there is not yet any evidence of sizable secondary effects in the labour market. Inflation will remain elevated for longer than the ECB predicted but is expected to decline to levels compatible with the price stability definition in the medium term. Monetary policy can tackle supply side shocks, but only at a high cost to output and employment. So far, the ECB has chosen the correct monetary policy path. It is going to continue reviewing the evidence in March 2023 and decide on the normalisation of monetary policy.

A Central Bank official stated that the green transition is one of the megatrends that the ECB has observed. In the medium term, green energy will produce lower energy prices than fossil fuels. But in the short term, there are transition costs related to the fact that storage capacity for electricity produced from green energy has not been secured. This is the reason for so much dependency on natural gas. As a consequence, the transition to green energy will cause a relative price change, elevating inflation for the short term.

2.2 Inflation is back and should not decline as quickly or by as much as projected

A Central Bank official suggested splitting the whole period into what has happened and what can be expected in future months. It is fairly widely accepted that the drivers of current inflation are related to the past crisis: energy prices, the initial shock of sharply declining prices and reversal to the previous levels. There are disturbances related to the spending patterns of people and businesses. Some very concrete measures were adopted during the crisis and before we put an end to the pandemic, its economic consequences had gradually unwound. However, the share of prices that increased has widened and is not related only to specific groups anymore. The range and pool of prices that are growing faster and faster is increasing.

A second important factor is related to expectations of citizens and firms. Due to more prolonged shocks as compared to initial expectations, different dynamics and different contributors to inflation as opposed to the initial phase can be expected in the following months.

A longer spell of higher inflation increases the danger of it becoming more entrenched and broader based. In addition, expectations of future inflation are highly state dependent and tend to react strongly to current inflation. Higher inflation could therefore result in a feedback loop through higher wages and increased inflation expectations.

A Central Bank official emphasized that, when talking about normalisation, it is necessary to answer three questions about uncertainties. The first is related to inflation, the second is related to the security situation and the third is related to the question of being too early or late.

Regarding inflation or the origins, there is a supply and demand side, but the demand side has been underestimated in the sense of major changes in the composition of demand moving from hospitality to hardware. If this hits a high, the question in the inelastic supply side is whether it is demand or supply side. The argument might not fully hold.

Secondly, when someone says there will be price increases in the short term in green energy, but they will go down in the medium term, one has to change the notions of short and medium term. The short term will be around 20 years or so, and then there will be a decrease in around 30 years.

A Central Bank official underlined that he could talk for the whole day about Ukraine, but there is a great deal of uncertainty. It also depends on how much Europe will 'give in' again.

2.3 Russia's invasion of Ukraine would cause a surge in inflation

A Central Bank official stated that he is not sure how the Ukrainian crisis will develop. Most scenarios acknowledge that the current crisis will have an additional negative (in the sense of connotation) impact in terms of prices, meaning that additional pressure towards higher inflation can be expected. There is also a small possibility that matters will turn in other directions, at least in the short term.

3. When should central banks act in the shorter term?

Some speakers explained that the continuation of very low interest rates in the euro area would intensify negative consequences for financial stability and growth. Others were more cautious and stressed that the ECB is aware of the risks of both being too early and being too late.

3.1 It is time to change gears

The dangers of normalisation are currently smaller than those of accepting persistently high inflation. Waiting too long will not make life easier for central banks or the economy.

3.1.1 Pushing too hard and too long on the monetary pedal has severe negative economic and financial consequences

An expert explained that monetary policy is said and known to help to avoid depressions and the seizure of the financial system. However, continuously stimulating and ultra loose monetary policy has increased the vulnerability of the financial system. It has led to asset bubbles and low or negative interest rates, which are detrimental to growth and investments.

With inflation soaring to record heights of 5.3% on an annual basis in Europe, normalising is urgent. The paradox is that there are constant discussions about the dangers of tightening, but monetary policy is becoming looser and looser. With 5% inflation, the interest rates are now -5% or a little more; this was not the case a few months previously. It is necessary to accept that monetary policy has not only not heightened; it has enormously loosened, and this can shed some light on the question.

He added that, if the ECB does not start to increase interest rates meaningfully, albeit gradually, there is a risk that inflation will be entrenched, and corrective actions will eventually have to be much sharper. The risk is that hesitation could later force central banks to tighten credit far more abruptly.

The ECB's very accommodative monetary policy has not been able to solve major issues. The inelasticity of the supply side of the economy shows that there are three major problems: energy is moving towards more decarbonised forms, the ECB has been restricting the share of wages in its economy to the detriment of wage earners and there are investment issues. Investment as studied by the International Monetary Fund (IMF) has declined in real terms by around 3 percentage points of global gross domestic product (GDP) over the last 20 years.

A Central Bank official stated that some of the unintended consequences of monetary policies are raising financial risks. In a low yield environment, investors are seeking yields in riskier segments of the markets or pushing the prices of some investment alternatives into levels where abrupt repricing could pose a threat to the macroeconomic environment. Furthermore, maintaining favourable financing conditions across all sectors and jurisdictions during the pandemic has contributed to increased debt levels in these sectors. The longer the highly accommodative policy is maintained, the more pronounced these risks become, and the more painful the normalisation process might have to be.

3.1.2 The dangers of normalisation are smaller than those of accepting persistently high inflation at present

An expert noted that the Governing Council and all policy-makers have to take short term and long term views and balance them. On the short term side, it is really necessary to look at the data for 9 and 10 March, what will happen to the wages and how much the inflation will really creep into it. Furthermore, it is necessary to consider the ECB projections.

There is also a long term view. Fortunately, the ECB is very far away from a deflation scenario. Secondly, it really needs to ask for the reason for further purchases. There is a question around why monetary policy support is necessary due to the current position on a longer projection. The war is a structural issue that will have inflationary tendencies.

An expert underlined that he strongly believes that the dangers of normalisation are currently smaller than those of accepting persistently high inflation. He also fails to see that the ECB cannot have a first interest rate set before stopping all of its QE. The credibility of monetary policy is of utmost importance, but it still does not have to be exactly in that order. It is necessary to look at it in the short term and long term. Should the data not change, and the influence of the war not change the panellists' minds, the way towards normalisation currently makes the most sense.

3.1.3 Waiting too long will not make life easier for central banks or the economy

The risk is that hesitation could force central banks to tighten credit far more abruptly later on, causing more pain than if they acted in timely fashion.

An industry speaker stated that the point is the 'when' question. He believes the answer is 'as soon as possible'. Due to how negative interest rates are, the direction of monetary policy is clear. The markets understand what needs to happen. However, the longer the wait is, the faster it will be necessary to move later on. If inflation keeps increasing and spreading into other sectors, then that option will be limited, and it might be necessary to move much more dramatically.

An industry speaker agreed that it is not advisable to wait too long before having to move too aggressively later on. This is the trade off. Moving gradually earlier before seeing the market response and incoming data seems to be the correct sequence; that is more important than finetuning asset purchases versus interest rates. It can be done either way. The precise sequencing is less important than sending the message that a regime shift is happening. The ECB has signalled the aforementioned to the markets, so that element of surprise and uncertainty is not really present. There will probably be relief when the process begins. Now is the time to begin a gradual move higher in rates; the markets are well prepared to intermediate the risk from that change.

The Chair stated that there are no negative interest rates in the US. However, Europe's negative interest rates have a relatively serious implication for financial stability. The worst possible asset price bubble is one in the real estate market. It is not possible to remove real estate market price increases without removing the negative interest rate.

An industry speaker added that the US has negative real interest rates. This discussion can apply equally to the Fed due to that reality. The Chair agreed, although added that negative nominal has an even stronger psychological effect on people.

3.2 We will be at the curve

The ECB is aware of the risks of both being too early and being too late.

A Central Bank official stated that the Ukraine issue is not only in the news; it should also be on the table in terms of policy-making. It is serious and is not happening far away. It is a huge structural shift, and it will not go away. Its implications will not be limited to where inflation is seen, at least in the short term.

He added that this will be inflationary in the short term in terms of energy prices, food prices and increasing risks of this route into the system. It will most likely have a negative impact on growth. The medium term and longer term outlooks are still uncertain, but the short term outlook is very clear. The problem will not go away in terms of inflationary dynamics or financial stability. The issues that Klaus Knot mentioned in the morning, including cyber resilience, are not an invented future scenario. If the panellists have been asleep, it is time for them to wake up.

A Central Bank official underlined that he does not believe that central banks are falling behind the curve on the inflationary story. However, the ECB should be aware of the risks of being too early or late. The ECB's forward guidance consists of three conditions that must be met before deciding to act on rates: inflation must reach its 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 there should be sufficiently advanced progress in the observed underlying inflation. The way the ECB operates is very well suited to addressing these problems.

A Central Bank official emphasized that soft budget constraint or too much debt is never a good idea. It leads to bubbles, reduces willingness to reform and reduces growth potential. What has happened in Ukraine has added much more to the uncertainty, but the direction is very clear. It is reducing the monetary policy support that has been necessary. It has been very ample, but it is necessary to start rebuilding policy space.

3.3 The ECB needs to pursue a clear, determined, data driven, gradual normalisation

A Central Bank official stated that it is very easy to say that the inflation number is very high, and it is necessary to act. However, the ECB Governing Council is very aware that its decisions to control inflation could kill the economy. The trade off should be understood.

On the other hand, the path to normalisation has become clearer. On the budget constraint point, a Central Bank official completely rejected the proposition that there is fiscal dominance. It is incredibly important for the ECB Governing Council to focus on its price stability mandate. It has to communicate and set out its analysis, thinking and understanding clearly so that everybody in the markets and elsewhere understands what it is doing. The ECB must follow through on what it says.

On the fiscal side, the ECB's monetary policy framework in the euro area is sound. However, that does not mean it will stay the same forever. The ECB performed its strategy review in 2021 and arrived at some changes. It will probably arrive at some changes during its next strategy review in 2025, but the heart of the framework is sound. The ECB said in its strategy review that fiscal policy can help to stabilise the economy.

A Central Bank official added that the ball is in the governments' court to decide on how to support the stabilisation of the economy, how to modernise the stability and growth pact and what decisions they are going to make to address the budget constraints. The ECB has to continue to focus on price stability and making the right decisions at the right times.

4. How should central banks act in the shorter term?

The sequence of monetary normalisation was actively debated.

4.1 An increase in interest rates before the end of the pandemic emergency purchase programme would have a much stronger effect

A Central Bank stated that the major question is around whether the ECB is entering too early or too late. There are three items for normalisation, but only two are normally addressed. The first is when to stop the purchase of assets, the second is when and how much to go for the rates and the third is when to think about starting to reduce the balance sheet. The latter has not entered the discussion yet in Europe.

The first question is whether it is advisable to first move out of the liquidity part or increase the interest rate. In the ECB's forward guidance, it has a sequence. Since it has fulfilled the forward guidance, it is free to decide what comes first. Economically, it is difficult to say that it has the correct answer or sequence.

If the ECB first removes additional liquidity, then it can start to consider increasing rates there. However, the broad public, and even many economist colleagues who are not central bankers, have never understood what the purchase of the assets should do economically. For them, stopping assets will not create the kind of urgency that would mean taking it seriously. An increase in the rates here, e.g. moving the deposit facility rate towards zero, has a much stronger signalling effect than the prices there.

A Central Bank official added that another element is which direction the ECB would want to move in if it moved with the rates first, or even later on. In the US, the Fed clearly signals the estimate of the equilibrium interest rate in real and nominal terms; it is also important for the ECB to think in this way. It is important to keep optionality, but not the small parts. It is about the long term, and it would also be important to signal the direction in order to inform the financial markets.

A Central Bank official noted that there might be disagreements in terms of sequencing. He believes that the current sequencing is appropriate, and the first step is to stop asset purchases. This is a fairly near term decision.

A Central Bank official explained that his next disagreement is on the rate increase because he does not believe that the ECB should tie its hands in terms of announcing a specific calendar. Instead, it should look at how the economy develops and the impact from Ukraine before making decisions. It is most important that there is an increased understanding that it is necessary to weigh both risks, but the situation of inflation being unacceptably high is clarifying the need to move fairly soon.

A Central Bank official underlined that the ECB should follow through on what it has said. It needs to pursue a clear, determined, data driven, gradual normalisation. It started on that path with the ECB's December decision, and the current question is to what extent it is lifting its foot from the gas pedal.

4.2 'Gradual' does not mean 'slow'

A Central Bank official highlighted the case of Latvia. Inflation is above 7%, which is in the current top five in the euro area. Latvia is small in terms of economic size. There is a target of 2% over the medium term for the euro area. National policies should join in to avoid the labour market overheating.

Monetary policy is an important, and in times of crisis critical, element. It can move quickly, but it is not by any means the only one. The ECB will be gradual and will not try to 'rock the boat'. It will try to guide the market, be flexible, keep the optionality and be data dependent. 'Gradual' does not mean 'slow'. The ECB will do the best it can and move as soon as possible. It will not happen immediately, but it is necessary to be ready.

4.3 The prospect of less friendly central banks has the attention of market players

An industry speaker stated that markets hate uncertainty and surprise, as do policymakers. However, they are facts of life that have to be dealt with. It is not advisable to be intimidated or stop what is necessary because somebody will be upset or surprised. The sequencing laid out previously does not need to hold based on circumstances and what has been learned. The markets understand that central banks will adapt to circumstances based on the environment and what has been learned from analysis and other central banks. The possibility of surprise should not stop what needs to be done.

4.4 Tapering followed by ending the negative ECB deposit facility rate would be welcomed by the banking sector

An industry speaker noted that the market does not like uncertainty or surprises, and both exist. There is uncertainty due to inflation, and the events of the previous day were surprising. As Professor Klaus Knot said in his speech, the industry really does not want a disorderly readjustment to the new reality.

An industry speaker saw three adjustments as rates go positive. Firstly, credit spread needs to price at better margins because the excess liquidity has distorted credit pricing in the market. Seven and a half years of negative rates and a flat yield curve have increasingly questioned the sustainability of banking in the eurozone. Secondly, real estate prices might have to adjust to reduced money supply in the system. Thirdly, purchases of sovereign debt in Europe will need to transfer into private investments. Policymakers need to provide the path and ensure as little surprise as possible given the heightened geopolitical situation.

He added that these unconventional measures or negative rates and excess liquidity will take an adjustment after seven years. It will be a significant adjustment for financial institution customers and governments. The last few years have been an easy ride from the perspective of balance of payments, financing debt and government debt. That adjustment needs to be made as orderly as possible. From a financial institution perspective, it is still preferable to take away the supply of money before starting to raise rates. The market could then be allowed to gradually normalise.

5. The challenge of fragmentation along the path of normalisation and its consequences on monetary policy decisions

5.1 Monetary policy cannot address structural issues

A Central Bank official emphasized that it is very difficult to solve fragmentation quickly, so it is necessary to be ready in real time. Market fragmentation is largely a sign of macro weaknesses in terms of the cross country comparison, but monetary policy cannot fix macro weaknesses. The incomplete architecture of the European

Union and euro area on the fiscal front and the common fiscal facility are critical. Fiscal and structural policies are responsible for improving productivity growth, and there will need to be a transition. That means immediate overall support from the EU is necessary for specific instances in specific countries. Unless weak economies are able to report strong productivity growth and credibly show that they can grow out of this, there is not going to be a reasonable solution to fragmentation risks.

5.2 The financial fragmentation risk needs to be addressed by domestic structural policies

A Central Bank official underlined that he is intrigued by the comment that it is fine for the time being that central banks have biased the prices of sovereign debt. If the private sector needs to take over, spreads will change implicitly there due to the move out. This is a very important message about fiscal levels. It is part of the fiscal policy to assure that, but it makes the Central Bank official nervous to hear that fiscal policy has to consider something like that because the European Union has already put the recovery and resilience funds on the table. Given that the magnitudes are outstanding, they are fairly high, so they will not bring what the ECB has in mind.

A Central Bank official added that he would provoke the private sector somewhat and say that the ECB considered the interest rate and stopping the purchases, but there was no discussion in Europe about when to shorten the balance sheet of the central bank. It is far away in Europe because there is a major part involving the US. The private sector should know that this is a critical part.

A Central Bank official noted that there is a common monetary policy for the euro bloc of countries, but all other policies are still in the domains of individual states. These structural policies will determine the final outcome. The question of wages is currently missing from the argument that inflation will become entrenched, but this is an issue on the euro area level. The individual country situations might be very different.

The Chair stated that there is a whole new set of interesting questions on wages. Late the previous evening, there was a discussion of how some countries that run high current account surpluses have managed to do so without increasing wages for so long. The currencies have not been appreciating and making workers richer as they have in the past, which means that many of the benefits of the monetary union have not been passed onto the workers. Instead, they have gone into the very high current account surpluses. This issue is one for discussion at the next Eurofi.