Monetary policy and stagflation challenges

1. Persistent inflation and its causes

1.1 Two approaches to address monetary policy challenges

An expert remarked that there are two attitudes for looking at the macroeconomic monetary problem of Europe. One is to try to be reassured, because energy prices should decelerate, and inflationary expectations should peak before the end of this year and will gently decline in 2023 to reach the sacrosanct 2% target in 2024. In addition, there are no significant increases in wages. With this view it is only possible to 'normalise' monetary policy in a gradual way, pushing nominal interest rates towards neutrality. This view is present in Europe, but not in the United States, because of a belief that inflation is exclusively a supply-side problem.

However, while oil prices will probably stabilise, long-term considerations like the ecological transition imply energy prices should continue to rise. Secondly, wages in Europe have not yet reacted much to inflation, but they are starting to be revised upwards. The trend towards systematic indexation that many European countries showed in the 1970s should not be forgotten. The assumptions of the European Central Bank (ECB) for a wage increase of 4% in 2022 is optimistic. The depreciation of the euro/dollar exchange rate, as well as the current very expansionary fiscal policies, are fuelling additional inflationary risks in Europe. Lastly, on the convergence of inflation expectations towards 2% in 2023, claiming that monetary policy will reach neutrality if nominal rates reach the 2-2.5% range is circular reasoning. After the increase of 75 percentage points, it seems a bit far reaching to consider that monetary policy is moving towards neutrality when nominal rates of 0,75% can be compared to 10% inflation. Given the uncertainties, procrastination carries financial stability risks that a central bank dedicated to monetary stability cannot take.

1.2 Inflation is driven both by negative supply shocks and positive demand shocks

1.2.1 Monetary policy in the face of the pandemic and energy shocks hitting the euro area economy

A Central Bank official pointed out that the euro area is seeing inflation driven by the two unprecedented shocks of the pandemic and the war in Ukraine. When inflation is driven by supply-side pressures, an undue tightening of monetary policy would aggravate the negative output effects of the supply-side shocks. The energy crisis is equivalent to an energy tax, because Europe is a very large net energy importer. Europe is different from the United States, which is a neutral or a large energy exporter. 75% of the disruption in consumer prices and output comes from natural gas, which, due to Europe's electricity marginal cost pricing rules, affects the electricity price one-to-one.

Models and estimations suggest that between 2022 and 2023 the gas price will go up by 40%, and so the same holds for electricity. This is what keeps average inflation at 5.8% next year compared to 8.1% this year according to the ECB baseline scenario.

The issue is not wage growth. On average wage growth in Europe is 3.5%. Subtracting productivity growth, it is very close to the 2% target. It is not inflationary expectations, either from surveys or from the five-year/five-year swaps, which are also close to 2%. It is not a positive output gap.

1.2.2 An unprecedented energy crisis

An industry representative remarked that the source and clear trigger for the inflation was the surge in energy prices. Between 2015 and 2019, the EU imparted roughly €400 billion of oil and gas, at $55 per barrel of oil and €20 per megawatt of gas. The jump in energy prices amounts to a new permanent tax. We can make various assumptions on prices and reduction in consumption, but it will be not far from €400 billion and €500 billion. . That is a meaningful and permanent shock. It was of paramount importance for the Governing Council to raise the three key ECB interest rates by 75 basis points. A Central Bank official warned that the very high energy prices have to be accommodated as soon as possible. The ECB wants to be more proactive and to have strong increases in rates as a result.

1.2.3 Inflation as both a supply and demand shock

A Central Bank official explained that as to inflation, the risks are on the upside. First, multiple supply-side shocks came in over the past year. Most likely more supply shocks will be seen in terms of energy or food supplies. However, it is not only supply; the demand side is also kicking in. Monetary policy has to do its job, which is price stability. The ECB has raised rates twice already and expects to do so at the next several meetings as well. Uncertainty is extremely high, so providing detailed forward guidance would be a mistake, but the direction is very clear. The inflation differentials across the euro area countries are natural because different sets of economies have different fundamentals (e.g., weight of energy in consumption, domestic demand growth…). However, if inflationary differentials build up that is an issue.

1.3 Avoiding recession will be very difficult

A Central Bank official suggested the risks to growth are to the downside. With the current high inflation for the European economy to pull through without recession would be a massive success story but quite unlikely. With high inflation, avoiding recession as such will be

very difficult. A Central Bank official stated that the question is whether there should be patience or whether there should be a somewhat more aggressive monetary approach because the upside risk for inflation is higher than the downside risk. The issue is not only monetary policy but also accommodative fiscal policy. There is the question of whether inflation expectations have been destabilised. There are strong signs of inflationary expectations being unanchored, so there is a need to be very careful.

1.4 While wage growth appears limited in Europe monetary policy cannot remain expansionary

A Central Bank official emphasised that one of the aims of monetary policy is to anchor expectations. Another Central Bank official noted it should be asked whether the pandemic is temporary or not. The same holds for the war and energy supply. It should be ensured that trust is built that expectations will be anchored where the target lies.

A Central Bank official remarked that when policymakers take decisions, they should always think on acting at the margins. There should be humility in the present moment of high uncertainty in which Europe is at war. Recognized that the ECB's decision that had taken place the previous day sent a very clear signal that the ECB is taking action and will continue to act. This message is also very clear to the labour markets. There are no signs of second-round effects in European labour markets, and the workings of Europe's labour market proved to be much more efficient in the reaction to the Covid crisis and the current challenges.

Europeans always feel that the speed of adjustment and efficiency typically seen in the US labour market does not translate to Europe, but this is wrong. In Europe, the numbers show the same Beveridge curve as before the crisis. In the context of a huge shock to the economies, Europe's labour markets kept going, even when the government support faded away. Contrary to that, the US showed a significant outwards shift in the Beveridge curve, meaning that for the US to fill a vacancy a much higher unemployment rate is needed, or, putting it differently, there is a huge number of vacancies compared to the number of unemployed people in the US.

The ECB's decision is a signal to the labour market that there is a need to continue in this way. It is not a call for wage restraint, but for the labour markets to continue working as they currently are. When the Beveridge curve is moved outwards, something has to give, which means wages. There is a need to be patient and to act at the margin. While times are very challenging for Europe, they are not yet difficult. Monetary policy aims at bringing inflation back to target.

The Chair agreed that this applied to Central Eastern Europe. On aggregate in the eurozone, wage pressures have not been high so far, but Central Eastern Europe looks to be between Western Europe and the US in terms of the labour market. It is a more flexible labour market, with higher wage pressures and a tighter labour market than in Western Europe. He noted that, looking at the current statistics across Central and Eastern Europe, wages are growing much more quickly in the private sector than union-negotiated wages under collective bargaining. They are a small share of overall wages, so the pressure in the labour market is higher and inflation rates are higher in Central and Eastern Europe.

2. Calibrating the policy responses to rising inflation

2.1 The strong price increase is hitting society

The Chair highlighted that Europe is suffering a large terms-of-trade shock. In a terms-of-trade shock of this size, somebody has to pay. An industry representative observed that there will be further elevated public debt after the crisis. It is unlikely, in the medium term, there will be lower debt rates. Talk of monetary and fiscal policy is always very strategic and high-level but the numbers on the ground give a sense of how people feel. The spill-over into consumption is taking place because inflation has already eaten away significantly into what people put aside. The German savings banks association issued statistics highlighting a net deposit inflow of only €600 million in the first half of the year. That compares to €25 billion in the previous half year, which is a drop of 97%. The average European saver who has a small, conservative portfolio of investments, with lots of bonds and a little equity, was down 7-9% in the first half of the year. That is a significant negative wealth effect. People are suffering, and that needs to be acknowledged.

2.2 Weapons to tame inflation

A Central Bank official pointed out that the inflation problem can be compared to the three-headed Hydra from Greek mythology. There are three heads, so he suggested three weapons are needed. Monetary policy is one of the weapons, but it should not be the only one as that will be very costly in terms of output and employment. The other two weapons are fiscal and energy policies. Energy policy is needed to disentangle, temporarily at least, the electricity price from the natural gas price and to retain incentives for energy conservation and green energy investment. Fiscal policy has to retain a stance which should not be in conflict with monetary policy, while using targeted rather than horizontal measures to support the most vulnerable. Tax subsidy instruments are also needed.

A Central Bank official added that national fiscal, structural and macroprudential policies are extremely important to establish a healthy and effective policy mix. Even if national policies can contribute to addressing inflation challenges, there is a lack of broad common policies, especially in terms of common fiscal policy, for the euro area.

2.3 Drawing the line between warranted and unwarranted interventions is a major challenge for monetary policy

A Central Bank official suggested the bigger picture presents an economy that did not suffer coming out of the pandemic because of the fiscal help and monetary easing. It is still strong, and that can be seen on the

labour-supply side as well, which is different from across the Atlantic. There is also financial stability with a strong banking sector post-financial crisis.

On the negative side, there is a war. Governments today have successfully helped households and industry because it was said the pandemic would be short-term and the desire was to hit the ground running. In a way that did happen, given the enormous pumping of money. Although energy prices are a price signal, and there is a need to economise, but current governments will not allow it. They have been used to solving problems and helping households by spending and currently there are no regulations in place at the European level. Government attitudes have changed. At the same time there is globalisation. With sanctions and bad relations with China it is really moving, which will affect efficiency. Then there are climate risks.

Central banks cannot afford to make mistakes. However, the limitations of their instruments have to be understood. They are demand-oriented, but the response is to a supply shock. While the ECB's commitment to stable prices applies over the medium term, to account for the supply side dislocations behind the current spike in the price level, an annual rate of increase of consumer prices above 8% warrants a normalisation of the supportive monetary policy stance of the Euro system. A too slow withdrawal of accommodation risks entrenching a high inflation regime and prompting second-round effects on wages. At the same, the necessary normalisation of the policy stance must be implemented given the uncertainty in the global economy.

2.4 Normalising effectively monetary policy

2.4.1 Monetary policy has become even more accommodative in the eurozone

An expert reminded the audience that people think very low interest rates are going to create more productive investment, but they are mistaken. The charts calculated by the International Monetary Fund (IMF) show that over the last 20 years of real negative interest rates global productive investment has fallen significantly. Negative interest rates are not good for investment. They are the cause of the liquidity trap that Keynes described so well, and which makes people place savings into very short-term liquid instruments instead of long-term projects that carry risks. When risks are not remunerated but taxed there is not much appetite for long-term investment.

An expert remarked that there have been 15 years with very low inflation around 1% per year and nominal interest rates from central banks of effectively zero. So, there was an environment of -1% in real terms. The current situation is much worse than during the last 20 years because instead of doing the arithmetic with negative interest rates of -1%, it is now -8,75% (considering the current annual inflation rate of 10% and the ECB fixed rate of 1,25%). With interest rates of -8,75% the conclusion is that, in real interest-rate terms, there has been a move towards immense accommodation of monetary-policy conditions.

There are complaints because interest rates have been "boldly" increased by 0.75% at the September ECB meeting, but, at the same time, the monetary conditions have been enormously relaxed. This is very important, if the fight against inflation is considered, real interest rates must be considered. If real interest rates are so advantageous for the borrower, the monetary causes of the past inflation will continue because some are saying that it is a supply-side shock. It is a supply-side shock, but it is in a monetary environment of strong monetary creation. If no attention is paid to this, a very dangerous track will be followed.

2.4.2 Inflation cannot be broken with high negative interest rates

An expert pointed out that normally, central banks should tighten when inflation threatens. Instead, we see the opposite: a significant de facto loosening monetary policy conditions. Before saying there is monetary neutrality, nominal interest rates have to be brought to a point that they offset. They should offset the basic guess that anyone in the street would make, which is that inflation is going to be around 4-5%. When Volcker made his break of inflation, inflation continued at 5%. Supposing there is 5% inflation, the European 0.75% increased rate can be looked at. That is not up to it; it will have to be increased further. That is disagreeable to hear, but people are not in these roles to be agreeable. They are present to look at reality. The question whether it is truly believed that inflation will be broken with significantly higher negative interest rates. Waiting too long in the euro area for effectively normalised monetary policy will not make life easier.

A Central Bank official noted central banks cannot determine the real rate of interest in the medium to long term. They can only determine nominal magnitudes. Before the pandemic there was secular stagnation. Despite huge quantitative easing (QE), inflation was almost negative and interest rates very low. Productivity growth and the natural interest rate were decreasing. That is what drove the developments.

The real interest rate should be the difference between the expected interest rate and expected inflation, and according to that real interest rates have been going up since normalisation was started in both the US and Europe. Bond yields are 2.5% because people expect that inflation will decrease, because it is supply-side issue in Europe. Monetary policy normalisation has started. Huge losses on output and employment could be imposed, so there has to be caution.

A Central Bank official pointed out that supply shocks are quick to pass through to prices and inflation jumps up quickly. In contrast, monetary policy has significant lags. The full impact of the monetary policy will come in about a year and a half. That is why it is extremely important to ensure that expectations remain anchored at about 2%. Another factor is core inflation, which has been trending up and increases the risk of inflation becoming entrenched. This is why the ECB will not stop at the September rate raise by 75 basis points.

A Central Bank official noted that the monetary-policy strategy was revised also because inflation was previously anchored on the downside. There is now symmetry in the

rules. It is introduced to grant more leeway for the ECB.

A Central Bank official referred to the fall in the equilibrium rate over the last 40 years. The full answer for what has driven that is not known, but productivity has played a role. The second issue is population and an ageing demography. The third issue is the accumulation of excess savings in the north EU countries. The task is to consider this not as an exogenous variable, but as one that that can be influenced by policies. If and when it is possible to make the green transition with the creation of high productivity, that will allow for this but also get rid of some of the excess savings. There is a major role for policies that needs to be discussed.

2.5 Building more structural resilience

2.5.1 Fiscal measures must be targeted for the households that need them most

The Chair asked about the loss of purchase power and the effect of inflation on households. Inflation has a compound effect whereby with 6% or so for three years in a row almost a quarter of a person's wealth is gone if their income does not increase. A Central Bank official understood that the major problem is a political one in terms of messaging, because if there is a terms-of-trade shock it cannot be compensated for. Only the most vulnerable can be compensated. The result of trying to compensate everybody is hyperinflation. What can be done is an attempt to reverse the terms-of-trade shock through specific measures, and here the problem is Europe is caught in an unfortunate investment, which is its full dependency on gas. Looking at the broader worldwide picture, things have already changed. The shock that happened last year, before the war, was a demand change in Asia. The situation has changed again, and liquefied gas can be bought very cheaply in Asia, but it does not come to Europe.

An industry representative noted monetary policy is playing its part. Fiscal agents are also playing their part, but handouts cannot be the solution. That is a short-term fix, and, in many instances, it is important that support fiscal measures are targeted at the right level. However, there is another avenue not being discussed enough which is around the regulatory and fundamental finance framework within Europe.

2.5.2 Further integration of banking and capital markets would strengthen the capability of Europe to address asymmetric shocks

A Central Bank official noted that, from the macro perspective, Europe's capital market does not yet exist, so it is always inclined to use fiscal policy to compensate for asymmetric shocks. In the US, at least half of the shock is absorbed by the capital market. At the micro level, there is a lack of equity in small and medium-sized enterprises (SMEs). In most countries, the legal effects are often not there.

2.5.3 Accelerating the green transition

An industry representative emphasised that the energy transition needs to be accelerated. On top of the monetary response, conditions to reduce the impact of energy on the economies must be created. The right incentives to adapt consumption of oil and gas are needed, all the while protecting citizens and especially low-income households. Governments need to put in place a massive increase in both public and private investment to prepare a better energy mix. At the same time, dependencies need to be reduced for the sake of European Sovereignty.

An industry representative remarked that the energy-transition conversation should not be limited just to investment in renewables. Four-fifths of the European commercial buildings there are not fit for purpose and need massive investment to reach the energy targets. When thinking about big policy measures, there should not just be quick fixes. The long-term impacts should be considered.

A Central Bank official noted changes in the setting of energy prices are possible; there is a need for Europe to be more differentiated in how it gets energy. There has to be clarity and greater strength on the green transition. While it is important to think the energy crisis can be aided by putting windmills on mountains, using a great deal of hydrogen and putting photovoltaics into fields will help, that will not solve the problem. For sustainable and renewable energy, the thinking has to go beyond what is currently on the table, and this is something that will occupy people in the future.

2.5.4 Private investors should play a role in public policy transformation

An industry representative referred to the lack of diversification of savings assets across Europe. There are not enough real assets in these portfolios because they are a key element to protect purchasing power for the long run. Real assets are not very difficult to combine. There is a significant demand out there, as Europe is hopefully transitioning to energy independence. This is a longer-term problem and the shift to energy independence will be crucial. One way of doing it is investment in renewables.

In the first half of the year, Europe saw €44 billion of private money raised for infrastructure projects, mainly in renewables. There is significant demand, not just in Europe but also in the US and Asia, for investments to come into Europe and for what will be a generational shift in terms of energy policy and energy investment opportunities. There should be much more strategic public-private partnerships to tackle these elements. They will help with inflation, the shift to renewables, a longer-term prosperity picture and much more stability in Europe.

The Chair noted people from the energy sector usually comment that there is plenty of money. The problem is that they cannot get the permits or plan projects because there is always somebody complaining, often the same people who insist on having renewable energy and on fighting climate change.

2.5.5 Banking industry solutions to address negative consequences of inflation on households

An industry representative reminded the audience that 70% of European financing is currently coming from banks. Monetary policy has therefore a more pronounced impact than it does in the US, where 75% of

the economy is market-financed. In France, we do not witness a deterioration in the creditworthiness of clients, either retail or corporate. The level of bankruptcy is still below 2019 levels, and the same is true for households. There is a social and governmental demand for coordinated action by banks, and that is what the industry is doing in Europe. This ranges from a freeze on fees and commissions, to bespoke, proactive actions to help clients, such as specific repayment holidays from bills, raising very technical issues. A default must not be triggered according to European Banking Authority (EBA) regulations. In this context, the industry is striving to find solutions.

2.6 Thinking in general equilibrium terms and being more optimistic about EU responses to the crisis

A Central Bank official recommended considering the most difficult period experienced, starting from March 2020. Workers were told to stay away from their jobs, so supply was very depressed. Nonetheless, there was deflation in 2020. The fiscal stimulus in the US between 2020 and 2022 was 18 percentage points of GDP larger than Europe. Nevertheless, Europe is panicking about fiscal policy today. That does not make sense. There should be more consideration in general equilibrium terms. European sovereignty is feared, but with that there will always be difficulties moving ahead in a global world.

In 2019, 14 out of the 19-euro area Member States were at their medium-term objectives for fiscal policy. That was the first time there was a period without excessive deficit procedures in any country in the euro area. It is a very difficult task for a country to be at its medium-term objectives according to the treaties. But that was the position and there was to be even further convergence in the coming years had it not been for the Covid crisis. Fragmentation is an issue in Europe, but Europe is doing its job. No one else will do it for the region. Europeans must believe themselves. There are very strong institutions, they have been improved but they have to be improved. The CMU and on Banking Union will need to be achieved.

A Central Bank official agreed about the need for certain optimism. For fiscal policy, support for the vulnerable groups must be provided in a targeted way without fuelling inflation further. High inflation is a problem, and the longer it stays high the stronger the second-round effects will be, and so the more monetary policy action will be needed. There should be a healthy policy mix that includes monetary, fiscal, macroprudential and structural policies. Fragmentation is monitored very closely by the ECB. Ultimately there is one monetary policy for the whole of the EU and it has to be ensured that is transmitted throughout the euro area. There is a very powerful backstop in the Transmission Protection Instrument (TPI) to address issues of unwarranted and disorderly market dynamics when things go wrong.

A Central Bank official suggested if policymakers are not optimists, then depression is transmitted to the private sector, households and companies. There should be anti-fragmentation instruments in the Euro area because it is not a perfect Economic and Monetary Union. It does not have a fiscal union or a Banking Union. There is no Capital Markets Union (CMU). This is why, with the first signals of instability, the classical division between north and south comes to the surface, irrespective of the fiscal situation of countries.

The European south is now solvent. The debt-to-GDP ratio of Greece, for instance, is high but falling rapidly. The old-fashioned procyclical fiscal policies have been abandoned, and now the snowball effect is favourable. (This is the difference between the growth rate and the average interest rate of public debt). These are the kinds of policies needed. Anti-fragmentation instruments are needed at the central bank, because the other part of the Economic and Monetary Union (EMU) is not perfect yet so the burden falls on the monetary side.

A Central Bank official remarked that fragmentation is a problem due to a lack of unity. Markets would respect a common front and would not pick up on and attack individual countries. There is a question of a moral hazard at the bottom of the CMU, Banking Union and depository guarantees being incomplete. Strong countries would not contribute if they saw weaker or vulnerable currencies not doing their job. They would say they want to be disciplined and need reforms. By voluntarily undertaking those reforms and showing seriousness about them, unity will come.

In various Council, Parliament and ECB discussions this moral hazard is not discussed, but it can be seen. With unity, there is no need for any instrument because the flaws are made up for. It is a political union because it is willed, and whatever is necessary will be done. The moral hazard has to be addressed. The stronger countries need to be generous, but, at the same time, they need the assurance that the weaker ones will pick themselves up and stand up.

A Central Bank official added risk reduction measures should take place at the same time with risk sharing measures, and that will solve the moral hazard problem. A Central Bank official suggested NextGenerationEU is an experiment in this respect. More than €750 billion has been distributed asymmetrically, with the hope that this will help to reduce some of the economic differences, allowing Banking Union to be proceeded with, and for there to be more fiscal public investments.