Inflation and monetary policy: way forward

The Chair introduced the discussion by describing inflation as the "elephant in the room"—specifically, an inflation rate in the euro area that still stands at more than three times the European Central Bank (ECB) target. Headline inflation is drifting down, but core inflation is stubborn, and no one would be shocked to find it higher than headline inflation in some months.

The panel discussed whether central banks are still behind the curve despite increases of nominal interest rates, agreeing that further tightening of monetary policy is necessary to combat persistently high inflation. Moving cautiously and adjusting gradually, central banks should also get out of directly shaping the yield curve.

1. Central banks have more work to do despite increases of nominal interest rates

1.1 Inflation remains high in the euro area and the monetary policy stance needs to become restrictive

A market expert reflected that inflation remains persistently well above the 2% target with no evidence that it is coming back under control. Although central banks have raised policy rates since spring 2022, the real interest rates are still negative. While it is often suggested that positive interest rates in real terms would be a nightmare, the argument can be turned around. Positive rates would force over-indebted states to reduce deficits and debts, savings would receive remuneration. Low interest rates misprice risks and encourage the survival of non-productive and unworkable enterprises and push households to favour illiquid savings rather than long-term productive investments, which are poorly rewarded.

A central bank official mostly agreed with the comments. Although the ECB Governing Council has differing views, it has raised rates significantly since the previous Eurofi meeting and there is a clear understanding that inflation remains too high, and rates need to go up further. If the outlook for medium-term and longer-term real rates already is positive, then short-term rates will soon become positive. The importance of bringing inflation down to the 2% target and the determination to do so should not be doubted. The current forecast expects inflation to reach 2% by the end of 2025 yet bringing it down sooner (say by end 2024) will be beneficial to reduce the negative impacts of high inflation.

1.2 The ultra-loose monetary policies over the last 10 years have inflated asset prices

A market expert highlighted that central banks have pursued a policy of monetary accommodation, manufacturing financial vulnerabilities for more than 20 years. The long lasting very low interest rates have favoured the growth of debt which has reached unprecedented levels, increased financial leverage and undermined financial stability. A normal monetary policy will monitor credit growth, but over the past 15 to 20 years credit growth has exploded without control by central banks. This is creating conditions for financial and real estate asset inflation and subsequent demand side inflation, as well as discouraging productive investment. The addiction to permanently zero interest rates has weakened the financial system over the past 20 years. A McKinsey report shows that the 75% of the trebling of net wealth came from higher market valuations and only 25% from real investments and wages. In conditions where fiscal dominance has been superseded by financial dominance, it is imperative to fight against inflation and accept some economic slowdown if necessary.

1.3 The ECB was too late in starting to respond to inflation

A public representative stated that the ECB has done a good job during the past months and the only problem is that they started too late, recalling that he wrote in early 2022 that the inflation problem was not transitory. The Fed started in March 2022, when the situation was worse in the US than in Europe; the ECB lost four months, so now that situation is reversed. Dutch and Belgian members of the Governing Council are warning that there are clear wage pressures on the horizon, which will disadvantage the euro area and give consistent extra pressure to the inflation problem. Additionally, two further invisible but very real elements are the rescheduling of supply chains and the de-risking of China, and the cost of decarbonisation, which will exert ongoing pressure on prices in the system.

1.4 The transmission of monetary policy to bank lending rates is working so far

In relation to the 350 basis points of rate hikes so far, a central bank official could not offer any further indication about interest rates but highlighted the difference between monetary policy and fiscal policy. Fiscal policy is restrictive or expansionary depending on whether government increases expenditure or whether it increases taxes. The monetary policy stance depends on many issues besides the level of the key rates, including past inflation and even more inflation expectations. Inflation expectations are still anchored in the range of 2-2.5%, so the stance has probably moved into the restrictive territory. However, market expectations that the ECB will reverse scores sooner than suggested by another central bank representative could make monetary policy looser than intended.

Transmission is working and interest rate hikes have transmitted quicky into lending rates. Loan momentum has sharply decelerated, in part also due to the decline of energy prices. The energy sector in particular has repaid some of loans needed to finance the working capital when energy prices were very high. The transmission to lending rates has been very quick and strong, but money market rates have not responded fully. The floor is «leaky» because banks and other market participants have forgotten how to operate in the money market, while in Europe non-banks cannot place deposits with the central bank like in the US. The problem of «leaky» floor is overly exaggerated and has not affected the transmission of monetary policy, but there have been stronger increases in bank interest rates in some countries and lesser increases in others.

In Croatia it has been necessary to slash reserve requirements before the accession to the euro-area, so excess liquidity has increased hugely, and this has muted the transmission of tighter policy. Croatia is one of the countries with the lowest lending rates for corporates or housing purchases, but it probably has more to do with Croatia's adjustment of monetary instruments than the way that monetary policy works.

There are three important issues going forward: first, the inflation outlook needs to be assessed in more nuanced way and consider not just the headline but also underlying inflation and detailed price indicators. There will be many groups of goods and services where prices are moving in different directions. Wages and the prices of products and services with a high wage component will increase faster this year and those that are energy intensive will decline. Second, the economy has been stronger than initially expected and it has avoided recession so far, which supports further policy hikes. The instability in the financial markets may not yet be over, so central banks have to look at this carefully. Finally, after this period of very loose monetary policy it is necessary to check the strength of monetary policy transmission month-by-month.

2. Inflation and monetary policy: the way forward

2.1 Monetary policy in the euro area needs to tighten further

2.1.1 The cost of not doing enough to tackle inflation is higher than doing too much

A central bank official highlighted the lessons from the '70s and '80s that one better deals with inflation in one attempt, cautioning against stopping too early which will require a second attempt and result in higher policy rates and a higher employment rate. The risks of doing too much by raising rates remains smaller than not doing enough, so the only way is up. The modus operandi for monetary policy is very clear: look at the data and do it step-by-step. There is little forward guidance provided because the situation is too uncertain. It is important to monitor underlying inflation, which is a major concern and yet to come down in the euro area.

If we experience a situation when the headline inflation is below core inflation and core remains well above the target, it will be necessary to continue monetary tightening. The labour market remains tight and there are wage pressures, so corporate profit margins should come down to reduce the possibility of inflationary wage increases. The transmission of monetary policy, financing conditions and lending conditions are variables that will be monitored. It is encouraging news that financial conditions are tightening and lending is slowing, which is necessary to break the backbone of inflation persistence.

It is only once inflation is at risk of sustainably undershooting the 2% target when one should think of rate cuts. The current market expectation of a rate cut in early 2024 is not consistent with the baseline scenario and economic outlook. The financial market volatility is worrying from the perspective of monetary policy transmission rather than in terms of financial dominance. There is the separation principle and there are instruments to deal both with inflation and with financial market instability.

2.1.2 If the fight against inflation stops too early, inflation could get out of control

A public representative warned that if action stops too early inflation will end up out of control, there will be recession, weak expansions, and constant financial instability. Rates will need to stay up for at least another 18 months to combat negative real interest rates and fight inflation. Considerations of financial instability should not be mixed up with the considerations of inflation, because regulators can intervene in a way that does not hamper the anti-inflation interest rate policy. There is no logic saying that raising interest rates will increase financial instability. There should be policy room built in to allow a response to upcoming market shocks. Interest rates should increase until negative real interest rates are gone. Policy action is needed to ensure that European interest rates return to 2% instead of relying on models to predict this.

2.1.3 All the monetary tools should be used to tame inflation

A central bank official highlighted that it is necessary to align all the instruments of monetary policy, including the balance sheet. There is no limit for increasing interest rates, which are the key element to deal with inflation. Quantitative tightening (QT) is not a substitute for interest rates increases. With QT, the balance sheet is like playing an accordion: to make sound it needs to be moved; the balance sheet has to be squeezed so that it can expand again in the future, if necessary. The recent IMF report about the estimates of real neutral rate (R star) predicts that after this episode R-star will be back to around zero. Then there will be effective lower bound problems where monetary policy is not that effective.

Without a common fiscal facility, a situation of effective lower bound and insufficient room to expand the balance sheet will lead to trouble. It is necessary to be cautious in reducing the balance sheet because central banks do not want to harm the transmission of monetary policy, but QT is an important and integral part of monetary policy going forward.

A central bank official stated that the interest rate policy is definitely the main inflation-fighting tool, but that there needs to be some normalisation of the balance sheet. There has already been the removal of the targeted longer-term refinancing operation (TLTRO) benefits and the repayment of €0.9 trillion TLTROs since October, which is also good for the profitability of the Central Bank, although increases in policy rates will induce substantial losses for central banks. It may be time to consider reserve requirements and reverse tiering, this time of positive interest rates, which could further support the monetary policy stance. There are pros and cons, but there is definitely some merit in discussing such proposals.

2.2 Moving cautiously and adjusting gradually

2.2.1 The problem of inflation seems more acute in Europe, but the pace of tightening should slow to avoid potential accidents

An industry representative agreed that inflation remains a problem, and that policy needs to tighten both on the rates side and the balance sheet side. A year and a half ago, the US had a worse inflation problem than Europe and now that is reversed. Negative real interest rates can be reduced by moving rates higher or lowering the inflation rate. In the US, the inflation rate has come down about 2% from the peak, but the combination of the Fed's tightening with that minor reduction in inflation means that the real interest rate is now almost zero. There are probably going to be positive real interest rates sometime over the course of the next quarter. Europe is roughly four to six months behind, because the inflation began a little later. The ECB should be open to the possibility that the pattern will be the same. As the peak of the cycle emerges the pace of tightening should slow to avoid potential accidents, as has been seen in the US and Switzerland. If there has been enough movement Europe ought to be aware of possible signals that enough has been done or will be done not too far ahead.

2.2.2 Gradually reducing the ECB's balance sheet, but without rushing

A public representative counselled caution in terms of reducing the balance sheet too abruptly to avoid causing the kind of financial shocks that central banks want to avoid in the first place. Letting bonds that mature fall out of the balance sheet and ensuring there is enough economic growth will result in a spontaneous reduction of the balance sheet over time. An extra push might need to be given, but officials should be careful not to go too quickly.

The Chair noted that the €4 trillion of excess liquidity could be soaked up either by shrinking the balance sheet or immobilizing some portion via higher reserve requirements. Reserve requirements played an important role when the Federal Reserve broke the back of the post-World War II inflation in 1948. The ECB's operational framework review will look at issues including excess liquidity, whether the floor is a leaky floor and the link between excess liquidity and the fact that bank deposit rates are not moving much. A central bank official highlighted that there are pros and cons to a floor with this much excess liquidity, although demand is difficult to predict. The excess liquidity will shrink but will not end soon. The floor system has benefits and will remain for some time. This matter will be discussed at length in the Governing Council and it is important not to comment pre-emptively.

2.3 Central banks must get out of the business of directly shaping the yield curve

The Chair quoted Stefan Ingves: 'When it comes to running a Central Bank, it is not about talk. It is all about the balance sheet and using the balance sheet and having the guts to use the balance sheet'. A market expert noted that he wants faster QT. In the transition towards a more normal interest rate situation, it will be necessary to change the quantitative easing into a form of tightening, otherwise normal market-oriented rates will be limited by maintaining the enormous amount of assets that have been bought by central banks. With a €15 billion reduction per month, it would take 27 years for Europe to reach normality. One of the inevitable aspects of this transformation towards normality is to have a reasonably convincing monetary policy of tightening.

Central banks cannot continue to shape the yield curve through the bureaucracy of central banks, because in a free-market environment it is the supply and the demand of capital which shapes interest rates on the market. If a central bank continues to believe it can determine the exact interest rate of a bond of 15 or 20 years, the transformation will be missed. Over the past decades, Europe has been living in an environment where it is normal for a central bank to determine the exact amount of interest rates all along the yield curve, but it is not normal and it should be abandoned.

2.4 Learning from the 'US Accord' after the Second World War

A public representative noted that the President of the Bundesbank has recently said that there is more than €4 trillion excess liquidity in the euro area. While this number is contestable, there is a huge amount of excess liquidity which is the origin of financial instability. There is no other way to get liquidity out of the system than balance sheet reduction in conjunction with credit tightening. Immediately after the Second World War the Federal Reserve let bonds mature and did not replace them, so there was an automatic reduction of the balance sheet. The post-war inflation provided a lot of help to bring down the balance sheet as a percentage of GDP and something can be learned from that experience.

2.5 The best institutions know what they know and know what they do not know

An expert highlighted that a responsible institution should know what it does not know and central banks should accept a degree of modesty with regard to the future. If an insufficient degree of modesty in action is not taken, one believes one can forge destiny through bureaucracy, which is not possible.

The Chair asked what the panel thought of moving to zero reinvestment or even outright sales. An industry representative stated that they will not be doing outright sales. The Fed is doing the right thing in letting the balance sheet run off by letting securities mature. The central banks are not only tightening interest rates, but shrinking balance sheets, which they have never done before. It is not known exactly what effect this will have on markets, but it is important to be modest and cautious and monitor indicators. The balance sheet shrinkage should be done predictably, and the pace should be changed only for good reason. A public representative suggested that humility will probably translate into caution.

The abandonment of forward guidance is a mark of humility

A central bank official stated that stepping away from forward guidance is a recognition on the part of the ECB of the need to be humble and cautious using models. Uncertainty is high, there are structural shifts, and it is not possible to know everything that is going on in the world. The models are mean reverting ultimately, because the economics' world is built on equilibrium, so one has to be cautious.

An investor representative asked the panel what should be done to address the risk that Italian bonds would be declared non-investment grade. A central bank official stated that monetary policy cannot be the solution to structural problems. An industry representative noted that the central bank official would likely not comment on how the ECB would treat Italian collateral in their operations. The speakers agreed that staying in the investment grade was something for the Italian authorities to ensure.