Monetary policy and inflation prospects in June 2023

Note[1] written by Jacques de Larosière

We will focus on three themes:

- The scale of the shocks suffered by advanced economies and, in particular Europe, over the past 3 years.
- Their significance for monetary policy.
- Recommendations for overcoming the crisis and the danger of stagflation.

Let's look at these three themes in turn.

1. The scale of the shocks affecting European economies

1.1 The energy price shock

In the summer of 2021, Europe – the hardest-hit region energy wise – had to replenish its gas stocks for the post-pandemic winter. The war in Ukraine (March 2022) only amplified this phenomenon[2].

1.2 The exchange rate shock

The euro (whose monetary policy was more hesitant than that of the Fed) depreciated sharply against the dollar between January and September 2022 (-13,3%).

This depreciation only added to "imported inflation" in Europe.

1.3 The terms-of-trade shock

Commodity price rises contributed to a sharp deterioration in the terms of trade in 2022. It is estimated that the loss of income in the eurozone due to international price rises is equivalent to 2% of GDP in 2022.

1.4 The European current account shock

The rise in European import prices (relative to export prices) combined with a highly accommodating fiscal and monetary policy explains the disappearance of the Eurozone's customary current account surplus. While this surplus had reached 400 billion euros in 2018, it had fallen to -100 billion in 2022.

1.5 The shock of goods and services price inflation

The following factors have contributed to the surge in CPI (consume price inflation):

- Rising energy prices;
- Rising demand suppressed during the pandemic;
- Disruption of international production chains;
- Insufficient productive investment over the past 20 years, which explains in large part the inelasticity of supply;
- Wage increases to compensate for the loss of purchasing power due to inflation, which had already begun to appear before the war in Ukraine[3].

The seriousness of this inflation was initially denied by central banks (the ECB even predicted that it would fall back to 2% by the end of 2022, and that it would therefore be "transitory").

Even though nominal consumer price inflation has been declining since Q4-2022 in the Eurozone, it remains high (around 6-7%) and continues to grow at worrying levels in terms of core inflation (5.8% in Germany in March 2023 and 4.5% in France).

2. What do these shocks mean in terms of monetary policy?

2.1 Can we say that the inflation that started in 2022 has nothing to do with monetary policy?

Observation shows otherwise.

- Unprecedented credit growth – made possible by the accommodative monetary policy – has been a powerful driver of inflation.
- The ratio of global debt to GDP rose by 54 percentage points between 2008 and 2022 (BIS).

1. Speech delivered on the occasion of the Global Official Institutions Conference (GOIC) organized by BNP Paribas.
2. From 10 euros per megawatt-hour at the start of 2020, the price of natural gas imported into Europe jumped to 80 euros in February 2022, reaching 240 in August 2022 before stabilizing at around 50 euros since the start of 2023.
3. OECD inflation had reached 7.9% by February 2022, before the invasion of Ukraine.

This is mysterious: how is it that the major central banks have allowed credit to increase so massively without reacting? Historically, the explosion of credit (to governments and companies) has been considered a leading indicator of inflation to be watched very closely. Yet the credit boom of the past 20 years seems to have aroused no concern on the part of central banks.

However, the prolonged rise in low-rate credit favors:

- financial valuations to the detriment of growth;
- the proliferation of assets bubbles;
- the development of "zombie" companies (those that survive only thanks to the subsidy provided by low-interest loans);
- the onset of a financial crisis when debtors begin to experience repayment difficulties.

All in all, we arrive at the following conclusion:

- Easy money encourages indebtedness and therefore increases the vulnerability of financial market players.
- Easy money always explains the inflationary surges that are normally observed after a sufficiently long period of easy money.

2.2 How did inflation enter the international arena?

Inflation is an often a belated revenge of reality.

For twenty years, the world's major central banks lived – and made us live – in a state of illusion. They claimed that monetary growth could be accelerated without any danger of inflation, as long as the sacrosanct inflation target was respected. ("slightly below 2%").

But this belief was unfounded: the 2% figure was arbitrary and should have been a maximum limit on inflation. But it was, mistakenly considered has an objective to be reached by money creation. It could in no way be considered THE warning signal of the coming crisis. Asset bubbles (the inevitable harbingers of inflation) were already proliferating, and nobody worried, the reason being that price inflation was still under 2%.

The market's slowness and reluctance to realize that zero interest rates were not eternal was due, among other things to:

- the influence of the belief held by central bankers that 2% was the "norm", and therefore bound to influence the market's inflation expectations;
- the excess of financialization: the longer interest rates remain close to zero, the higher valuations become, and the more difficult it will be to manage the consequences of a fall in asset prices following an eventual rise in interest rates, leading then central banks to intervene by buying securities at the cost of moral hazard.

In fact, in the spring of 2023, as central banks raised interest rates to curb inflation, bond portfolios saw their book value plummet.

This is what happened to Silicon Valley Bank, which saw the value of its heavily concentrated securities portfolio fall, prompting depositors to withdraw their deposits en masse.

3. How to steer monetary policy?

There are practical recommendations, and others that have more to do with the state of mind.

3.1 Practical aspects

3.1.1 We need to put an end to recipes that have not worked, such as:

- The belief that interest rates can remain at zero indefinitely.

This is absurd for two fundamental reasons:

- Money is used to measure the value of any product or service.

If it is itself worthless, *i.e.*, if it can be produced at no cost and with no remuneration, the economy cannot function properly. Thus, the gauging of risks and the allocation of resources is flawed.

- Long-term savings tend to dwindle (yet 95% of productive investments are normally financed by household savings). Expropriating or overtaxing savers can only have deleterious effects on long-term savings and the growth of productive capital (which has actually fallen for the first time during the last 20 years).

The bureaucratic and arbitrary setting of long-term low interest rates by central banks must be replaced by the free play of the market: the supply and demand of capital must determine the value of money.

3.1.2 Fighting inflation

We are told that central banks are determined to fight inflation. But as long as real rates remain negative in the EU: (3.5% key rates -5% inflation. resulting in a real rate of -1.5%), we can doubt this determination.

What's more, the current rise in stock market values and the restraint of long rates show that the market believes that the present policy – where negative rates in real terms continue to push people into more debt –, is not going to succeed fighting against inflation.

3.1.3 Quantitative tightening (QT) hasn't really happened yet

I sometimes hear it said that this is not a bad thing. QE created a lot of liquidity. Much of this has ended up in reserves held by commercial banks with central banks. Insofar as these reserves are not transformed into loans, the inflationary effect of money creation would be nil.

It is argued that abundant reserves and liquidity enable banks to strengthen their resistance in the event of a shock.

But this reasoning fails to take into account the fact that unless the mass of liquidity created by QE is significantly reduced (central bank balance sheets have reached astronomical figures, at around ¾ of eurozone GDP), we will maintain a degree of ease in financing the economy that seems hardly compatible with the fight against inflation.

The question is an important one. How do we purge the system of 15 years of monetary accommodation?

The majority of specialists believe that we need to proceed on two lines:

- First, higher interest rates for a while (at least until mid-2024);
- accompanied gradually by a reduction of the stock of liquidity created, without going as far as restoring pre-QE between balance sheet amounts.

The reason why these experts wish to moderate the QT is essentially the fear of a liquidity crisis.

But there remains a fundamental and unresolved question: can we fight inflation while maintaining a monumental stock of liquidity?

I do not have a precise answer to this question, and I agree that we need to proceed with caution. But I note that the subject is relatively little studied, whereas in periods of high inflation, it should be absolutely essential to be concerned about the relationship between price trends on the one hand, and balance sheet inflation on the other. So, we must call for more studies and transparency on this fundamental issue.

3.2 The mindset

Far from having succeeded in controlling inflation, which was their mission, central banks have allowed it to re-emerge. A little humility would therefore be in order:

Those in charge of monetary policy need to accept:

- That they do not know everything, and they should know which are the things they don't know;
- Not to try to "indoctrinate" (or "guide") the markets on the indefinite sustainability of a low interest rate policy combined with monetary stability;
- That the world has entered a zone of higher rates for long,
- That more and more money chasing too little goods eventually leads to inflation,
- That QT must be studied carefully but implemented firmly and intelligently,
- That any victory against inflation comes at a cost (less growth and fewer jobs) for a time,
- That the persistence of lax fiscal policies is not compatible with the fight against inflation, unless monetary policy were to be tightened even further.

In short, as the head of Blackrock recently put it: "We let the system deteriorate for decades. And now we are paying the price".

If we don't accept to pay the price, it is likely that the specter of stagflation will reappear.