

Fighting inflation and addressing low growth

The EU faces a difficult trilemma: containing inflation, improving public finances and generating sustainable growth.

The Chair welcomed attendees and noted that the current environment increases the need for clear policy choices and proper instruments to have a soft landing and to increase long-term growth drivers. Tackling inflation is imperative; high inflation disproportionately affects the less affluent parts of society. A proper monetary-fiscal policy mix is needed, and short-term, energy-related support measures can be phased out. Fiscal space shrinks due to higher interest rate costs and room for future investment needs has to be found. Quality of public expenses, reforms improving the economic functioning and private financing are the additional growth mobilisers which need to be activated to address long-term challenges.

Questions on how that landing can be managed, how soft it will be and what it means have become more prevailing, because some expectations on the growth momentum of international economy have not materialised. The question of how persistent inflation is, how it can be brought down, and its impact are more prevailing. The issue of stagflationary risks is has come more to the forefront. The question is what policy tools Europe has to properly manage that.

1. Slower growth in Europe amid a moderate fall in inflation expected

1.1 A reduced growth momentum

An official explained that on 11 September the European Commission released its summer economic interim forecast, which is an update of its fully-fledged spring forecast. A soft landing for the euro area economy is on the cards, but it is not out of the danger zone. The euro area showed remarkable resilience and the outlook is now for a very modest growth. Weakness in economic demand, in particular consumption, shows that high and still increasing consumer prices in most goods and services are taking a heavier toll than expected. For 2023 as a whole the projection is a real GDP growth of 0.8% for the euro area and 1.3% for 2024. That is a sharp deceleration compared to the strong recovery growth of 3.3% in 2022. Momentum in 2023 is even weaker, when considering that around 0.5 percentage points of the growth rate in 2023 is owed to carry over effects from 2022. There are stark differences of growth performance across countries. Germany has a contraction of 0.4%, whereas Spain is growing at 2.2%. 2024 will see more convergence.

1.2 Inflation to further decline

An official stated that inflation is set to continue to come down while employment remains strong. Inflation

continued easing in the first half of 2023 as a result of declining energy prices and moderating inflationary pressures from industrial goods. The baseline scenario for the euro area headline inflation is projected to come in at 5.6% in 2023 and reach 2.9% in 2024. Continued wage increases are gradually restoring household purchasing power, while the expectation is for unit profits to normalise and fiscal support to be phased out. The corporate sector is expected to absorb most of the increased wage bill. The fiscal stance is more contractionary, and the inflation process remains on track, both in the labour market and the financial sector. Both avoid major disruptions, and the latest July European Banking Authority (EBA) stress tests provide support for that.

The slowdown of growth is primarily the result of monetary policy working its way through the economy, but also of a weak global environment. While the US and other advanced economies are holding up, China's post pandemic reopening rebound was very short-lived. The widespread confidence problems in China are deeper-rooted than expected.

1.3 An outlook challenged by risks and uncertainty

An official explained that uncertainty remains high and the baseline projections are surrounded by important risks. The war in Europe and wider geopolitical tensions could deteriorate and further compound the outlook. Inflation could turn out to be stickier, prompting interest rates to stay higher for longer, with negative repercussions on financial stability, investment, employment and consumption. There are forceful factors challenging the European economy on a longer term basis, notably the ongoing demographic change, the imperative green transition, the fragmentation of the geopolitical landscape and high levels of public debt, not only in Europe.

The Chair noted the description of minimal growth forces in 2023, but that inflation is still very high and far above what the ECB sees as compatible with the inflation objective.

2. Tackling inflation is imperative

2.1 High and persistent inflation would be costly in terms of output and investment

An official explained that Europe is in a period of sluggish growth. In October 2022 the IMF forecasted a projection for 2023 of growth of 0.5%, which was upgraded to 0.9%. In the third quarter manufacturing is decelerating and services growth is slowing down, but there is also a strong labour market. The drivers in the future are expected to be nominal wage growth and real income recovery, which is going to be the underlying push on growth. Inflation is the issue. High inflation

hurts private investment and has distributional consequences which hurt the poorer segments of society the most. An expected decrease in headline inflation occurred, which reflected lower energy prices and an undoing of the supply chain disruptions faced. Core inflation is more persistent than expected, excluding the volatile parts of headline inflation, showing that the feedthrough of energy increases and costs is slower. In the future it should be expected that nominal wage increases are going to feed into core inflation.

The ECB is predicted to hit the inflation target of 2% by mid-2025. Supply shocks are usually persistent. In successful cases, 60% of the time it takes central banks at least three years to deal with bringing down inflation. 40% will not have brought down inflation after five years. This risks a de-anchoring of inflation expectation, so a restrictive monetary policy is needed for a considerable period. It is important to err on the side of overtightening, as costs in dealing with inflation shock with overtightening is far lower than dealing with de-anchored inflation expectation. The current path of interest rates of 3.75% in the eurozone and with the ECB is expected to deliver on the inflation target by mid 2025.

An industry representative noted that inflation itself is the worst number to look at, and what needs to be examined is the evidence around the inflation number such as the price surveys, the activity surveys, the markets and the inflation expectations. Activity is slowing dramatically. All supply chain tensions, expansionary fiscal policy and the elements that contributed to the current inflation surge are now in the past. The ECB bank lending survey shows a substantial slowing of both the credit demand and the credit supply side. The labour market remains tight, but when looking at the forward-looking indicators there are signs of softening. Unemployment has been exceptionally low; bankruptcies were exceptionally low due to the fantastic fiscal support, but they are now increasing.

Many corporates need to go out and refinance. Fiscal policy is tightening, and quantitative tightening (QT) is taking place. Corporates will absorb some wage increases but there needs to be some wage gain to rebalance the wage profit split and to ensure a soft-landing scenario. If inflation problems are structural and linked to an insufficient supply side then investment is needed.

Inflation is decreasing, and with a forecast of 3.0% for 2024 it will be heading towards 2.5% by the second half of the year. The danger is currently more on the growth side than on the inflation side, but the worry for the euro area is if there is insufficient investment, because energy supply is becoming more inelastic. Significantly more price volatility could then take place. The danger on the inflation side is if governments respond with untargeted, untailored and untemporary measures.

2.2 Eastern European countries face higher inflation than eurozone countries

An official explained that the real issue is inflation, and that central Europe experienced a dramatic inflation situation after the Communist era. After the pandemic central Europe immediately started tightening and

undertaking rate hikes, one year before the ECB. Central Europe was also much more intensively hit by the war and the energy crisis, the inflation was much higher and the interest rate was also much higher than the ECB rate. In Poland headline inflation is set to reach 11.4% in 2023. High interest rates hit the economy hard, resulting in an immediate shock for the credit markets, growth figures and prospects. The 2023 growth figures in the Czech Republic and Hungary show that both countries are in technical recession. Poland is also very negatively hit in terms of GDP growth, but the outlook for 2024 is much more positive.

Central Europe is trying to ease monetary policy by the second half of 2023. Central European central banks are applying a forward looking approach, while ECB decisions are data driven. The easing and decreasing of interest rates have already started and the outlook is now much better, with 3-4% growth expected for 2024.

The Chair agreed that central and eastern European economies were hit harder by the conflict but there is hope for a faster recovery. Some people feared that if monetary policy was slowed down it meant the same for fiscal policy.

2.3 Avoid nominal wage growth outstripping inflation and productivity growth

An official stated that peak rate has almost been reached on the monetary policy side, and there are currently signals on maintaining that stance for an extended period of time. It is important that wage increases take place, but the worry is if nominal wage growth is larger than inflation and productivity increases. If nominal wages grow by 5% in 2023, 3% in 2024 and profit shares then fall back to the levels of 2015 to 2019 the inflation target would be achieved. The increase in nominal wage is important because a recovery in real incomes is needed to reduce the purchasing power losses and to support growth.

On the monetary side the situation is appropriate and the situation on the fiscal side is adequate. That fiscal stance needs to continue, but for the medium term it has to be stepped up because the creation of a fiscal space is needed. Efforts are also required on the supply side, such as structural reforms ranging from re-skilling the workforce with an emphasis on digital skills, to integrating immigrants. Improving the flexibility of the labour market and promoting innovation are essential. Investments are also vital, particularly to facilitate the transition to renewable energy and green technology.

2.4 Changes in interest rates are like tectonic shifts in financial markets

An official emphasised that high and persistent inflation is a problem. However, since monetary policy has implications not just on real economy price levels but on all parts of the financial system, it is important to avoid one dimensional analysis, especially in a high-debt environment with monetary policy tightening at record pace. Since the 2008 financial crisis and the start of highly expansionary monetary policy, there has been a significant increase in borrowing from capital markets, both by sovereigns and corporates. These dynamics increased

further following fiscal and monetary expansion in the face of Covid. In inflation adjusted terms, the outstanding amount of corporate bonds in the EU has increased by almost 75% since 2008. For non-investment grade issuers the figure is almost 170%. While the aggregate development is similar to that of the US, the EU's growth has been more concentrated in higher-risk segments.

Europe also stands out when it comes to central bank involvement in corporate bond markets. The Eurosystem's corporate bond holdings stand at just below 3% of eurozone GDP, or almost 6% of the domestic market, much more significant than markets like the US and UK, where central banks have unwound their corporate bond positions. In a vulnerable situation like this, monetary policy needs to proceed cautiously and with financial stability risks in mind. It also cannot be left alone in this fight – it is vital that fiscal policy and prudential supervision help address high inflation while maintaining financial stability.

Delivering the capital markets union (CMU) would help reduce the financial stability uncertainty associated with rapid monetary policy tightening. Monetary policy functions through financial markets, meaning that the better functioning and the more liquid these markets are, the more efficiently monetary policy can be implemented. More efficient transmission makes it easier to gauge the impact, and thereby reduces the risk of sharply restrictive policies triggering financial instability.

3. The appropriate response to past shocks and to structural challenges facing European economies is to implement structural reforms, fiscal consolidation and investments that promote growth

3.1 Governments face pressure to consolidate their debts while creating fiscal space for appropriate investments in the green and digital transitions

A policy-maker noted that the Eyjafjallajökull volcano eruption in 2010, which happened during the previous EUROFI in Spain, was a good exercise in finding an alternative supply side. Four crises have been weathered: the great financial crisis, the euro area crisis, Covid and the war in Ukraine. The fifth crisis is the first we know it in advance: the environment and climate crisis. Covid, war and the environmental crisis are so complex that they cannot be solved with one or two instruments. Unconventional supply side instruments need to be used.

The two fundamental things a policymaker should do when going to the market is understand why and how. Europe did a world class job when it went to the market and asked for money for green, digital and social, and was very clear in all its communication that those were the three things that mattered. Every month the EU gives €1.5 billion of macro financial assistance to

Ukraine, a non investment grade country, because it is looking at the design of a larger and safer Europe.

The response of member states has been excellent. With the agreement of Council and Parliament, minimum spending requirements for the Recovery and Resilience Facility (RRF) were put in, with green at 37% and digital at 20%. Member states had green at 40% and digital at 26% because the targets made sense in the market. Work has been done with member states on spending reviews and performance based budgeting, as well as increasing the quality of public administration.

The Chair agreed on the EU's world class response. It is important to the money that flows from NextGenerationEU (NGEU) on the ground and get investments done.

3.2 The implementation of NGEU is spurring a wave of ambitious reforms across Europe

An official stated that inflation expectations are overall well anchored, including in European Commission surveys. Wages are behaving well so far. The interest rate cycle is posing a big policy dilemma. The green transition requires a significant amount of investment. Europe's response to the pandemic has put the RRF in place, which is a powerful tool that leverages investment and reforms in key areas.

3.3 Experiences with the RRF and NGEU are mixed and controversial

An official noted that the RRF is a success story to some extent. Member states are responsibly overcommitting themselves and focusing on green transition and digitalisation, but in terms of execution it is not a success story; a survey was conducted between the member states and only 23% of them were satisfied with the progress of the RRF. The NGEU turned out to be an extremely bureaucratic tool that put heavy burden on national administrations. The implementation requirements of the national recovery plans remained rigid, with substantial delays in transferring payments to member states. Five member states still have no access to those funds more than two years after the pandemic, and against the background of the high interest rate environment it has become much more costly.

An official stated that the vast majority of countries are on track with the implementation of their recovery and resilience plans. More than €150 billion of grants have been distributed, and several countries are in the process of transmitting their third if not fourth payment request. The process of protecting and ensuring that the European taxpayer's money is well spent required the setup of audit and control mechanisms in a completely new performance based model.

A policy-maker observed that the fact that only 25% of the RRF has been spent is good news, because with 25% there has been a rebound. The rebound will be even bigger when 100% is spent.

The Chair added that with the requests that had been made for loans, the utilization of the RRF would be running up to at least 75%.

3.4 A tight fiscal stance in 2023/24 will help avoid additional inflation pressures and rebuild space; it is imperative that fiscal policy contributes to an improvement in the economy's supply side

An official explained that fiscally there is alignment with monetary policy in order to support the disinflation effort, but more needs to be done to create that fiscal space for the future. One of the weaknesses of European fiscal policy has always been procyclicality, as it can spend and support the economy during a crisis but cannot consolidate when times are good. There needs to be fiscal space for investment for the future on the public side, which will require hard choices and a 'rejjing' of spending. Revenue measures will be needed in order to do the required fiscal consolidation. NGEU was an excellent instrument, as it was performance based, focused on structured reforms and did not just provide money for future investment. The IMF has estimated that NGEU can lift potential GDP by 1.5% by the end of the programme in 2026.

On the European side a fund for countercyclical fiscal policy could be set up so that investment does not need to be cut. The second aspect is to think about a climate fund, as climate is a public good. Investment is needed across Europe. A European instrument would be useful for member states, but also in creating the fiscal cohesion required for good macroeconomic management.

3.5 The current state of the reform of the Stability and Growth Pact (SGP)

An official underlined that challenges and trade offs for fiscal policies are becoming tougher. The European Commission has come forward with proposals for a reform of fiscal rules in Europe. One of the design elements is to keep room for public investment and to have incentives in place that allow member states to continue doing that, and to avoid the errors that happened during the financial crisis and the follow-up where public investment cuts were the first victim of consolidation strategies.

The European Commission will hopefully be smarter after the informal Economic and Financial Affairs Council (ECOFIN) meetings on 15 and 16 September. The Spanish presidency is working intensively with member states, including in bilateral talks, to make progress. There are three difficult areas of discussion. The first is the overall balance of the governance of the proposals, the role and the responsibilities assigned to the Commission, the Council and possibly the European

Fiscal Board. The second is the role of investment and whether the incentives in the Commission proposal are sufficient. The third is centred on the safeguards and benchmarks; the Commission proposal is centred on a medium-term debt sustainability analysis, but some member states would feel more comfortable if there were a greater amount of hard benchmarks to clearly monitor every year.

3.6 Towards an NGEU 2?

An industry representative noted that the ideal next step was NGEU 2, and highlighted Mario Draghi's recent editorial in *The Economist* outlining that a fiscal union was unrealistic when looking inside EU member states and understanding their social dynamics, but that the alternatives are also unrealistic. Mario Draghi also highlighted that the ECB had informed the markets that the euro system could redo quantitative easing (QE), and that the Outright Monetary Transactions (OMT) and the Transition Pathway Initiative (TPI) would be important in creating fiscal rules and fiscal room for national governments.

The ECB is engaging an operational framework review and the results will be seen towards the end of 2023. The operational review is important for what the future looks like regarding fiscal room. It is not ideal to link the monetary side and the fiscal side, but markets need to understand that unwarranted spread widening in Europe is something that will not be tolerated.

The Chair summarised that speakers recognised the macroeconomically tighter situation regarding inflation and growth. There are different appreciations of how the crisis may be exited in terms of how fast inflation may decelerate and how monetary policy may react going forward. Broad agreement was reached on the fact that the quality of public finances and investment are important. Europe has launched important initiatives and a world class NGEU, even though panellists have different views on implementation. There remains an element of worry if inflation stays higher. Markets have not yet priced in fully a scenario of "higher-for-longer" interest rates.