STAGFLATION IN EUROPE: WAY FORWARD

AXEL A. WEBER
President - Center for Financial Studies (CFS)

Cheap money and rising debt undermined the growth potential of the euro zone

Most developed economies today are facing the same structural problems: many sectors, especially the public sector, are over-indebted, many markets, especially the labour market, are over-regulated and the workforce in many countries has been shrinking due to adverse demographics.

Instead of fighting structural problems with structural reforms, most countries over the last decade have attempted to counter structural problems with expansionary monetary and fiscal policy – cyclical policy instruments. Not surprisingly, the success is limited.

Even if monetary policy were effective in countering some of these problems, which it is not, it would have been the wrong tool. With interest rates at zero or slightly negative and central bank balance sheets massively expanded by quantitative easing, the ultra-loose monetary policy has largely operated through the exchange rate channel and the asset price channel, whilst the traditional interest rate channel and the credit channel of monetary policy transmission had become ineffective. Policymakers were trying to solve massive structural problems by pushing up debt to unprecedented levels and by using cheap money for devaluing their currencies and artificially inflating stock and real estate prices.

The longer the underlying structural problems are not tackled, the greater they become. Incidentally, I think that this ultra-expansionary monetary and fiscal policy itself has become a drag on economic growth, meaning that their negative side-effects in the long run by far outweigh their short-term positive effects. Nothing in the long run is as expensive as cheap money.

Cheap money has undermined European price stability, financial stability and the growth potential.

What are the risks of cheap money?

First, a long period of ultra-expansionary monetary policy leads to adverse redistribution. Monetary policy itself cannot create income or wealth. A central bank cannot solve a debt crisis by assuming debt itself. What monetary policy can do, however, is redistribute. Monetary policy can shift the costs of debt from debtors (e.g., households, firms, banks, governments, states) to creditors, i.e., savers and investors. By lowering interest rates to zero or even below and by buying up government bonds, monetary policy subsidizes governments and other borrowers at the expense of the private sector, savers and creditors. This can be seen as financial repression. In a broad sense, financial repression also includes liquidity and capital regulations for banks or regulations for pension funds, which give preferential treatment to low-yielding government securities, which in turn favours public debtors and at the expense of pensioners and savers.

Secondly, with their ultra-expansionary monetary policy, central banks have endangered their mandate of price stability and financial stability. With the recent massive reflation the risks to price stability have materialized. Central banks have also endangered financial stability by massively distorting asset prices. Distorted prices send the wrong signals to investors, who took bad investment decisions, for example in driving liquidity-fuelled boom-bust cycles in property markets or investing in the wrong financial products, firms, sectors, regions, or countries. Some of these investments will have to be written-off at some point in the future. In Europe, two specific risk that warrant detailed monitoring are related to real estate markets in the core and sovereign debt markets in the periphery of the euro zone.

Third, the ultra-loose monetary policy has undermined the growth potential of the euro zone. By subsidizing highly indebted countries or ailing economic sectors, central banks have not only lowered the cost of refinancing, but they also have contributed to reducing the pressure for the necessary consolidation and delaying restructuring. Labour and capital remained trapped in stagnant or, in the worst case, even value-destroying investments and were missing elsewhere. Reforms were being put off; structural crises became protracted.

By favouring government debt, monetary policy has damaged the long-term growth potential. I doubt that the high level of newly issued government debt in many countries in recent years has been used to make wise investments. The infrastructure of many developed economies including the euro zone is dramatically worse today than it was 10 years ago. Rather, government debt financed government consumption directly or was redistributed and consumed. Debt-financed consumption may stimulate the economy in the short term. In the long term, however, it is a burden for economic growth.

The production potential of the economy decreases with increasing debt levels, because the interest burden of servicing the higher public debt levels has now become a meaningful government expense again with higher interest rates. This will lead to a further increase of taxes and duties, with all their negative knock-on effects on economic incentives and future growth. In the long run, there will be a high price to pay for this recent period of cheap money.

ALFRED KAMMER

Director, European Department - International Monetary Fund (IMF)

Taming inflation while protecting growth: a tough act for European policymakers

Europe avoided an all-out recession this winter—but it is facing a triple challenge of too-high inflation, rapidly cooling growth, and financial market jitters. Ripple effects from the US banking sector woes and the failure of Credit Suisse have tested financial stability. Wage growth has accelerated but real incomes are still falling, depressing consumption, and growth in the second half of last year. Across the region, inflation remains too high and persistent. While food inflation keeps increasing, natural gas and electricity prices dropped to about half of their 2022 averages, reducing headline inflation. However, core inflation surprised repeatedly on the upside and continued increasing to double-digit levels in several advanced and emerging European economies.

The double blow of the pandemic and Russia's invasion of Ukraine raises the specter of lower potential output and high inflation. There is reason to believe that potential output has taken a hit. Long COVID is likely to have durably decreased the number of workdays. Along with shifting worker preferences toward shorter hours, this is contributing to record-high vacancy-to-unemployment ratios in advanced Europe. Simultaneously, permanently higher energy prices reduce productivity and further lower potential output. Another upside inflation risk is that nominal wages catch up with price increases, although in advanced European economies wage growth has been subdued in 2022 and firms' increased profit margins could provide some room to accommodate wage demands.

Monetary policy should remain tight until core inflation is unambiguously on a path back to central bank targets Although the cumulative increase in policy rates has been larger than in past tightening cycles, real rates remain low in many European economies. A tighter stance is still needed in the euro area. And monetary policy should remain tight for an extended period in emerging European economies where real policy rates are low, labor markets remain strong, and wage growth and risks of persistent inflation are high. Continuing quantitative tightening will support this tighter stance and reduce distortions from large central bank financial-market footprints.

Taming inflation while supporting growth requires policies to act in tandem.

Reducing inflation now is also desirable from a risk management perspective. While we cannot be certain how persistent inflation is going to be, overly optimistic assumptions about a quick return of inflation to targets could come at high social and economic costs. This is because underestimating inflation persistence would entrench high inflation and force central banks to tighten much more forcefully later, pushing the economy into a sharp recession.

The materialization of financial stability risks would warrant changing the course of monetary policy. In principle, financial risks should be contained through financial sector policy action, strong supervision and where appropriate liquidity provisions through the central banks' lender of last resort role. Unless strains in financial markets ratchet up and raise broad-based stability concerns, monetary policy should stay the course. This does not mean that central banks should not adjust their stance with new data and circumstances: bringing down inflation will be possible with lower policy rates if financial conditions tighten for other reasons, or vice versa.

Decisive fiscal consolidation is needed starting this year to support monetary policy and build buffers. More ambitious fiscal consolidation would help central banks meet their objectives at lower rates, with positive spillovers for public debt service costs and financial stability. Tighter fiscal policy would also enable governments to restore depleted fiscal space to cope with large future shocks and long-term spending pressures. Lower energy prices and the windfall tax revenue gains from inflation provide an opportunity to consolidate more.

Structural reforms should prioritize lifting crisis-damaged potential output and easing the growth-inflation trade-offs. This is particularly relevant given the restrictions placed on macroeconomic policies in the context of a currency union. Structural reforms should prioritize raising labor force participation of women and older workers—including through childcare and pension reforms. Workers' job transitions should be facilitated by scaling up and better designing active labor market policies. While only second best to an EU-wide fiscal capacity, Next Generation EU remains an important tool to lift productive capacity, ease medium-term price pressures, and green the economy.

This contribution has been co-written by Alfred Kammer and Sebastian Weber, IMF.

DECLAN COSTELLO
Deputy Director General, DG for Economic and Financial Affairs, European Commission

The time is now: reforming the EU economic governance framework

Europe has entered 2023 on a stronger footing than previously projected. Despite the exceptional shock stemming from Russia's invasion of Ukraine, it looks as if a technical recession has been narrowly avoided in both the EU and the euro area, which is a sign of the remarkable resilience of the economies in the Member States. Labour markets continue to perform strongly, and the unemployment rates remain at historically low levels. Economic sentiment is also improving. In addition, European gas benchmark prices have fallen significantly, below the levels that prevailed before Russia's invasion. Recent inflation readings suggest that the peak in headline inflation is now behind us. Nevertheless, core inflationary pressures persist, with risks on the upside, and monetary policy is expected to continue tightening.

In this economic environment, fiscal policies need to be well calibrated and coordinated, also to facilitate the task of monetary policy. Triggering the general escape clause of the Stability and Growth Pact in 2020 was the right thing to do, as it allowed Member States to cushion the blows caused first by COVID-19 and then Russia's war against Ukraine. Due to the economic support measures at national and EU level, millions of people kept their jobs and business remained open.

However, these measures have not always been sufficiently targeted to the most vulnerable and all of them are well-designed in terms of preserving incentives to limit energy consumption. In some cases, the temporary emergency measure could turn into permanent ones. The fiscal support has also increased public debt, in some cases to very high levels, which now needs to be addressed. Hence, the focus of policymakers should now shift to phasing out emergency measures, starting with the least targeted ones, while refraining from broad-based fiscal support.

Credible fiscal rules are essential to ensure sound public finances across the EU.

As we expect the general escape clause to be deactivated by the end of 2023, fiscal policies should aim at ensuring medium-term debt sustainability as well as raising potential growth in a sustainable manner. Prudent fiscal policy will help ensure macroeconomic stability and facilitate the effective transmission of monetary policy in a high inflation environment. Moreover, sound financial management will be essential to tackle the common challenges that Europe is facing. Fostering the green and digital transitions and bolstering Europe's security capacity require significant and sustained public investments. Following a decade of ultra-low interest rates, financing conditions can be expected to be less favourable in the years ahead. In addition, the impact of ageing on public finances is becoming increasingly visible.

Credible fiscal rules with the right tools for enforcement are essential to ensure sound public finances across the EU. That is why the Commission has put forward concrete ideas on how to re-design the rules based on a number of key principles.

Firstly, we have to acknowledge that economic challenges and contexts differ across our Member States. A one-size-fits all approach does not work. Therefore, our new framework should differentiate between countries and allow for different adjustment pace, depending on public debt challenges.

Secondly, we want Member States to take ownership on their fiscal plans. This is the best way to ensure that ambitious plans are also implemented. Therefore, we want each Member State to design medium-term fiscal and economic strategies, but within a clear and transparent common framework.

Thirdly, based on our positive experience with the implementation of the Recovery and Resilience Facility so far, we know that both reforms and investments are essential. The right combination of ambitious reforms and investments, which are mutually enhancing, can boost growth and help reduce public debt.

Finally, rules only work if they can be enforced. But for rules to be enforceable, they must be realistic, credible, and owned by all. Therefore, our proposal seeks to achieve simpler rules and more realistic debt adjustment paths, coupled with a stricter and clearer enforcement regime.

Reaching an agreement across the EU on the new rules is essential. Recent financial market turbulences add to the important and urgency of making progress. The Commission is now engaging in a debate on its vision for the most comprehensive reform of the EU's fiscal rules since the economic and financial crisis. It will be crucial to reach a swift agreement on the future economic governance framework that fully takes into account the new post-pandemic reality.

MICHALA MARCUSSEN

Group Chief Economist - Société Générale

The stability trade-off is not in the ECB

With the recent turmoil in financial markets, the debate as to whether the European Central Bank (ECB) will have to choose between price stability and financial stability is once again live. This debate is not unique to the ECB, but financial fragmentation and the reality of having to deal with 20 national governments' policies raises specific challenges. The ECB toolkit is today well placed to address both risks, and the stability trade-off lies not within the ECB, but resides rather with governments to ensure effective fiscal policies and advance structural reforms.

The ECB monetary policy tightening that began last summer is the fastest on record, yet both headline and core inflation remain well in excess of the 2% target at, respectively, 8.5% YoY and 5.6% YoY in February. As monetary policy feeds through with considerable and uncertain lags, central banks draw on both medium-term and near-term analysis to set policy. The medium-term analysis builds on economic forecasts and risk hereto. Data releases help track any gaps to the near-term forecast, and near-term analysis is further informed by financial conditions and various inflation expectations. The fact that central banks meet frequently to set policy helps mitigate some of the uncertainty that surrounds this process.

The latest ECB Staff projections show a gradual decline for both headline inflation to 5.3% in 2023, 2.9% in 2024 and 2.1% in 2025, but with inflation "projected to remain too high for too long", the Governing Council decided to hike 50bp at the 16 March meeting. With on-going financial turmoil, a debate has opened as to whether the ECB will face a choice between price stability and financial stability. There is good reason, however, to believe President Lagarde's view that there is no such trade-off.

Fundamentally, the idea of a trade-off assumes that the credit crunches and asset price collapses that result from untamed financial instability would contribute to stagflation. History shows, however, that such shocks are powerful deflationary forces, as the resulting collapse in demand plays out much faster than that of supply.

The ECB, moreover, today has ample tools to tackle financial stability risks, be it through liquidity provision to banks or to combat unwarranted fragmentation in the euro area sovereign bond markets.

This is not to say that there is no risk of monetary policy error triggering adverse economic outcomes. Nor is it to say that stagflation risks do not exist.

Geopolitical shifts and accelerated transitions are likely to bring more volatile economic cycles.

The shocks of the Covid19 pandemic, the ugly War in Ukraine and heightened geopolitical tensions have driven a focus on more resilient supply chains, greater strategic autonomy and accelerated the green and digital transitions. Geopolitical shifts and accelerated transitions are likely to bring more volatile economic cycles and significant relative price shifts, raising the risk of stagflationary outcomes.

Limiting stagflation risks at the cyclical level, requires that monetary policy and fiscal policies work together. In mitigating the energy price shock, ECB President Lagarde warned that fiscal measures should meet a three Ts test – "temporary, targeted and tailored to preserving incentives to consume less energy". Looking over the individual member states, however, we can observe very divergent fiscal policy responses including several that fail this test and add to inflationary pressures.

Within the euro area, good fiscal policy co-ordination among the member states is a further prerequisite. Here, it's key that the ongoing review to produce a new set of fiscal rules delivers an efficient result. In times of crisis, moreover, additional measures may be required at the European level and the Next Generation EU facility agreed in response to the Covid19 pandemic marked an important milestone. Although presented as a one-off, many hope to see such a facility become permanent.

The final element relates to structural reforms, to boost growth and strengthen the resilience of the euro area economy. Such reforms are key at both the national and European level. Finalising the Banking Union and deepening Capital Markets Union are of particular importance given the significant financing needs of the transitions. The Commission estimate increased EU investment needs of €520bn per annum out to 2030 to deliver on the Green Deal and a further €125bn per annum for the digital transition. Much of this will have to be financed by the private sector.

The political reality is that this list of measures will require some challenging trade-offs. These reside outside the central bank, but euro area governments must be careful not to overburden the ECB. Herein lies the real stability risk.

DINO KOS

Special Advisor to the Chief Executive Officer, CLS

Inflation and monetary policy: way forward

Eurozone headline inflation peaked at 10.6% in October 2022 and has been steadily decelerating in the months that followed. The most recent reading, in March, came in at 6.9%. So, is the ECB's work done? With inflation decelerating so rapidly, should the ECB simply pause its tightening cycle and watch as the current trend continues and brings inflation back toward the 2% goal?

Unfortunately for the ECB, the situation is complex, and this is no time to declare victory over inflation. The primary driver of the decline in headline inflation is the fall in energy prices. If that had been the only factor pushing inflation higher, then the ECB would have far more flexibility. However, the initial spike in energy prices spilled over into other sectors and created secondary effects. Core inflation – excluding energy prices and food, alcohol and tobacco – in the eurozone continues to rise. In March, core inflation rose 5.7% and showed no sign of leveling off. Service prices – which provide a better indication of underlying inflationary pressures – have risen from less than 1% in mid-2021 to 5% by spring 2023.

The evidence is clear. Underlying inflationary pressures remain with key measures of inflation at record highs since the launch of the euro with little sign of a turn lower. Despite the ECB's tightening of policy, real short term interest rates remain negative. The ECB's policy stance is not yet exerting restraint.

So, what can monetary policy do from here? The ECB has two main instruments. First, it can continue to increase short term interest rates. The overnight lending rate is 3.75%, having risen from 0.25% in mid-2022. In the near term the ECB should continue to nudge this rate higher, but probably slow down the pace of tightening so as to assess the impact of earlier increases.

Second, the ECB can vary the pace at which it shrinks its own balance sheet – so-called "quantitative tightening" or QT. The ECB has contracted its balance sheet about 10% over the past 9 months (though it still exceeds pre-pandemic levels), mostly by not replacing securities and repurchase agreements when they matured. In the United States, the Federal Reserve is going through a similar process of raising interest rates and contracting its balance sheet.

As any tightening cycle progresses, the central bank has to be alert to signs that it should either accelerate tightening or decelerate and ultimately stop, as monetary policy works with a lag. This was the argument many analysts made in 2021 when inflation was picking up and central banks were anchored to zero interest rate policies. During 2021 central banks, including the ECB, should have begun a gradual increase of interest rates recognizing the lag inherent in policy outcomes. They failed to do that, and the result was the highest inflation in more than four decades.

Given the risks of too much or too little tightening, the prudent course is to move cautiously and adjust gradually.

In the same way, they should now be considering what signposts would make them slow down or stop. If tightening continues until reported inflation is back to 2%, the lagged effects of earlier tightening will assure both a further decline of inflation below target <u>and</u> a deep recession.

One signal to watch for is the health of the banking sector. Banking stress in both the United States and Switzerland has been noteworthy throughout early 2023. Perhaps these are coincidental idiosyncratic events that are unconnected to monetary policy and broader liquidity conditions. But perhaps not. In a period of uncertainty – and with other signs pointing to a slowdown or recession – should central banks be taking that risk?

The prudent course would be to slow down the pace of tightening and be prepared to adjust (faster or slower) as circumstances warrant. Similarly, the pace of quantitative tightening could also slow down for the same reason. Tighter policy could impact banks in several ways. First, all other things being equal, the economy will slow down, and the resulting pressure on certain sectors like commercial property could lead to rising bad loans. Second, banks will naturally hold back and be less willing to make new loans. Finally, the withdrawal of liquidity through quantitative tightening will tend to increase volatility and thus risk premiums, further pressurizing financial intermediaries to hold back new credit.

Ultimately, the ECB and other central banks were slow to tighten in 2021 in response to rising inflation, and then raised rates very rapidly in Q1 2023. Their recent haste creates a new set of risks that could restrain the economy in the future. Given the deep uncertainty and divergent risks of too much or too little tightening, the prudent course is to move cautiously and adjust gradually.