Stagflation in Europe: challenges and way forward

Europe is facing is facing a triple challenge of too high inflation, rapidly cooling growth, and financial market jitters

The Chair stated that Europe is experiencing a stagflationary period following the double shock of the pandemic and the Russia's war in Ukraine and the subsequent energy crisis. The European Union has not experienced this structure and combination of shocks in modern economic history. At the same time, Europe is in a global monetary policy tightening cycle after an extended period of declining and very low interest rates.

Europe has shown a great deal of resilience so far, but it is also experiencing financial fragilities. It avoided an all-out recession this winter but is facing a triple challenge of too high inflation, rapidly cooling growth and financial market jitters. Many find this setting worrying. Although some find reassurance, but others also find it potentially explosive. Stagflationary periods always pose difficult policy challenges, but this is a particularly severe setting in which to ask for the appropriate monetary and fiscal policy response. That will be done in this opening panel and later in the conference, and it is very appropriate to put so much emphasis on the macroeconomic environment because it is such an interesting setting.

1. Monetary policy should remain tight until core inflation is unambiguously on a path back to central bank targets

An official explained that there were great concerns about a deep recession in Europe over the winter because of a Russian gas shut off and that did not happen because of very strong policy action, helped by a mild winter. There was a strong recovery from the pandemic in the first half of the year and then the Russian invasion of Ukraine set up this year of slow growth and high inflation. It increased the costs for businesses, resulted in inflation, cut people's purchasing power and required tighter monetary policy.

This year, aside from the slow growth that is expected to recover into 2024, it is necessary to tackle high inflation. Headline inflation will come down because of lower energy prices, but food inflation is still going up and underlying core inflation rate remains more persistent. This reflects energy costs working themselves through, but as core inflation affects a very broad base it also reflects the very tight labour market and the fact that the euro area is working at capacity.

Monetary policy needs to take this into account. Defeating inflation is the number one priority. Monetary policy needs to stay tighter for longer to bring inflation down. In failed episodes of monetary tightening, there was a premature loosening or failure to react decisively enough when inflation risks were recognised. Therefore, the European Central Bank (ECB) should tighten further. That requires a hike in policy rates and higher rates need to remain for longer to bring Europe back to the inflation target of 2% during 2025.

1.1 Taming inflation requires positive real interest rates and fiscal consolidation

The resurgence of inflation started before the war in Ukraine and monetary conditions have not been tightened in real terms in the euro area

A market expert explained that the facts need to be accurately determined to assess the situation and work out a solution. It is a mistake to say that the Ukrainian war triggered inflation because inflation was already more than 5% when the war started. Despite nominal rate increases, between January 2021 and April 2023, real rates remain very negative. Monetary policy has been loosened, not tightened, and the key question is the level of real interest rates that would be consistent with taming inflation. The answer is not known, but it is imperative to fight against inflation and accept a modicum of economic slowdown.

The Chair recalled the German Bundesbank President Joachim Nagel's statement that, if inflation is stubborn, it is necessary to be more stubborn, though monetary tightening comes at a cost.

A public representative commented that the inflation problem necessitates policies that impact the economy overall. That is basic knowledge, but getting control of inflation is an absolute priority. Paul Volcker, the man who killed inflation in the 1970s, always repeated the same mantra. Once there is an inflation problem, two things are necessary: first, positive real interest rates for a sustained period of time and, secondly and unfortunately, a recession to get inflation under control. This basic truth remains accurate.

It is undeniable that central banks increasing interest rates to a level of positive real interest rates will have an impact on economic growth. However, one must take into account the substantial worldwide budget stimulus. In the US, the Inflation Reduction Act is stimulating inflation. In Europe, only around €130 billion of the €700 billion Recovery and Resilience Facility has been spent. China is also reopening. To speak of budgetary restraints at a time when there are still important national deficits is not realistic.

This expansionary budgetary policy sits alongside increasingly restrictive monetary policy. To get control of inflation, which is very destructive notably for poorer people, monetary policy will have to go further. There must also be a process of reducing national budget deficits because of the huge stimulus at the European level with the Recovery and Resilience Facility, REPowerEU and the European Sovereignty Fund.

1.2 The shocks of the Covid 19 pandemic, the war in Ukraine and heightened geopolitical tensions have created a great deal of uncertainty for monetary policy, which should not be overtightened

Another speaker stated that the present situation is strikingly unprecedented. There have been exceptional price shocks but also forced savings during the pandemic, meaning that the reopening occurred amidst very large household savings. That unusual buffer is beginning to fade, as are the exceptional corporate profits, although they remain strong. Bankruptcies also remained exceptionally low during Covid because of government support for companies, though corporate defaults are now beginning to tick up. Their absence during the pandemic meant the job losses associated with them did not materialise, explaining the exceptionally tight labour market. These buffers are exceptional but, as the price shocks work their way through, they are beginning to fade. This creates tremendous uncertainty for monetary policy, raising the question of whether the fading buffers should be minded to avoid over tightening.

Several indicators point to a pause in the rise of interest rates

A speaker explained that corporate defaults are a lagging indicator of the cycle. The leading indicator is credit conditions and bank lending surveys show a substantial tightening in the pipeline, both in the US and in the euro area. The European Commission's survey of selling price expectations is also a good leading indicator of core inflation and these are falling.

The other issue, tied to financial stability, is that this exceptional period of unusual buffers and rapid tightening comes after a long period of exceptionally low interest rates. That argues for a little caution. Although policymakers should not cut rates, they should take some time given the uncertainty and the lags with which monetary policy feeds through. 3.75% is a good place for the ECB to get to and take a pause. Real rates on longer maturities have moved back into positive territory. There is a very delicate balancing act at play.

On fiscal policy, it was right to provide support during Covid and Europe did a much better job than the US. However, the response to the energy crisis should have been more targeted and it is right that these measures are rolled back.

1.3 Fighting inflation should be the policy priority which requires further tightening monetary policy

A public representative stated that, as there is a great deal of fiscal stimulus in Europe and the US China is reopening, there should be more restraint at the national level. The policy mix of budgetary policy and monetary policy should always be considered. A huge sector of 'zombie companies' that cannot survive without low interest rates and fiscal support has been created by recent monetary and fiscal policy. It is necessary to deal with this.

With respect to credit tightening, Joachim Nagel recently stated that there is more than €4 trillion of excess liquidity in the euro area. It is not possible to bring inflation under control without tightening credit to reduce that amount. Otherwise, that excess liquidity will continue in perpetuity and prevent policymakers from controlling inflation. European policymakers must focus on inflation because a return to the stop go policies of the 1970s will produce the worst of all worlds: inflation that remains out of control, recessions followed by weak recoveries and the constant threat of financial instability. It is simply necessary to bite the bullet.

The Chair commented that the low productivity companies suffering at present are small and medium sized enterprises (SMEs) without access to capital markets, as they are dependent on banks, whose credit standards are tightening. Getting rid of 'zombie companies' would imply wiping out parts of the SME sector, which would represent quite a structural change for some countries. The question is how dramatic this action should be and whether progress must first be made on Capital Markets Union (CMU) to offer them alternative sources of finance. That is not yet in place yet and will only become effective in several years into the future, but monetary policy is already tightening. It is unclear which companies would replace these parts of the economy if they went out of business.

1.4 Whatever the uncertainties of the moment, the fight against inflation must be the priority

An official stated that monetary policy needs to focus on bringing inflation down because if this is not achieved, there needs to be a second attempt and the duration of financial stress is going to increase.

A market expert explained that pursuing an aggressively stimulative fiscal policy alongside an accommodative monetary policy in recent years was bound to create inflation. Inflation was already present in financial and real estate assets, but it was not recognised and eventually inflation caught the whole system. Monetary and fiscal stimulation together is creating inflation. Now, the fight against inflation must be the main priority, because having some inflation with some growth does not work. The stagflation in the 1970s and in the early 1980s was a disaster. There was no growth and there was a great deal of inflation, with all its attendant negative social consequences. Uncertainty has always been a feature, but it is necessary to reduce inflation.

Real interest rates are still negative. This is a call to operators to borrow more, but this will not solve the problem of inflation. It is necessary to accept that monetary policy is being restrained after a very accommodative period. Credit is becoming less easy, but it is not possible to have it both ways. Credit restrictions and higher unemployment are necessary to combat inflation. Larry Summers has calculated

that unemployment must increase from 3.5% to 5% in the US to tame inflation. This is realistic. Summers acknowledges that there is a price for reducing inflation, but it will be impossible to benefit from eliminating inflation if this price is not paid. A degree of realism is necessary.

If the banking system is characterised by large portfolios of bonds with fixed and low returns on the balance sheet, as in some regional banks in the US, there is an additional problem, as seen in recent cases. But if the banking system is well regulated, as in Europe, banks can benefit from higher interest rates and their portfolios are less affected by the reduction in value that comes from higher interest rates.

1.5 Price stability can be achieved without jeopardising financial stability

1.5.1 There is no trade-off between price stability and financial stability

A speaker commented that, ex post, there is no trade-off between price stability and financial stability, given that financial crises are deflationary. However, it must be acknowledged that, although liquidity support can be provided, it is harder to counteract falling collateral values and no one argues that central banks should provide this support. Caution is necessary because it will take time for the cost of credit to roll over due to increased durations and liquidity support cannot address the substantial underlying tightening that the signals indicate is coming through to financial markets.

A market expert expressed a view that price stability can be achieved without jeopardising financial stability. Restrictive monetary policy is compatible with necessary, limited liquidity provision to banks caught in the trap of higher nominal rates reducing the value of their bond portfolio. In the US, the consequences of crumbling bond portfolios have been acute in some deeply mismanaged cases that have been aggravated by poor supervision and even tinkering with accounting rules.

1.5.2 In principle, financial risks should be contained through financial sector policy action, strong supervision and, where appropriate, liquidity provision through the central bank's 'lender of last resort' role

An official observed that the financial stability risk is different from 2008. The banking system is well capitalised and has high liquidity. In Europe, it is well supervised and well regulated. It has some resilience going into this period of financial stress. More can be done on the supervisory front. There needs to be stress tests for interest rate risks and liquidity and funding issues need to be examined.

It is normal for there to be financial stress during a period of tightening. European policymakers need to be prepared for issues in commercial real estate side and for an increase in non-performing loans (NPLs), but the system should be able to cope. If there are problem spots, the central bank and supervisors can intervene, but there is no reason to subsume monetary policy to financial stability. They should go in tandem, with a focus on bringing down inflation.

2. Decisive fiscal consolidation is needed starting this year to support monetary policy and build buffers

An official stated that more ambitious fiscal consolidation will help central banks meet their objectives at lower rates, with positive spillovers for public debt service costs and financial stability. Tighter fiscal policy will also enable governments to restore depleted fiscal space to cope with large future shocks and long-term spending pressures.

Expansionary fiscal policy during the pandemic was appropriate to avoid the collapse of the economy. The focus on cost of living in 2022 was correct, but could have been targeted more efficiently to save money. In 2023, the energy and cost of living packages should be phased out because energy costs are coming down. At a minimum, they need to be made more targeted because that contributes to aggregate demand, which is contrary to fighting inflation. Fiscal policy must be aligned with central bank policy to fight inflation.

Consolidation is necessary in the medium term because the next crisis is just around the corner and there must be fiscal buffers to be able to intervene. Structural reform is going to be key both for this and for inflation, because active labour market policies can reduce the impact of labour market issues on inflation.

2.1 Expansionary fiscal policies have enabled European economies to cushion the blows caused by Covid 19 and Russia's war against Ukraine. Europe has also entered 2023 on a stronger footing than previously projected

A policymaker observed that the European Commission might be a touch more positive than the panellists in its growth expectations for 2023 and 2024 because of more positive recent data and the significant reverse terms of trade impact of falling energy prices, but the narrative is very much the same.

Fiscal policy in recent years helped increase the resilience of Europe's economy in the face of two large shocks. Fiscal policy supported demand during Covid when large sectors were shut down. During the energy crisis, it played a critical role in supporting corporates and vulnerable households cope with the pace of the energy price increase. Finally, it has helped to reverse the declining levels of public investment and bring these back to levels seen before the global financial crisis. A great deal of that is due to additional spending at EU level and this is essential to support European economies and help with the critical structural changes in the climate and digital transitions.

2.2 Very high levels of public debt need to be addressed and fiscal policy should ensure medium term debt sustainability

A policymaker commented that fiscal support has left the European Union with a legacy of higher deficits and debt levels from already elevated levels before Covid. Highly indebted Member States must now move towards some process of consolidation, and it is a question or getting the pace of that right.

The recent fiscal outcomes are better than expected, due to two reasons. The impact of the energy support measures has turned out to be lower than expected because energy prices have declined and inflation has had a very positive impact on public finances in terms of higher revenues, particularly from indirect taxes. Nominal GDP has gone up, which has had a positive impact on public debt levels, but this could turn over the longer term because there are additional expenditures associated with the energy support measures and interest rates will push up the cost of servicing debt.

The budget positions of Member States are probably overly expansionary for 2023 in the context of higher inflation. For 2024, the fiscal plans shown to the European Commission are contractionary, but that contractionary stance is contingent upon the energy support measures actually being phased out. That is currently the case on paper, but it remains to be seen if it will transpire. One issue to watch is that some of the short term positive windfall effect on fiscal outcomes that inflation is having is being spent in some of the budgetary plans. This is leading to additional current expenditure, and it is going to be a critical priority to make sure that this fiscal illusion is not inadvertently spent.

2.3 The most important challenge is that European populations have now understood that it is easy to do fiscal policy when something goes wrong. This is going to be very difficult to walk back from

A speaker suggested that existing fiscal support measures could result in pressure for more fiscal spending to counteract food price inflation or for support in response to a new shock somewhere else. This is going to be very dangerous, and the worst situation would be to end up with fiscal policy overburdening monetary policy in the other direction, with too much fiscal impulse and too much monetary policy tightening. It is necessary to be cautious of this situation because it would result in the private sector being crowded out. Limiting stagflation risks at the cyclical level requires that monetary policy and fiscal policies work together. Christine Lagarde, President of the ECB, warned that fiscal measures to mitigate the energy price shock should be temporary, targeted and tailored to preserve the incentives to consume less energy. Individual Member States have very divergent fiscal policy responses and several fail this test, adding to inflationary pressures. Effective fiscal policy co ordination between Member States in the euro area is therefore necessary.

Euro area governments must be careful not to overburden the ECB

A speaker warned that while it is important to be careful on inflation, it is also important to be careful on the stability of the real economy. Following the recent successes on the fiscal policy side, fiscal policy will be tightening and there is room to take things a little more slowly.

2.4 Structural reforms are of the essence to promote growth

Another policymaker stated that fiscal policy has done a good job in recent years, but it is now more expansionary than it needs to be. It needs to be a bit more contractionary to support the efforts to reduce inflation, and the two key objectives for this year are severely restricting the energy support measures given the reduction in prices and avoiding spending the short term inflation bonus.

Some other elements are key. First, important fiscal and structural reforms that can be growth friendly and improve fiscal sustainability need to be pursued. The significant tax reforms being discussed in Italy, Spain and Lithuania need to proceed and be ambitious. Belgium also needs to progress on pension reform. European countries need to look at the way they design their social benefit systems, because the inability to provide sufficiently targeted support to those most vulnerable has led to overly generous or expansionary support measures.

2.4.1 Structural reforms should prioritise lifting crisis damaged potential output and easing the growth inflation trade offs

An official commented that increasing productivity in the long term will require reskilling the labour force for digitalisation and supporting the green transition. Growth is what matters in the long term and long term growth is driven by productivity growth. The focus must now be on medium term growth and structural reform, which is important in the short term but essential in the medium term. The NextGenerationEU Fund is a fantastic vehicle to incentivise structural reform and lift productive capacity. It is an appropriate vehicle to provide investments in key drivers of the transition and needs to be spent well.

Another speaker observed that structural reforms are key at both the national and European level to boost growth and strengthen the resilience of the euro area economy. Good visibility is a priority, as this is critical for the private sector to have certainty and understand what is happening. There also needs to be the right type of financing given the significant financing needs of the green and digital transitions. Europe is still highly dependent on bank lending as a source of financing for its economies, but while bank lending is very important, it cannot finance the new technologies that are needed in Europe today. Capital Markets Union is critical.

2.4.2 NextGenerationEU is an essential tool to support public and private investment

A policymaker noted that while inflation in recent years is partly driven by demand, much of it has been due to supply side shocks. Looking forward, with the fragmentation of the global economy being noted in recent discussions in Washington, global supply may be less responsive to fluctuations in demand. That could be an important challenge for policymakers. European policymakers can help by supporting both public and private investment, and this is where implementing the Recovery and Resilience plans is important. Approximately €160 billion has been disbursed to date, but that still leaves close to €500 billion still to be disbursed in the coming years. That implementation should be progressed.

2.4.3 Credible fiscal rules with the right tools for enforcement are essential to ensure sound public finances across the EU

A policymaker commented that it was essential for the Economic Governance Review to be agreed quickly. The legislation must be adopted within the current European Parliament cycle and, ideally, by the end of the year, because it is necessary to benefit from a credible medium term framework for fiscal policy to get the right policy mix.

2.4.4 The mistake that has been made for a very long time is to believe that the deficiency in potential growth lies mainly in the insufficiency of demand, whereas this deficiency was and remains above all a problem of supply. When monetary policy is too loose, it damages aggregate supply

A market expert stated that, for four decades, the belief was that the main problem was a lack of demand and there have been attempts to correct this so called lack of demand by providing money to the system. This was a mistake. In reality, economies were suffering from a lack of supply. The supply system is very inelastic, notably in Europe, and it is not possible to revive it by throwing money at it. Only by investing more and making the right structural changes is it possible to enlarge the potential growth of a country, but more money has obstinately been put in to create more demand, which was not the problem.

Another speaker concurred that the problem was on the supply side and observed that, if central banks misdiagnose what is really a negative supply side shock as a negative demand shock, the real neutral rate is pushed down and unproductive investments are created. This has a very negative effect, so it is critical that those reforms are delivered.