MONETARY POLICY AMID RESURGENT INFLATION, WEAK GROWTH AND HIGH DEBT

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Monetary policy under high uncertainty

Since late February, central banks across Europe have been contending with yet another large, adverse shock of uncertain magnitude and duration. Higher global energy prices following the war in the Middle East have quickly fed through to inflation and weakened activity. The challenge central banks now face is how to adjust monetary policy in response to this latest energy supply shock which pulls inflation and growth in opposite directions.

Large shocks—from energy market disruptions and geopolitical fragmentation to trade shifts and technological change—have become a recurring feature of the policy landscape. The task for central banks is further complicated by the high uncertainty surrounding the scale and length, the propagation of such shocks through the economy and the persistence of their effects. Shocks can appear temporary, yet leave lasting effects through pricing behavior, wages, inflation expectations and financial conditions. Across Europe, while institutional settings differ, the ECB, the Bank of England, and central banks in the Czech Republic, Poland and Romania face the same challenge: distinguishing transient shocks from those that risk leaving lasting effects. But their room to "wait and see" differs. Central banks in central and eastern Europe, in particular, are confronting the shock from a starting point of higher wage and price inflation, which can make the risk of propagation through wages, prices and expectations more immediate.

In the current moment, central banks will be well served by adopting a flexible, state-contingent policy approach. Small and temporary shocks can be accommodated, especially when demand is subdued and inflation expectations are well anchored. But when indicators such as inflation expectations, firms' selling price intentions and wage trackers suggest that the shock is likely to feed into wages and broader prices, monetary policy should respond quickly. If it doesn't, the monetary stance could become overly accommodative in the face of rising wages and prices, encouraging borrowing and spending and further broadening price pressures. The response must be sufficiently firm to prevent a relative price shock from becoming generalized inflation. Once households and firms expect inflation to deviate persistently from target, and these expectations become embedded in wage and price setting behavior, restoring price stability requires a larger and more costly monetary policy adjustment.

While deciding whether and how quickly to adjust policy settings, central banks must assess the strength of transmission of their policy stance to financial conditions and the broader economy. Policy rates are the principal lever, but they do not fully capture the monetary stance. Liquidity conditions, credit conditions, and risk appetite are all useful indicators of transmission to help assess the degree of policy restraint. The stance should therefore be assessed using a broad set of indicators, not a single rate.

Beyond the principal lever of the policy rate, central bank communication is an important tool to help steer financial conditions in highly uncertain times. In this regard, scenario analysis can be helpful to guide expectations regarding policy rates by clarifying how the central bank would respond to alternative paths for inflation, growth and financial conditions. At the same time, to be effective, communication must balance flexibility and commitment: it should be flexible enough to respond to new information, but clear enough to keep expectations anchored. It is important not to muddy the waters by communicating too frequently or with a large number of scenarios that could make financial conditions unduly volatile.

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Central banks should remain flexible with a state-contingent policy approach while consistently signaling their firm commitment to price stability. When shocks threaten to leave lasting effects on inflation expectations or price-setting behavior, they should act early enough and communicate clearly on how future decisions will evolve with incoming information to prevent temporary shocks from becoming persistent inflation.

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Monetary policy and price stability

The Iran war and the uncertainty surrounding its prolongation retain the potential, primarily through their significant impact on oil and gas prices, to fuel a substantial rise in the overall inflation rate. It has been five years since inflation first began to increase after the Covid pandemic, with energy prices, in particular, skyrocketing after Russia's invasion of Ukraine. The ECB was a year late in combating inflation. To avoid repeating this, the risk of unanchored inflation should be taken very seriously.

For inflation to remain "tamed," it is of utmost importance that inflation expectations remain, as the saying goes, well-anchored. In plain language, this means that consumers and producers behave as if the 2% inflation target will be rigorously respected. If that belief vanishes, all prices within the economy will tend to rise because the majority is convinced that inflation will be (much) higher than the 2% target. For the "2% belief" to be respected, the central bank needs to signal loudly and clearly that it will act accordingly. Given current inflationary trends, reassuring words are no longer sufficient. Despite the negative impact interest rate rises will have on national budgets, especially for countries carrying a heavy debt burden, the ECB cannot refrain from implementing restrictive monetary policy to combat inflation.

Moreover, the fear that monetary tightening will significantly impact economic growth appears overblown. Other concerns, closely related to the structural growth potential of the economy, support the argument for higher interest rates at this moment in time.

The business cycle in industrialized countries is no longer primarily determined by changes in monetary policy but much more by the unwinding of financial imbalances. This thesis has, in recent years, emerged from a research program at the Bank for International Settlements (BIS) under the leadership of Claudio Borio, who headed the BIS' Monetary and Economic Department until the end of 2024. The 2008 meltdown in the financial markets and its destructive impact on the real economy clearly illustrate this sequence. The pattern of the euro area business cycle in the first part of the third decade of the 21st century generally confirms this thesis, which has profound implications for monetary policy. More specifically, what is often referred to as the unintended consequences of monetary policy should occupy a much more central role in decision-making regarding monetary policy than is currently the case.

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First and foremost, low interest rates encourage taking on more debt and increase the degree of leverage throughout the financial and economic system. The IIF Global Debt Monitor shows that global debt (private + public) peaked during the Covid-19 pandemic and now stands at a historically high 308% of worldwide GDP. Government debt in the world has not been as high since the Napoleonic wars of the early 19th century. The more debt that permeates through the system and the higher the degrees of leverage, the more pronounced financial imbalances become, increasing the risk that even a partial unwinding of these imbalances will negatively impact the growth path of the economy.

Secondly, there is the phenomenon of zombie companies. First described during the long stagnation period of the Japanese economy despite relentless budgetary and monetary stimulus, zombie companies are entities that can only survive in an environment of extremely low interest rates. Otherwise, their debt burden would drive them out of business. Some estimates indicate that up to 15% of corporate entities in the West exhibit zombie-like characteristics, which means that huge amounts of capital and labor remain trapped in these zombies at the expense of new, more profitable endeavors. The forces of creative destruction that underpin real economic development are seriously hindered by the zombie phenomenon, which is fundamentally a consequence of very low interest rates.

Last but not least, there is the impact of expansionary monetary policies on wealth inequality. Very low interest rates consistently give rise to a search for yield by investors, both large and small. Money is channeled into stocks and bonds, benefiting those who already own these assets as compared to savers who cautiously keep their money in savings accounts. Wealth inequality increases, leading to heightened tensions within society, a force that does not directly stimulate smooth economic and social progress. Moreover, in the search for yield, a whole range of more exotic but practically always riskier investments (art, cryptocurrencies, etc.) become more attractive, simultaneously increasing the fragility of the financial system. Again, the unwinding of such imbalances negatively impacts economic growth.

To conclude, monetary policy remains a powerful tool of economic policymaking. More than ever, monetary policy should focus on price stability.