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Daniel Gros

The Political and Technical Aspects of Controlling Inflation

The task of central banks is to keep prices stable. The current resurgence of inflation could thus be regarded as nothing more than central banks engaging in their normal job. However, this time is different in that the current bout of inflation arrives after a long period of too low inflation and, moreover, low inflation which persisted despite years of very loose monetary policies, a period which one contribution to this issue's Forum characterises as the "Great Monetary Expansion".

Over the past two decades, central banks all over the world embarked on the biggest monetary easing ever recorded in central banking history. The full panoply of monetary policy instruments was used, and new instruments were invented for the purpose: repurchase operations at all maturities; limitless extension of the collateral lists; outright purchases of all types of securities; announcements of future (expansionary) actions; negative rates. Modalities varied a bit here and there but all in all, it was a globally consistent, strong and temporally sustained phase of monetary easing.

However, until 2020, inflation remained stubbornly low, despite this concerted and prolonged easing, creating the impression that the combination of expansionary monetary policies and low inflation was the new normal (the slogan was "low for long"). When inflation suddenly took off starting in 2021, central banks were unsure about how to react and what instruments to use given that in the preceding decades, nothing seemed to make a large impact.

The ECB does not constitute an exception. If anything, it provides the best illustration of this confusing situation. Inflation in the euro area had remained below its target for years on end despite negative policy rates, special low

cost credits to banks and an unprecedented amount of bond purchases.

This is the background to the CEPS Ideas Lab 2023 session entitled, "Inflation strikes back: How to restore control?", in which participants analysed different aspects of the situation, ranging from the political view to the technical aspects of central banking.

ECB: Restoring control and regaining credibility

Bobeica, Holton and Koester (2023) from the ECB provide an in-depth description of the various drivers of inflation and how they change over time. A key difficulty facing the ECB over the past couple of years has been to distinguish between transitory and permanent or underlying elements of the inflation process. Underlying inflation, which aims to provide a signal about medium-term inflationary pressures, cannot be directly observed but must rather be estimated – and there are many ways to do this.

The standard approach to identify the more persistent elements in inflation is to look at core inflation (headline inflation minus energy and food), but there are also other indicators that eliminate different volatile elements, such as the trimmed mean, which ignores all price changes outside a certain range.

Bobeica et al. (2023) find that different indicators are useful at different points in time. For example, the core inflation measure is useful to strip out the more volatile energy and food components of the Harmonised Index of Consumer Prices. But when energy and food prices stabilise, this measure becomes less indicative of what elements drive the inflation process.

The authors note that all measures of underlying inflation clearly increased starting in the middle of 2021, rising above the medium-term 2% inflation target threshold towards the end of 2021. They note that around that time the ECB announced a normalisation of its policy stance, but had not yet increased rates and continued its net purchases in its asset purchase programmes (which ended only several months later). They also note that different measures of underlying inflation diverged considerably during 2022 with the lowest at 4% and the highest at 8%. This shows that measures of underlying inflation are at best an imperfect guide to monetary policy.

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Moderate wage increases are thus the key for returning inflation to the ECB's target. The ECB has created an experimental wage tracker, which is based on the agreements for wage increases concluded up to the present. Monetary policy does not have a direct impact on wage agreements, which are determined by a mixture of labour market conditions, political constellations and inflation expectations. The ECB can hope to influence the latter with a strong commitment to its goal of bringing inflation back under control. This is the key challenge for the ECB.

A tightening of monetary policy usually has a positive impact on the income of central banks. The purpose of monetary policy is obviously not to maximise the profits of the central bank, but to keep prices stable. However, it is still important to track the profits (or losses) of central banks because they ultimately accrue to the national treasuries. The problem with the present tightening cycle is that the national central banks in the euro area have accumulated huge amounts of government bonds on their balance sheet. These bonds were bought during the preceding long period of very low interest rates and thus yield very little interest income. However, the bank reserves that financed these asset purchases now have to be remunerated at the deposit rate, which the ECB has increased to over 3%. This puts the national central banks (NCBs) within the Eurosystem (and the ECB itself) in a difficult position. With a total deposit base of almost €5,000 billion, the increase in the deposit rate of almost four percentage points (from -0.5 to 3.25 as of May 2023) means that the Eurosystem has to pay banks almost €200 billion per annum more.

As an aside, one should note that Angeloni (2023) uses the shortcut ECB for the income and the balance sheet of the entire Eurosystem, which consists of the ECB and the NCBs. For the conduct of monetary policy, this distinction between ECB and NCBs does not matter. But, as the author explains, the euro area is an incomplete monetary union in which each national central bank maintains its own balance sheet and the profits and losses from government bond purchases are not pooled centrally as is done for all other monetary policy operations. The NCBs transfer their income to their national treasuries. This implies that the losses calculated here accrue in the ultimate instance to member states and in somewhat different proportions according to the different amounts of bonds bought and their yields.

It would of course be possible for the Eurosystem to stem these interest payments to banks by offloading its bond portfolio through sizeable sales of government bonds in the open market. These sales would lead to an equivalent reduction in bank reserves, which would allow the ECB

to return quickly to its pre-crisis balance sheet's size and structure. But the ECB has clearly rejected this course of action since it has decided against any sales of bonds, relying instead for balance sheet reaction only on the non-reinvestment of bonds coming due.

The official reason for this choice is essentially that the ECB fears that large bond sales would lead to financial market tensions for highly indebted periphery countries. Moreover, selling bonds would crystallise the loss in the ECB balance sheet and concentrate it in a shorter period of time. The total amount of the losses, in present value, would be roughly the same, but concentrating them in a shorter period would make the fiscal cost of past bond buying more apparent and thus politically more difficult to defend.

In order to reduce the interest payments by the Eurosystem to commercial banks, Angeloni proposes that the deposit rate should be differentiated by the bank and be correspondingly lower the higher the amount of outstanding central bank deposits of that bank.

To achieve this interest rate savings, the ECB would need to engage in a large-scale new reverse long-term operation under which it would auction rights to swap central bank deposits for long-term securities on a long-term basis. These new operations could also be calibrated taking into account the balance of each bank at the deposit facility. Banks deciding not to swap out their central bank deposits would be penalised by a lower or even zero deposit rate.

This approach could be managed in such a way that the system-wide average rate on the ECB deposit facility (the key variable impacting the ECB accounts) would be lowered alongside the decline of the deposit stock – resulting in considerable savings for the entire Eurosystem. The approach proposed in Angeloni's Forum contribution would be essentially equivalent to a new reserve requirement as they existed in the 1980s and would thus represent a tax on banks, which might be counterproductive given the high profile bank failures over the past months. However, Angeloni argues that European commercial banks are benefitting at present from a significant increase in their lending margins, making it easier for banks to absorb the income reduction stemming from a decline in the return on the central bank deposit facility.

Ferber's (2023) contribution illustrates the quandary the ECB finds itself in. On the one hand, higher prices reduce everyone's purchasing power, especially that of the poorer and more vulnerable. On the other hand, monetary tightening threatens the recovery Europe needs after being hit by two exceptional shocks in the space of a few years.

The biggest issue at present is of course the loss of purchasing power through inflation. The non-experts in monetary policy only see inflation way above the target and an ECB that was late to react to a clear inflation threat. This has clearly damaged the trust that citizens had in the ability of the ECB to keep inflation under control.

The late reaction of the ECB is difficult to understand for outsiders, thus inviting speculation about what might have motivated the ECB to wait for months with inflation clearly overshooting its target by a wide margin. One explanation could be that the ECB wanted to support highly indebted member states. As Ferber points out, this would mean “fiscal dominance”, i.e. a situation in which the ECB does not dare to tighten policy because this would increase the cost of servicing public debt. The more recent rate increases by the ECB contradict this impression of fiscal dominance, but some suspicion will remain as long as inflation is not brought back under control. A member of the Governing Board of the ECB has confirmed recently that fiscal concerns did play a role in 2022, but that the aim of the ECB was not to support highly indebted countries, only to preserve financial stability. The Transmission Protection Instrument created in the early summer of 2022 provided the necessary protection of financial stability, thereby allowing the ECB to start a vigorous rate hike cycle.

As of early summer of 2023, there is little evidence that the tightening has had a strong impact on the economy. But with policy rates now already very high by the standards of the past decade and the rates paid by borrowers also increasing steeply, concerns are mounting that high rates could lead to a recession.

These contrasting political pressures are typical of the problems central banks face when they have to bring inflation under control.

The ECB is of course not the only one in this situation. One salient feature of the current bout of inflation is how widespread and nearly simultaneous both the increase in inflation and the monetary tightening has been. The contribution by Moessner, Xia and Zampolli (2023) from the Bank for International Settlements documents this feature in depth.

Moessner et al. (2023) show that both the increase in inflation and the ensuing monetary tightening have been happening almost simultaneously in most advanced countries (with Japan being the main exception). Interestingly, the authors find that this co-movement – measured by the variance explained by a “common factor” – reflects not only the influence of energy and food prices but also that

of less volatile components, as it also holds for core inflation. Domestic elements of inflation have thus increased everywhere at about the same time. The euro area is no exception in this regard. Moreover, cross-country inflation spillovers, i.e. the extent to which shocks to inflation tend to propagate across economies, have increased considerably, even after filtering out the impact of the contemporaneous correlation between shocks. This suggests that the dynamics of domestic inflation, including that of the euro area, depend more on the path of inflation abroad than has been the case for the past 15 years. This factor might complicate the task of the ECB if other countries are less successful in fighting inflation.

The mirror to this globalised inflation has been a globalised tightening of monetary policy. This leads to concern that spillover effects of monetary policy could lead to an excessive tightening because the tightening of any one country tends to depress economic activity in other countries. Monetary policy in the US in particular has a strong impact on financial conditions around the world, especially in emerging economies. The direct impact of US monetary policy on the euro area should be limited. However, US monetary conditions could still impact the euro area via their global impact, for example, via euro area exports to emerging economies. This shows that the ECB has to take not only domestic, but also global factors into account and that the success of its fight against inflation also depends on factors outside its control.

The general message from these four contributions is that the ECB must confront an unprecedented combination of challenges to bring inflation back under control and regain its credibility as an institution.

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