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Markus Ferber

The Rocky Path to Inflation Reduction

The European Central Bank's mandate is clear: ensuring price stability within the euro zone. In a recent review of its monetary strategy, the Governing Council of the European Central Bank has elucidated what that means. The targeted goal is a symmetric medium-term inflation of roundabout 2%. To measure that value, the ECB continues to rely on its Harmonised Index of Consumer Prices (HICP) as a suitable benchmark.

The ECB's task therefore is pretty clear, as is the standard by which its success in achieving price stability must be measured. However, it is just as clear that, in recent years, the European Central Bank has missed its self-imposed goals by a long shot. While most likely having surpassed the peak of inflation with a euro area-wide average of 10% in October 2022, current inflation rates of 7%, as measured for April 2023, do not indicate much relief – especially with rates reaching close to 15% in some member states (Eurostat, 2023). Therefore, even with the most generous interpretation of the ECB's mandate, it can no longer be said that the ECB is successful at ensuring price stability.

This elevated level of inflation is not only a short-term problem, but it also causes long-term concerns. One of these concerns is that the constant high levels of inflation have also caused the future expected inflation values to rise. The numbers given by the European Central Bank's (2023) Survey of Professional Forecasters recently had to be revised up to 5.9% for 2023 and 2.7% for 2024. This shows that confidence in the ECB's ability to effectively combat inflation in the foreseeable future is diminishing. Such a lack of confidence might have implications in the real world by starting a wage-price spiral. Due to ongoing high inflation, trade unions often demand two-digit pay rises. Examples of this are manifold. In some member states, such as Germany, trade unions have already en-

gaged in industrial action in order to exact annual wage rises in excess of 10%.

Economic actors and citizens have good reason to mistrust the ECB's ability to reduce inflation. This mistrust is a direct result of the ECB's policy of publicly downplaying the problem for a long time. Even in the second half of 2021, when inflation rates were far above the ECB's set targets, ECB President Lagarde still referred to it as a temporary problem that would level off in the following year. Following that logic, an adaptation of the ECB's accommodative monetary policies would not be needed. As we now know, this prediction would soon prove to be very wrong. Missing the mark by such a margin also poses fundamental questions regarding the quality and reliability of the ECB's economic and inflation forecasts.

Although central bankers have recognised the signs of the times and responded with unusually high adjustments of 50 basis points or even 75 basis points, one thing is nevertheless clear: the ECB has been painfully late to the party. The central banks of other major economies, especially the US Federal Reserve, have reacted much faster and much more decisively. By now, it is becoming apparent that the early and decisive reaction has paid off and that the US has most probably already passed peak inflation. In Europe, inflation remains stubbornly high despite the ECB raising rates to levels not seen since the days of the financial crisis.

In a twisted feedback loop, the divergent responses of the Federal Reserve and the European Central Bank have added to inflationary pressures in the eurozone, as higher interest rates have made the US dollar more attractive compared to the euro. This has been reflected in the euro-dollar exchange rate in the form of a strong dollar and a weak euro, particularly earlier on in the cycle. The fact that many commodities – energy contracts in particular – are settled in US dollars has fuelled inflation throughout much of the 2022 energy crisis. This unfavourable exchange rate relationship has once again significantly accelerated energy price inflation especially in September and October 2022 – a case of “imported inflation” that was largely due to the ECB's hesitant course early on in the crisis. With the normalisation of the euro-dollar exchange rate in the last few months, this effect has become less pronounced. The exchange rate is not at pre-crisis levels yet and the episode has highlighted

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the value of some degree of international coordination among central banks.

Fiscal dominance as a problem for the ECB's ability to act

More fundamentally, the difference in approach between the European Central Bank and the Federal Reserve naturally raises the question of why the ECB has reacted so hesitantly. Was the ECB's initial inaction only due to an honest mistake in getting inflation forecasts wrong? There is a strong case to be made that there is in fact more to the story than just a miscalibrated inflation forecast. The suspicion arises that non-monetary policy considerations may also have played a role. After all, the ECB has provided a favourable financing environment for eurozone member states through low interest rates and extensive government bond purchase programmes for an extended period of time. Particularly against the backdrop of the enormous increase in government debt in all member states as a result of the COVID-19 crisis, this favourable environment was a factor on which some of the member states with poor credit ratings have relied. Although the ECB is legally prohibited from direct monetary government financing, by acting on the secondary markets and by referring to a dysfunctional transmission mechanism, the ECB has in fact become an important player for the refinancing of eurozone member states. This development is somewhat at odds with how monetary policy in the eurozone is supposed to work.

When designing the blueprints for the single currency, its founders envisioned that the euro area would be built on the concept of monetary dominance. Monetary policy was supposed to have free reign within its mandate, while member states would have to adjust their respective fiscal policies to the changing interest rate environment, if deemed necessary. This concept fits well with the idea of a politically independent central bank.

Over the years, however, and in particular since the economic and financial crisis, the ECB has moved further and further away from this ideal and has become, to some extent, a lender of last resort for many member states. For highly indebted member states such as France, Italy or Spain, this has had the welcome side effect that refinancing costs fell despite rising government debt. For a long time, this also removed the politically uncomfortable market pressure on governments to consolidate national budgets, which allowed them to avoid making tough choices. This development was also made possible by the fact that the European Commission has failed to properly enforce the existing strict European debt rules enshrined in the EU's Stability and Growth Pact.

As a result of that development, the ECB has manoeuvred itself into a self-made trap. The relationship between monetary and fiscal policy has gradually shifted towards fiscal dominance. This puts the ECB in a dilemma: on the one hand, and in line with its mandate, the ECB should have reacted quickly and decisively to rising inflation as early as 2021. On the other hand, the ECB was acutely aware of the implications of rapidly rising rates for the refinancing costs of highly indebted member states and saw the danger of possibly triggering a new sovereign debt crisis by acting too hastily.

The ECB was only able to extricate itself from this self-created dilemma by deciding to set up a monetary policy instrument to protect monetary policy transmission, the Transmission Protection Instrument (TPI). This instrument is intended to counteract unwarranted, disorderly market developments, and its activation is subject to strict conditions. Nevertheless, the instrument was to some extent perceived by the markets as a guarantee that the ECB would intervene if a member state came under acute market pressure. At least the risk of a new sovereign debt crisis therefore seems to be off the table for the time being.

With the establishment of the TPI, the ECB has initially gained the necessary room for manoeuvre to pursue a more aggressive monetary policy course, although there was noticeable grumbling from some southern European members with regards to the pace of key rate adjustments. However, the ECB will have to endure these reactions. After all, it is the job of an independent central bank not to listen to the moaning from national capitals.

Monetary tightening as a challenge for the European economy

The monetary tightening initiated by the ECB is not only a problem for some highly indebted member states; it is also a problem for the economy in general and the banking sector in particular. After all, raising interest rates is supposed to contribute to a slowdown in credit demand and thus indirectly to a contraction of aggregate demand. There is a distinct likelihood that central banks' fighting inflation might in fact engineer a recession in the process. In view of a difficult macroeconomic environment and especially high energy prices in the context of the effects of Russia's war of aggression, this approach is not completely uncontroversial.

There are even more distinct challenges for the financial sector. On the one hand, higher interest rates make it possible to achieve a positive interest margin in the long term, and the abolition of the negative deposit rate for money

parked at the ECB has a positive effect on profitability. On the other hand, rapidly rising interest rates are a problem in the short term. After all, banks have issued many new loans at favourable conditions and with long maturities in the past years in the low interest rate environment and now have to remunerate new deposits with higher interest rates. While this is partially offset by margins on newly issued loans, a swift tightening of financial conditions does cause problems in the short term. It will probably take some time before the stock of outstanding loans reflects the new higher interest rate level.

So monetary tightening comes with side effects and is not popular with everyone. Some argue that the high inflation rates are mostly due to interrupted supply chains and high energy prices and that these problems cannot be tackled with monetary policy measures anyway. This argument falls somewhat short, however. Even if particularly volatile elements that make up a substantial amount of many households' budgets, such as energy and food, are removed from the inflation calculation, today's core inflation is even higher than it was at the peak of inflation in October 2022: with figures of 5.2%, it is estimated more than 2.5 times higher than the desired value. This indicates that inflation is taking hold on a broader basis and goes beyond a one-off spike in energy prices that will subside eventually.

At the end of the day, inflation is always a monetary phenomenon. Now we are getting the bill for the ECB leaving key interest rates at record lows for a decade and expanding the money supply even further through continuous bond purchases over that period. It was foreseeable that this strategy could not last forever.

Even if interrupted supply chains cannot be repaired by monetary means and even if the gas supply is not improved by interest rate hikes, there is still a lot for the ECB to do. The high level of inflation also has classic monetary policy reasons. Waiting is definitely not the answer. The ECB's hesitancy has already gambled away a lot of trust among citizens and thus undermined confidence in the stability of the common currency.

With the slow and limited effects of the measures currently taken, the ECB should also look at the second lever at their disposal: the wind-down of its balance sheet. By using unconventional monetary policy operations in the context of quantitative easing, the ECB was able to counter recent deflationary pressures, not least during the coronavirus pandemic. With these effects vanishing and at the current inflation levels, it is high time to switch gears towards quantitative tightening. As a first step, the ECB should stop reinvesting upcoming maturities across

its public and private sector holdings purchased over the past years. As a second step, the size of the portfolio needs to be reduced in a more active fashion. Once again, those steps might come with undesirable side effects, in particular for sovereign issuers. If the ECB wants to regain the public's confidence, it has to endure such criticism.

Return to the primary objective of fighting inflation

Inflation expectations have already decoupled to some extent from the ECB's inflation target. This process must be stopped urgently, otherwise high inflation expectations will quickly become a self-fulfilling prophecy. Runaway inflation would both undermine Europe's economic substance as well as its social cohesion in our society. After all, inflation hits low-income households particularly hard. Accordingly, it is high time for the European Central Bank to concentrate fully on its core task, namely fighting inflation.

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