

The ECB and the inflation monsters

Central banking & social justice since 1999

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What is the issue today?

- Since mid-2021, reemergence of inflationary pressures in the EU
- In reaction, the ECB raised its interest rates for the first time since 10 years & announce QT
- Lagarde says that the ECB must do more to tackle the inflation monster.
- But is it the same « end of 20th century monster » against which the ECB was designed? Or is it a new beast in demand of new policy solutions?
- How does the ECB navigate the distributional dilemma between capital and labor in inflationary times?

ECB must do more to tackle inflation 'monster', says Christine Lagarde

Central bank not seeking to 'break economy' but price pressures remain sticky, warns president



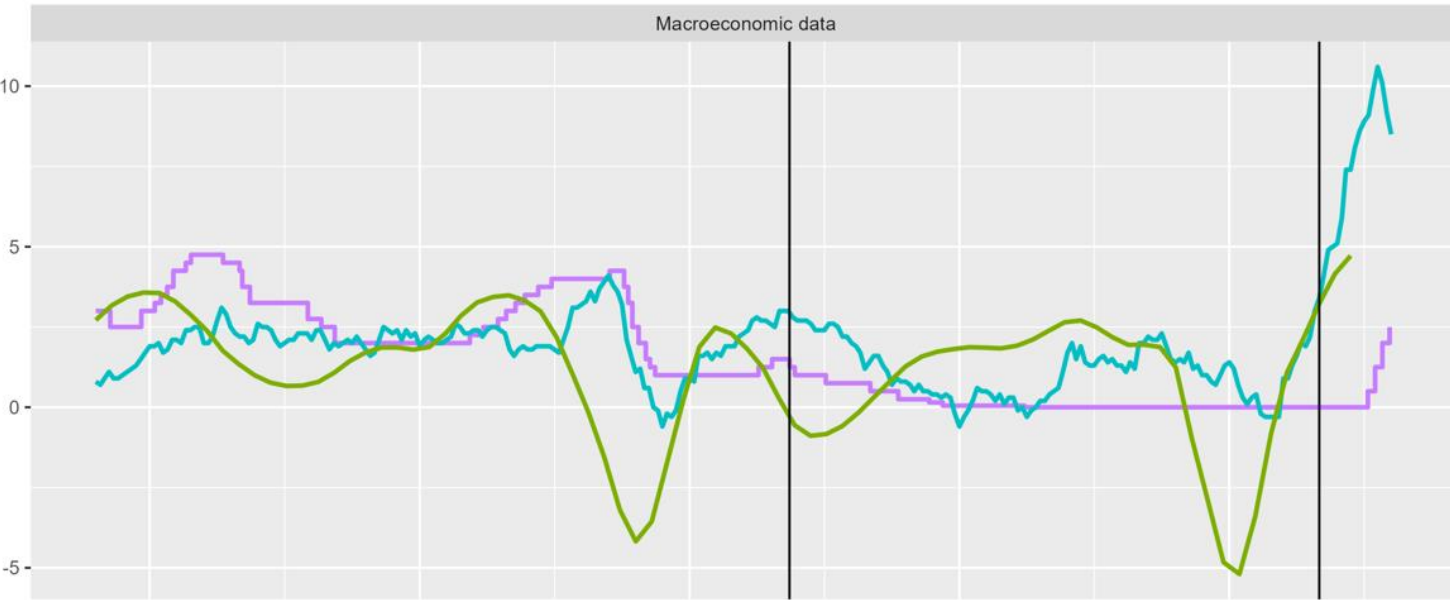
European Central Bank president Christine Lagarde: "We are making progress, but we still have work to do" © Fre /Getty Images



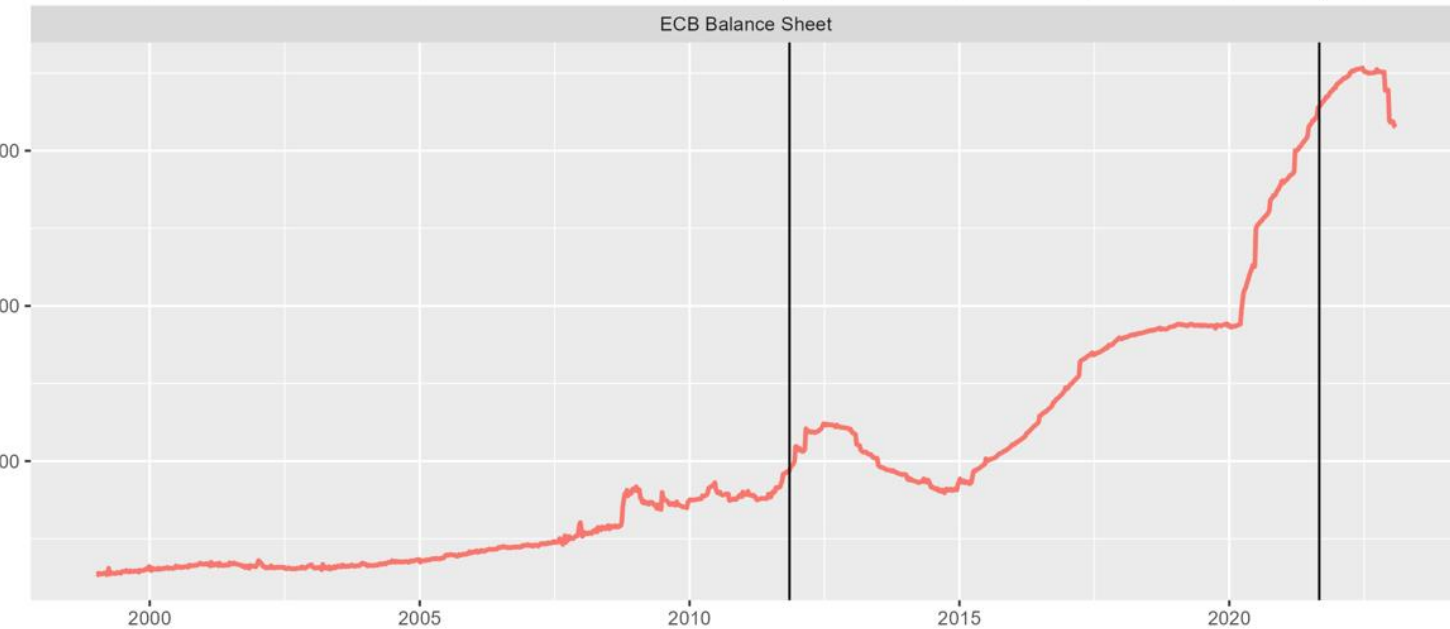
Price stability:
why is it
important
for you?

Teachers' booklet





1999-2011: the Central Bank Independence era
 2011-2021: the secular stagnation era
 2021- today; the polycrisis era

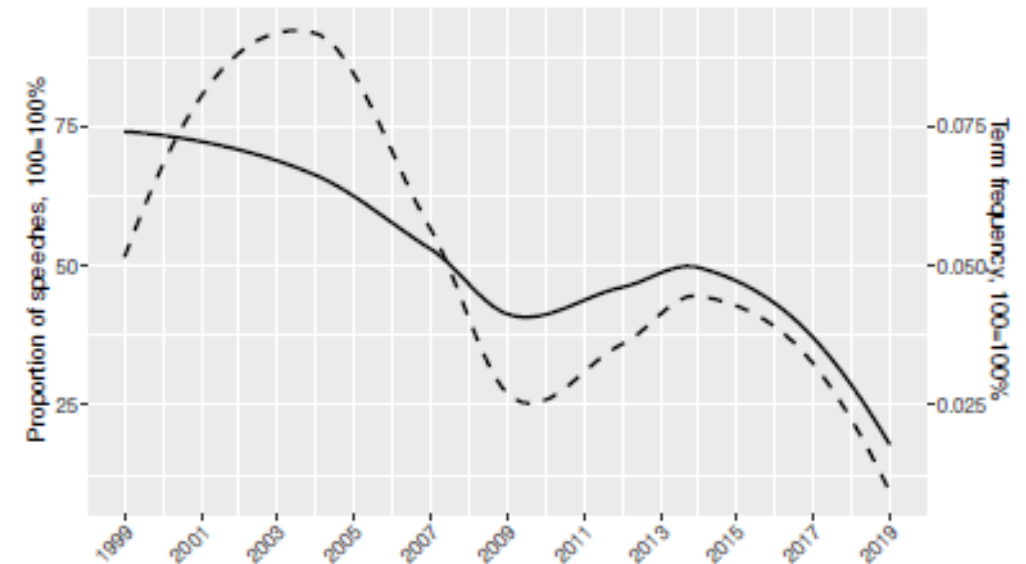


- Eurosystem Total Assets
- GDP Yearly Growth (Smoothed)
- HICP Inflation
- Main Refinancing Operation (Key Interest Rate)

The CBI era (1999-2011)

- The CBI template
 - One principle: the independent conservative central banker to reach an optimal societal outcome in a context of wage bargaining
 - One objective: price stability, one tool: interest rates through open market operations.
 - Division of labor: other players ensure growth potential & other EU objectives (inequalities, climate change...)
- The ECB policies
 - Building anti-inflationary credibility: the 2003-05 SGP feud & 2011 IR hike
 - Constant call for wages' flexibilisation (end of indexation schemes/minimal wage) & structural reforms

Figure 1: "Structural reforms" and "structural policies" in ECB speeches, 1999-2019



The secular stagnation era (2011-2021)

- The secular stagnation debate
 - Despite massive injections of liquidity, “missing inflation puzzle”
 - Search for structural factors, including weakened labor unions
 - After Troika’s austerity enforcer role, calls for wages’ & fiscal expansion since 2015
- New ECB monetary tools & priorities
 - The macroprudential debate
 - QE & inequalities
 - Greenflation
 - 2021 monetary policy review

Isabelle Schnabel May 2021

Conclusion

Let me conclude.

The challenges central banks are facing today are fundamentally different from the ones that were relevant when they gained broad political independence. Inflation is less of a concern to many people, in large part reflecting the achievements of central banks over time.

As a result, expectations towards central banks have changed. Many call for central banks to have a more active role in tackling wider societal challenges, climate change in particular. Such shifts in preferences coincide with a broad distrust of far-reaching and complex monetary policy measures taken by central banks in recent years to protect the economy from a perilous spiral of falling prices and wages.

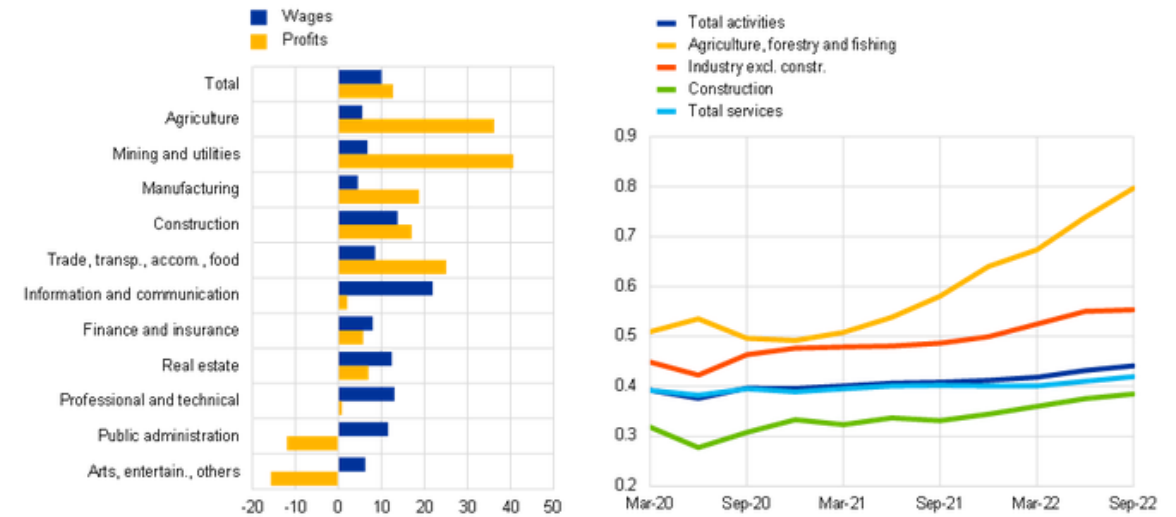
The polycrisis era (2021-)

- Drivers of inflation
 - Confinement & bottleneck in supplychains
 - Russian war strategies inflated energy prices
 - Some firms used surging prices to expand their profits
 - No signs of real wages' growth
- ECB dilemmas
 - No direct tool against drivers of inflation
 - But rise in interest rates, call for wage moderation
 - Main aims: FX channel, « anchoring » inflation expectations
 - Risk of economic recession & slowing down energy transition

Chart 6

Sectoral wage and profit developments

(left: change since 2019 Q4 to 2022 Q3; right: gross operating surplus over real value added, level)

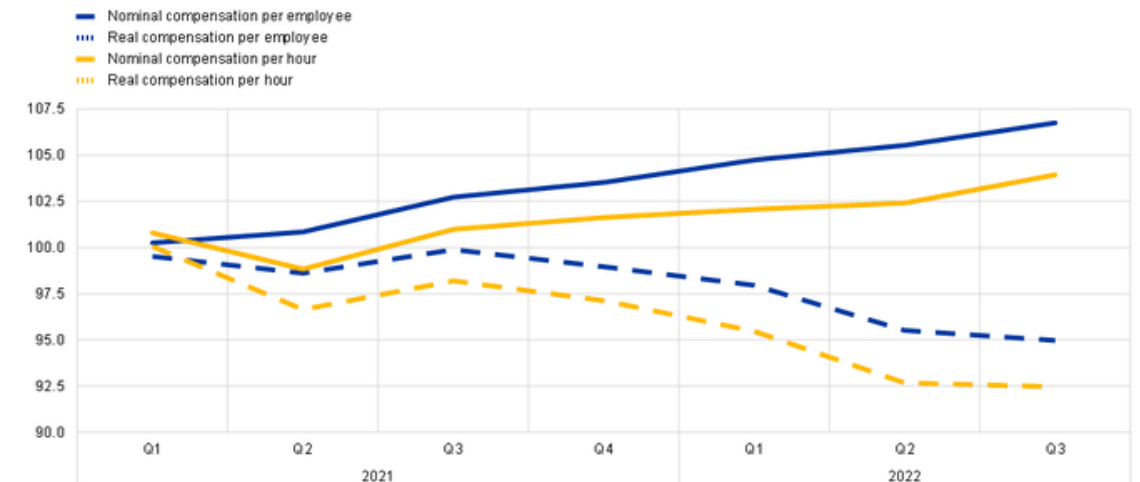


Sources: Eurostat, and ECB staff calculations.

Chart 11

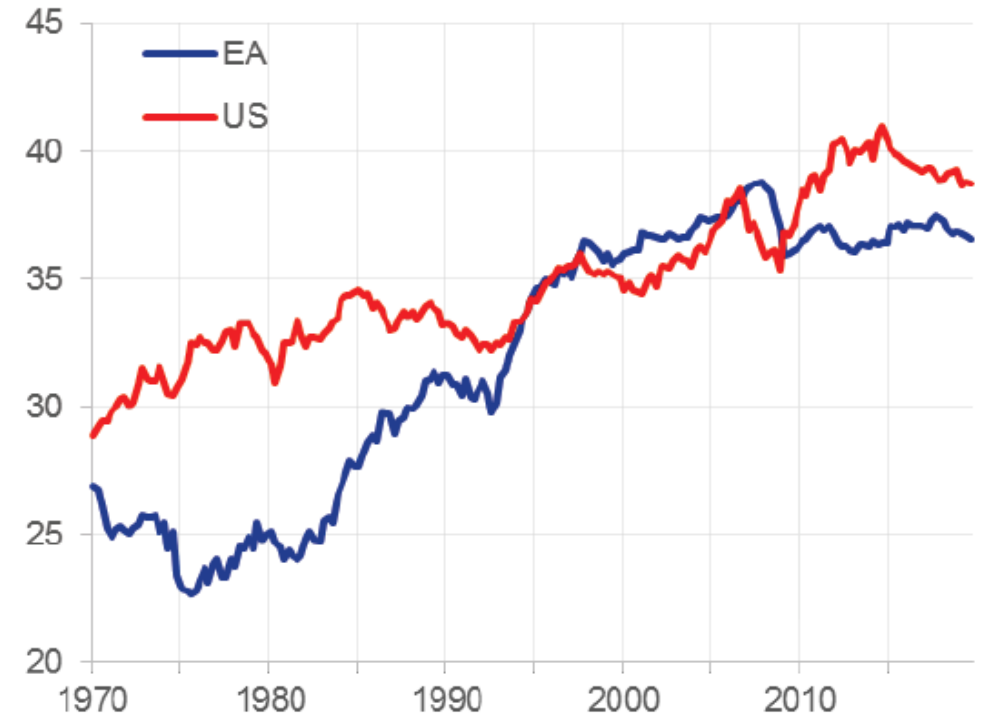
Nominal and real wage growth (consumer wages)

(index: Q4 2020 = 100)



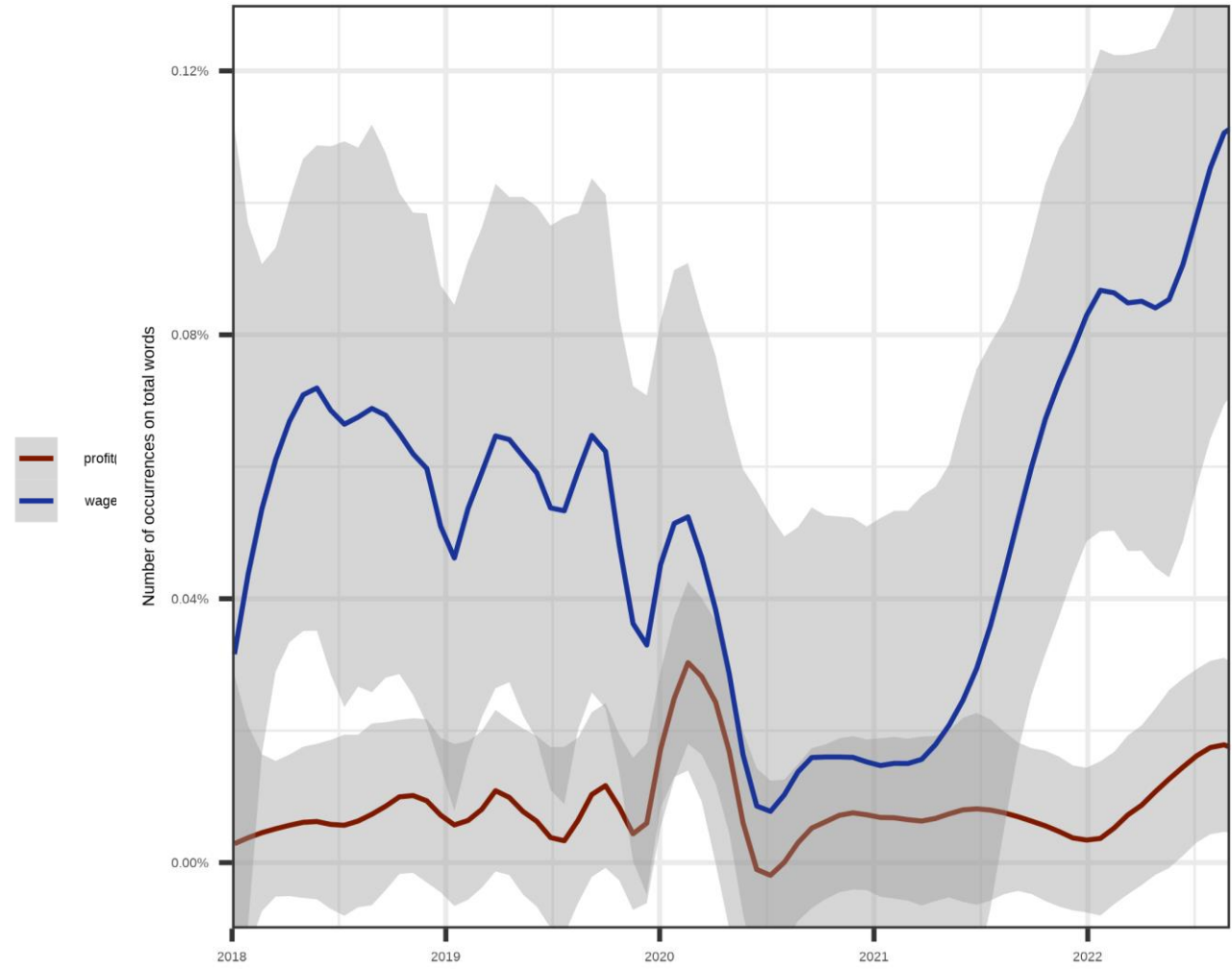
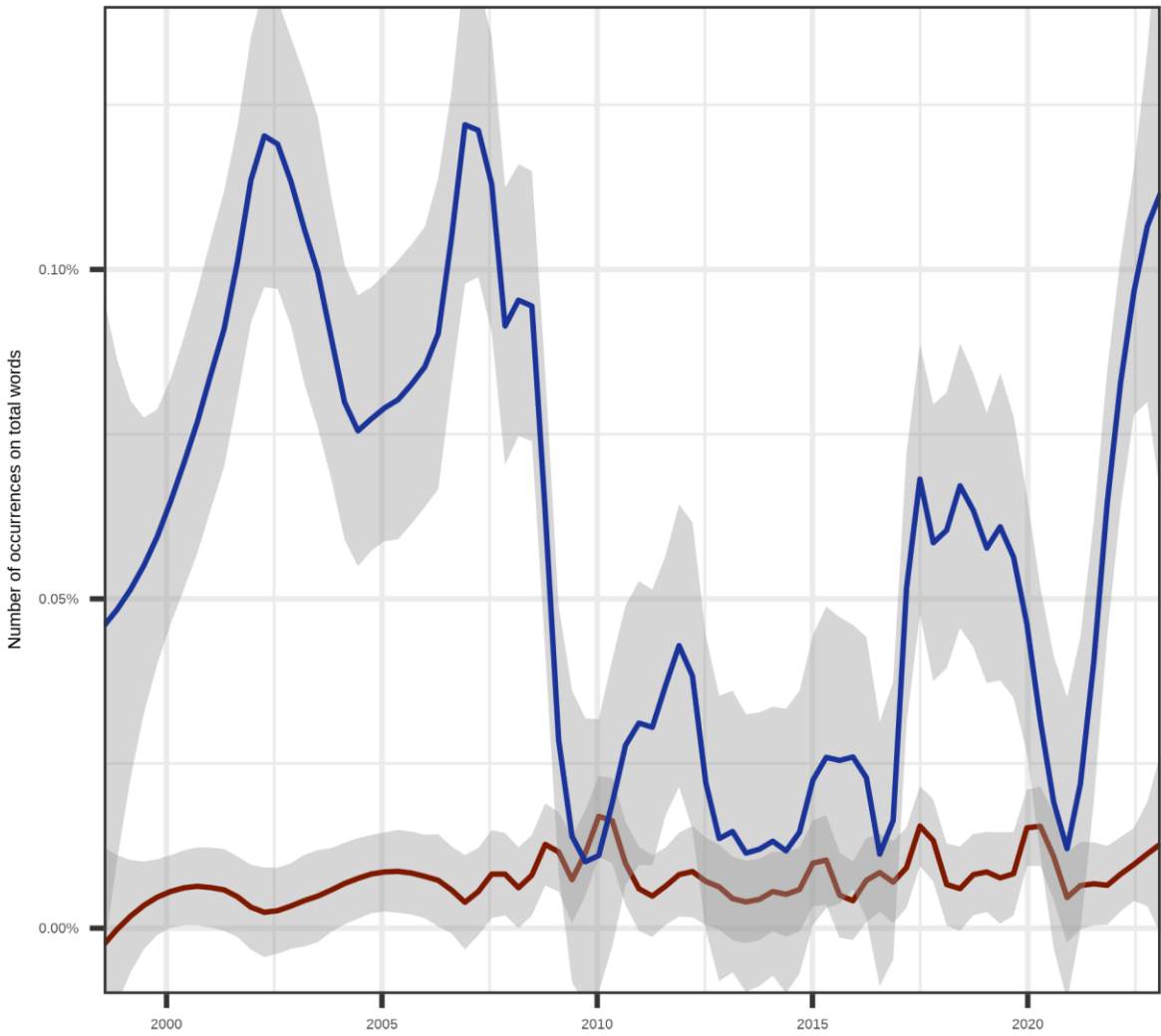
Profits and wages

- Schnabel February 2020: Firms' profit margins became structurally so high since 30 years that rising wages do not lead to inflation anymore
- Schnabel May 22: both higher profits and higher wages could lead to + inflation. Both are likely
- Lagarde March 16, 2023:
 - There should be burden sharing of inflation by capital and labor but it is a political issue
 - CB job is to avoid second round effects (ie rising **nominal** wages), whatever the burden sharing outcome is
- Maintaining CBI playbook at the risk of augmenting social damage? ECB could fight a wage-price spiral while real wages fall.



Sources: Eurostat, Area Wide Model database, OECD and ECB calculations.

Notes: The profit shares are calculated as the share of gross operating surplus over gross operating surplus plus compensation of employees. Gross operating surplus is corrected for the self-employed.



Solutions

- Shift the narrative, forget the CBI playbook
- Other solutions exist
 - Why not dual interest rates?
 - Risks of inflated responsibilities: EP must offer guidance on secondary objectives



Comment

The ECB needs political guidance on secondary objectives

While EU Treaties clearly stipulate that the ECB “shall support the general objectives of the European Union”, it is not appropriate to simply stand b

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