Belgian Financial Forum

Towards a ‘new normal’ for the monetary system?

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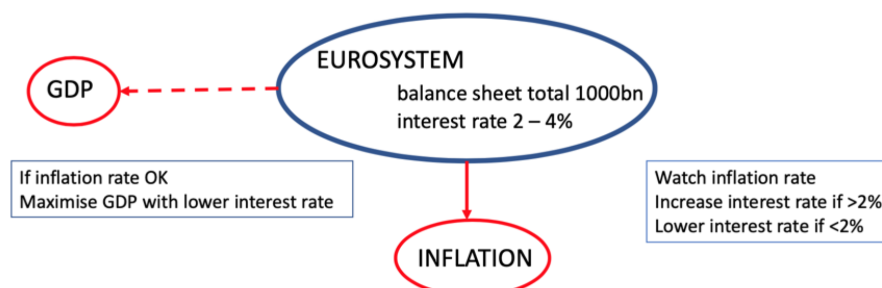
ABSTRACT

This article summarizes the key-messages of the presentations given by Freddy Van den Spiegel (Professor VUB), Gert Peersman (Professor University Ghent) and Bruno Colmant (Partner Roland Berger) during the BFF Webinar *‘Towards a “new normal” for the monetary system?’* on 20 May 2022.

Introduction - Freddy Van den Spiegel

Introducing the webinar organised by the Belgian Financial Forum, Professor Freddy Van den Spiegel recalls the monetary policy context in Europe when the euro was created. At that time, the total balance sheet of the ECB and the central banks of the participating member states combined, was about that of an average-sized bank, and the interest rate moved between 2 and 4 per cent.

Easy life for the ECB before the financial crisis

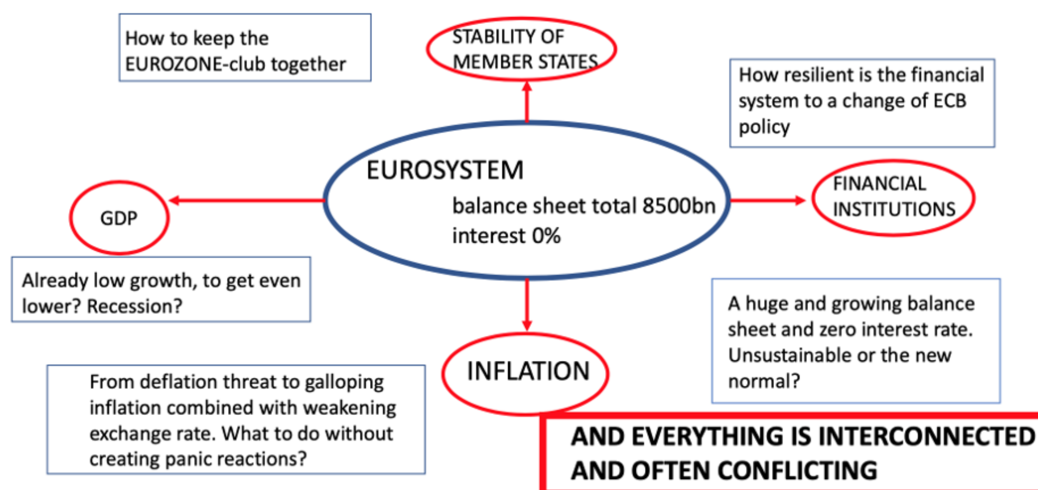


The goal for the ECB was to keep inflation under control, meaning “close to but not exceeding 2 per cent”. On condition that inflation was indeed kept under control, a secondary goal was that the ECB should stimulate GDP growth, by bringing the interest rate as low as possible without creating

inflation. Getting to an agreement at EU-level proved much more difficult than what could be expected from these stated goals. Indeed, not all member states shared the same strict monetary policy tradition of Germany, the operational model for the ECB.

Since 2008 however a string of disruptions has raged through global and European financial markets: first the banking crisis, then in 2010-2011 the sovereign crisis, after which came a euro crisis, then at the end of 2019 the Covid-19 pandemic and finally the Ukrainian crisis in 2022. Each time financial systems were impacted, as well as the economy and government budgets. Each time, the ECB felt compelled to react. To date, the ECB's balance sheet stands at €8.5 trillion, a number that makes it by far the most important bank in Europe. On top of that, the official interest rate has been negative for years on end. So, the ECB's reality has become much more challenging than at its onset at the end of the previous millennium. Then about a year ago supply chain disruptions reignited inflation. Today inflation stands at 8 per cent p.a., and so the question for the ECB is 'What to do?'

In principle, this is a simple decision: if inflation is higher than 2 per cent, the ECB must react. However, circumstances are unpropitious: low GDP growth, certainly with the war in Ukraine, so maybe the euro area faces stagflation. When the ECB raises interest rates, financing the high debt levels of some member states will become more difficult. Furthermore, if the ECB were to start reducing its balance sheet, lots of assets could potentially be released, destabilizing the financial system and markets. The simple rule of fighting inflation thus could create a recession, political problems in Europe and a new banking crisis. As the ECB is also the supervisor of the banks, monetary policy might conflict with the ECB's mission as a prudential supervisor. So, the current monetary context makes the question of 'What should the ECB do?' so particularly relevant.



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Is inflation here to stay? – Gert Peersman

According to Professor Peersman, there are sound arguments to put forward why the current inflation hiccup may last longer than what is expected in the mainstream narrative:

- With an economy at full capacity, inflation in the euro area has become domestic.
- Fiscal policy remains expansionary even if this is no longer warranted by economic policy needs.
- Sround effects i.e. wage/price spirals are likely, all the more so as international food commodity prices shoot up and their effect on inflation is much higher (v. double) than the effect of an equivalent oil price shock.

So, there are 3 questions:

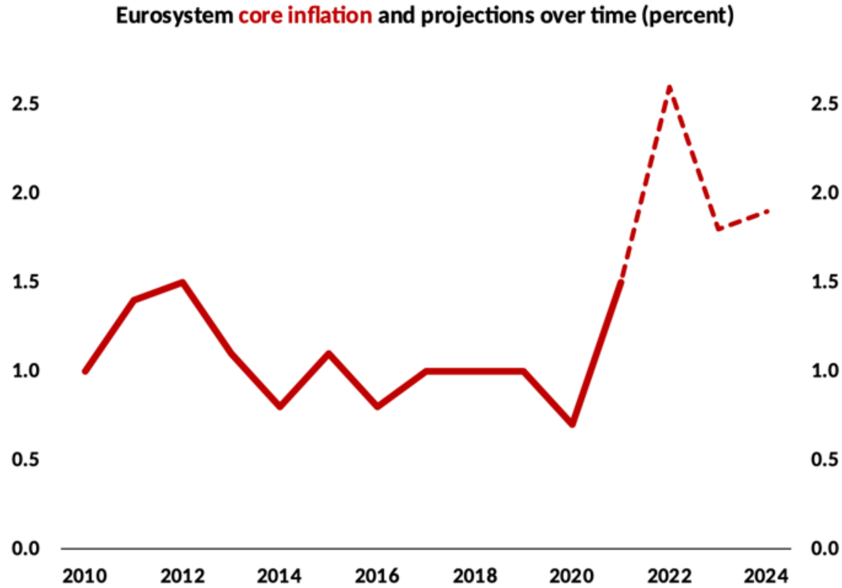
- Are we in a new era of high inflation?
- Should we expect high interest rates in the near future?
- What about interest rates at a longer horizon?

A first thing to note is that the ECB, in its 2021 Strategic Review, has redefined its operational target. Where since its inception the ECB has strived to keep inflation “below but close to 2 per cent”, the ECB has now redefined the target to “2 per cent exactly, over the medium term”. An inflation below 2 per cent is now considered just as bad as an inflation above 2 per cent. However, this should only be evaluated **at the medium term** as monetary policy changes typically lag one or two years before taking effect. This wider time frame permits some flexibility in establishing the source of the shock because, according to the optimal monetary policy arguments in recent literature, **only domestic demand shocks require monetary intervention**. This is the situation we see in the United States, where rising profit margins of firms, tight labour markets and rising wages indicate a demand shock requiring interest rate hikes.

When the source of inflation is imported however, and it is not passed on to domestic factors, this **imported inflation should be tolerated**, as monetary intervention will only hurt the economy. This seems to be the popular narrative for the euro area today. Higher prices of imported oil and imported food commodities should not be addressed by the central bank because it cannot solve the problem in the first place and because it destroys the economy reducing economic activity, growth and increasing unemployment.

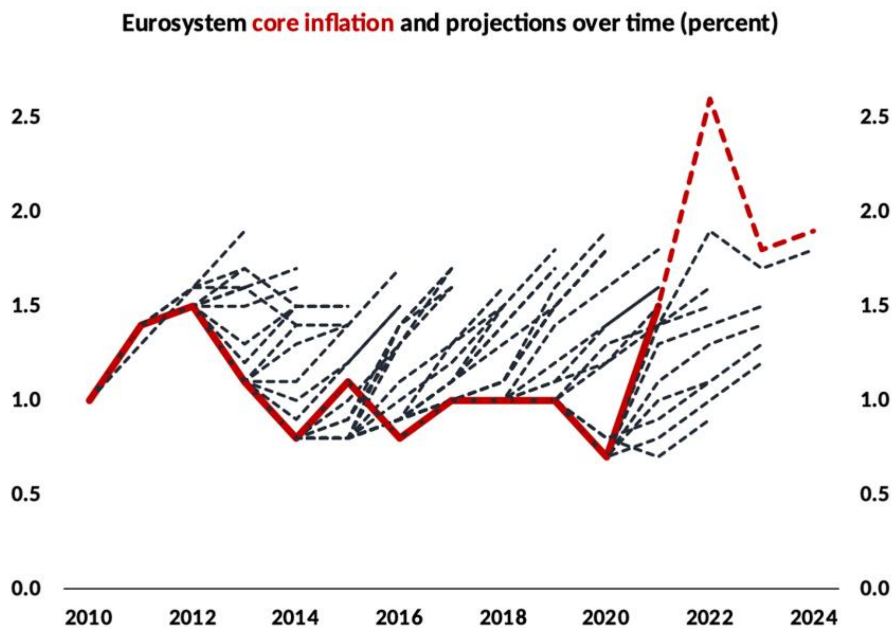
Now if we look (Exhibit 1) at the projections for core inflation, excluding the very volatile energy and raw food commodity prices, we can see that core inflation in the Eurosystem is projected to rise above 2.5 per cent in 2022, but then return below the target of 2 per cent in 2023 and 2024. So according to this projection, there seems to be no problem.

<u>Exhibit 1</u>: Core inflation is projected to decline again below 2 percent



The view of Exhibit 1 may however be overly optimistic. When looking (in Exhibit 2) at the full picture of the projections, we can see that for 10 years, between 2010 and 2020, the ECB has systematically been overestimating the increase of core inflation while since Covid-19, the ECB has been underestimating actual inflation. There clearly was something biased in the ECB's forecasts.

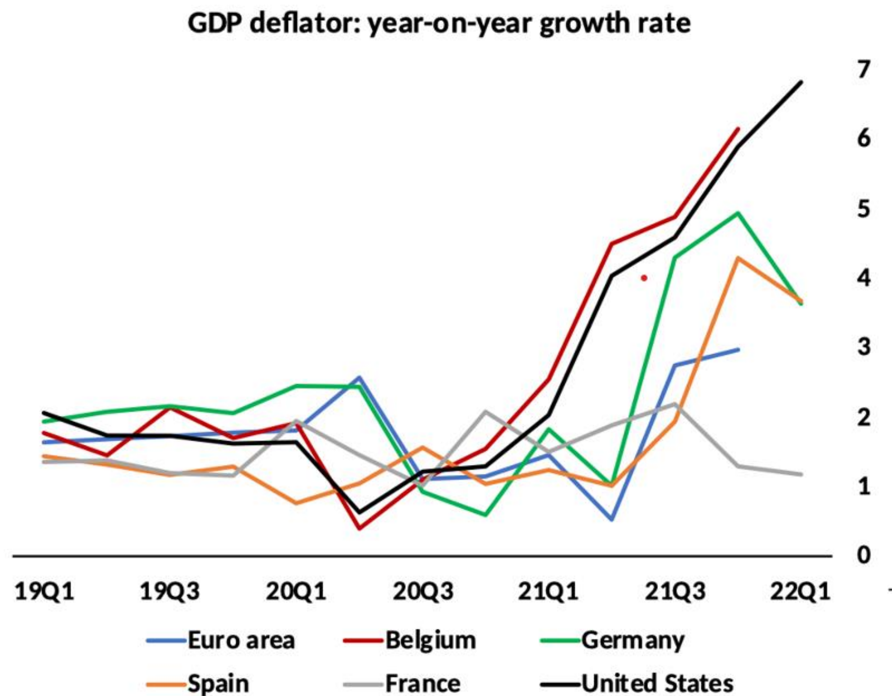
<u>Exhibit 2</u>:



According to Professor Peersman, there are three reasons why the forecasts missed the mark.

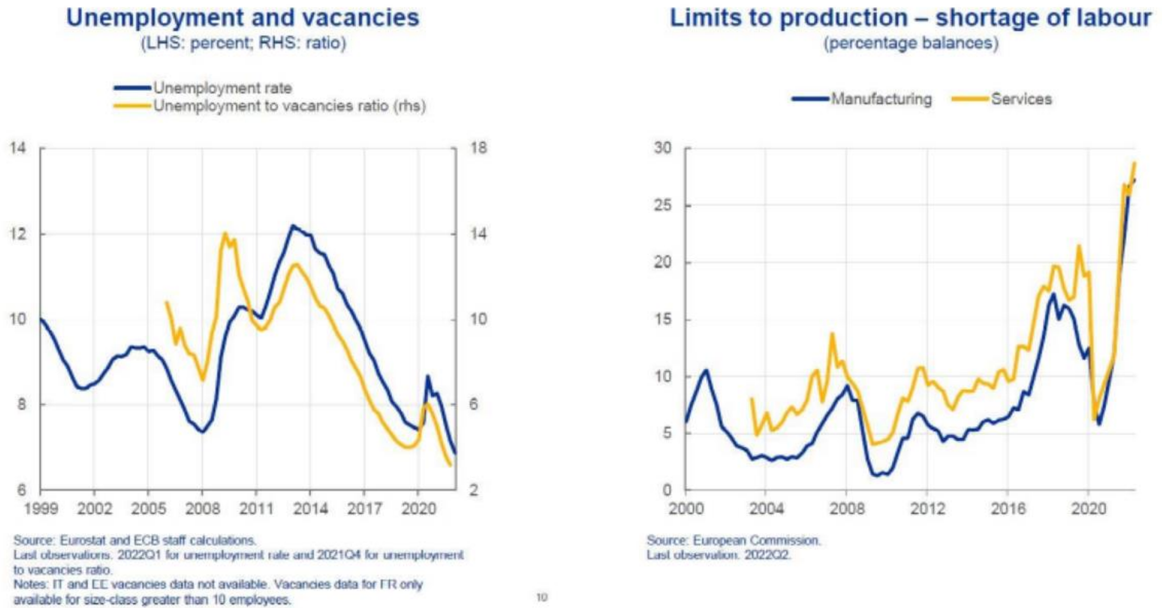
First and foremost, it could well be that **inflation in the euro area has become domestic**. To check this, one should look at the GDP deflator, an often-overlooked indicator that measures the price of domestic value added (see Exhibit 3).

Exhibit 3: GDP deflator measures the price of domestic value added



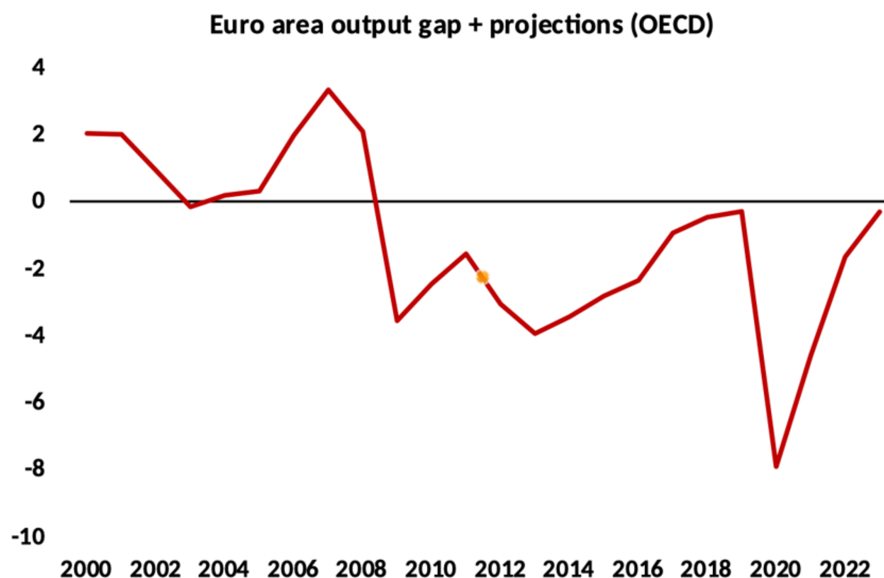
As we can see in Exhibit 3, the GDP deflator is moving upward. This is obvious for the US, but it also can be observed in the euro area. France seems to be the exception but that is only because energy prices are artificially kept low there. In Germany and Spain however, the GDP deflator has risen to above 3 per cent. The main reason why the GDP deflator is up, is the fact that firms have increased their profit margins, thus further affecting prices. In Belgium it's a combination of profit margins and wages that go up. In other countries it's not yet wages, but that's only a matter of time because labour markets are very tight. Unemployment is historically low in the euro area and if you look at shortages of labour, and production is at the highest level over the past 20 years. So there is a lot of domestic pressure (see Exhibit 4).

Exhibit 4: Tight labour markets and production level at an all-time high



The fact that the recovery from the Covid-19 period is really going strong can also be read in the output gap (Exhibit 5). The output gap is the difference between potential output and actual output of an economy. If the output gap is zero, it means that the economy is working at full capacity, as is currently the case. This is impressive, especially if we compare it to the situation after the recession of 2008 where it took about a decade to return to full capacity.

Exhibit 5: Output gap in the euro area

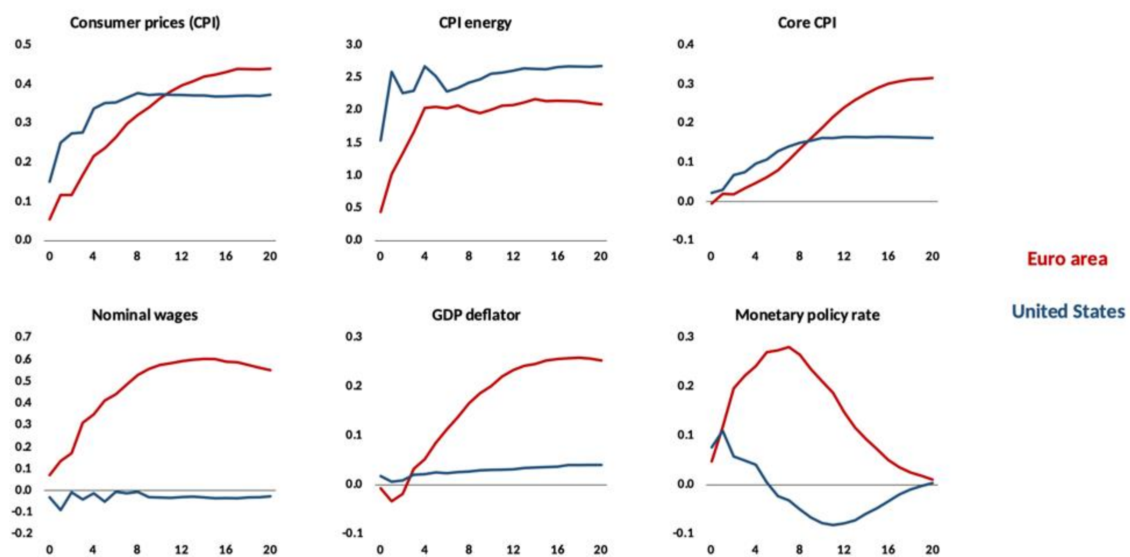


A second reason why inflation is no longer just a one-off imported price shock is that **the fiscal policy regime may have become expansionary**. The fiscal support to households and firms during Covid-19 has been very successful in avoiding the collapse of the economy. This fiscal support during Covid-19 is also the reason why the recovery is so strong today. However, the loss in purchasing power for households due to rising prices of energy and food commodities cannot be compensated by governments at a time when the economy is working at full capacity. Expansionary policy when at full capacity generates inflation. The extra money the government blows in an economy at full capacity just translates into higher prices.

The third reason why inflation has become a domestic problem are so called **second-round effects or wage/price spirals.** These second-round effects occur when employees want to be compensated for their loss in purchasing power, and thus increase the cost to firms which in turn raise prices for which employees want to be compensated. As is well know, this works almost automatically in Belgium through the wage indexation mechanism but in other countries tight labour markets also lead to higher wage demands.

Now research shows that the effect of price shocks has a much more lasting impact on the economy in Europe than they have in the US. Exhibit 6 shows the effect of a 10 per cent increase in global crude oil prices on the economy, in quarterly periods.

Exhibit 6: Dynamic effects of a 10% increase in global crude oil prices



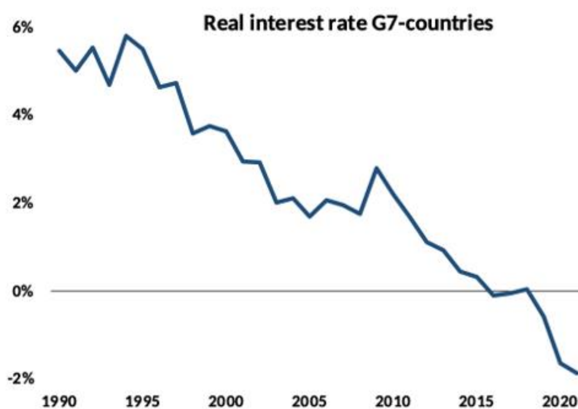
In the exhibit the effect of an oil price shock in the first quarterly period is shown over the next 5 years for the different price indicators in both the US and the euro area. For the United States, the

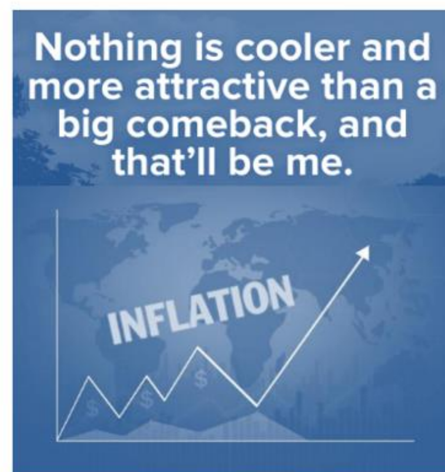
external oil price shock leads to an upward reaction in CPI and core inflation in about 2 years. Firms do indeed pass on their higher energy costs into their own prices, as can be seen in CPI and with some lag, in core inflation.

In the euro area however, consumer prices adapt more slowly and take about 5 years to adapt compared with 2 years in the US, and core inflation in the euro area shows a smoothed out but ultimately higher effect than in the US. The difference in reaction in nominal wages and the GDP deflator shows how wages follow prices and the presence of the wage / price spiral in the European economy. So these second-round effects will cause an external shock to creep into nominal wages ultimately resulting in higher interest rates over a substantial number of years after the shock.

Now energy prices are one thing, but it turns out that the effect of a shock in international food commodity prices on the economy is almost double the effect an equal shock in energy prices, and that, since Covid-19 international food commodity prices have increased by about 80 per cent. The impact of shock has started to show, and in Belgium first and foremost because of the automatic wage indexation. Monetary policy in the euro area will furthermore be complicated because there still remain large differences among countries in the euro area because countries with higher inflationary consequences from an external price shock require a more aggressive monetary policy than others.

Exhibit 7: Real interest rates





So, Professor Peersman concludes that inflation in the euro area no longer can be regarded as a purely external and temporary shock, but that inflation has effectively become a domestic problem. Because of the expansionary fiscal policy and of the existence of second-round effects in Europe, inflation might well last several years. Should however the war in Ukraine have a depressing effect on aggregate demand and cause a recession, these second-round effects might be stopped. This is not fictional, a similar effect happened in the recession of 2007-2008. There, oil prices moved

upwards, setting in motion the wage/price spirals but in the end the recession kicked in and ultimately made inflation vanish. Yet as things stand, even considering the risk of recession, the ECB should end its expansionary policy and gradually begin raising interest rates.

As far as interest rates are concerned, Prof. Peersman does not expect nominal interest rates to substantially exceed inflation, as real interest rates are on a downward trend and as the factors underlying interest rates like demography, low productivity growth, and income inequality have not yet turned. A change in the real interest rates will only come about when countries seriously start to address both government debt and balance their budgets and at the same time raise military expenditure and seriously tackle climate change.

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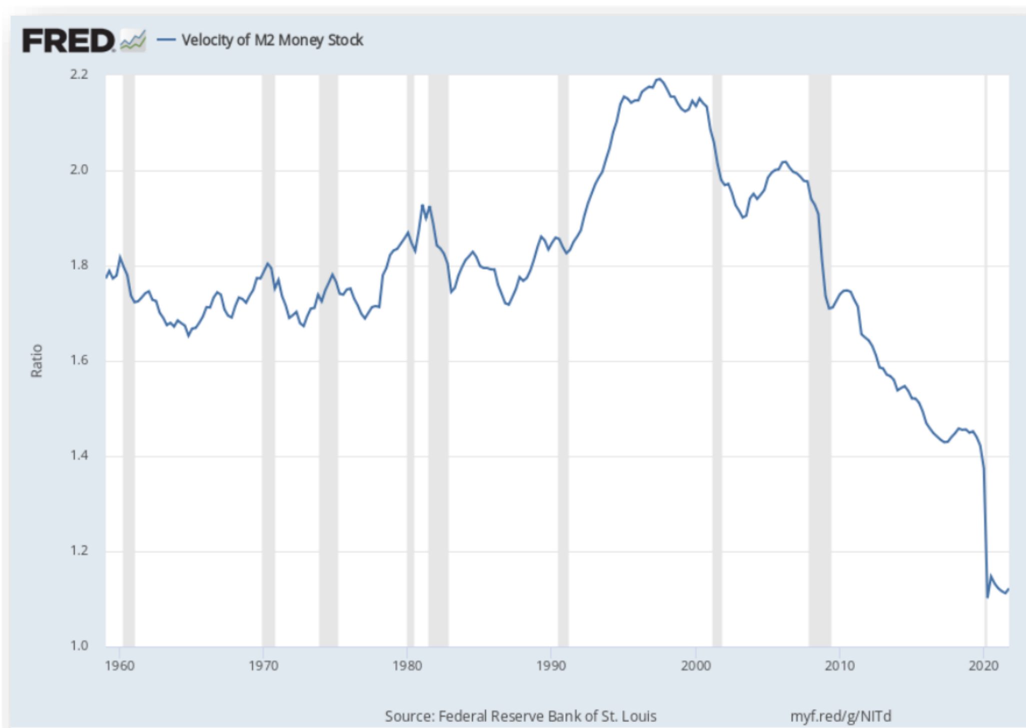
A new monetary order: some intuitions – Bruno Colmant

Mr. Colmant starts from an intuitive approach, rather than an academic one. In his view the Central Banks (CBs) have lost their independence over the last few years. The relations between Governments and CBs have created a new world that is far away from the market economy. In fact, we are witnessing a nationalization of the economy.

First, money is a public good, mainly created by private institutions. It is a stock and a flow. Since some years the money stock has increased, while the velocity of private money has decreased. That is why the increase of the money supply did not lead to an inflation beyond what we all know.

Figure 1: The velocity of M2 money stock



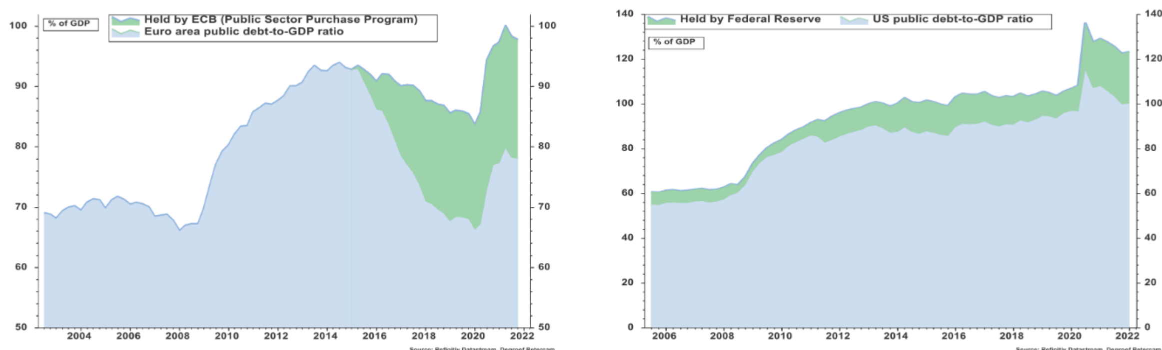
Secondly, the Euro has fundamentally changed since the crisis of 2008. The Euro was a postulated neo-liberal choice based on the mobility of capital and labour and defined by its own inflation rate. It was there to protect capital, asking labour to adjust to the concept of money. The philosophy has changed from the Euro as the protection of savers to the (ongoing) support to the economy, for instance the promotion of labour.

The ECB has failed in managing the 2% inflation limit. The assumption was a closed economy, not imported inflation. What we see is that the ECB is stuck between its own mandate and the realities that we are facing with food and energy prices significantly rising over the last two years. The design of the Euro is flawed in the face of present circumstances.

For Mr. Colmant inflation is here to stay. The disinflation, which started in 1979 with the decisions of Mr Volker to fight the US inflation, was helped by the globalization. But the same globalization is not as strong as we thought and will become more expensive, leading to an inflationary trend: the supply chain of food and energy, the war and the climate transition must be financed. But this inflation will not be fuelled by in the increased money supply since this is compensated by decreased velocity.

The role of the CBs has deeply changed: the CBs now control the full yield curve and have become market infrastructures. Governments and the ECB have exchanged their assets and liabilities. Governments become the assets of the CBs. Since 2 to 3 years the ECB is refinancing the welfare state. We cannot separate the actions of central banks from the promise to finance high social costs with public debt.

<u>Figure 2</u>: Debt to GDP Eurozone & US



Who will pay for social refinancing? The savers, according to Mr. Colmant. Public debt will continue to increase and that is the price of social peace, financed by the CBs. But what if the CBs should decide to not refinance the debt nor increase the money supply? In that case domestic banks will be doing the financing. Yes, there will be a little inflation (to lower the cost of this debt), taxation of capital, etcetera, but in the end, banks will be nationalized (or close to be nationalized) because they will be forced to refinance Governments. That means that savings will yield almost nothing. Governments can then ask the population directly to finance public debt. It could lead to a tacit nationalization of private buildings.

Finally, Mr. Colmant thinks that, to avoid social disruption, at some point in time, capital will have to be channelled directly, or indirectly through the balance sheet of the banks, towards the financing of the governments. At least if the CBs no longer increase their money supply or decrease the pace of creating money. But even if CBs continue discounting or buying public debt, there would still be inflation, hitting public savings. So, either way, savers will have to pay for the successive crises. And because of that, they are less rich than they think they are.