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"Slack, bottlenecks, and post-pandemic inflation" - Remarks by Governor Gabriel Makhlouf at the Dublin Economics Workshop

17 September 2021 **Speech**

Remarks by Governor Gabriel Makhlouf at the Dublin Economics Workshop

Good afternoon

I know the Dublin Economics Workshop (DEW) has been an important forum to discuss economic and public policy issues over many years, so it's a pleasure and a privilege to address you today.

I will start by giving an overview of the outlook for the Irish and the euro area economies. I will then provide some historical context to the current inflationary dynamics we are seeing as we emerge from the pandemic. I will briefly outline some key elements of the outcome of the ECB's strategy review, in particular focusing on our revised inflation target and what the current dynamics might mean for monetary policy. Finally, I want to discuss the interaction between monetary and fiscal policy in a post-pandemic world.[1]

The economic outlook for Ireland and the euro area

The economy today is at a curious juncture.

As with many aspects of our lives, COVID-19 continues to have a profound impact on the economy. We see it in the labour market, in government finances and of course in inflation, the topic of today's panel.

We also see light at the end of the tunnel although there remains considerable uncertainty about the trajectory of the pandemic and its knock-on effects on the economy.

Here at home, although the vaccination programme has continued at pace, we saw the epidemiological situation worsen throughout August as public health restrictions were unwound. Cases are, however, expected to peak this month.

After contracting in the first quarter of the year, domestic economic activity is continuing to increase at pace. The rebound in the second quarter, with modified domestic demand increasing by 8.4 per cent on a quarterly basis, has been followed by further positive news in higher frequency business and consumer confidence indicators, labour market developments, and indicators of consumer spending. All told, the outlook for the Irish economy for the rest of the year is increasingly positive.[2]

But the economic experience of the pandemic and the road beyond is not uniform across all sectors.

Some of those less affected are reaching capacity constraints, with a risk of sector-specific wage pressures. At the same time, some sectors have seen a surge in labour demand partly driven by the pandemic, in areas such as logistics and sanitation. And now, as more face-to-face service sectors open up, vacancies in these areas are rising.[3] Yet about a quarter of the labour force is still on some form of State support.[4]

Support through the Pandemic Unemployment Payment and Wage Subsidy schemes insulated household incomes from the shock but it has also led to difficulties in assessing the true state of the labour market.However, quantitative and qualitative indicators suggest that employment rates are recovering quicker than previous recessions, where firm bankruptcies and insolvencies were typically more evident.

Costs are increasing, particularly for indigenous businesses in manufacturing and services, while construction costs are increasing and we are seeing supply-chain issues and energy prices (largely due to base effects) in particular leading to price pressures.

So we are seeing both slack and bottlenecks.[5]

This is not just an Irish phenomenon.

Growth across the euro area has improved strongly. Confidence indicators across the Eurozone are at their highest level in more than two decades, reflecting surging optimism among firms and consumers, and boosting demand.[6]

Inflation was about 3 percent in August for the euro area – as in Ireland – and we expect similar levels of inflation in the coming months.

The latest ECB staff projections show a spike in headline inflation this year resulting largely from temporary factors, such as the rebound in the energy inflation rate and the reversal of the German VAT rate cut.[7]

Increases in input costs related to supply disruptions and one-off re-opening effects on services prices have also added to the upward pressure.[8]

These temporary effects are expected to dissipate in 2022 and inflation is likely to weaken again to levels below 2 per cent over the medium-term.[9]

But there is considerable uncertainty about the persistence of price pressures and we need to interpret this data and the outputs of our models with caution.

The pandemic is bringing about structural changes in our economy, which may only become more evident over time. At the same time, it has highlighted the importance of the interactions between monetary and fiscal policy for the continued economic recovery and in promoting price stability.

But before discussing some of these issues, I would like to give you some context to better understand the inflationary dynamics we are seeing at this curious juncture and how our new monetary policy strategy will guide us in our response.

Some historical context to today's price pressures

Over the past decade, we have seen euro area headline inflation average at about 1.2 percent, far below the ECB inflation target.

Why is this?

Long run trends like an ageing population have weakened future expected demand. Waning productivity growth has dis-incentivised investment. We have seen a rise in mark-ups, and a surge in risk aversion in the wake of the global financial crisis. All these factors have contributed to a protracted global decline in the natural rate of interest.[10]

The natural rate is the rate of interest that balances the economy and that is consistent with output at potential and inflation at its target. While the rate is not directly observable, it is widely estimated to have declined, or even turned negative in some cases, across most major economies in recent decades.[11]

Similarly, downward pressure on inflation has come from economies becoming more interconnected globally and more digital.[12]

Overall, while monetary policy cannot control all these factors, it must respond to them.

This sustained period of low inflation required significant monetary easing on the part of the ECB and has led to the implementation of a range of extraordinary monetary policy measures.

As part of those measures, we at the Governing Council reduced the deposit facility rate into negative territory.[13] This is not unique to the euro area. Central banks across the world have set record low interest rates since the global financial crisis.[14]

A decline in the natural rate of interest is challenging for central banks as our ability to use interest rate policy – our preferred monetary policy instrument – to stabilise the economy is constrained. Instead, central banks have utilised unconventional or non-standard instruments to ease policy and boost inflation, instruments that have now become part of our toolkit, albeit those unusual tools that ideally you would only look for occasionally.[15]

The ECB Strategy Review

These longer run trends were important features in the ECB's review of its monetary policy strategy.[16]

Given the length of time since the last strategy review in 2003, there was a need for a thorough and encompassing review of all areas of our monetary policy. At the launch of the review, ECB President Christine Lagarde promised that "we will leave no stone unturned". I believe we kept that promise although there remains a number of areas to explore further.[17]

As I'm sure this audience knows, the Governing Council concluded the Review in July. There are five outcomes that I would highlight:

1. a new symmetric inflation target of 2 percent over the medium-term;
2. a decision to incorporate owner-occupied housing (OOH) into our preferred measure of inflation;
3. an action plan to incorporate climate change into our monetary policy framework;
4. more structured communication with the public; and
5. more regular reviews of our monetary policy strategy, with the next one expected to take place in 2025.

Given the theme of this panel, I will focus on the role of our new inflation target.

Since the formation of the ECB, we have adopted an inflation target to achieve the mandate of price stability (the mandate given to us by the EU Treaty).

In 2003, after the previous strategy review, the ECB's target was for an inflation rate of "below, but close to, 2 percent".

However, this objective was often accused of being both asymmetric and ambiguous.

Asymmetric due to the wording of "below" 2 percent, which created a perception that the Governing Council would react more strongly to deviations above this level than below, and ambiguous as "close" to 2 percent did not give a precise point target.

Despite former President Draghi's attempts to clarify the ECB's reaction function, as the euro area was hit by a series of deflationary shocks in recent years, the formulation of the price stability objective may have contributed to inflation expectations de-anchoring in the euro area, particularly in the proximity of the effective lower bound.[18]

In this context, the Governing Council decided to amend our price stability objective as part of the Strategy Review.

We will now aim for an inflation rate of 2 percent over the medium-term.

This target is symmetric, in that the Governing Council will treat deviations above and below 2 percent as equally undesirable.

It also provides clarity and consistency.

Post-pandemic inflation and our monetary policy response

So returning to the inflationary pressures we are seeing today.

In line with the ECB staff projections I referenced earlier and recognising the prevailing uncertainty, I expect the current pick-up in inflation to be transitory, and we have a lot of evidence to suggest that this is the case.

But, as my colleague Isabel Schnabel highlighted this week, "there are growing indications that the current supply disruptions and commodity shortages could be prolonged…. The longer the supply chain problems persist, the greater the likelihood that firms will pass through their cost increases into consumer prices."[19] So we need to be humble and recognise the uncertainty reflected in the slack and bottleneck conundrum and vigilant to the risks.

In the meantime, it will be important to maintain an accommodative monetary policy stance for some time to ensure the continued recovery from the COVID-19 pandemic remains solid.

Raising interest rates in response to a temporary rise in prices would be harmful as we are trying to nurse the economy back to health.

With the correct monetary and fiscal policies in place, a sufficiently strong demand-driven recovery should see inflation return to 2 percent over the medium-term, in line with our inflation target.

After a decade of too-low inflation, we should welcome a growing confidence and a faster-than-expected recovery to help inflation expectations re-align more closely with the ECB's objective.

The medium-term orientation of our strategy allows us to look through shocks that are expected to be transitory, and act once we see a persistent path for inflation that is consistent with our aim.

Our commitment to our new strategy is manifest by our decision to change forward guidance on interest rates in July.

Specifically, we stated we expect to keep interest rates at present or lower levels until the Governing Council *"sees inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two percent over the medium term."*[20]

We wanted to provide reassurance that rates would not be increased until there is robust evidence and a high degree of confidence that the inflation rate will reach two per cent on a sustained and durable manner, avoiding the risk of reacting to forecast errors or to short-lived forces generating inflation only on a temporary basis.

In addition, as part the review, the Governing Council recognised that while policy rates remain our primary tool for economic adjustment, we will continue using all monetary policy instruments, including new ones as necessary, and in a persistent manner, in line with meeting our inflation aim.[21]

The change in the ECB's monetary policy strategy will ensure that we can better deliver on our primary mandate of maintaining price stability, but we must always remain conscious of the other policy areas that impact on our objective.

Fiscal policy has a role to play in helping to drive aggregate demand, sustaining the recovery, and supporting the path to the ECB's inflation target and the normalisation of monetary policy.

The interaction between monetary and fiscal policy, and reforming the EU fiscal framework

When it comes to the interaction between monetary and fiscal policy, the EU's framework for Economic and Monetary Union (EMU). which was designed around thirty years ago, has shown its limits, in particular over the last decade.

The framework underestimated the role of fiscal policy to counter the cycle. The experience of the global financial crisis highlights how the framework did not provide sufficient incentive for governments to build fiscal buffers during good times that could have been used to counter the negative shock that the crisis imposed upon the euro area economy.[22] Subsequently – although fiscal consolidation was unavoidable in some countries including Ireland – the framework obliged other countries in the euro area that had sufficient fiscal headroom to undertake a tightening too soon.

For the most part, monetary policy was left to deal alone with the recession. That was a mistake.

This understatement of the importance of counter-cyclical fiscal policy – combined, at least in a first phase, with some hesitancy on the monetary side in implementing decisive unconventional tools – did not help to produce a smooth recovery from the recession.

Moreover the insufficient policy response was poor at dealing with the emergence of self-fulfilling bad equilibria, and most likely contributed to the subdued inflation that Europe has experienced over the last decade.

Since then, the consensus with respect to the interaction and interdependence of monetary and fiscal policy has shifted.[22]

An appropriate coordination between the two is now considered to be important at all times.

I do not see this as threatening central bank independence. Independence does not mean isolation.

Most importantly, it is now clear that combining monetary accommodation with fiscal expansion is especially powerful to stabilise the economy when policy rates cannot be lowered further.

At the effective lower bound, where monetary policy faces constraints, fiscal policy can have a greater impact thanks to the lower cost of financing debt.[24]

Combining monetary accommodation with countercyclical fiscal policy – while also avoiding fiscal dominance – may not only accelerate the recovery, but also affect long-run outcomes, improving trend growth, preventing damaging hysteresis effects and the risk that multiple equilibria emerge.[25]

When we look at the pandemic, the overall macroeconomic response deployed by European and euro area institutions and governments has certainly been more coherent and impactful than in the years after the global financial crisis, precisely because of better coordination between monetary and fiscal policy.

But this coordination has not been achieved as a result of the automatic operation of the existing framework. For the fiscal policy response to be adequate to the magnitude of the shock, it took the suspension of the Stability and Growth Pact.

Arguably, EMU's fragmented macroeconomic framework emphasises a point that I have made before: monetary policy needs friends.

The creation of a completely new instrument, the Next Generation EU, has contributed to restore confidence.

The incentives of monetary and fiscal authorities have so far been aligned in the response to the pandemic. This has contributed to counter the deflationary shock and keep the private sector economy at a level of activity which would have been much lower otherwise, with potentially disastrous consequences in terms of job losses.[26]

However, the current framework potentially allows for a suboptimal policy mix to re-emerge in the future.

Substantial reforms are therefore needed, to make sure that an appropriate coordination between fiscal and monetary policy is achieved systematically and not just episodically.

The current framework has also been criticised for its excessive complexity and its reliance on unobservable indicators and real-time data, often subject to subsequent revision:[27] improvements on this dimension could enhance its transparency and effectiveness.

Economies and financial systems never stand still, so it is good practice to evaluate all of our frameworks regularly to ensure they are fit for purpose. Rethinking the paradigm guiding the EMU fiscal framework should be an ongoing process.[28]

I also believe that the discussion should be inspired by thinking about the long term, about the challenges that the macro-economy will face not only over the next three years, but over the next three decades.

For instance, once we consider a longer time frame, the commitment to move toward net zero carbon emissions by 2050 will likely require a level of public investment, alongside private investment, that was not expected when the current EMU framework was developed. Having said that, the timescale to transform our economies is not very long: 2050 is closer to us than the fall of the Berlin Wall.

To be clear, I am not suggesting that a new framework should ignore public debt sustainability or the dangers of pro-cyclical policies: such considerations must remain central in any new system, as sustainable policy remains a necessary condition for improving our economic wellbeing.

The record high levels of public debt – not only in Europe but for most advanced economies[29] – makes it necessary now more than ever to have realistic and credible anchors that can help to maintain sustainable public finances over the long term.

But we should ask ourselves whether the parameters in use are still able to provide for that.

Existing indicators could be upgraded to better reflect country-specific factors that can influence debt sustainability and macroeconomic stability in individual Member States and for the euro area as a whole. They could moreover take into account not only the level of indebtedness, but also the composition and the efficiency of government spending and revenue collection, with a particular focus on the way they can catalyse private sector investment to address longer-term challenges such as climate change.

All these dimensions together ultimately determine whether, in the long run, public investment will enable the necessary economic transition to take place, so that future generations inherit a more resilient economy rather than a more fragile one.

Conclusion

To conclude, there are many challenges in front of us, and the ability of monetary policy to tackle some of them depends not only on the different tools at the central bank's disposal, but also on the actions of other policy areas beyond central bank control.

When it comes to the risk of inflation, however, our tools have been tested and proved effective in the past; in this respect, it's mostly a matter of commitment to employ such tools if needed.

I believe that, at the moment, fears of excessive euro area inflation are overstated and that the current price pressures reflect transitory factors that will fade out over time.[30]

However humility and vigilance are necessary so that we can react as necessary if conditions change. Our commitment to price stability remains as strong as ever, as does our ability to fight unsustainable euro area inflation.

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[1]I would like to thank Giuseppe Corbisiero and Neil Lawton for their contribution to my remarks.

[2]The Central Bank's forthcoming Quarterly Bulletin, containing updated forecasts, will be published on 6 October.

[3]See forthcoming Quarterly Bulletin.

[4]These supports include the Pandemic Unemployment Payment, those associated with the Live Register and the Employment Wage Subsidy Scheme.

[5]In Ireland we have seen a doubling in size of the 'Potential Additional Labour Force' (PALF). The PALF is the sum of the two groups: (i) 'persons seeking work but not immediately available'; and (ii) 'persons available for work but not seeking'.

[6]See I. Schnabel, 2021, Escaping low inflation?

[7]See ECB staff macroeconomic projections for the euro area, September 2021.

[8]See ECB staff macroeconomic projections for the euro area, September 2021.

[9]The most recent ECB inflation forecasts for the euro area, which were released last week, show inflation is expected to be 2.2 percent this year, before declining to 1.7 percent in 2022 and 1.5 percent in 2023.

[10]See Brand, Bielecki and Penalver, 2018, The natural rate of interest: estimates, drivers, and challenges to monetary policy. ECB Occassional Papers

[11]See Hong and Shell, "The Global Decline of the Natural Rate of Interest and Implications for Monetary Policy", *Economic Synopses*, No. 4, 2019.

[12]Globalisation and digitalisation influence the structure of goods, services and labour markets and have a direct effect on prices that – when interacting with other factors, including constraints on monetary policy – may affect inflation beyond the short term. See An overview of the ECB's monetary policy strategy.

[13]It now stands a record low of -50bps. The rate on the deposit facility acts as a floor for money market interest rates. In June 2014, the ECB was the first major central bank to lower one of its key interest rates into negative territory. As discussed by Isabel Schnabel, Member of the Executive Board of the ECB, the reason for negative rates was twofold: "to trigger a repricing of the expected future path of short-term interest rates by "breaking through" the zero lower bound and to encourage banks to provide more credit to the economy." See I. Schnabel, 2020, "Going negative: the ECB's experience" for a discussion.

[14]In the US and the UK, the Federal Reserve and the Bank of England cut rates to close to 0 percent, while in Denmark, Sweden, Switzerland and Japan, interest rates were cut into negative territory by the respective central banks in each country.

[15]For example, since 2008, quantitative easing (QE) has been employed by most major central banks, including the ECB, the Fed, the Bank of England, and the Bank of Japan.

[16]An overview of the ECB's monetary policy strategy

[17]In total, there were 13 workstreams as part of the review. Those workstreams included analysis on the measurement of inflation, our price stability objective, our monetary policy instruments, the role of financial stability, climate change, our communication with the public, the interaction between monetary and fiscal policy, and topics such as globalisation and digitalisation among others. See Strategy review key topics.

[18]In fact, in 2014, then ECB President Mario Draghi had to clarify that, "The Governing Council will be equally active in responding to medium-term developments in inflation that fall short of our objective as to those that exceed it."

[19]See I. Schnabel, 2021, New narratives on monetary policy – the spectre of inflation.

[20]See July 2021 Monetary Policy Decisions.

[21]See an overview of the ECB's monetary policy strategy.

[22]See European Fiscal Board, 2020, "Reforming the EU Fiscal Framework: Now is the Time".

[23]See e.g. Bassetto and Sargent, 2020, "Shotgun wedding: fiscal and monetary policy" for a survey of the literature on monetary-fiscal interactions. G. Corsetti, L. Dedola, M. Jarociński, B. Maćkowiak, and S. Schmidt, 2019, "Macroeconomic stabilization, monetary-fiscal interactions, and Europe's monetary union," review models of business cycle stabilisation and argue that, after a large recessionary shock, a joined effort of monetary and fiscal policy may be necessary to stabilize economic activity and inflation.

[24]Unless country-specific risk premia are large.

[25]See O. Blanchard and L. Summers, 1986, "Hysteresis and the European Unemployment Problem," S. Morris and H. Shin, 2000, "Rethinking multiple equilibria in macroeconomic modelling," and O. Blanchard and L. Summers, 2017, "Rethinking Stabilization Policy. Back to the Future."

[26]For details about the impact of government interventions on the private sector during the Covid-19 crisis see e.g. C. Girón and M. Rodríguez-Vives, 2021, "The role of government for the non-financial corporate sector during the COVID-19 crisis", ECB Economic Bulletin, Issue 5/2021.

[27]See J. Bedogni and K. Meaney, 2017, "EU Fiscal Rules and International Expenditure Rules." IGEES Staff Paper 2017.

[28]A number of interesting proposals have been made, including A. Bénassy-Quéré et al., 2018, "Reconciling risk sharing with market discipline: A constructive approach to euro area reform", V. Constâncio, 2020, "The return of fiscal policy and the euro area fiscal rule", and the more recent P. Martin, J. Pisani-Ferry and X. Ragot, 2021, "Reforming the European Fiscal Framework", and O. Blanchard, A. Leandro and J. Zettelmeyer, 2021, "Redesigning EU fiscal rules: from rules to standards".

[29]While public debt reached a record high of 96.5 per cent of GDP in the euro area at the end of 2020, the figure is well below levels seen in most of the other advanced economies, which on average reached a 120.1 per cent debt-to-GDP last year: see the IMF Fiscal Monitor April 2021.

[30]See I. Schnabel, 2021, Escaping low inflation?

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