# Joachim Nagel: Too low, too high - what's next for inflation?

Speech (virtual) by Dr Joachim Nagel, President of the Deutsche Bundesbank, at the J oint Spring Conference 2024 "Structural Changes and the Implications for Inflation", Eltville am Rhein, 7 May 2024.

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## 1 Introduction

Ladies and gentlemen,

I am delighted to welcome you to the conference today. I truly regret that I cannot be there in person to speak to you at the conference dinner that awaits you shortly.

Six weeks ago, Harvard economist Stefanie Stantcheva kicked off a conference by asking: Why do we dislike inflation?[1] She presented new survey-based evidence, corroborating previous findings that inflation attracts a high degree of attention among the public.  Its largest impact on the lives of the survey participants has been the increased cost of living in general. In second and third place, they answered that it is harder to afford food and gas.

I see Stantcheva's findings as additional motivation to continue working on a timely return of inflation in the euro area to our target level of 2% in the medium term. Yet, once the high inflation phase in the euro area is over, will we see weak inflation rates like we did before the pandemic? Or will structural forces put upward pressure on inflation rates in the years to come?

## 2 Starting point: pre-pandemic inflation

Inflation in the euro area was persistently too low in the period between 2013 and 2019. As measured by the HICP, the average inflation rate in this period amounted to 1%, which was clearly below the Eurosystem's aim. At the beginning of this too-low inflation period, some economists called this phenomenon a missing inflation" puzzle.[2] According to empirical research, this weakness resulted from a combination of cyclical and structural factors.[3] With respect to the cyclical factors, the financial crisis and, later on, the sovereign debt crisis caused recessions in the euro area in 2009 and 2012. However, structural factors may well have played a role, too: globalisation, digitalisation and demographic change.

Globalisation is – or maybe was – accompanied by higher global value chain participation and increasing financial openness. It might therefore have lowered inflation by reducing costs and diminishing the bargaining power of employees as well as firms' market power.

In the context of digitalisation, we have seen prices of digital consumer goods fall significantly. Digitalisation may sometimes also contribute to price transparency, which, by diminishing firms' local market power, could affect inflation indirectly.

The effect of demographic trends on inflation is less obvious. If the dominant effect were greater willingness to save for retirement, one channel would go through a decline in the natural rate of interest, implying that monetary policy could turn out tighter than intended – leading to lower inflation.

## 3 Possible post-pandemic inflation factors

The period of missing inflation came to an abrupt end in 2021, when the pandemic began to lose its grip. The surge in energy prices, supply chain distortions induced by containment measures as well as supply bottlenecks due to strong consumer goods demand all fuelled the return of inflation, in a way never seen since the start of the monetary union. The Russian attack on Ukraine amplified this return, especially owing to a further drastic rise in energy prices.

Central banks around the globe had to act decisively to curb high inflation. In the euro area, the ECB Governing Council increased interest rates ten times in a row, a pace of tightening unseen since the start of the euro. Since late 2022, the wave of inflation has been receding. Energy price dynamics even reached negative territory, supply-chain strain eased, and core inflation has started to decline. In the euro area, inflation is expected to return to values of around 2%. This is evidence of the success of the Eurosystem's tight monetary policy. But looking ahead, do we need to prepare for a return to the world of too low inflation we were used to in the last decade? I am not convinced – for at least three reasons.

First, take geopolitical uncertainties. We have just learned the hard way that cost-efficient global production chains and trade patterns may come to a sudden halt. Of course, it makes no sense to fully abandon the advantages of international division of labour altogether. However, to improve resilience, some form of de-risking seems reasonable, especially in the case of strategically important goods.[4] We should keep in mind that greater security for supply chains is likely to come with some additional price pressures.

Second, take demographics. Previously, many focused on the effect of demographics on propensity to save. Now, a shortage of labour is becoming more and more visible in developed countries. For example, in Germany, there are currently 1.2 vacancies per unemployed person on average, despite the weak economic setting. Before 2015, this number mostly fluctuated between 0.2 and 0.5. Moreover, according to our projections, from 2026 onwards, the potential labour force will decrease on average by 80 thousand persons every year. This development may lead to persistently higher wage growth, and, as a by-product, stronger domestic inflation. With geopolitical uncertainties, production off-shoring may no longer be as easy a solution as before.

Third, take the need to decarbonise our economies. Climate change has already caused significant damage – record temperatures and the images of floods and droughts are in all our minds. Carbon prices should reflect the true costs of carbon emissions so as to incentivise a rapid and complete decarbonisation process. Decarbonisation implies a far-reaching restructuring of the economy. Over a transition period, it may contribute to inflationary pressures.

However, there is conflicting evidence about the economic effects of decarbonisation – not least due to dynamic and general equilibrium effects of carbon prices and other climate policies that may counteract the initial inflationary impact. For example, on the one hand, according to the IMF, decarbonising the generation of electricity will lead to additional 0.1 to 0.4 PP of inflation per year globally – if countries do not further delay a credible transition.[5] On the other hand, colleagues at the Bundesbank's Research Centre have shown that shocks to transition risk may have dampened price increases so far.[6]

All in all, we do not know how strongly these structural factors will affect prices and whether or not the pre-pandemic price dynamics will show up again on the horizon. I am thus very glad that this conference is taking a close look at structural changes and the implications on inflation.

## 4 Possible implications for monetary policy

But what implications could such developments have for monetary policy? One thing is clear: Our mandate is price stability! Perhaps the interplay of structural drivers of inflation that I have just outlined will lead to some sort of sweet spot for monetary policy – with inflation at about 2% and the level of interest rates not too high but at a safe distance from the effective lower bound. But if there is more price pressure in the medium-term, we must take action against it.

At first glance, it may seem as if tighter monetary policy and higher interest rates would complicate coping with future challenges, especially with decarbonisation. However, closer inspection reveals that price stability is a prerequisite for an efficient adjustment process. Carbon prices, for example, provide crucial price signals to emitters of carbon dioxide. A lack of price stability would distort these signals, reducing the efficiency of climate policies.

What is more: Actual inflation has a major impact on inflation expectations. This is well documented in the literature.[7] In the Bundesbank's surveys among households and firms we observe a strong relationship as well.[8] Against this background, even a temporary accommodation of higher inflation rates bears a risk of inflation expectations becoming de-anchored. We should not allow this risk to materialise.

## 5 Concluding remarks

Ladies and gentlemen,

let me conclude.

A range of potential factors could lead to higher inflationary pressure in the future. As yet, there is no fully reliable empirical evidence on their effects. We need much more research on this topic. In my view, this conference does an excellent job in that respect, covering a wide range of issues related to inflation dynamics and monetary policy.

Among other issues, the programme includes papers on inflation expectations, the Phillips curve, digitalisation, industrial structure, and the natural interest rate. This research will help to improve our understanding of inflation dynamics and support our conduct of monetary policy.

I hope you have already enjoyed some insightful and interesting discussions today. And I wish you every success for tomorrow as well.

Thank you for your attention and enjoy your dinner!

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[1] Stantcheva, S., Why Do We Dislike Inflation?, Brookings Paper on Economic Activity, Spring 2024.

[2] Constâncio, V., Understanding Inflation Dynamics and Monetary Policy, panel remarks delivered at the Jackson Hole Economic Policy Symposium, Federal Reserve Bank of Kansas City, 29 August 2015.

[3] Koester, G., Lis, E., Nickel, C., Osbat, C. and F. Smets (2021), Understanding low inflation in the euro area from 2013 to 2019: cyclical and structural drivers, ECB Occasional Paper No. 280.

[4] Deutsche Bundesbank, Economic developments in emerging market economies: old problems and new challenges, Monthly Report, July 2023; see p. 62 for more on deglobalisation trends.

[5] IMF, World Economic Outlook: Countering the Cost-of-Living Crisis, October 2022, p. 71.

[6] Meinerding, C., Schüler, Y. S. and P. Zhang (2023), Shocks to transition risk, Bundesbank Discussion Paper No 04/2023.

[7] Binder, C. and R. Kamdar (2022), Expected and Realized Inflation in Historical Perspective, Journal of Economic Perspectives, Vol. 36, No. 3, p. 131-156.

[8] Huber, S. J., Minia, D. and T. Schmidt (2023), The pass-through from inflation perceptions to inflation expectations, Bundesbank Discussion Paper No 17/2023.