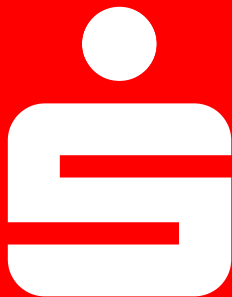
Finanzgruppe
Deutscher Sparkassen-
und Giroverband

STANDPUNKTE
DER CHEFVOLKSWIRTE



Monetary policy: Preventing entrenched Inflation!

5th April 2022

The ECB signalled in March 2022 that it intends to revise its monetary-policy stance. The Chief Economists of the Savings Banks Finance Group welcome this sign. The ultra-expansionary monetary-policy mode was appropriate to combat the economic fallout from the Covid-19 shock. Given the continuing recovery of the European economy it is no longer warranted but may do damage. The risks have risen that the current inflation wave will morph into a long-drawn-out inflation process – even though the economic recovery will be dampened by the Ukraine war. From this point of view, the Chief Economists of the Savings Banks Finance Group consider it of urgent importance that:

- The ECB should continue along the path vaguely mapped out in February and March and prepare the economy and financial markets for a tightening of monetary policy, outlining a tightening road map.

- Such a tightening path, following the PEPP unwind, could involve the APP bond purchase programme also being rapidly scaled back from the higher volumes already announced, with net asset purchases under the APP already being discontinued in the upcoming summer. Furthermore, if possible also still in 2022, the deposit facility rate should be raised to at least zero percent. Provided that no shifts occur in the outlook for economic growth and inflation, this normalisation process should be continued through 2023.

Authors:

Uwe Dürkop - Berliner Sparkasse
Jochen Intelmann - Haspa
Dr. Ulrich Kater – DekaBank
Dr. Moritz Kraemer - LBBW
Christian Lips - NORD/LB
Dr. Jürgen Michels – BayernLB
Dr. Reinhold Rickes - DSGV
Dr. Gertrud Traud - Helaba
Prof. Dr. Carsten Wesselmann - Kreissparkasse Köln

Coordination:

Dr. Holger Schulz
Holger.Schulz@dsgv.de

The war is a political and economic turning point

The war in Ukraine is one of the major political and economic disruptions in Europe. It releases great binding forces in supranational Western institutions such as NATO or the European Union, while it very largely separates the Russian economy from the Western economic world. Although the use of the most extensive economic sanctions requires careful consideration because of their impact on the international division of labor, they are a legitimate, effective and appropriate means of dealing with states that flout the rules of the international community in such a way as Russia is doing in its war of aggression against Ukraine. The resulting need for structural change, especially for the raw materials base of the European economies, is enormous and will demand extraordinary things from all sectors of the economy and politics.

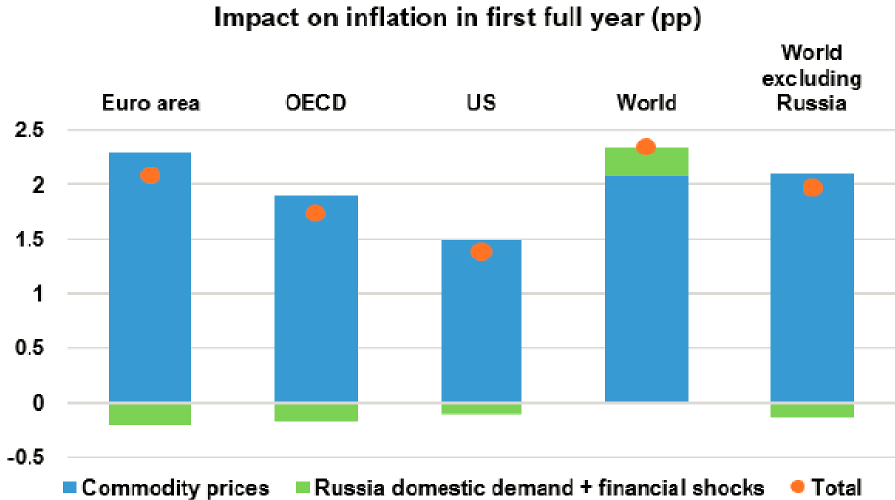
For monetary policy, this collapse in geopolitical and economic relations comes at a special time. A major economic crisis has just been successfully overcome with the Corona pandemic, but its aftermath is still evident in the form of high aggregate demand and continuing production bottlenecks. The danger of a major inflationary process building up, similar to the one in the 1970s, which does not stop during economic downturns, is increasing from month to month.

Risk of stagflation steadily increasing

The renewed serious impairment of international supply chains due to the shortfall in Russian supply continues to drive up inflation and at the same time is damaging to the economy. In this situation, however, it is not an alternative for the European Central Bank to support demand via an ultra-loose monetary policy to the same extent as it did in the recent pandemic. Instead, more and more attention must be paid to preventing a progressive inflation process, the economic costs of which would ultimately be higher than the economic setbacks to be expected in the euro area this year.

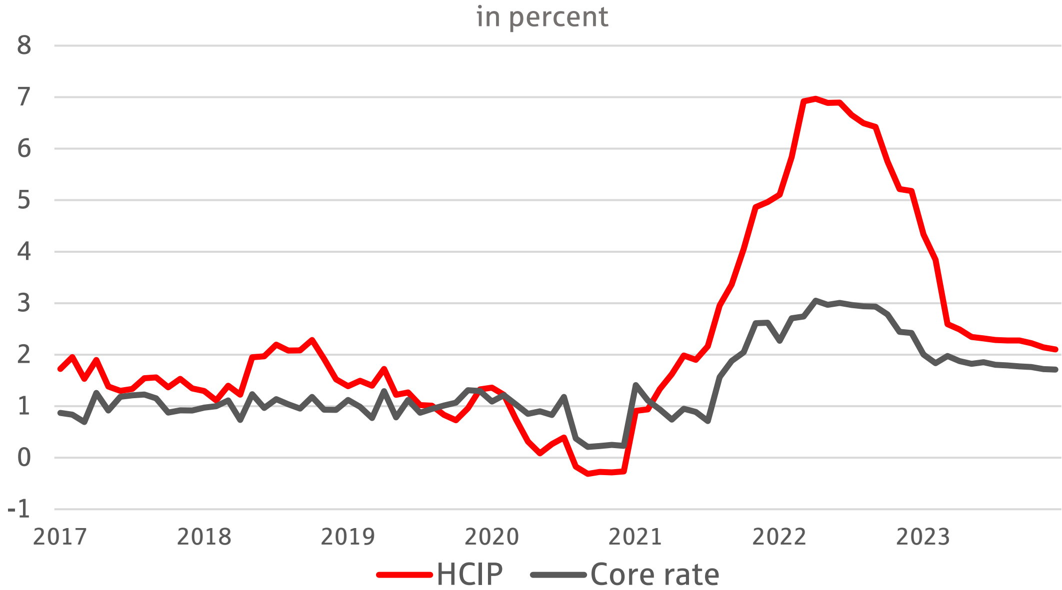
Initial impact studies of the war by the OECD, for example, show that significant price increases are to be expected in the long term - at least throughout this year. For example, the OECD expects an additional 2 percent increase in inflation for the entire world this year as a result of the war.

Inflation Impact of the Ukraine Conflict Worldwide



Source: OECD

All regions of the world are affected by inflation increases. For Germany and the euro area, we expect inflation to remain at a high level, and it remains to be seen whether the currently moderated increases will materialize from 2023. In times of war, permanent inflation processes cannot be ruled out. In our inflation forecasts, however, we currently still assume that further escalations of the war will not follow.



Source: DekaBank

The monetary-policy successes scored in the past ...

The European Central Bank's monetary policy over the past two years was part of an unified global economic-policy response to the outbreak of the corona-virus pandemic. All governments and central banks acted, mobilising the means at their disposal, according to an economic-policy watchword wrung from the devastating experience of the Great Depression in the first half of the 20th century. In keeping with this watchword, in situations marked by severe exogenous shocks affecting the entire economy, it is incumbent on the government to prevent downward spirals involving a vicious circle of deteriorating expectations at companies/private households and plunging aggregate demand.

The ECB's stance during the pandemic was sensible and exercised an important positive influence

In line with this, a whole host of fiscal and economic-policy measures were deployed in the euro area economies following the outbreak of the pandemic in spring 2020, ranging from the extension of short-time working benefits to the suspension of the obligation to file for insolvency. The ECB too put its monetary policy at the service of the macroeconomic stabilisation operation in question. In principle, such an approach was consistent with its statutory mandate of ensuring price stability, as a deflationary development of the kind which would also have been conceivable likewise poses a threat to price-level stability. To this end, the ECB used a wide range of instruments, the most important of which were - and still are - a negative deposit rate, ample liquidity provision through refinancing operations and the widespread purchase of bonds.

It is true that the European Central Bank had to weigh possible side effects to a greater extent than other central banks when selecting and calibrating its instruments, because the ECB was only given a mandate by the euro area member states to conduct monetary policy and is therefore not allowed to exert a manifest influence in the fiscal-policy or distributional-policy fields.

The measures have been successful, but are no longer needed

Praise is called for in the sense that such a monetary-policy approach was successful in stabilising economies during the most severe health and economic crisis for a hundred years. In conjunction with fiscal-policy measures of historic proportions, such an approach made it possible to maintain credit relationships and thus preserve financial stability, thereby safeguarding a high degree of continuity in terms of macroeconomic demand and jobs. The most visible sign that these measures have been crowned by success is the performance of financial markets, which have quickly regained their footing after serious initial slippage at the outset of the health crisis, in recent quarters. The cumulative effect of all the measures taken is that the global economy has returning to virtually the same growth trajectory which it left on the downside in March 2020 in response to the coronavirus outbreak. Such a successful stabilisation effort in the teeth of a major crisis has never been seen before in economic history. Such heavy deployment of monetary and fiscal-policy instruments

has therefore achieved its purpose. The fact is that the global economy is on a very robust recovery path despite the ongoing adverse effects of the current Omicron wave. Accordingly, the emergency mode of monetary policy is no longer needed.

… with negative knock-on effects: Inflation risks

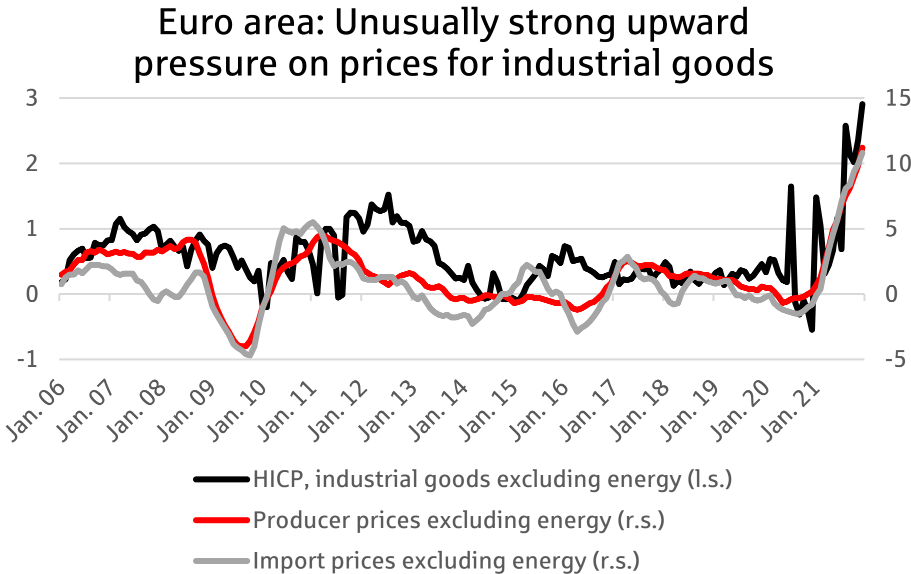
But this stabilisation policy also entails costs and side effects. In the case of fiscal policy, it is the immense increase in public debt, which is set to deprive future governments and generations of some of their room for manoeuvre.

A loose monetary policy can lead to collateral damage

In the case of monetary policy, the collateral damage is the surge in inflation rates. What sets the coronavirus shock apart from other macroeconomic crises is that not only the demand side but also the supply side of the economy has been affected. It is true that, with each infection wave, companies around the world have learned better and better how to produce even with the headwind of the pandemic in their faces. However, demand, strongly stimulated by fiscal and monetary-policy measures, increasingly outstripped raw-material, production and transportation capacities, particularly in the goods sector, as 2021 progressed. The outcome has been price increases that far exceeded all expectations of analysts and observers.

The current price wave is simply too high, meaning that lasting negative effects are likely

Even before the Russian invasion of Ukraine, there were growing indications at the beginning of 2022 that the price wave would be so high that it would not simply run out without consequences. Peak inflation is going to be higher, and the decline from this peak could well take longer than was being assumed until recently. On the one hand, sentiment indicators tracking activity in the corporate sector do suggest that global supply-chain problems are improving slightly. On the other hand, producer and import prices from the euro area show that there is still considerable price pressure in the pipeline, especially for industrial goods.



Source: Eurostat, DekaBank

This situation was exacerbated by the additional commodity price shock caused by the war in Ukraine. Energy and commodity prices rose again at double-digit rates. In the meantime, monthly inflation rates of over 6 percent are to be expected in the euro area into the fall. Average inflation in 2022 could be a good 6 percent. However, especially in the event of supply freezes for raw materials, these values could also be significantly exceeded.

The inflation process may become self-sustaining

This gives rise to the risk of second-round effects and thus of an inflation process liable to feed on itself. That process is reinforced by the Ukraine war. At the same time, we are seeing increasing signs of labour shortages, particularly in the United States, but in the euro area as well. As a result, considerable upside wage pressure is currently building up across the U.S. economy. Counting in other factors, such as the sharp upward traction of housing rents, a situation has arisen that local monetary policymakers can no longer afford to ignore.

In the euro area, the data available so far admittedly still testifies to a moderate wage development, and we continue to assess the potential for immediate second-round effects as being lower than in the USA. But on our side of the Atlantic too, we believe that the extremely low inflation expectations of the past are a trend which has been broken, at least for the time being. Increasing capacity utilisation on the labour market will sooner or later spur real wage growth. Unlike in the years prior to the pandemic, wages should then at least no longer dampen inflation.

The degree of monetary expansion needs to be dialed back

The combination of longer-lasting supply-side disruptions and a rapidly recovering labour market could mean that inflation in the euro area will no longer fall below the ECB's two percent target variable on a sustained basis. For the ECB, which is explicitly monitoring a broad spectrum of possible scenarios in view of the heightened uncertainty, this means that the balance of risks has shifted. Scenarios factoring in a long-term inflation undershoot have become less important, while the risk of a longer-term target miss on the upside has increased. This new balance of risks therefore urges that monetary stimulus should be scaled back at a rapid pace.

Yet swift monetary-policy tightening would be necessary even under a favourable scenario in which inflation falls back to two percent over the course of this year:

- Firstly, the emergency mode for monetary policy in regard of the pandemic situation has outlived its usefulness. It is true that the economic - to say nothing of the societal - after-effects of the coronavirus crisis have not yet been overcome. It is equally true that the Omicron wave currently rolling across the globe may again temporarily crimp economic activity. But the danger of macro-economic downward spirals being triggered by an abrupt onset of crisis no longer exists, and it was exclusively to counteract such hazards that the monetary and fiscal-policy superweapons of the

past quarters were wheeled into position. The hoped for stabilisation of national economies has now been achieved, and thus the fiscal and monetary-policy medicines administered have served their purpose. Were they to be dished out further, though, such medicaments would have more of a drug-like effect on economic life.

The harmful side effects of the zero-interest-rate policy reside in a distorted perception of risk on financial markets, in resulting financial-market or real-estate price bubbles, in the resources wasted by propping up business models that are no longer viable, in ballooning debt levels, and in a weakening of the banking system carrying negative consequences for future lending capacity. In our view, the harmful consequences of these side effects far outweigh the now very limited benefits deriving from such a policy.

Former danger of disinflation is gone

- Secondly, the monetary-policy playing field appears to be quite different from what it was a few years ago. Before the pandemic, a persistently disinflationary environment (a terrain characterised by falling inflation rates) had concerned the European Central Bank. With inflation rates lingering well below two perent for many years and with long-term inflation expectations on the part of financial market participants and companies equally low, the danger of falling down a deflationary regime (an environment characterised by negative inflation rates) was obvious. This was, moreover, the ECB's main - and sole legitimate - justification for its extremely expansionary monetary policy, marked by continued bond purchases and historically low interest rates, even before the coronavirus crisis hit. The goal of this policy was always an inflation rate "close to but below two percent" or, in the wake of the ECB's recent Strategy Review, a symmetric two percent target. This has now been achieved: inflation expectations have risen to the targeted levels.

  It is true that the ECB has, in the interim, adjusted its monetary-policy strategy in that it now considers temporary overshoots of its two percent inflation target to be temporarily tolerable. However, the ECB's yardstick for action is still its own inflation projections, which must contain an inflation forecast of sustainably above two percent, especially for the second half of the projecttion horizon, in order for the central bank to initiate a tightening of its monetary-policy stance. In the light of the ECB's own staff inflation projections from December, which pencil in an inflation rate of 2.0 percent for the coming years, the ECB has already come so close to this situation that it should at least prepare the economy and the markets for a gradual change of course on the monetary-policy side.

- Thirdly, medium-term risk factors for inflation are slowly shifting as well. In the short term, the pandemic may have reduced the labour supply, so that spare capacity in the economy as a whole is no longer at the level calculated using pre-crisis models. Other uncertainties are also looming on the medium-term and long-term horizons: although the influences of such factors as demographic change, a climate-compatible transformation to sustainability or a declining degree of globalisation have not been unambiguously quantified from a scientific angle, these all appear to us to be risk factors that could increasingly put upside pressure on inflation during the coming years.

Risk factors fueling inflation are on the rise

Preparing the monetary-policy turnaround

We consequently believe, firstly, that the anti-Covid-19 crisis policy still in operation is no longer needed in the meantime and, secondly, that the current ultra-accommodative monetary-policy stance is no longer appropriate in view of the changed risk environment for inflation, even given the Ukraine war.

The ECB needs to act now in order to avoid frantic adjustments at a later stage

From the vantage point of the economy and of financial markets, sudden changes in the direction of monetary policy pose a particular threat to stability. The longer necessary monetary-policy tightening is postponed, the more draconian tightening measures will have to be in the end. We see this as another problem cropping up if the European Central Bank were to abide by its present wait-and-see approach: if the current inflation projections do turn out to be too low, monetary policymakers will have to change tack so abruptly that economic agents and financial-market participants will be compelled to make hectic adjustments.

We therefore support the rapid reduction in bond purchases announced by the ECB in March. We are in favor of no net bond purchases being made after the end of the PEPP and also under the APP bond purchase program from October at the latest. As soon as possible after the end of net purchases, but in any case still in 2022, moderate key interest rate increases should take place, initially raising the key interest rate level to zero percent. This normalization of interest rate conditions should be continued in 2023.

For all the differences compared with the 1970s, experience nevertheless suggests that the buildup of an inflationary process can only be prevented by the instruments of monetary policy. The lesson from the period of stagflation should also be that the longer the fight against inflation is delayed, the more it costs. The U.S. Federal Reserve is currently taking this experience to heart by resisting inflation dynamics (which are even higher than in the euro area). In principle, the ECB should follow the same philosophy, with a degree of tightening appropriate for the euro area.

Disclaimer

This position paper by the Chief Economists does not necessarily reflect the position of all institutions comprising the Sparkassen-Finanzgruppe.

Impressum

Publisher
Deutscher Sparkassen- und Giroverband
Charlottenstraße 47, 10117 Berlin
Tel: +4930 20225-5303
DSGV-Volkswirtschaft@dsgv.de
www.dsgv.de

Editorial deadline for this issue
29th March 2022

Design
Franz Metz, Berlin

Picture credits
pixabay/Tama66

Responsible
Dr. Thomas Keidel - DSGV
Director
Head of Department
Financial Markets & Economics
thomas.keidel@dsgv.de

Dr. Reinhold Rickes – DSGV
Chief Economist
Deputy Head of Department
Financial Markets & Economics
reinhold.rickes@dsgv.de

Note
All publications in this series can be found at:
https://www.dsgv.de/positionen.html#standpunkte

ISSN
2509-3851