Intervention de Jacques de Larosière auprès de la *Harvard Law School*

Table ronde sur l'inflation et les moyens de la combattre

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Participants : Jacques de Larosière - Charles Goodhart, *London School of Economics* - Don Kohn, *Brookings Institution* - Hall Scott, *Harvard Law School*.

INFLATION : it is a complex phenomenon :

-It involves supply factors (rises in oil prices and other commodities, disruptions in supply chains, climate catastrophies, wars....)

- It is also be produced by demand overheating, which is the case today (explosion of pent up demand after the lifting in 2022 of sanitary restrictions, the effects of which are clashing against supply problems)

It is also produced by fiscal stimulus or by lose monetary policy (the monumental surge in M2 in the US over the last two years was bound to unleash inflation).

So, we have a petty ominous situation with all the factors at play simultaneousy (strong rise in pent up demand, supply rigidities). as Charles rightly observed the monetary dilemma is much tougher in Europe (who import Russian goods which is not the case of the US) than in the USA.

Those who are focusing on the supply side aspects, are tempted to state, or even to believe, that the present bout of inflation will be short lived, because supply issues usually get sorted out rather quickly. That lead some central bankers to minimise present inflation and to repeat that it would subside end 2022 or, at the least in 2023, so they thought that no fundamental change in monetary policy was called for.

In fact, that benign view was mistaken for obvious reasons :

- Most of the supply side issues are not short lived. Indeed decarbonation is bound to raise the price of energy in the years ahead and it is an illusion to believe the contrary ;
- As for the labour markets, we are starting to see structural rigidities and the beginning of a new-phenomenon : the need for entreprises to increase wages in order to keep skilled people at work.

So, with consumer price figures exploding to 40 years record hights, the language of central bankers on the « temporary » nature of inflation had to change lest their credibility woud vanish.

Some may say that this explosion of inflation and its effect on reducing real interest rates (real rates are historically low) is a good way of addressing the over extended debt situation : the servicing of debt is no more a problem and the roll over of existing liabilities is the solution to all our worries.

Unfortunately, this view is a dangerous illusion :

- Firstly, it is a » cicular conundrum» :the more governments resort to debt without limitation because « money doesnt cost anything », the more they will be accelerating inflation through the inevitable monetisation of bolooning deficits(in such a situation,no one could even think of raising more taxes) . And when inflation feeds on inflation, the danger of a hyper inflation spiralling gets closer ;
- Secondly, in such a situation, long term investment stops ; indeed if long term and risky projects are no more remunerated- and are paying the inflationary tax-,the liquidity trap feared by Keynes will become – as we see it already in Europe- the name of the game. This would lead to stagflation for years with all its social and politicall consequences.
- A last word. We should not believe that inflation is « good for growth while it penalizes the rich. »
- In this regard, the Phillips curve has been misleading in many ways.
- If a modicum of inflation may well have helped employment under certain circumstances(when fiscal positions were in relative balance,) it is observed that stimulus weakens as public debt becomes problematic and it is also true that for many years the ratio did not work.
- The truth is simpler : structural poblems cannot be solved by issuing more money and running enormous deficits. Only structural remedies can help.
- Adding more money and more debt will only end up in less wealth and more inflation.
- And inflation is not a friend to the bulk of people : even with indexation of wages on inflation, the catching up is never perfect, and eventually higher prices will always pinch revenues and demand.

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To sum up, three observations:

- 1/ Europe is much more affected then the US by the present crisis (energy dependency on Russia, lack of grains…)
- 2/ Supply-side problems do not always fade away quickly. Two structural issues are hard to tackle :
  - Long term price increases in energy (decarbonisation)
  - Tightening of labor markets
- 3/ We need adequate reactions of central banks :
  - Inflation has brought down real interest rates to record lows.

The ECB is particularly slow to move : any further delay will only make more costly the inevitable adjustments.

Jacques de Larosière - may 2022