Perspectives of inflation

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The present inflation in a very complex issue.

It combines:

- demand driven inflation (pent-up inflation resulting from pandemics confinement);

- oil and raw material price increases;

- supply side factors : disruption of production chains,

- the war in Ukraine.

The question is: “how long will it last?”

There are two schools of thought:

- Those who believe that it will be transitory once supply conditions ease,
- Those who fear that many factors will push inflation higher:
  - increase in energy prices (decarbonization…)
  - indexation of wages on past inflation (for the moment, the ECB assumes that workers will stand to bear all the brunt of inflation, thus leaving enterprises immune from price increases).

It is difficult to decide at this stage, but the risks of higher inflation are very serious.

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Let me now come back to past reminiscences.

I. The anguish of central bankers: Memories of the 1970s

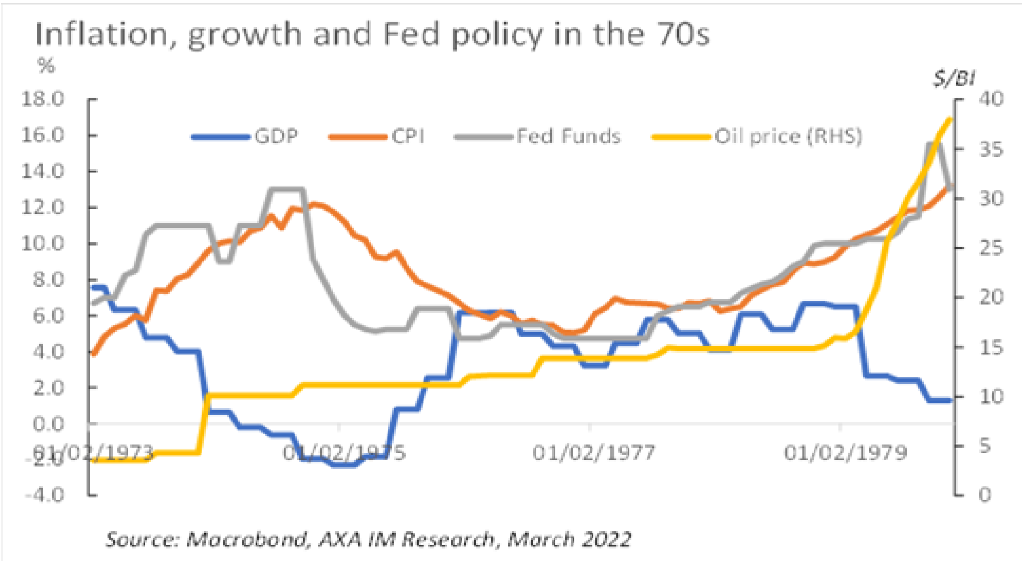
I remember the 1970s when inflation was raging, driven by significant increases in the price of oil.

The US Fed reacted aggressively in 1973 in response to the first oil shock.

But it did not have the political courage to maintain the right pace of tightening for long enough because of the cost to GDP growth (see chart 18).

Graph 18

<u>Inflation, growth and Fed policy in the 1970s</u>



In 1975, the Fed gave up the fight and cut rates aggressively despite runaway inflation.

Thus, real rates went into negative territory. Oil had stabilized but inflation remained above 5% and eventually the consumer price index exceeded 10% before the 2nd oil shock (1979).

Paul Volcker, the new chairman of the Federal Reserve, took the decision in 1979-1980 to break inflation by raising interest rates to 20%.

He had the courage to act vigorously.

Double-digit inflation was broken, but the world went into recession. And over-indebted economies (especially in Latin America) were caught in a debt trap (interest rates rose on floating rate debt as the recession drove down export prices).

<u>II. The monetary dilemma in the event of an oil shock</u>

Bernanke, in 2004 (just before he succeeded Greenpan) said**: "Monetary policy cannot offset the recessionary and inflationary effects of rising oil prices at the same time. It has to choose".**

So the question is: how do you choose?

We have to weigh the relative advantages and disadvantages of each option.

<u>Option one: Let inflation rise to protect GDP growth?</u>

This option should only be considered if growth was strongly down, unemployment was rising dangerously and the economy was moving further and further away from full capacity in a low inflation environment.

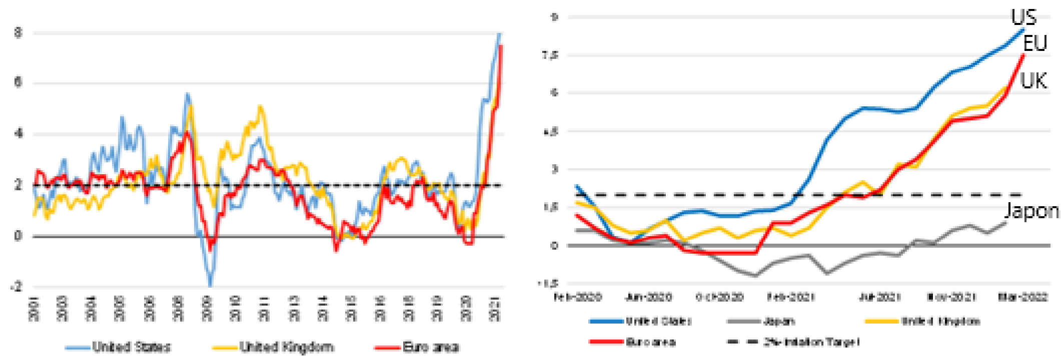
This is not the current environment.

In the U.S., the unemployment rate is down to a record low of 3.8% and wages are rising.

In Europe, the unemployment rate is on a downward slope and inflation is rising. The EU unemployment rate in February 2022 reached 6.8 percent of the labor force and remained at that level in April. This indicator is the lowest since Eurostat began compiling this series in April 1998. In contrast, the annual inflation rate for the euro area is estimated at more the 8% in April 2022, up from 6.2 percent in February...

Chart 19

<u>Growth in the consumer price index in the main advanced economies, annual % of money creation</u>



Sources : BIS, Eurostat
As of February 2022 for the UK and Japan, and March 2022 for the Euro area and the US

<u>Second option: Tightening monetary policy: this is advisable if inflation has become a serious risk in itself.</u>

This is the case today. Inflation in the Eurozone reaches an annual rate of 8.1% in May 2022 (compared to 7.4% in April[1]), while real interest rates become more negative due to ECB policy and high inflation. The Fed has rightly decided to start raising interest rates during the current energy shock, but very gradually.

[1] Eurostat estimate May 31, 2022.

Never has monetary policy been as accommodative as it is today in terms of real interest rates. When inflation appears, monetary policy has to be tightened, but this time central bankers are letting it loosen.

The question many people ultimately ask is "Isn't inflation the miracle cure for debt? The higher the inflation, the lower the debt burden in real terms. This is what happened after the great conflicts of the 20th century, to the detriment of creditors.

Why not consider a similar solution today, when the capacity of central banks to finance public debt has become massive?

Faced with this question, two remarks are in order:

1) This reasoning is based on unlimited inflation: one must be prepared to suffer very high double-digit inflation to neutralize a debt that is out of all proportion to that of the past. Such a solution is not without risk:

- Social risks and the development of populism; even if salaries can be protected from inflation by indexation, the same cannot be said for income from services or financial investments. Thus, an important category of the population ("the middle classes") will see the ineluctable decrease of their income.

- The investment horizon is blurred and altered for entrepreneurs in an uncertain inflationary context.

- The exchange rate falls with the development of inflation, which increases the cost of imports ("imported inflation").

2) The recessionary effect of inflation should not be underestimated: consumption tends to decrease with the sustained rise in prices and the loss of purchasing power; the margins of companies in strong competition are reduced, investment is sluggish because of the fall in real rates and the lack of clarity on the outlook and stagflation is taking hold...

III The ECB's response: after a long period of hesitation and ambiguity, in June 2022 it began to identify the real problems

The Euro system's initial position was to deny the seriousness of inflation, which was supposed to be "temporary" and to end in 2022. As a result, the policy choice was to focus on a reduction in securities purchases - which was to end in the third quarter of 2022 - followed only "later" by a rise in interest rates.

In the face of persistent and worsening inflation, the ECB began in June 2022 to take a more realistic direction:

- Asset purchases (APPs) were to end on July 1, 2022, but reinvestments of maturing securities will continue "for an extended period." As for the repayment of pandemic-response securities (PRS), they will be reinvested "at least until the end of 2024."

"The above guidelines can be relaxed at any time should the need arise.

- Policy rates: a 25 basis point increase has been scheduled for July 2022. Until then, the key rates remain unchanged: the interest rate on the main refinancing operations and on the marginal lending facility and deposit facility remain at 0.00%, 0.25% and 0.50% respectively.

Against a backdrop of 8% annual inflation, the above refinancing rates are reaching record negative real interest rates: monetary policy has become even more accommodating.

Beyond that, in September 2022, the ECB expects a "gradual but sustained sequence of further hikes".

- The ECB will ensure that the maturity of the TLTRO III operations does not impede the "smooth transmission" of monetary policy.

All in all, the economic growth outlook for the euro area remains quite positive in the ECB's baseline scenario. From this point of view, it can be considered that the ECB does not retain the stagflation hypothesis.

But there are doubts about the ECB's rather optimistic growth forecasts.

IV. The ECB's inflation projection has been seriously revised to be more realistic in June 2022

Graph 20

ECB forecasts: they are reassuring about the growth rate but recognize the dangers of inflation.

Growth and inflation projections for the euro area

(annual percentage changes)

	June 2022				March 2022			
	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	2.8	2.1	2.1	5.4	3.7	2.8	1.6
HICP	2.6	6.8	3.5	2.1	2.6	5.1	2.1	1.9

Source : ECB - AXA

The chart above shows:

- Inflation projections have been raised sharply: 6.8% for 2022 (from 5.1% forecast in March 2022), 3.5% for 2023, and 2.1% for 2024.

- The economic growth outlook for the euro zone has been revised downwards: 2.8% for 2022 (compared with 3.7% forecast in March 2022), 2.1% in 2023 (compared with 2.8% forecast in March 2023) and 2.1% in 2024 (compared with 1.6% forecast in March).

But there are doubts about these rather optimistic ECB growth forecasts.

Indeed, commodity prices are soaring (with the war in Ukraine, but also independently) and market expectations take into account more extreme assumptions than those of the ECB with oil at $125 per barrel and the impact of a collapse of Russian demand for goods from the EU.

Add in the inevitable "energy transition" and the cost of decarbonization, and it is difficult to see energy prices easing in the coming years.

A BlackRock Institute[2] paper highlights the seriousness of the risk of stagflation given Europe's dependence on Russian gas. Eliminating Russian gas imports could add 1 to 1.5% to inflation in Europe and significantly reduce its growth.

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One might ask: "If inflation and its recessionary effects on growth are rising, is this the right time to tighten monetary policy? The risk is that we will have more recessionary effects".

The answer, in my view, is this:

- Interest rates in real terms are dangerously low at : -6% - the easing of monetary policy that results from high inflation creates massive distortions:

Investment (essential for growth) cannot be restored with such a severe "taxation" of savings. Yet investment is the key to reducing the output gap between potential and actual growth.

Zombie companies (left alive because of interest rate subsidies) are reducing global productivity.

Real estate bubbles will continue to inflate with very low interest rates making mortgages so cheap.

Stock buybacks will continue to grow ($267 billion in annual buybacks at the end of Q1 2021 and now $319 billion at the end of Q1 2022).

So, the right question seems to be "if we let inflation rise even higher and allow very accommodative monetary policy, what do we gain?"

Not more long-term growth: because of the "liquidity trap" (savings are kept liquid since long-term projects do not pay off) and because high inflation reduces purchasing power and

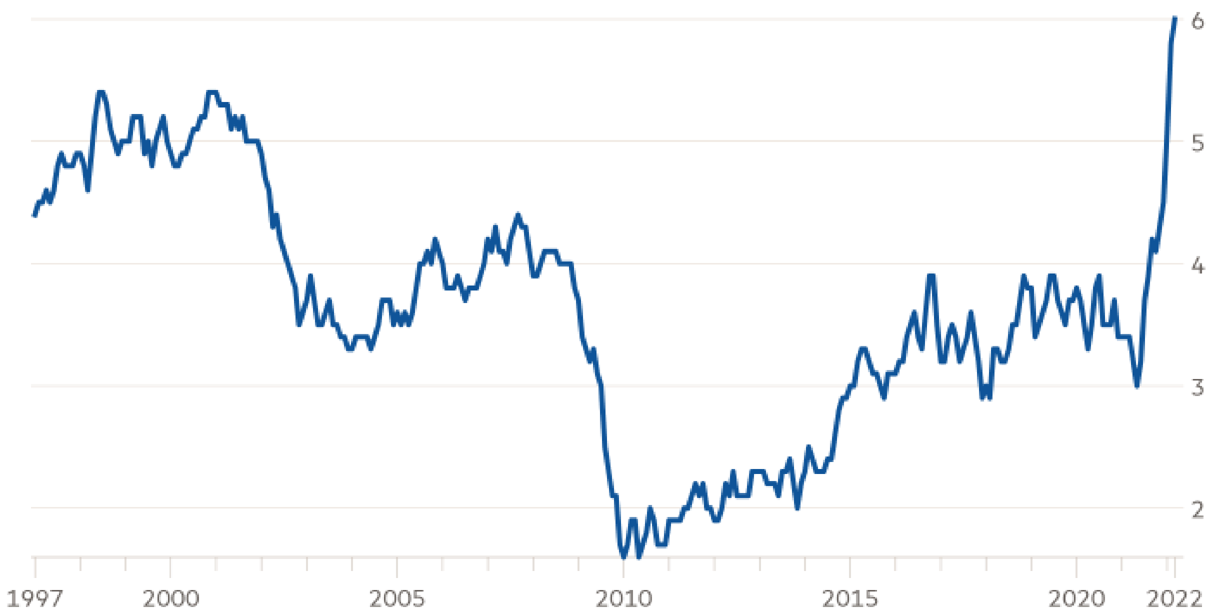
[2] BlackRock Investment Institute, " Taking stock of the energy shock ", Mars 2022.

therefore demand. The consequences of this "liquidity trap" are devastating: the preference of investors - especially in Europe - for liquidity, real estate and speculative assets - encourages bubbles and diverts long-term productive investment.

What we would get is more "inflation", the kind that results from supply-side bottlenecks, war and commodity price shocks, and which is met with a sharp increase -post covid- in demand. This inflation, if allowed to run unchecked, could be dangerous and feed (through wage indexation) the "spiral" of the past. Indeed, it is difficult to imagine that in such an inflationary environment, wages will remain stable in nominal terms. The graph below illustrates the strong growth of nominal wages in the United States.

Graph 21

Wage growth in the U.S. has picked up since 2015



Source: Atlanta Fed's Wage Growth Tracker
© FT

So in my opinion, the only possible answer is to do everything in our power to reduce inflation and raise interest rates, which is the condition to restart growth.

A European central banker recently said, "How can higher interest rates reduce the price of oil?"

I think the more relevant question would be:

"How could accommodative monetary policy (with even lower real interest rates) stimulate demand?"

The answer is that it couldn't.

- Demand depends on confidence and purchasing power (both of which are affected by inflation and rising commodity prices).

- In fact, oil prices would tend to rise even more if we let our currencies depreciate (the traditional OPEC reaction to exchange rate depreciations).

So the time has come to raise interest rates.

It would be abnormal not to do so when real rates are becoming so negative and capacity constraints (labor market) are getting worse[3].

To this argument, some object to two points:

An increase in interest rates in real terms would recreate higher spreads to the detriment of most indebted countries. This would be a major challenge for the eurozone.

Because of this potential financial fragmentation, some government debt would be difficult to service.

As we have said before, raising interest rates seems inevitable in the current inflationary environment. If a recession were to occur, we would have created the necessary margin to cut rates when it did, whereas if we do nothing now, monetary policy will be powerless to deal with a recession.

Raising rates now would have a much smaller restraining effect than doing nothing and letting inflation flourish. Indeed, as long as interest rates in real terms remain negative or zero, the nominal increases implemented can only generate extremely weak recessionary effects.

We might add that the fear of the reappearance of spreads in Europe should not dominate the decision-making process. Indeed, sooner or later, structural spreads - based on the past accumulation of fiscal and structural deficiencies - in Europe will appear on the markets. The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But does it have an obligation to erase forever all traces of interest rate differences in the appreciation of the markets? If so, the central bank would have to buy "vulnerable" securities without limit. If this were to be proposed, it would be difficult to reconcile with the Maastricht Treaty, as some member states place greater emphasis on the objective of monetary stability (believing that the ECB should not monetize public debt).

Moreover, such an open-ended decision would discourage member states from undertaking structural reforms.

Inflation rates vary widely across Europe (from 5.6 per cent in Malta to 20 per cent in Estonia in May 2022). This diversity poses a specific problem for Europe. Indeed, the single monetary policy can only be average, which is an admission of the inadequacy of monetary policy for the countries most affected by inflation. Diversified national economic and macroprudential

[3] Recall the two axioms of Paul Volcker when he broke inflation in the late 1970s:
- Price stability is essential to achieve sustainable full employment in the long run, while overheating and the resulting inflation leads to stagflation and higher levels of unemployment.
- There can be no tangible progress against inflation without a substantial increase in real interest rates.

policies must respond to their specific individual problems in order not to fall back into the trap of the 2000[4].

The result of monetary inaction would therefore be an acceleration of inflation. As a result, productive investment would continue to fall, as we have seen over the past 20 years in periods of very low interest rates. In essence, the implicit policy behind the objection leads to a combination of high inflation and low growth (stagflation). This is the main weakness of those who claim that high and ever-increasing debt combined with zero interest rates is the "magic wand" for the future. It is not a magic wand. It is a fatal trap: structural reforms are discouraged and productive investment is penalized by the tax on savings.

So what to do?

If the idea is to give checks to all economic actors in order to abolish all the effects of inflation, we would be condemned to an endless spiral of high inflation, due to the monetary creation thus produced, and low growth. Indeed, from a certain stage of public indebtedness, the recipe of stimulating demand by increasing public spending and deficits works with increasing difficulty, as the credit rating of the stimulating country deteriorates and the fiscal multiplier weakens.

If fiscal policies were to remain expansionary to address old structural problems unrelated to the crisis, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus.

In this respect, the issue of revising the Stability and Growth Pact appears central and urgent.

There are reasonable proposals on this subject that would avoid the drawbacks of the past Pact. They still need to be decided and implemented. Otherwise, the cement of the Monetary Union would disintegrate and financial fragmentation would increase, which could, in the long run, call into question the very existence of the euro[5].

History has taught us the social and political price of a policy of stagflation. Reason calls us to deal with these issues in a more constructive way: to reduce excessive public deficits, especially when they are caused by current expenditure, to restore the remuneration of productive investment, to encourage work rather than redistribution and not to accept the fatal chain of decline.

The fact that money has been thrown at the problems for years has worked against supply-side policy. In order to reduce the unused margin of the economy ("output gap"), it is necessary to deal not only with the stimulation of demand, the reduction of unemployment but also to increase productive investment and productivity gains, which have been the orphans of this story. Otherwise, stimulating demand does not translate into increased production, but leads to a widening of our trade deficit. In this respect, the quality of public spending is becoming an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt.

[4] From 2000 to 2010, the much higher inflation in the countries of the South was not corrected, which fueled sovereign tensions in the 2010s

[5] See Eurofi article by J. de Larosière and Didier Cahen. "Reforming the Stability and Growth Pact" February 2022.

Europe has a large surplus of savings. Instead of letting these savings go outside the EU and finance the rest of the world, and in particular the United States, it would be important to make this money work within Europe, which requires a remuneration that is at least as attractive as that which exists across the Atlantic. In this respect, **if the divergence of interest rates between the two sides of the Atlantic were to increase in favor of the United States, the problem of a transfer of savings to higher interest rate areas could have extremely negative consequences for Europe.**

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Interest rates that are too low - as we have had in Europe for the last 10 years - are actually extremely dangerous.

- They push savings into liquidity and discourage them from financing long-term productive investments (the "liquidity trap").

- They encourage the survival of zombie companies,

- They weaken the banking and financial system.

While neither the Fed nor the Bank of England has allowed nominal interest rates to enter negative territory (see chart 15), the ECB has. This is a sign of a lack of understanding. Indeed, central bankers should know that productive investment - which depends, in part, on returns - has fallen over the past 20 years, especially in Europe, threatening our future growth. Negative interest rates are not conducive to investment. Quite the contrary.

The ECB must learn from its mistakes. In 2017, it missed the opportunity to withdraw from an ultra-accommodative monetary policy when the economic situation would have made it easy.

Five years later, there is no justification for the current procrastination. If the ECB continues to hesitate, it will have to take much stricter measures later if and when inflation gets completely out of control.

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Fighting inflation is a demanding exercise. It requires vision and courage.

The Fed has decided to act to tighten monetary policy. But the question remains: as long as real rates are negative - which they are today - can we say that monetary policy is tight enough to eliminate inflation?

We need to be mindful of the risks that negative real interest rates pose to investment and confidence, with real estate ultimately remaining the recourse against inflation.

In short, the risk of inflation is inherent in any policy designed to close the "negative output gap" by eliminating the difference between potential and actual growth through money creation. This risk was hardly considered likely a year ago, given the scale of the pandemic crisis and the structural forces at work, such as aging and globalization. But since the fall of 2021, the specter of inflation has arisen. And the real interest rate environment remains one of the lowest in our history.

It is surprising that the ECB in particular is stubbornly insisting on negative real interest rates, given the negative consequences of such a policy on growth. More generally, the desire to systematically keep rates low raises the essential question of the value of money. This is based exclusively on confidence. The risk of a loss of confidence would seem to be threatening if those who are responsible for this confidence were to resolve to see their role as suppliers of an unlimited raw material at zero cost rather than as the vigilant guardians of its stability.

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Ultimately, the paradox of the euro is that a single currency and national economic policies coexist without a strong cement of coordination.

Ultra-accommodating and asymmetric monetary policy has been used to overcome the contradictions of this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth Pact should help to resolve these contradictions and thus make the euro sustainable.