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## Wirtschaft

# Lessons learned from the present Inflation episode

**No one could have predicted the inflation effects of covid pandemic and the Ukraine war with any accuracy. But the European central bank's misjudgments were particularly pronounced and consequential. The fight against unexpectedly high inflation will weaken growth and burden households and firms. These costs cannot be avoided. However, they can be limited if the central bank pursues a clear and reliable stabilization course. Von Michael Heise**



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The current debate on the ECB's monetary policy mainly revolves around the question how many more interest rate hikes could be in store before the peak in this cycle is reached. Most financial markets expect two (smaller) rate hikes by the end of the year. However, there could be more if core inflation, which is not directly influenced by energy and food prices, remains as stubborn as it has been in recent months. For bond markets and stock prices, the policy stance is certainly of high relevance, and may cause recovery or setbacks.

From a long-term perspective, the important question is, what conclusions the ECB may draw from the experience of the past decade and a half, in which inflation targets were first clearly undershot despite ultra-expansive policies, and then exceeded them in a rather drastic and unexpected manner from 2021 onward, forcing the ECB into an abrupt turn-around. What are the „lessons learned“ from this development?

## **In times of low inflation, the ECB changed its strategy in 2021**

As a starting point one needs to look at the strategy review that the ECB completed in July 2021. Under the impression of years of low inflation and a downward trend of real interest rates, the ECB announced some changes. Most importantly, a symmetric and medium-term inflation target of 2% was set, replacing the previously applicable stability target of below, but close to 2%, inflation. Also, the ECB confirmed the potential use of unconventional instruments such as longer-term interest rate guidance („forward guidance“), large-scale bond purchases, long-term loans, and negative key interest rates.

Regarding the analytical framework for monetary policy decisions, the Bank announced an integrated approach replacing the previous two-pillar system with an economic and a monetary pillar. With this change the relevance of monetary aggregates for policy decisions is qualified further. The integrated analytical framework also allows greater attention to be paid to the real economic and financial consequences of ECB policy. The strategy is complemented by stronger support for climate targets.

## **Serious Misjudgments of Inflation**

Neither central banks nor other forecasters have complete foresight about future economic and price

Few forecasters caught these effects early. However, the central bank's misjudgments were particularly pronounced and of high relevance for the stance of monetary policy. Citing the transitory nature of inflation and favorable projections for price stability, the ECB was slow to change its policy. Even in November 2021, when the annual change in the Harmonized Index of Consumer Prices had reached 4.9 percent, ECB Director Isabel Schnabel like other ECB representatives argued, „We expect inflation to have peaked in November [21] and for inflation to decline gradually again in the coming year, towards our inflation target of two percent.“

Things turned out completely differently – admittedly also because of the Ukraine war. In the spring of 2022, the ECB then signaled a stronger need for action, but it wasn't until July 2022 – with inflation at a whopping 8.9% – that the first hike in the key interest rates took place (for the deposit rate from -0.5% to 0%). In the meantime, the tone has completely changed and the ECB is pointing out the dangers of excessively high and very persistent inflation.

## **The long-term commitment to an expansionary policy was counterproductive**

One reason for the ECB's delayed response to the inflation surge was the so-called „forward guidance,“ an unconventional tool used by the central bank to anchor expectations in financial markets. In the later part of 2020 and early 2021 markets were expecting policy rates to remain practically at zero until 2024. The design of the forward guidance changed somewhat over time, but it was clear that net bond purchases under the APP would have to end before any rate hike and that inflation would have to be compatible with the price stability objective well within the ECB's projection horizon and also over the medium term. Tying interest rate hikes to the end of net bond purchases under the APP, which was decided to be at the beginning of the third quarter of 2022, proved counterproductive as inflation by then had soared. A timely reaction was made difficult by extensive forward guidance.

Consequently, the ECB beginning in August 2022, switched to a meeting-by-meeting (MBM) approach entailing the evaluation of incoming data for policy decisions. This approach grants more flexibility, which is needed in times of extremely high uncertainty and considerable inflation dynamics.

The uncertainties in diagnosing and forecasting economic developments that have always accompanied monetary policy decisions have arguably been somewhat underrated in the model-based paradigms of recent years (not only in EMU). The notion that we live in a world of very low, possibly at times even negative equilibrium interest rates and that central banks can therefore only exert influence via large-scale bond purchases has shaped policy for many years. But there are major uncertainties attached to such calculations and in today's situation, the thought may lead to quite different conclusions. By and large, the persistent overshooting of inflation above the desired two percent suggests that the current interest rate level has not yet reached the equilibrium interest rate, which is not directly observable. It seems to be much higher than suggested by the earlier model calculations. Any such conclusions are however problematic in an environment of very high uncertainty.

## supply

Stabilizing the price level and macroeconomic developments is a medium-term objective. This has probably been widely accepted since the failed and inflationary attempts at short-term cyclical policies in the 1960s and 1970s. But how can it be implemented? One way, in the years of monetarism, was to assess the contribution of monetary policy to the stability of prices and macroeconomic developments via the evolution of the money supply and credit aggregates, which monetary policy can influence more directly than the ultimate objective of the price level. Over time, the focus on monetary aggregates has fallen out of fashion again, and the ECB has also relativized the importance of monetary developments due to a supposedly looser connection with price level developments in the more recent past.

However, empirical results are always time-dependent. If in the past three to four years attention had been geared a bit more to money growth – M1 growth skyrocketed by around 25% in 2020 and 2021 combined – the normalization of monetary policy would probably have been tackled much earlier and more whole-heartedly. Although many other factors beyond monetary growth played a major role for inflation in the short term, its rise to 8.4% in 2022, which followed the surge in M1, could at least have been slowed. In the meantime, and mainly as a result of the interest rate hikes since mid-2022, the narrow monetary aggregates in the euro area have come back down significantly, which bodes well for an imminent slowdown in inflation.

## In retrospect, the huge bond purchases appear questionable

During periods of low inflation, the ECB often pointed to potential problems in transmitting its monetary stimulus to the real economy especially as a result of the effective lower bound for interest rates, which limits its room for maneuver. It therefore launched immense bond-buying programs, removing interest rate risks from the market on a large scale and depressing yields on the capital markets. Government bond prices rose sharply and also pulled up the valuations of asset securities such as equities, shareholdings and real estate.

The extent to which the rise in asset prices stimulated aggregate demand and price developments is debatable, as there were also negative effects. Greater inequality in the distribution of wealth and slower growth in retirement assets may have led to higher saving, dampening expansionary effects of bond purchases.

Regardless of how one views the effects of unconventional policy, what is clear is that we are now witnessing a correction. The reversal of monetary policy has resulted in significant valuation losses. In 2022, both bonds and equities were heavily affected, and while stocks have been recovering in 2023, real estate is undergoing further revaluation. Financing conditions have deteriorated considerably as a result of much stricter lending standards on the part of banks, and corporate loans and housing loans have become markedly more expensive. The euro area economy is stagnating. The adjustments to higher interest rates are ongoing and can be seen as a burden for private households and the corporate sector. Moreover, the central bank itself is affected as the huge stock of bonds it acquired as part of quantitative easing has lost considerable market value. Selling these bonds would turn hidden into realized losses and further increase the rise in yields. Also for these reasons, only a slow reduction in the ECB's bond holdings can be expected.

## **Inflation expectations are of particular importance for monetary policy**

An important prerequisite for the long-term stability of the price level is to anchor economic agents' inflation expectations as firmly as possible at the stability target. The ECB succeeded quite well in this until the current inflation shock. Even in the current situation with very high inflation, financial market participants only foresee inflation of around 2.5% over the next five or ten years, which is at least not very far from the central bank's target.

With regard to private households, however, there are significantly greater inflation concerns and thus deviations from the central bank's stability target. The ECB should and will take this into account in further decisions and continue its stabilization course to normalize household's inflation expectations.

In this respect, the credibility of the central bank is of central importance. The ECB will now have to prove its continuity and stamina under difficult conditions. A continued exit from years of expansionary policy with increased interest rates and a reduction in large bond holdings will not only put a strain on the central bank's own balance sheet, but will also further slow economic development.

## **Conclusion**

The economic environment has changed quite dramatically since the ECB's 2020/21 strategy review. The sudden spike in inflation has significantly raised perceptions about longer-term inflation trends and the „equilibrium“ level of interest rates. The task now is to curb inflation and anchor overly high inflation expectations back near the 2% target.

reliable the central bank's actions are, the lower they will be. A consistent and clearly communicated stabilization course, in which the required interest rate level is maintained for a while and the reduction of the bloated balance sheet is tackled, should soon repair the reputational damage brought about by the inflation acceleration and consolidate the ECB's credibility.

Because of the costs of a stabilization policy, there are already calls for the central bank to tolerate higher inflation or to abandon inflation targets altogether. That would be the wrong way to go. Price level stability is a crucial prerequisite for steady growth in the long term.

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