On Inflation's Front Line

ECB's Philip R. Lane discusses the importance of bringing euro area inflation back to target

THE EUROPEAN CENTRAL BANK (ECB) is on the front line of the fight against inflation. Policymakers have raised interest rates to 15-year highs to bring euro area inflation, which peaked at more than 10 percent in October, back to the 2 percent target. Inflation is expected to slow this year, but monetary policy will continue to attract scrutiny as the continent's economic growth slows, consumers continue to struggle with the cost-of-living crisis, and governments seek to finance large debts in a new era of higher interest rates.

In an interview with F&D's Nicholas Owen, the ECB's chief economist, Philip R. Lane, calls on governments to start rolling back fiscal support to consumers as the energy crisis trigged by Russia's invasion of Ukraine becomes less acute. He discusses the importance of steering inflation expectations back to target, the challenges involved in shrinking the central bank's balance sheet, and the lessons that can be learned from the monetary moves of the past year.

F&D: After rising to highs not seen for 40 years, inflation in Europe is showing signs of slowing. How important is it to the euro area's economic outlook that the authorities succeed in returning inflation expectations to 2 percent?

PL: The worst-case scenario for a central bank is that a prolonged phase of high inflation causes the public to lose confidence that price stability (in practice, a 2 percent inflation target) will be maintained over the medium term. If the public comes to believe that inflation will remain high on an indefinite basis, this would be baked into price and wage setting and become self-sustaining. So it is essential that monetary policy is clearly set to make sure that inflation returns in a timely manner to our 2 percent target. This has been especially important over the last year, given that monetary policy had been previously geared for several years to address a persistent below-target inflation pattern. So we have been moving in a sustained manner away from a super-accommodative monetary stance toward a stance that is sufficiently restrictive to make sure inflation returns to target and thereby keeps longer-term inflation expectations anchored.

F&D: What lessons can policymakers learn from the inflation shock? Most economists expected price pressures to be only transitory. Do we need to do monetary policy differently?

PL: This episode will no doubt be studied for many years to come, so my answer to this question is highly provisional. At the same time, I think it should be recognized that the twin forces of the pandemic and the war-related surge in energy

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prices constituted extraordinarily large and asymmetrical shocks that were bound to generate an initial phase of high inflation. It is certainly true that it warrants ongoing examination to assess whether the ECB and other central banks could have done a better job in assessing the size and duration of this inflation shock. We should always strive to learn from such episodes and be open to internal and external critiques. Over the last year, central banks have reversed out of quantitative easing programs and cumulatively raised interest rates quite a bit over a relatively short period. We will also learn a lot about the conduct of monetary policy and the effectiveness of monetary policy over the coming months.

F&D: Do you think ECB policies to shrink its balance sheet will pose problems for governments in the euro area with large financing requirements? Some heavily indebted governments have grown accustomed to selling bonds effortlessly to the ECB.
PL: These programs have always had the primary focus on ensuring that the long end of the yield curve contributed to the monetary easing that the overall economy needed to avoid prolonged below-target inflation: these were not programs to directly finance governments. While it is too early to draw conclusive lessons from our experience in moving away from quantitative easing and now embarking on quantitative tightening, we have seen in recent months that the normalization of interest rates has meant that many institutional investors (both European and global) have high demand to purchase euro area government bonds.

In relation to fiscal policy, we are quite clear that, in line with the EU's economic governance framework, fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt.

Of course, there is an important role for fiscal policy to shield the most vulnerable in the economy from the energy price shock. There is not only a moral but also an economic imperative to that. But we are also emphatic that fiscal support measures to shield the economy from the impact of high energy prices should be temporary, targeted, and tailored to preserving incentives to consume less energy. In particular, as the energy crisis becomes less acute, it is important to now start rolling these measures back promptly in line with the fall in energy prices and in a concerted manner.

F&D: Rising interest rates are piling pressure on households across Europe. Do central banks have any role to play in lessening that pressure, or is it something that should be left entirely to governments and fiscal policy?
PL: All households benefit from medium-term price stability. The poor are the hardest hit by persistent inflation. Accordingly, it is in our collective interest that the ECB maintains a primary focus on the timely return of inflation to our 2 percent target. We should be efficient in our monetary policy: delivering our target, while minimizing the costs in terms of output and employment. In analyzing the transmission of monetary policy, we closely examine the impact of interest rate movements on households: not only the direct effects—which, at any point in time, vary across borrowers and savers and across different age groups—but also the indirect effects through the impact of monetary policy on output and employment. These vary between those who work in the sectors most sensitive to interest rate movements (such as construction and consumer durables) and those who work in less cyclical industries. Governments should always protect the most vulnerable in society, but fiscal measures that directly offset the impact of interest rate movements can be problematic in terms of the efficiency of monetary policy and may be less effective than other income policies. FD