Monetary Policy: How to Get Inflation Back to Target?

Monika Merz
University of Vienna and CEPR

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A straightforward answer

- credible, unambiguous communication of being committed to inflation target of 2 percent, accompanied by
- further increase of ECB’s key policy rates
- continued QT by significantly reducing net asset purchases

Whatever it takes to re-establish low inflation rates is necessary!

Why are these measures indispensable?

- high inflation rates impose inflation tax, redistribute from lenders to borrowers, and increase uncertainty about future path of economy
- ECB must demonstrate that it has taken back control of monetary policy
- break rising inflationary expectations, e.g. to avoid setting off a wage-price spiral and reduce inflation

Inflationary expectations and labor markets

- upward pressure on real wages due to (i) high inflationary expectations, and (ii) increased labor shortages
- labor shortages more severe at lower end of skill/wage distribution ("real-wage compression", D. Autor et al. ′22), and in fast-ageing societies (C. Goodhart et al. ′21)
- upward pressure on real wages arising from labor shortages is higher in Euro area than, e.g., in USA, but opposite holds for avg. labor productivity growth [%]: .9 in Euro area < 1.6 in USA, 1999-2019

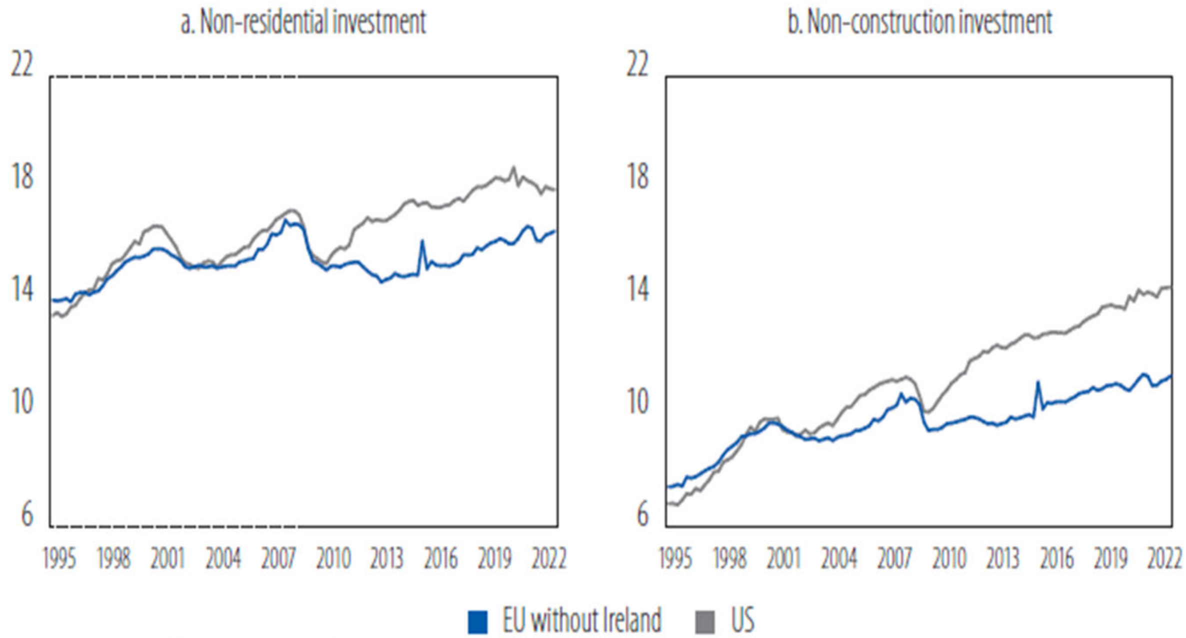
- wage-price spiral if rising real wages exceed labor productivity growth

  Ex.: postal worker wage negotiations in Ger **+11.5%** - 8.7% = 2.8% > .9%

- taming inflationary expectations is crucial for moderating real wage rises – in the Euro area even more so than in USA

- low labor productivity-growth due to aging labor force and too little business investment, also in ICT

Private Investment-to-GDP ratios [%]

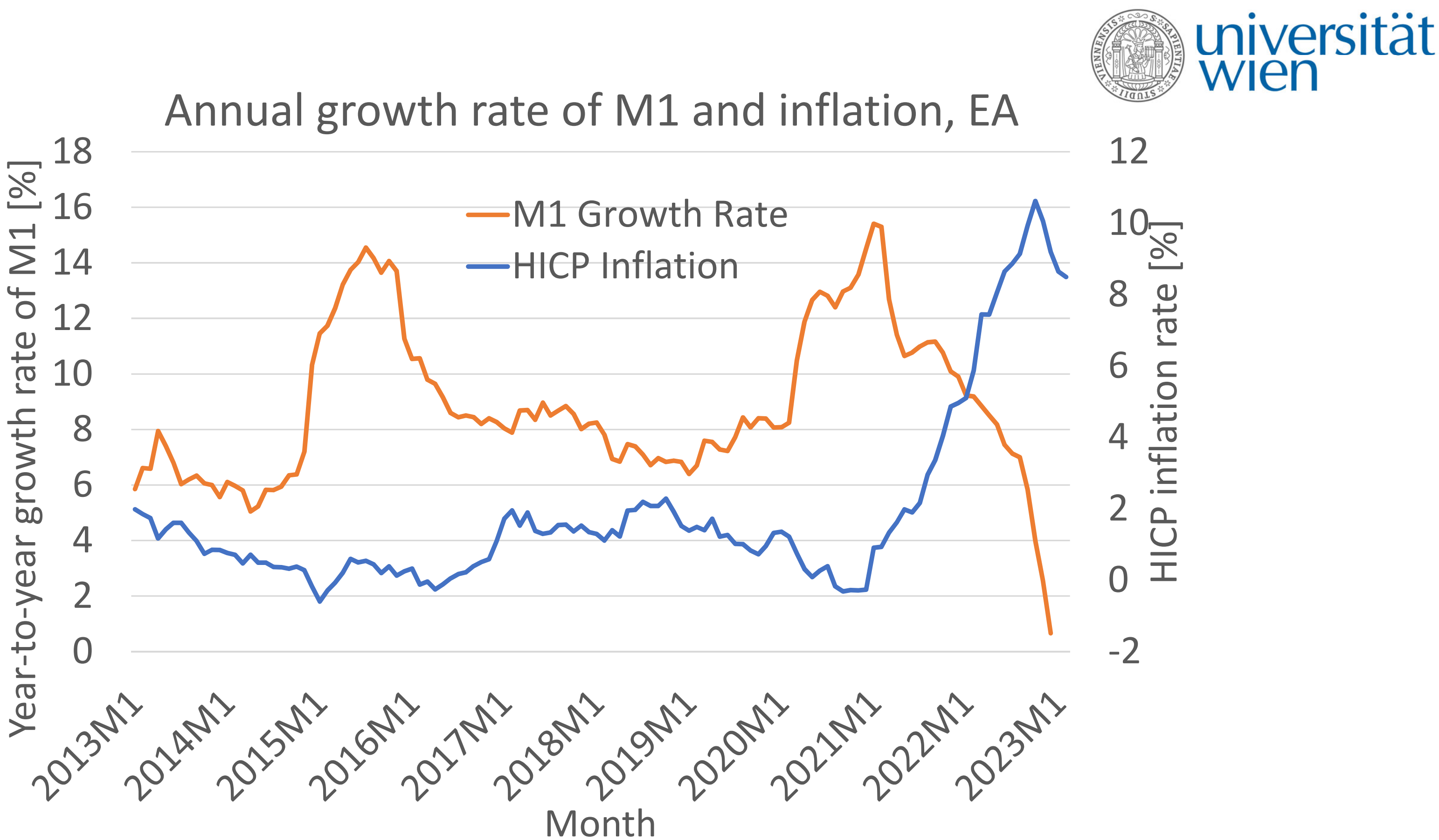


Source: EIB, Investment Report 2022/23.

- widening investment gap between EU and USA since 2000

What went wrong?

- since 2015 ECB pursued strongly expansionary monetary policy, keeping interest rates historically low
- crises-related fiscal stimuli, emergency support programs, and price caps stabilize income, but raise debt-to-GDP ratio to 100%
- continued anaemic growth of GDP, lack of sufficient productivity-enhancing investments incl. in ICT
- EU Recovery Fund of € 750 bn in May 2021 addressed problems, but hasn’t produced fundamental changes yet (“time-to-build”)



Source: ECB Statistical Data Warehouse. Own calculations

Lessons to be learnt

- keep it simple and enforce mandate of price stability – no micro mgmt.
- disciplining inflationary expectations is key to controlling inflation, e.g., to avoid kicking off wage-price spiral, or master market’s interest rates
- crucial to continue QT to tame inflationary expectations and avoid worsening economic situation
- improved communication of ECB officials

“The success of a CB should be judged by how boring it is.”

Lord Mervin King