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A Price Stability Guide for Policymakers

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Summary

Inflation is back with surprising force. Should inflation remain significantly elevated over an extended period, detrimental effects on the EU's economic model, on growth and on social peace can be expected. A coordinated macroeconomic response is required, combining monetary and fiscal policy. The European Central Bank needs to continue to signal its willingness to stick to its price stability mandate to keep inflation expectations under control. It should not succumb to the goal of fiscal dominance by targeting public debt sustainability more than price stability. This would imply giving up its independence. Fiscal policy should facilitate the objective of monetary policy to target inflation while minimising the impact on economic growth. To reduce the danger of a wage–price spiral, fiscal policy should strive to limit the impact of extreme price rises and should be targeted towards those members of society most affected by the higher prices. In contrast, general expenditure increases or tax reductions for an extended period of time carry the danger of overburdening governments. Price interventions should be the very last option, as they decrease the incentive to reduce the demand for higher priced goods and thus do not allow for the signalling power of prices regarding scarcity. Due to high inflation rates and supply-side constraints, it is currently not the right time for a fiscal demand stimulus.

Keywords Price stability – Inflation – Monetary policy – Fiscal policy – ECB (European Central Bank)

Considerable inflationary pressures in the medium term[1]

A combination of several factors have contributed to a large and persistent rise in inflation. The Corona-crisis led to major and still ongoing disruptions of global supply chains, rendering final and intermediate goods more expensive. The Russian invasion of Ukraine has exacerbated this effect and, in addition, led to severe shortages of fossil fuels supplies and massively rising energy prices in Europe. As a result, inflation has come close to double-digit levels and is unlikely to fall rapidly back to its target level of 2 percent in the medium term.

Inflation might stay more elevated than expected due to key economic trends of this decade: demography, de-globalisation/geopolitics, decarbonisation and digitisation. Table A sketches a brief overview of the results of this analysis. It is mainly the first three megatrends that will tend to lead to higher price pressures in the coming years:

- The retirement of the baby boomers and the fact that younger generations are much smaller will exacerbate the labour shortages that have already become prevalent in many European countries since the coronavirus crisis. The greater scarcity of employees, particularly, but not only, of skilled labour, and their resulting higher bargaining power in wage negotiations will lead to higher wage cost pressures that will feed into higher inflation.

- Globalisation and offshoring contribute to lower inflation via many channels, but only for as long as the degree of internationalisation increases. This process has stalled since around the time of the global financial crisis in 2008/2009. In the medium term, already visible tendencies and proposals to reverse globalisation and to reshore or nearshore production have the potential to increase inflation, as import prices and domestic production costs will rise, also due to less international competition.

[1] This paper forms part of a larger research project undertaken by the German Economic Institute (Institut der deutschen Wirtschaft, IW) which will be published by the Martens Centre in 2023.

- Decarbonisation entails higher costs for carbon-intensive production, for example due to increasing CO_2 prices. Moreover, higher investment in the green transformation and the resulting higher demand for the required material resources also have the potential to increase inflation in the near future.

- Digitalisation could lower inflationary pressures, for instance via greater price transparency and the resultant higher competition. In addition, more efficient production processes and better products should dampen inflation through higher productivity growth, although proof of this still remains somewhat elusive in productivity statistics.

In view of these medium-term trends, it is even more important to rein in the current spell of inflation with sufficient rigour. This is all the more true when the—mainly negative—economic effects of inflation are taken into account.

Table A Main price effects of global megatrends in the medium to long term

	Effects on prices and inflation rate	
	Increasing	**Decreasing**
Demography	• Scarcity of labour, mainly due to retirement of baby boomers > higher bargaining power of employees and labour cost increases	
Deglobalisation / geopolitics	• Reshoring, less division of labour > lower productivity • Less competition • Smaller markets and fewer economies of scale	
Decarbonisation	• Increasing price of CO_2 emissions • Investments for transformation • Costs of negative climate effects	
Digitalisation	• Less competition due to superstar firms	• More competition due to lower entry barriers and more price transparency • Innovations / productivity

Source: IW.

Detrimental economic and social effects of high inflation

There are various detrimental economic effects of high inflation rates. Table B provides an overview of the main issues:

- Purchasing power losses and financial wealth losses usually result from a lagging reaction of incomes and interest rates to higher inflation rates. The incurred real income losses could induce changes to consumption and wealth patterns that are likely to be welfare-decreasing.

- As higher inflation hides the ability of prices to signal real scarcity in an economy, the allocation of production factors is likely to be distorted, with negative consequences for economic growth in the medium term.

- Investment decisions might be particularly distorted, as inflation (and even simply fear of inflation) induces a flight to safety which could possibly lead to a welfare-decreasing change of capital allocation. For example, property prices could rise in the case of a flight to 'concrete gold'. As a result, the middle classes and especially younger generations might find it more difficult to become property owners. Moreover, asset price bubbles may occur and, if they burst, this could even cause financial and economic crises.

- Economic distortions could also surface in trade and cross-border capital transactions, as international competitiveness often declines in a high-inflation economy, usually leading to current account deficits and rising foreign debts.

- Purchasing power losses go hand in hand with highly problematic redistribution effects. The more vulnerable groups of society (which tend not to own real assets) are especially negatively affected, while better-off owners of real assets might even benefit from higher real asset prices. Moreover, creditors will usually profit to the detriment of debtors. For example, the government can finance its debts more easily, while private owners will suffer from real income losses if they hold government bonds with fixed interest rates. Furthermore, taxpayers, be they private households or companies, will also suffer from higher real tax burdens.

- The costs of disinflation also need to be included as a negative effect of higher inflation rates. These stem from the output and employment losses that are likely if the central bank increases interest rates to fight inflation. In cases of high and persistent inflation this can temporarily lead to a deep recession.

Table B Main economic and social effects of high inflation

Negative effects on purchasing power and wealth	• Purchasing power losses in incomes and wealth due to lagging reaction of wages and interest rates • Negative welfare effects of induced changes to consumption and wealth patterns
Negative effects on the allocation of production factors	• Distortion of relative prices and of scarcity signals • Distortions of investment decisions (flight to safety/real assets) and danger of overheating real asset markets • Distortion of factor allocation due to inflation-induced changes in consumption and wealth structures • Loss of international competitiveness, potentially rising foreign indebtedness, and the related distortions of trade structures and international factor allocation • 'Menu costs' – i.e. higher corporate transaction costs and efficiency losses • 'Shoe leather costs' – i.e. higher transaction costs for households
Problematic effects on income distribution	• Redistribution to the detriment of wage earners and transfer recipients and to the benefit of owners of real assets • This often implies a redistribution that is to the detriment of the more vulnerable groups in society • Redistribution from creditors to debtors (e.g. from private actors to the government)

Higher tax burdens	• Higher real tax burden on household incomes in case of progressive income taxes (cold progression) • Higher real tax burden on corporate profits due to reduction in real depreciation values (investment tax) • Higher tax burden on wealth in case of (only) nominal wealth increases
Investment and employment effects	• Potential positive investment and employment effects in certain constellations with lagging increases in wages and interest rates (in case of surprise inflation, but not realistic in the medium term if inflation expectations adapt to higher inflation) • Danger of stagflation if inflation gets out of control (as in the 1970s)
Costs of disinflation	• Temporary output and employment losses as negative side effects of higher interest rates in the wake of fighting inflation

Source: IW.

Overall, high inflation is likely to damage the growth potential of an economy in the long run. This also is reflected in several empirical studies on the negative growth effects of inflation rates above a certain level. Current inflation rates of more than 8% in the summer of 2022 likely exceed the critical inflation threshold in advanced countries. High-single-digit inflation rates also carry the danger of inflation getting out of hand, as inflation expectations rise and wage–price spirals tend to set in, resulting in people generally becoming accustomed to higher inflation rates and adapting their economic behaviour. Thus, self-reinforcing mechanisms can set in and lead to further increases in inflation rates and even more negative economic effects.

Inflation and public debt sustainability

There have been fears that an inflation-induced rise in interest rates could endanger the sustainability of public debts in highly indebted European countries. However, unless political shocks interfere, this is unlikely to be the case. As governments tend to benefit as creditors from higher-than-expected inflation (to the detriment of private debtors) due to the usually lagging response of interest rates, public debt sustainability has been reinforced and is not currently in danger.

Several scenarios are simulated for the short to medium term based on existing economic forecasts. These simulations assume the absence of a deep recession (e.g. due to an energy supply crisis) and of politically destabilising events. Using varying assumptions for inflation and economic growth (with market interest rates even optimistically assumed to fully follow inflation rises immediately), all scenarios show a declining trend in the public debt ratio in the larger euro area countries up to 2027. This is mainly due to the fact that higher market interest rates only gradually affect the interest burden of governments. Higher market interest rates only become relevant if maturing existing government bonds (currently with low interest rates) have to be refinanced by new government bonds at significantly higher interest rates. As the bulk of government bonds have a maturity of several years, this shift takes time.

However, if high inflation should persist for a longer period, public debt sustainability is likely to be seriously endangered in the longer term. This would be the case if inflation-induced higher interest rates gradually feed into the existing public debt stock and inflation is brought down only after that. In this case and at that time, governments would face a dangerous combination of a high interest rate burden and low inflation. In the course of the required disinflation process, a possible deep recession could further endanger public debt sustainability. Thus, fighting inflation in the short term is essential to avoid the risk of public debt crises in high-debt EU countries.

Outlook and policy recommendations

Many experts and also the European Central Bank (ECB) expect inflation to come down again from its current peak levels to lower rates. In fact, the current bout of inflation will become weaker as and when supply-chain disruption and energy shortages abate. For that matter, if energy prices and import prices do not rise further next year, the impact of these drivers on inflation will lessen. If these prices should decline somewhat from their current peak levels, their contribution to inflation would even be negative, that is, they would contribute to lower inflation rates. However, there are also factors that will prevent a large and immediate decline in inflation as soon as these scarcities wane. As import and supply prices have risen very strongly in recent months, it will take some time for these price increases to feed through the value chains into the final consumption and consumer prices. This is an important reason why inflation will remain significantly higher than 2% (the ECB's inflation target) for the next one to two years. However, after this period inflation should come down again to more normal levels, unless significant new price pressures or 'second round effects' occur.

An important second round effect would be a rise of inflation expectations of economic actors. This is why the ECB needs to signal its commitment to getting inflation down to its target rate of 2% in the medium term. Another important second round effect—one that is closely connected to inflation expectations—is the potential for a wage–price spiral. In fact, this represents the largest current danger as it could lead to high inflation becoming much more persistent.

Import price increases (and particularly energy price shocks) must not be amplified by further labour cost shocks, but instead the resulting loss of purchasing power must be shared between employees (through lower real wages) and employers (through lower profits as firms cannot usually fully pass on higher input costs in their sales prices). If trade unions force high labour cost increases to keep real wages constant or even rising, renewed cost shocks would lead to new price pressures for firms and force them to increase their sales prices further. This would most likely lead to a wage–price spiral and would force the ECB to raise interest rates even more, thus increasing the costs of disinflation and the danger of a recession.

To prevent a wage–price spiral, it is thus high time for macroeconomic coordination between the various policy actors. Monetary policy should focus on targeting price stability, while wage bargaining and fiscal policy should support monetary policy in this objective. Wage negotiation outcomes should include one-off payments by companies on top of normal wage increases. One-off payments would target purchasing power losses but would, at the same time, prevent a long-term increase in labour costs. Fiscal policy should make one-off payments attractive for companies and employees by allowing generous tax deduction possibilities. Even more important, fiscal policy should strive to limit the impact of the current large price increases by providing targeted income support for those members of society most negatively affected by higher inflation rates. In any case, due to high inflation rates and actual supply-side constraints, it is currently not the time for a fiscal stimulus via higher government expenditures.

About the authors

The authors are employed by the German Economic Institute (Institut der deutschen Wirtschaft), the largest privately financed economic think tank in Germany.

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