

Monetary Policy in Europe: Out of the Woods?

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The recent rise of inflation has been experienced by many advanced economies. While there is variation in the timing and magnitude, inflation was breaching 10% (see figure 3.1, panel A) and thus bringing back memories of the Great Inflation in the 1970s. The good news is that inflation has been falling sharply since peaking in 2022–23. What are the sources of this rapid disinflation? Some credit surely goes to the central banks. Policy rates increased from zero to 5% or higher rather briskly (see figure 3.1, panel B). However, the credit is likely only partial, for several reasons.

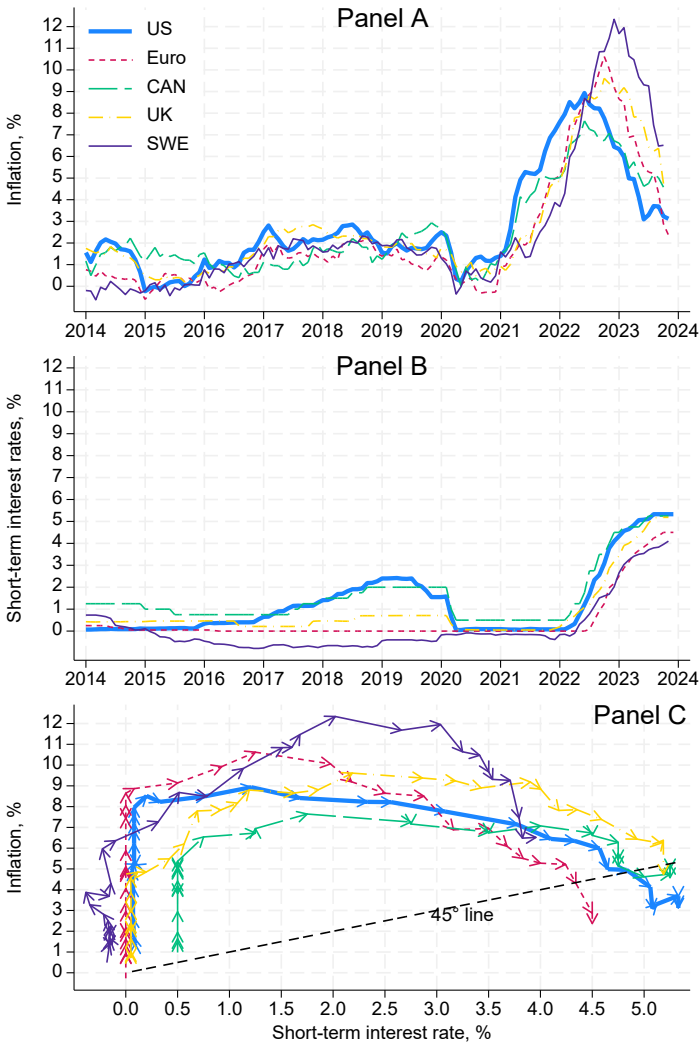


Figure 3.1. Dynamics of Inflation and Interest Rates

Three line graphs illustrating the dynamics of inflation and interest rates. Panel A: Jagged graph lines tracking the rates of inflation from 2014 to 2024 are shown for the US, Canada, UK, Sweden, and eurozone. The lines are roughly aligned and range mostly between 0 and 3% from 2014 to early 2021, then all rise sharply. The US line peaks at about 9% in mid-2022, then falls back to about 3% by late 2023. The other lines peak in a range from about 7.5% to about 12% between early 2022 and late 2022, then fall back to levels between about 6.5% and 2.5% in late 2023. Panel B: Lines for the same 5 countries track short-term interest rates from 2014 to 2024. The lines for the US and Canada are roughly aligned and are relatively flat in a range between 0 and about 1.25% from 2014 to early 2019, then gradually rise to peaks in a range between about 2.0 and 2.5% in early 2019, then fall back to a range between 0 and about 0.5% from early 2020 to early 2022, then both rise to a peak of about 5.25% in late 2023. The lines for UK, Sweden, and eurozone are all relatively flat at, slightly below, or slightly above 0 from 2014 to mid-2022, then rise to peaks in a range between about 4% and 5% in late 2023. Panel C: Lines for the same 5 countries are plotted on a graph of inflation percentage (vertical axis) against short-term interest rate percentage (horizontal axis). Arrows on each line show movement from left to right along the lines. All the lines start at about 0 to 1% inflation at about negative 0.25% to 0.5% short-term interest rate and spike vertically to a range of about 4.5% to 9%

inflation, then continue rising more gradually to their respective peaks within a range of about 7.5% to 12.5% inflation when interest rates are between about 1.25% and 3.0%, then fall back to a range of about 2.5% to 6% inflation when interest rates are between about 4.5% and 5.5%. A straight, 45-degree-angle line rises across the graph from 0 inflation at 0 interest rate to about 5.5% inflation at about 5.5% interest rate.

First, we know from Milton Friedman that monetary policy works with long and variable lags. Various estimates suggest that an interest rate hike generates a tangible decrease in inflation after 1.5 years or so. Furthermore, nominal interest rate increases have only recently led to positive real interest rates: figure 3.1, panel C, shows that inflation has been above short-term interest rates even when inflation started to fall. This tightening of monetary policy appears to be quite modest given previous experience. Figure 3.2 plots the time series of inflation and real interest rates during the Volcker disinflation in the 1980s and the current episode. Volcker raised rates to 5% for about five years to conquer inflation. In contrast, the real rate during the current episode is only lately, and modestly, above zero.

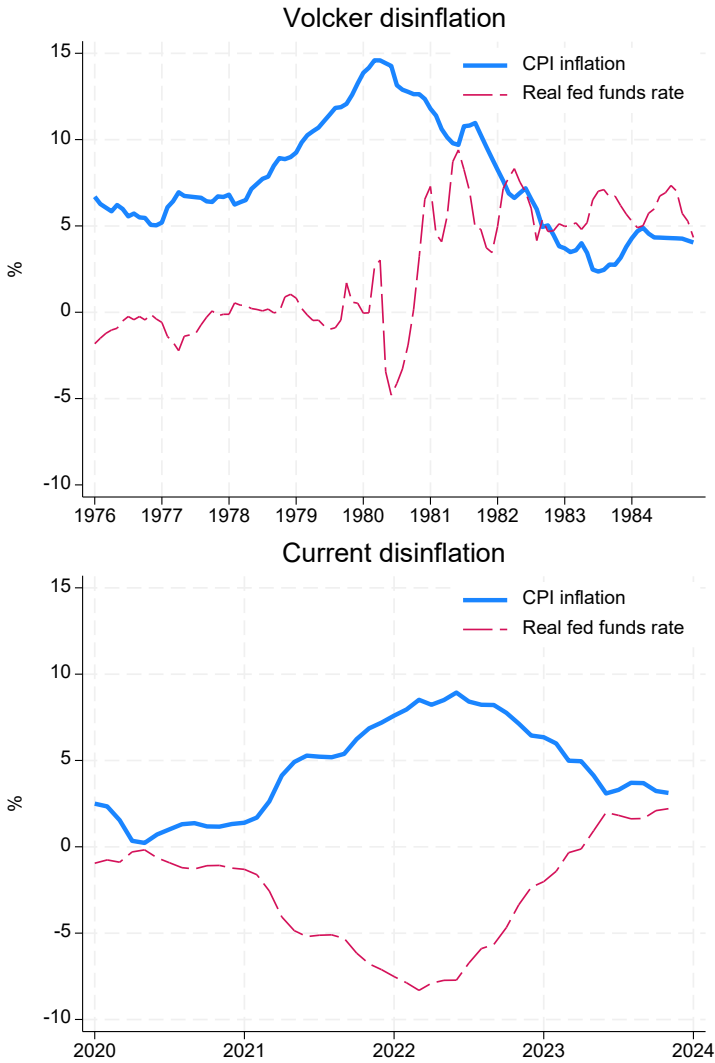


Figure 3.2. Dynamics of Inflation and Real Interest Rate

Two line graphs comparing the dynamics of CPI inflation and the real fed funds rate during the periods of Volcker disinflation and current disinflation. Volcker disinflation, 1976 to 1984: A line for CPI inflation starts at about 7% in 1976, is roughly flat until early 1978, then rises to a peak of nearly 15% in early 1980, then falls to a low of about 2.5% in mid-1983, then recovers to about 4% in late 1984. A line for the real fed funds rate starts at about negative 2% inflation in 1976 to a peak of about 3% in early 1980, then falls to a low of about negative 5% in mid-1980, then rises to a series of peaks between about 3% and 9% from early 1981 to late 1984. Current disinflation, 2020 to 2024: The line for CPI inflation starts at about 2.5% in 2020, soon dips to near 0, then rises to a peak of about 9% in mid-2022, then falls back to about 3% in late 2023. The line for the real fed funds rate is a near mirror image of the inflation line, starting at about negative 1% in 2020, falling to a low of about negative 8% in early 2022, then rising to about 2.5% in late 2023.

Second, one should look at the joint dynamics of inflation and other macroeconomic variables to better understand sources of disinflation. To this end, figure 3.3 reports the evolution of the inflation gap (inflation rate $[\pi_t]$ minus expected inflation $[\pi_t^e]$; expected inflation is the average one-year-ahead inflation forecast in the Michigan Survey of Consumers) and the unemployment gap (unemployment rate $[UE_t]$ minus the natural rate of unemployment $[UE_t^*]$ estimated by the Congressional Budget Office). Red arrows show the dynamic when inflation is rising, while green arrows describe the evolution when inflation is falling. Again, we compare the Volcker disinflation (figure 3.3, panel A) and the current episode (figure 3.3, panel B).

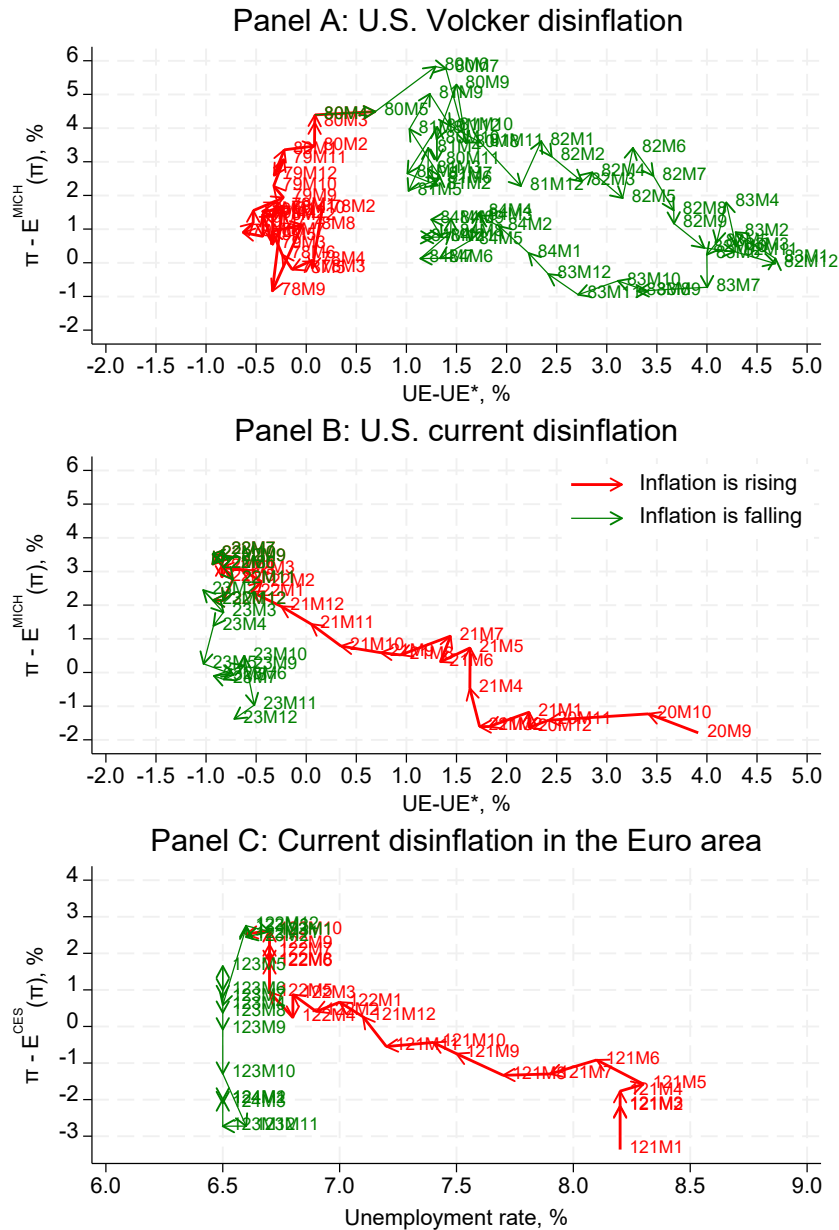


Figure 3.3. Dynamics of Inflation and Unemployment Gaps

The Volcker disinflation is a textbook case. Inflation increases are vertical shifts in the $(\pi_t - \pi_t^e, UE_t - UE_t^*)$ space. These shifts are consistent with cost-push shocks, that is, upward shifts in the Phillips curve. To disinflate, Volcker created a great deal of slack in the market. At

that stage, $(\pi_t - \pi_t^e, UE_t - UE_t^*)$ is moving down and to the left. One can interpret these dynamics as movements along the Phillips curve. In contrast, the current episode has movement along the Phillips curve when inflation is rising and a downward shift in the Phillips curve when inflation is falling. We do not have “Volcker” data for the eurozone in the 1980s, but the current experience in Europe is very similar to the US experience (figure 3.3, panel C).

These dynamics suggest that a chunk of disinflation in the euro area and other advanced economies was due to forces beyond the reign of monetary policy. While these forces are welcome developments, this also means that central banks are not fully in control, and falling inflation can turn into rising inflation or stubbornly high inflation. Unfortunately, the balance of risks for the eurozone is such that these scenarios could be more likely than many observers think.

After Russia invaded Ukraine on February 24, 2022, Europe could successfully decouple from Russian energy, but war-related risks were not eliminated. Many European businesses are still dependent on Russia. For example, Raiffeisen Bank, a systemically important Austrian financial institution, generates more than 50% of its profit in Russia. One can expect that these businesses likely face significant future losses, as Russia can seize their assets to pay for the war. The Black Sea is a major route for grain exports, not only for Ukraine but also for Russia (~70%). If these routes are disrupted (for example, in April 2022, insurance increased by a factor of ten and made commercial shipping infeasible), food prices are likely to soar. Russian oil refineries, depots, and terminals continue to catch fire, which may drive energy prices up again. In addition to potential increases in commodity prices, the shooting war creates immediate security risks for Eastern Europe (Russian drone and missiles occasionally fly into the European Union airspace) and beyond (Russia occupies a huge nuclear power plant in Zaporizhzhia and an

accident can pollute much of Europe). Furthermore, Russia creates instability in the European Union by weaponizing refugees, spreading disinformation, and interfering with political processes. If the Cold War is any guide, defense spending in Europe can increase by 50% or even double. Public finance could be further strained if the flow of refugees returns to or exceeds the level observed in April 2022 (Germany alone spent more than 20 billion euros on Ukrainian refugees in 2022–23). This expansionary fiscal policy can again ignite inflationary fears. In general, one may be concerned that the “Korean” discount¹ can be applied to Europe as well, and so the cost of doing business in Europe could get higher.

These developments may seem to be low-probability events, but the job of central banks is to think the unthinkable and be prepared for negative scenarios. Russian aggression in Ukraine turned into a war of attrition that may be hard to contain. As a result, the European Central Bank and other central banks on the continent should hope for the best but prepare for the worst.

¹ The Korea discount refers to a lower price-earnings (PE) ratio of Korean stocks relative to their global peers. For more details, see Romain Ducret and Dušan Isakov, 2020. "The Korea discount and chaebols," *Pacific-Basin Finance Journal* 63(C).