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Inflation and long-term interest rates

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I would like to thank Professor Pinardi for his kind invitation, which gives me the opportunity to discuss with you the sudden shift in the economic outlook following Russia's attack on Ukraine, above all with reference to what is happening on the inflation front, and to how the European Central Bank (ECB) is responding to these changes.

Inflation trends in the euro area and in the United States

Inflation has been increasing sharply at global level for several months now, following the rise in energy prices on the international markets, especially those for oil and gas. How these price rises came about and how important they are in relation to other factors nevertheless differs widely across countries, in particular if we compare the situation in the United States with that in the euro area.

The prices of the two main types of crude oil, i.e. WTI, which is traded on the United States market, and Brent, sold on the European one, have recorded similar increases. Compared with the situation on the eve of the pandemic, both types have doubled in price and are today around $120 a barrel. Generally, there have been bigger increases in the price of gas but while in the United States the price has gone from just under $10 to around $30 per megawatt hour on average in the first half of June, in Europe it has risen from just over €10 to more than €80 per megawatt hour. Furthermore, while in the United States the rise has been gradual, on our continent previously unimaginable highs were reached during the most acute phases of geopolitical tensions: up to €180 in December and, somewhat shockingly, almost €230 in March. These are very significant developments given that the price of gas plays a key role, not only for heating our homes and other domestic uses, for example cooking our food, but also for production of electricity.

Another important difference between the two regions of the world regards the economic policy response given in 2020-21 to the pandemic crisis. While almost all countries took fiscal measures on a massive scale to strengthen their health systems and support households and businesses, the measures adopted by the United States were particularly wide-ranging: over the two years, the debt-to-GDP ratio increased by 25 percentage points, to 130 per cent, against an average increase of 15 points in euro-area countries (this, despite the greater dip in nominal GDP in 2020 and its slower recovery in 2021). The exceptional level of support given in the United States had an unexpected effect on household disposable income which, in 2020, recorded the strongest rate of growth since the mid-1980s, rising to 6.2 per cent, against a drop in GDP of 3.4 per cent. In the euro area, instead, household disposable income actually declined, by 0.6 per cent, though to a lesser extent than GDP (-6.4 per cent). The United States economy overheated in a phase in which global supply had not yet recovered because of the successive pandemic waves, and this also created bottlenecks for intermediate goods in the international supply chains, with adverse effects on production in many countries.

The different trends in aggregate demand between the two regions is reflected in clear differences in their labour markets. In the United States, all the main metrics (average hourly earnings, the employment cost index and the wage growth tracker calculated by the Federal Reserve Bank of Atlanta) do in fact indicate wage growth that is clearly above 5 per cent. On the other hand, in the euro area the growth in negotiated wages stands at around 2 per cent, even if there is no lack of calls for bigger increases. The moderate wage growth is the result of persistently ample margins of idle capacity in the euro area, where the number of hours worked has still not returned to pre-pandemic levels, and of the low level of vacancies, indicating the absence of an excess of labour demand.

In the face of these trends, consumer price inflation has progressively accelerated. Both in the United States and in the euro area, inflation peaked in May at 8.6 per cent and 8.1 per cent, respectively (the second figure is based on a still preliminary estimate). However, the trend of the core inflation index, excluding food and energy products, was different: in the United States, it was equal to 6 per cent in May (after peaking at 6.5 per cent in March), whereas in the euro area it was below 4 per cent.

The inflation forecasting errors

On the basis of these considerations, the Eurosystem estimates that inflation, also taking account of the preliminary assessments of price growth in May, will be around 7 per cent on average this year. In 2023, inflation is already expected to settle at a considerably lower level, falling to around 3.5 per cent, before returning to around 2 per cent in 2024.

These projections are subject to a high degree of uncertainty, as the most recent developments also suggest. Indeed, in the last two quarters, the forecasting errors made by the ECB and by the Eurosystem's staff were much higher than in the past. Our analyses indicate that the direct effects of the forecasting errors relating to energy prices – which are the main exogenous variables, whose changes are inferred from the prices of futures contracts – explain over 60 per cent of the overall error made in forecasting inflation; the share rises to 80 per cent when indirect effects are also taken into account (e.g. those on sectors such as transport).

These results confirm the validity of the models used, though they draw our attention to the quality of the forecasts employed as inputs, which include, among others, in addition to energy prices, developments in world trade. There has undoubtedly been a general underestimation of the effects that the excess demand in the United States, particularly in the durable consumer goods sector, would have on the rest of the world via energy prices and, together with the impact of the measures adopted to counter the pandemic, via supply chain bottlenecks. Even more significant, however, has been the underestimation of the geopolitical tensions, with the sharp drops in gas supplies from Russia – observed as early as the beginning of last year – attributed first (and probably mistakenly) to the cold winter in that country and then to pressures by the Russian Government in connection with the Nord Stream 2 pipeline. But the most important factor has, of course, been the outbreak of the war: while the prices of futures had continued to predict descending oil and gas prices up to the end of last year, the conflict has left not only current but also expected prices at very high levels. The repercussions of rising energy prices for inflation, which were therefore to be considered as temporary owing to the widespread expectations of base effects soon turning negative, instead became more persistent.

The risks of a de-anchoring of inflation expectations and of a price-wage spiral

The worsening of the terms of trade and the loss of purchasing power caused by rising energy prices will tend to hold down final demand in the euro area, moderating the pressure on prices. However, the risk that long-term inflation expectations rise to levels that are not consistent with the ECB's definition of price stability, as well as that of a price-wage spiral, must be monitored closely.

Today, inflation expectations over the longer-term forecasting horizons do not diverge significantly from 2 per cent. The most recent forecasts of the main international institutions and private analysts concur with those of the Eurosystem in indicating that price growth in the euro area will remain high this year and then fall decisively in 2023, later returning to levels of around 2 per cent; the prices of financial assets linked to consumer prices confirm the anchoring of long-term expectations.

We are aware of the fact that an assessment of the risk of a de-anchoring of expectations from the inflation aim based exclusively on their current level would be dangerous. Given that economic theory and historical experience show that a de-anchoring could occur abruptly and in a non-linear way, it is crucial to consider carefully the risk that long-term inflation expectations could rise suddenly.

Expectations must therefore be assessed not only in terms of their long-term convergence towards the price stability objective, but also based on their responsiveness to shocks and their dispersion. Indeed, these metrics provide indications of how firmly the expectations are anchored. As regards their responsiveness, the expectations obtained through surveys and from financial assets linked to consumer prices continue to show a relatively low sensitivity to macroeconomic surprises, including those regarding inflation. The dispersion of expectations relating to price growth also remains moderate overall: in fact, the ECB's Surveys of Monetary Analysts indicate that a high and growing share of those interviewed expect inflation in the euro area to be in line with the 2 per cent objective in the long term. Deviations from that level, including small ones, are only expected by a minority of respondents.

As I said, the possible triggering in the area of a price-wage spiral is a second risk, which is not independent of the first risk, and which must be monitored carefully. While wage dynamics in the euro area have so far remained moderate, it would be imprudent to observe current developments without asking oneself what might happen in the future. In this respect, several reasons lead to the conclusion that a price-wage spiral is less likely than it was in the past. It is also worth clarifying that wage increases requested and granted on the basis of changes in productivity – and in any case where the profit margins make it feasible – do not create problems on the inflation front. Instead, wage increases aimed at mechanically – or rather, automatically – keeping up with price increases serve no purpose, as they trigger, in turn, further rises in inflation.

First of all, nowadays, monetary policy is transparent in its goals and credible, as shown by the resilience of inflation expectations. Secondly, aggregate demand in the euro area remains relatively weak, and a significant recovery over the next few months seems improbable. In addition, the structural characteristics of the labour market, especially the differences in the salary indexation mechanisms, make price-wage spirals less likely. Finally, the single currency itself lowers the odds that any accelerations in prices could lead to marked depreciations of the euro exchange rate, which in turn would fuel further increases in wages and in inflation.

The monetary policy response

The normalization of the ECB's monetary policy has been underway since last December when, given the progress made in economic recovery and in the convergence of expectations towards the inflation target, the Governing Council announced the start of the reduction in net financial asset purchases. This process was accelerated in the early months of this year: having concluded the purchases under the pandemic emergency programme at the end of March, and despite the greater downside risks to growth caused by the Russian invasion of Ukraine, the steady increase in current and expected inflation has led us to bring forward the end of net purchases under the asset purchase programme to the beginning of July.

In early June, the Council also announced that the key interest rates – with that on banks' deposits with the Eurosystem being exceptionally negative – will be increased by 25 basis points in its July monetary policy meeting and that, if the medium-term inflation outlook persists or deteriorates, a larger increment could be appropriate in September. A gradual but sustained path of further increases in the key interest rates will continue after that date, but its pace will depend on incoming economic and financial data and on how they will alter our assessment of the medium-term outlook for prices. In this regard, one trend that we are continuing to monitor very closely is expectations regarding the future movements of official rates: in recent days, the short-term real interest rate curve shifted sharply upwards, signalling widespread perceptions of a particularly hawkish stance on the part of the ECB; this perception is not, in my view, warranted, given the attention we will continue to pay to the evolving cyclical outlook, which continues to be highly uncertain.

The increase in short-term interest rates has accentuated the rise, underway for some months now, of long-term rates, which play a key role in the economic activity of firms and households. Compared with the first ten days of December, on the eve of the change in monetary policy made by both the Federal Reserve and the ECB, the 10-year interest rates rose by 185 basis points in the United States, by 200 in Germany and by 230 on average in the euro area. It seems difficult to reconcile the relative size of these rises with a situation in which core inflation in the euro area is more than 2 points lower than in the United States and wage growth is over 3 points lower. This is therefore a development that we will have to monitor carefully in the coming months to ensure that financial conditions do not tighten excessively, including a disproportionate increase in long-term interest rates, also considering, if necessary, a recalibration of the path of increases in the key interest rates, which is not predetermined but depends on the evolution of the economic and financial situation.

The pace of monetary policy normalization has to balance two risks. If it is too gradual, inflation could become rooted in expectations and in wage-setting processes, with the risk of compromising the credibility of the central bank and forcing it to adjust its stance, with more marked repercussions for economic activity and employment. On the other hand, if the pace is too fast or its announcement wrongly interpreted, markets could overreact and the tightening of financial conditions could be stronger than necessary, with risks to financial stability, economic activity and, ultimately, price developments, which have only recently been forecast to reach 2 per cent in the medium term.

If on the one hand, abandoning the policy of negative key interest rates can no longer be precluded, on the other hand, I believe it to be crucial that, as announced, the normalization of monetary policy continues in a gradual fashion, and with great attention paid to the uncertain evolution of the economy and of financial conditions. Only in this way will we be able to preserve and consolidate the wealth of credibility that we have built up over time.

The risk of market fragmentation in the euro area

On top of its vulnerability to the risk of general financial tensions, the euro area, being a monetary union, is exposed to the equally dangerous risk of unjustified capital market fragmentation along national borders. This possibility, which has arisen in the past, is amplified by the incompleteness of the European Union. It is a risk that does not concern only those countries that it affects, but that, given the economic and financial interconnections between Member States, may rapidly reverberate throughout the euro area.

Fragmentation leads to many serious problems from an 'operational' standpoint. In fact, it hampers the proper and homogeneous transmission of monetary impulses to all countries and, in this way, makes it impossible to pursue price stability for the area as a whole.

As early as last December, the Governing Council stated that flexibility in the use of its instruments would remain a key element of monetary policy whenever there are threats to monetary policy transmission. President Lagarde clarified that this included the possibility of deploying existing instruments or introducing new ones to prevent the risk of market fragmentation within the euro area from materializing. The pandemic in particular confirmed that, under stressed conditions, flexibility in the design and conduct of financial asset purchases successfully countered the impaired transmission of our monetary policy, making our efforts to stabilize the economy and inflation more effective.

In recent months we have witnessed a progressive materialization of the risk of market fragmentation. The marked increase in the spreads on Italian and Greek government bonds as well as, to a more limited extent, in other euro-area countries, is a cause for concern. These are tensions that do not appear to be explained by the changing macroeconomic outlook. For Italy, especially, our analyses indicate that a spread between the yields on Italian and German ten-year government bonds of less than 150 basis points would be justified by the fundamentals and, in any event, levels above 200 basis points would not. In recent weeks, the widening has intensified, accompanied by a progressive increase in market volatility.

It is in light of these developments, in many ways unjustifiable, that we must view the decision, taken only yesterday, by the ECB Governing Council to apply flexibility under the Pandemic Emergency Purchase Programme (PEPP) and to ask the Eurosystem committees to accelerate the completion of the design of a new anti-fragmentation instrument.

The first instrument – which takes advantage of the opportunity to flexibly reinvest the assets held under the PEPP – is already part of the monetary policy arsenal. Its use at this time is fully justified. Much of the tension dragging on the economy has sprung from the effects of the pandemic crisis: from the mismatch between supply and demand, which creates procurement problems and fuels inflation, to the sharp rise in national public debt, to the need to normalize monetary conditions which had become extremely accommodative in order to address the most acute phase of the crisis and to stimulate the recovery. The war in Ukraine has also caused GDP growth to fall compared with what had been expected based on the boost given by the NGEU programme, conceived precisely as Europe's response to the effects of the pandemic crisis.

The second instrument, currently being designed, will serve to increase – and to lay lasting, solid foundations for – the ECB's capacity to ensure that the impact of monetary policy is as uniform as possible across the entire euro area.

I would like to clarify two aspects of this decision and these instruments. First: their aim is purely one of monetary policy, intended to facilitate the pursuit of price stability; they have no other purpose, much less that of financing imprudent and unsustainable fiscal policies. Second: the gradual normalization of monetary policy and the action taken to fight fragmentation are fully complementary. The former cannot proceed in an orderly fashion without the latter; in order to defend the appropriate monetary policy stance, we must prevent malfunctions or interruptions in its transmission mechanism.

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I am convinced that the ECB's determination will also contribute to restoring order to the markets. This will help investors to more carefully and accurately access the real condition of our economy. Looking ahead, there are clear signs of improvement. The debt-to-GDP ratio is falling and, according to the European Commission's most recent assessments, it will continue to decrease this year and next. Thanks to the high average residual maturity (close to 8 years), the average interest rate on government bonds should remain lower than the nominal GDP growth rate, while interest payments should stay low in the coming years as well. The net international investment position is positive; Italian producers are successfully competing on export markets; household debt is the lowest among the main countries of the European Union and that of firms is below the average; conditions in the banking sector have improved in terms of the volume of non-performing loans and profitability, while capitalization, though down a little on last year, remains at high levels.

Today it is up to us to maintain and build on the strengths of our economy and keep the public accounts under control. In emergency conditions, financing current expenditure with deficit spending may make it possible to focus more carefully on the need for social justice and on protecting those who have been hit particularly hard by the crisis and by the changed situation. Budgetary deviation is a macroeconomic stabilization tool, but it cannot become the norm: a high and persistent deficit is not sustainable, it inevitably translates into an increase in the debt-to-GDP ratio. The way to achieve lasting progress is through economic development, enhancing the skills of the labour force and investment.

Considerable progress can be made through the investment programmes and the reforms envisaged by the National Recovery and Resilience Plan. The NRRP provides enormous funding for goals that must undoubtedly be shared across the political spectrum, namely accelerating the 'twin' green and digital transition, providing greater support for education and research, and remedying the development lags in the South. The nation is on the right path: our success in completing the main investment programmes, which are now all in the start-up phase, and the related reforms, which are not 'dictated by Brussels' but are in our own interest, will be essential to strengthen the growth potential as well as to counter the risks, including of a financial nature, determined by heightened global uncertainty.

The European Union continues to be a vital resource for our country. This has been clearly proven by the show of solidarity during the pandemic, including through a number of concrete decisions, by the European institutions, by the leaders and by the peoples of the Member States. There are no enemies in Brussels, let alone in Frankfurt. The fears and prejudices that surfaced with the double crises of the last decade must be definitively rejected. We must engage in dialogue and take decisions consistent with the path that we have forged together towards an innovative and more sustainable economy. We must do this in order to overcome the uncertainties and the problems posed by this very difficult economic situation; it is essential in order for us to be able to face the challenges, in many ways totally unexpected ones, that we find before us at the global level.

Grafica a cura della Divisione Editoria e stampa della Banca d’Italia