SPEECH

Monetary policy in an uncertain world

Speech by Christine Lagarde, President of the ECB, at “The ECB and Its Watchers XXII” conference

Frankfurt am Main, 17 March 2022

The Russian invasion of Ukraine has cast a shadow over Europe.

It has called into question the fundamental tenets of our security, based on territorial sovereignty and respect for international law and human rights. And it has revealed our collective vulnerability born out of economic dependence on hostile actors. As Europe’s leaders declared last week, this war of aggression constitutes a tectonic shift in European history.

The ECB’s Governing Council stands by the people of Ukraine, who have been subjected to this horrific act of aggression. As the central bank of the euro area, we will play our part in the common response. We will implement the sanctions decided on by the EU and we will take whatever action is needed to secure price stability and safeguard financial stability.

The euro area economy has faced a number of challenges over the last months. The rapid economic recovery from the pandemic emergency has been coupled with higher energy costs, supply-side constraints and price pressures. Now, owing to the war, Europeans will in the short term be confronted with higher inflation and slower economic growth.

Accordingly, the challenges facing monetary policy are changing. We are unlikely to return to the same inflation dynamics we saw before the pandemic. We have therefore begun adjusting policy so that, when the necessary conditions are satisfied, we can take additional steps towards policy normalisation. But we are also aware of the underlying risks caused by the war and the uncertainty it is creating in all directions. For this reason, all our monetary policy decisions in the months to come will necessarily be informed by the economic fallout from the war and be data dependent.

As Bertrand Russell said, we face an eternal test of “how to live without certainty, and yet without being paralysed by hesitation”. In that spirit, the best contribution that monetary policy can make in today’s circumstances is to provide clear guideposts regarding how we will react under uncertainty. The Governing Council last week agreed that its response will be guided by three principles: optionality, gradualism and flexibility.

In my remarks today, I would like to explain (i) how we saw inflation dynamics developing before the war began, (ii) how the war is expected to affect the outlook for inflation and growth, and (iii) how our recent decisions increase our optionality while embedding gradualism and flexibility.

The volatile recovery from the pandemic

The ongoing exit from the pandemic has created an environment of exceptional volatility. There are few episodes in history where conditions in the economy have changed so quickly. After one of the steepest contractions in GDP ever recorded in peacetime, we have seen the steepest recovery in GDP on record.[1] Employment has never fallen by so much and then rebounded so quickly.[2]

This remarkable turnaround was largely attributable to the strong and coordinated policy response from monetary, fiscal, supervisory and regulatory authorities, all of which helped to preserve jobs and incomes and laid the foundation for the economy to recover so quickly.

But it has led to two different effects on inflation.

First, volatile growth has led to volatile short-term inflation.[3] Policy actions have protected demand but could not fully offset the legacy effects of the pandemic on supply. This has been especially

noticeable in the prices of energy, food and durable goods.

Energy and food account for, on average, around two-thirds of inflation since June last year, with supply failing to catch up with demand as the world economy reopened.[4] Durable goods inflation is 16 times higher today than it was in February 2020. Consumers in advanced economies have spent more on goods relative to services, while producers have been constrained by “zero Covid” policies in parts of Asia, a major provider of consumer goods worldwide.

In many ways, the best analogy for what we have seen is the spurt in inflation that typically accompanies the end of wars, when demand for consumer goods runs ahead of sluggish supply as firms are slow to adapt to “normal” conditions. For example, between 1945 and 1947 the price of crude oil in the United States increased by 80%, as car ownership became more widespread but the supply of petroleum was unable to keep up.[5]

However, behind these short-term factors we have also been seeing a second effect: an improving medium-term inflation outlook.

Setting aside the impact of the Russia-Ukraine war, the economy has been on track to achieve a greater utilisation of resources and a tighter labour market than before the pandemic. The last time the euro area[6] saw unemployment rates at today’s levels was in the 1970s.[7]

Inflation expectations have also converged to our target of 2% across a range of measures, while inflation has become broader and measures of underlying inflation have risen. These measures have been influenced by energy prices and supply bottlenecks, but with pipeline pressures swelling, the upward impact may last for a while. An indicator of “sticky price inflation”, which captures items whose prices are changed less frequently, rose to 2.9% in December last year.[8]

All this suggests that inflation is increasingly likely to stabilise at our 2% target over the medium term. This was the outlook which led us, in December last year, to start with a step-by-step reduction in the pace of our asset purchases. We also adjusted our communication in February as the incoming data suggested that inflation was converging even faster towards our medium-term goal.

The inflation outlook and the war

The outbreak of the war has introduced new uncertainty into the outlook. In particular, the short-term factors pushing up inflation are likely to be amplified.

Energy prices are expected to stay higher for longer, with gas prices up by 73% since the start of the year and oil prices up by 44%. The pressure on food inflation is likely to increase. Russia and Ukraine account for nearly 30% of global wheat exports and wheat prices are up by more than 30% since the start of the year. Belarus and Russia produce around a third of the world’s potash, a key ingredient, alongside natural gas, in producing fertiliser – which was already in short supply.

Global manufacturing bottlenecks, which had shown some signs of easing over the last months, are also now likely to persist in certain sectors, prolonging price pressures for durable goods.

For example, Russia is the world’s top exporter of palladium, which is a key input for producing catalytic converters and is hard to substitute with other suppliers.[9] Ukraine produces around 70% of the world’s neon gas, which is critical for the laser lithography process used in semiconductor manufacturing. The euro area is highly dependent on Russia for cobalt and vanadium, which are key for the 3D printing, drone and robotics industries.

The ECB staff’s latest baseline projections – which include a first assessment of the impact of the war – see inflation, on average, at 5.1% this year. In a more severe scenario produced by our staff, inflation might exceed 7% in 2022.[10]

The balance of forces over the medium term

When faced with a supply shock, the key question for monetary policy is whether the effect of the shock on inflation is likely to become persistent. There are several considerations that we need to take

into account in the current situation.

First, as this shock is hitting the economy at a time when inflation is already high, the risk of it infiltrating inflation expectations is greater. We know from research that households' inflation expectations are strongly influenced by the prices of goods that they purchase frequently, typically fuel and groceries.[11]

Second, the war could set in motion new inflationary trends that take a while to play out.

There has been much discussion since the pandemic about whether we are seeing a structural break in the inflation regime caused by de-globalisation and accelerated de-carbonisation.[12] Now, the push for European strategic autonomy is likely to gather steam, with deliberate "friend-shoring" of critical supply chains. The energy transition is also likely to speed up, as the paths to achieving energy security and climate security now point firmly in the same direction.[13]

At the same time, the war poses significant risks to growth, in particular over the short term, and this could depress medium-term inflation if it means the economy returns to full capacity more slowly. The main risks are via energy prices and confidence.

As the euro area is a net importer of energy, rising energy prices represent a terms of trade "tax" that transfers purchasing power to the rest of the world. Higher energy prices already created a negative income effect of 1.4% of GDP in the last quarter of 2021 compared with the same period in 2019, which was only partly offset by higher export prices.[14]

Historical experience suggests that this effect will likely become stronger now. ECB analysis shows that swings in energy supply have been an important driver of household real income during previous episodes of large energy supply shocks. This was true both when OPEC increased oil production in 1986, causing a collapse in energy prices, and when Iraq invaded Kuwait in 1990, leading to soaring energy prices.[15]

The conflict might also negatively affect confidence through at least two channels.

First, we had expected the household saving rate to normalise this year and support stronger spending. But US research finds that large energy shocks typically lead to precautionary behaviour as consumers become more pessimistic.[16] Even before the war, the rise in inflation since last summer seemed to have dented euro area households' expectations about their future financial situation.

At a minimum, higher energy prices are likely to eat into the savings households accumulated during the pandemic, diverting them away from non-energy consumption. The ECB's consumer expectations survey shows that last year's energy price spike has already led households to save less and dip into savings more by an amount equal to 1.1 percentage points of income.[17]

Second, business investment could be affected. Major geopolitical events that have increased economic uncertainty in the past – such as the two Gulf Wars and the 9/11 attacks – are found to have foreshadowed declines in investment in advanced economies.[18]

These effects are reflected in the ECB staff's baseline projection, which sees slower but still relatively robust growth this year at 3.7%. But in the severe scenario GDP growth could be up to 1.4 percentage points lower than the baseline this year.[19]

These competing forces create a wider range of risks around the inflation forecast beyond the near term. This requires close monitoring of a broad set of real and nominal variables, including various measures of inflation expectations.

One such variable is the response of fiscal policy. Fiscal policy can help buffer the war's adverse effects on growth, while its impact on inflation depends on the nature of the support measures.[20] Many governments are currently taking decisive actions to protect real incomes, particularly for those most affected by rising energy prices. And we are also likely to see more investment into the green transition and defence capabilities.

A second variable is changes in household savings. If inflation expectations start to become de-anchored, that could come together with households frontloading their consumption and reducing the

amount they save by more than would be necessary to pay for higher energy bills.[21] But if savings start rising and consumption is postponed, it could indicate that growth effects are likely to prevail.

A third variable is the behaviour of wages. In general, when the inflation target is 2% and productivity growth is around 1%, average wage increases of around 3% would be consistent with on-target inflation.[22] If wages were to notably and persistently exceed that benchmark even as growth was slowing, it could be an indication that household inflation expectations are drifting upwards.[23]

However, if wages were to fail to catch up sufficiently – for instance because uncertainty leads to unions being more cautious – households would be exposed to an even stronger squeeze in real income. That could result in a fall in consumption and weaker growth in the medium term.

Optionality, gradualism and flexibility

When the Governing Council met last week, we weighed up these competing forces. We concluded that the challenges facing monetary policy are changing. We have become increasingly confident that the inflation dynamics of the past decade are unlikely to return. As a result, we decided it was appropriate to continue dialling back our net asset purchases, which were intended to combat an environment where disinflationary risks dominate.

But we also agreed that we needed a policy framework tailored to the current environment of heightened uncertainty and the new challenges it presents. To that end, we decided that our policy should be governed by three principles: optionality, gradualism and flexibility.

First, optionality should not be confused with ambiguity. It is about making clear how we will react to a range of scenarios, and ensuring that we are poised to react effectively if they materialise. We have therefore put in place a “conditional” approach to policy normalisation, conveying our reaction function under alternative scenarios.

Specifically, if the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases, we will conclude these purchases in the third quarter. This increases our optionality by removing obstacles along the potential path of interest rate normalisation if our expectations play out. It also gives us more scope to adjust policy in a timely fashion should we see risks of excess inflation extending into the medium term.

At the same time, we have decided that, if the outlook changes and financing conditions become inconsistent with further progress towards our 2% target, we stand ready to adjust the size and/or duration of our purchases. In this way, we are keeping open the option to take any necessary measures should the economic consequences of the war escalate and stifle the current recovery path.

Optionality also means that the path of our policy over the coming months will be data dependent. We will confirm the way forward only once we have more visibility as to whether our expectation for medium-term inflation materialises.

Under all scenarios, our stock of asset purchases is providing significant accommodation – it will exceed €5 trillion by the third quarter and will be reinvested even after the end of net purchases.

Second, gradualism is a well-established principle for central banks in times of uncertainty.[24] When faced with uncertainty about the resilience of the economy, it pays to move carefully. In keeping with this, we have adjusted our forward guidance on interest rates to temper expectations of any abrupt or automatic moves.

We now say that the adjustment of key ECB interest rates will take place “some time after” the end of net purchases. This maintains our traditional sequencing logic, but also gives us extra space if needed after we stop purchasing bonds and before we take the next step towards normalisation. This will allow us to test whether the convergence of inflation to our target that we project today is robust to current and potential new shocks.

The length of the interval between these two decisions will be determined by our strategy and by the three conditions that govern our forward guidance on interest rates. And we have made clear that future adjustments to rates, when they come, will be gradual.

Third, flexibility is a special principle for conducting monetary policy in a monetary union, as we must continually focus on ensuring that policy is transmitted evenly to all parts of the euro area. With diverging initial conditions, exogenous shocks can affect economies asymmetrically. If this leads to financial fragmentation, the transmission of monetary policy can be disrupted.

To reduce uncertainty under these conditions, the Governing Council has reiterated its commitment to flexibility. This means that we are ready to use a wide range of instruments to address fragmentation, including the reinvestment of our portfolio held under the pandemic emergency purchase programme.

If necessary, we can design and deploy new instruments to secure monetary policy transmission as we move along the path of policy normalisation, as we have shown on many occasions in the past.

Conclusion

Let me conclude.

Monetary policy today is facing a new challenge. We are increasingly confident that inflation dynamics over the medium term will not return to the pattern we saw before the pandemic. But we need to manage a shock that, in the short term, pushes inflation above our target and reduces growth.

We have reacted to this new environment by increasing our optionality and emphasising that we will act gradually and flexibly in order to deliver our mandate of price stability. We have also outlined a conditional path towards policy normalisation if the necessary conditions are satisfied. And, at the same time, we are mindful of the risks ahead, and we are ready to revisit our plan if the incoming data require us to do so.

Our outlook today can be neatly summed up in the words of Maya Angelou: we are “hoping for the best, prepared for the worst, and unsurprised by anything in between.”

1. For example, from the onset of the great financial crisis, it took seven years for euro area GDP to return to its pre-crisis level. Today, GDP has already surpassed its pre-pandemic level.

2. After the great financial crisis and the sovereign debt crisis, employment fell by around 5 million and it did not reach its pre-crisis level until late 2016. But during the pandemic, employment fell by around the same number and it has already risen by almost 5.5 million.

3. Inflation averaged 0.3% in 2020 but 2.6% in 2021.

4. According to ECB analysis, since the trough in April 2020, around 30% of the increase in the oil price is explained by oil demand, while around 45% is explained by oil supply.

5. Hamilton, J.D. (2013), “Historical oil shocks”, in Parker, R. and Whaples, R. (eds.), *Routledge Handbook of Major Events in Economic History*.

6. Euro area 12.

7. This figure still hides some slack: 2.5 million people were still enrolled in job retention schemes at the end of last year, and the number of hours worked in the economy remains below its pre-crisis level. But the overall picture is of a labour market returning to an expansionary phase.

8. This indicator is based on a weighted basket of items that change price relatively infrequently.

9. European Commission (2020), “Study on the EU’s list of Critical Raw Materials”, Factsheets.

10. See the box entitled “The impact of the conflict in Ukraine on the euro area economy in the baseline and two alternative scenarios” in ECB (2022), *ECB staff macroeconomic projections for the*

euro area, March.

11. D'Acunto, F., Malmendier, U. and Weber, M. (2022), "What Do the Data Tell Us About Inflation Expectations?", *Chicago Booth Paper*, No 22-09, Fama-Miller Center for Research in Finance and The University of Chicago, Booth School of Business.

12. Lagarde, C. (2021), "Monetary policy during an atypical recovery", speech at the ECB Forum on Central Banking "Beyond the pandemic: the future of monetary policy", Frankfurt am Main, 28 September.

13. European Council (2022), "Versailles Declaration", 10 and 11 March.

14. The net income effect from the deterioration of euro area terms of trade is estimated at around -0.65% in the fourth quarter of 2021 compared with the fourth quarter of 2019.

15. Battistini, N., Di Nino, V., Dossche, M. and Kolndrekaj, A. (2022), "Energy prices and private consumption: what are the channels?", *Economic Bulletin*, ECB, forthcoming.

16. Edelstein, P. and Kilian, L. (2009), "How sensitive are consumer expenditures to retail energy prices?", *Journal of Monetary Economics*, Vol. 56, No 6, September, pp. 766-779.

17. Battistini, N. et al. (2022), op. cit.

18. Baker, S., Bloom, N. and Davis, S. (2016), "Measuring Economic Policy Uncertainty", *The Quarterly Journal of Economics*, Vol. 131, No 4, November.

19. ECB (2022), op. cit.

20. D'Acunto, F., Hoang, D. and Weber, M. (2021), "Managing Households' Expectations with Unconventional Policies", *The Review of Financial Studies*, July.

21. There is strong economic and statistical evidence that households that expect higher inflation over the following 12 months have a higher current propensity to purchase durable goods. See D'Acunto, F. et al. (2022), op. cit.

22. Assuming a constant wage share.

23. Bodenstein, M., Guerrieri, L. and Kilian, L. (2012), "Monetary Policy Responses to Oil Price Fluctuations", *IMF Economic Review*, Vol. 60, No 4, International Monetary Fund, pp. 470-504.

24. Brainard, W.C. (1967), "Uncertainty and the Effectiveness of Policy", *The American Economic Review*, Vol. 57, No 2, May, pp. 411-425.

CONTACT

European Central Bank

Directorate General Communications

› Sonnemannstrasse 20

- 60314 Frankfurt am Main, Germany
- +49 69 1344 7455
- media@ecb.europa.eu

Reproduction is permitted provided that the source is acknowledged.

Media contacts

Copyright 2022, European Central Bank