Speech Klaas Knot - “The ECB strategic review and the inflation challenge”

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On April 4 Klaas Knot spoke at the Euro50 Group Conference, held at the Royal Automobile Club in London. Klaas talked about the current high inflation, the implications for monetary policy and the role of the strategic review.

Main messages

- *In the face of high inflation realizations and lasting supply-side pressures, it is important to acknowledge that demand plays a bigger role in driving inflation than expected.*
- *Persistently high inflation is creating an increasing risk of de-anchoring of inflation expectations, particularly by households. This could weaken the monetary transmission and threaten price stability, and means that monetary policy can and should act, in a gradual but timely fashion.*
- *The ECB’s new monetary strategy – devised mainly to deal with an environment of persistently low inflation – can help counter current inflationary pressures.*
- *In the process of policy normalization, the evaluation of the proportionality of our decisions and their potential side effects will play an important role. Financial stability considerations should be taken into account during the normalization path. This puts a premium on good analysis/monitoring.*
- *In our communication to the public we should be predictable and clear, and emphasize our commitment to price stability.*

Thank you for the invitation to speak here. Following up on our discussion before dinner, I would like to offer you my views on the nature of the current high inflation, what that means for monetary policy, and how the strategy review might help us to bring inflation back under control.

We are living in an environment of extreme uncertainty, caused by a pandemic that has held the world in its grip and the outbreak of a war in Europe. Against this background, inflation has risen sharply. In the US, it has reached levels last seen in the 1980s, while in the UK, the annual CPIH inflation rate has never been so high since 1992. In the euro area, current inflation rates are unprecedented in the history of the Economic and Monetary Union.

Confronted by persistently high inflation, experts, markets and the public at large are expecting central banks to act. Although inflation is also influenced by factors outside of the control of central banks, I will argue that monetary policy can and should play a role in bringing inflation back under control. And that our new monetary strategy will help us do so.

Drivers of inflation dynamics

My first argument of why central banks should act hinges on the role of demand factors in current inflation dynamics. In the early stages of the pandemic, both consumer demand and supply shrunk markedly. Despite an offsetting effect from fiscal policy, the net effect, however, was deflationary. This changed when the lockdowns came to an end. The combination of a release of pent-up demand, and continuing supply bottlenecks, led to a mismatch between demand and supply, which pushed up inflation. Rising energy prices did the rest.

Inflation has, however, been persistently high. To understand why, it is important to note that a mismatch between demand and supply clearly has two sides. We often hear a narrative that mainly focused on the supply side of the economy lagging behind the demand side.

However, there are two pieces of evidence that high inflation is not only a story of supply shocks. First, a closer look at forecast errors since mid-2021 reveals that both GDP growth and inflation have surprised on the upside (Figure 1). Second, price changes measured for individual sectors of the economy show that high inflation has become a broad-based phenomenon. This suggests that aggregate demand has recovered far quicker than expected, and – at least over recent quarters – has been an important driver of inflation.

Since the outbreak of the war in Ukraine, however, supply side factors have again come to play a big role. Initially at least, the war has been a large negative supply shock putting downward pressure on growth and pushing up inflation. The latest surge in prices of energy and commodities related to the war in Ukraine is clearly supply-driven. The longer-term consequences of the war are still unknown but could be far reaching.

My second argument for why we should act in the face of high inflation relates to the risk of inflation expectations getting de-anchored. A cornerstone of the ECB's strategy review is that inflation expectations anchored to the central bank's inflation target are essential for the transmission of monetary policy and for achieving price stability.

In recent years, policymakers have benefited from important insights from the research literature. One such insight, which we owe also to Ricardo Reis, is that we should focus not only on whether expectations by markets and professional forecasters remain anchored to the central bank's target but also on expectations held by households.

A further insight is that when the structure of the economy is changing, as it is now, the public learns only slowly about this new structure. And when forming its expectations about future inflation, the public is looking more to the past than to the future. If expectations are backward-looking, the current state of the economy will also influence the future state. In this situation, there are clear risks of a de-anchoring of expectations and of monetary policy becoming less effective.

In fact, Ricardo Reis has emphasized evidence that households' inflation expectations are not perfectly anchored to central banks' inflation targets (Reis 2022, Reis et al., 2022).[1] Importantly, as he argues, de-anchoring appears to be happening from the upside. In turn, inflation expectations by households are likely to have a significant impact on aggregate demand. Recent research carried out on Dutch and Italian households, for example, shows that higher inflation expectations have led to lower spending on durable goods (Coibion et al., 2021; Rondinelli and Zizza, 2020).

Another lesson from the recent research literature is that the private sector does not understand completely changes in the way monetary policy is conducted. For example, there is evidence that Fed communication about average inflation targeting had no significant impact on household inflation expectations (Coibion et al., 2020). This suggests that overly complicated communication is not effective in steering the public's expectations.

I have tried to convince you that monetary authorities can and should act. I want to conclude by mapping these insights to our latest monetary policy decisions and sharing lessons from the ECB's strategy review on *how* to act.

In the process of policy normalization, the evaluation of the proportionality of our decisions and their potential side effects will play an important role. This is a key element of the ECB's strategy review, which we still need to operationalize, and which will help us to credibly confront this new environment. Notably, the path of normalization will likely have an impact on the stability of the financial system, in a context of high and rising debt. The Covid crisis and the war in Ukraine have also major impact on the financial sector. Financial vulnerabilities have increased further during the pandemic and are approaching levels that are relatively high from a historical perspective (Figure

2). Public and private debt has risen. This puts a premium on strengthening our analytical tools to identify the build-up of financial imbalances in real time.

A main priority in a changing environment and high uncertainty is to be predictable, and to provide a clear and simple message about monetary policy. Most importantly, the ECB needs to be clear that its primary mandate is to safeguard medium-term inflation and that it will not hesitate to act to prevent a de-anchoring of expectations. A gradual but timely normalization prevents the need for bolder policy interventions in the medium-run. It is within this context that, at its latest monetary policy meeting, the Governing Council decided to accelerate the wind-down of our asset purchases. At the same time, the Governing Council retains full optionality and stands ready to adjust all instruments when needed.

[1] Recent research by DNB staff reaches similar conclusions (Galati et al., 2022).

Coibion, D. Georgarakos, Y. Gorodnichenko and M. van Rooij (2021). How does consumption respond to news about inflation? Field evidence from a randomized control trial. AEJ: Macroeconomics, forthcoming

Coibion, Y. Gorodnichenko, E. Knotek and R. Schoenle (2020). Average Inflation Targeting and Household Expectations. NBER Working Paper No. 27836.

Galati, R. Moessner and M. van Rooij (2022). The anchoring of long-term inflation expectations of consumers: insights from a new survey. Oxford Economic Papers.

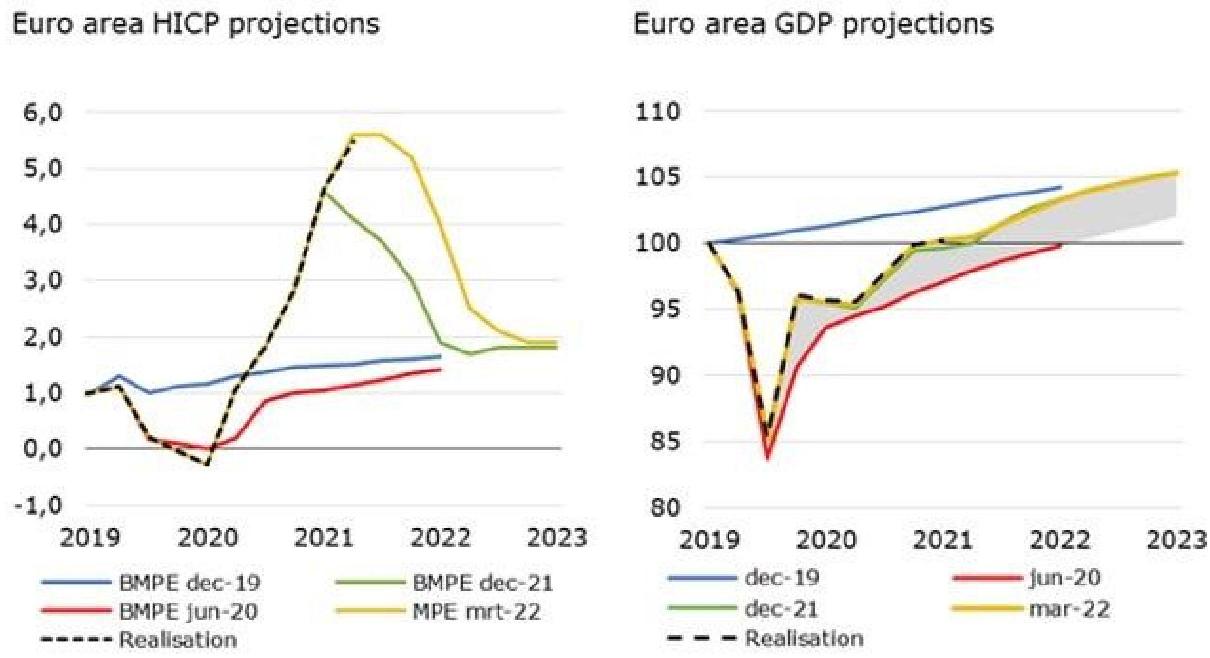
Hilscher, A. Raviv and R. Reis (2022). How likely is an inflation disaster?. Mimeo, LSE, February 2022.

Reis (2022). Losing the Inflation Anchor. Brookings Papers on Economic Activity, forthcoming.

Rondinelli and R. Zizza (2020). Spending today or spending tomorrow? The role of inflation expectations on consumer behaviour. Temi di discussione 1276, Bank of Italy.

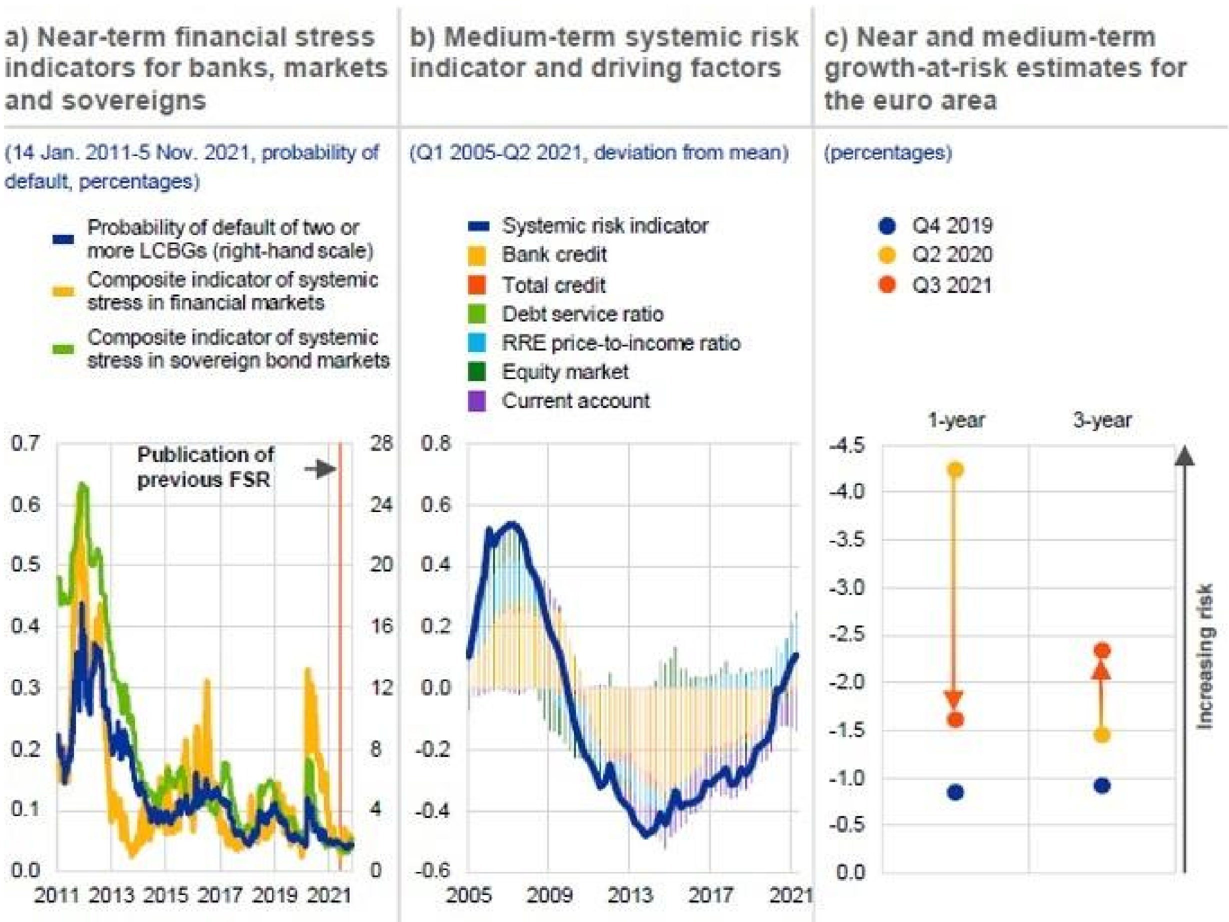
Figures

Figure 1 Revisions by professional forecasters



(c) ECB

Figure 2 Near-term and medium-term vulnerabilities in the euro area



(c) ECB Financial Stability Review, November 2021