Transcript of IMF podcast:

Philip Lane on the Nature of Europe's Double-Digit Inflation

Bruce Edwards:

So what's the difference between inflation in the US and inflation in Europe?

Philip Lane:

This is clearly mostly a supply shock in Europe, from this energy shock. The increase in energy prices in all the sectors that use energy as an input has led to this really extraordinary inflation rate of 10.7, double-digit inflation.

Bruce Edwards:

In today's episode, European Central Bank Chief Economist, Philip Lane, explains Europe's own special inflation conundrum, and what it means for governments and people there trying to stay afloat.

Philip Lane:

The most vulnerable groups do have to be supported, but the way to reconcile supporting those groups with maintaining, if you like, prudent public finances, is as far as possible, to make sure that the fiscal measures are targeted and contained. So targeted and temporary.

Bruce Edwards:

Philip Lane was invited to participate in the IMF's Jacques Polak Annual Research Conference, which this year honored former IMF Chief Economist, Maurice Obstfeld, and that's where I caught up with him.

Philip Lane:

Well, most of my career I've been an academic professor of economics, by the way, with many collaborations with the International Monetary Fund on studying the world economy, studying the world financial system. But in 2015 I became governor of the Central Bank of Ireland, which is part of the Euro system. And then in 2019 I moved to the European Central Bank where I'm a board member and where I look after the economics and monetary policy at the bank.

Bruce Edwards:

Thank you for that. And welcome to the podcast. So countries around the globe essentially are struggling with high inflation, but the eurozone has its own unique set of challenges. Fuel, and I guess food prices right now are at the center of that. How would you compare inflationary pressures in Europe to those in the United States?

Philip Lane:

So I think it's very important to recognize that inflation is basically high globally, but the nature of the inflation does have its differences. So in October, I think yesterday here in the US the inflation rate came out at 7.7. For the same month of October, the inflation rate in the Euro area was 10.7. So we now have higher inflation, and where's that coming from? In the US, the energy component I think was at 18% in October. In Europe, it's at 42%.

So this is basically when you boil it all down, it's an energy shock in the European situation. We also have, with the economy now recovering from the pandemic, demand has recovered. So it's not just purely supply side. There is a demand side to inflation in Europe. But it remains the case that the dominant issue is the energy shock.

You mentioned fuel. Fuel is probably at this point minor compared to gas and electricity. So we used to identify energy as a category with the price of oil. That's no longer, if you like, appropriate or sufficient, because oil prices, depending on your horizon, have settled down. Whereas we have this very high price of gas. And since gas is very important in the production of electricity in Europe, we have very high electricity prices. So for many families, many firms, the shock of the higher energy bills is really the dominant issue.

Bruce Edwards:

And so in terms of the Central Bank in Europe, is the approach any different do you think of trying to tackle that than it might be in the United States?

Philip Lane:

So I think there are differences between, if you like, demand-dominated inflation and supply-dominated inflation. But there are also commonalities. The commonality is no matter where the inflation comes from, if inflation is high, there's a risk of what we call second-round effects: that high inflation this year will lead to, whether firms trying to raise prices next year, workers looking for higher than normal wage increases.

Now to some extent that's necessary and appropriate. We cannot have living standards fall too much. It's perfectly reasonable for wages to go up to some degree in response to what's happened. But we have to make sure that that does not become a self-sustaining persistent momentum, which is this famous second-round effect. So what we need to make sure is that interest rates come up to a level, which basically means that we won't have a dynamic that leaves inflation above our target in the medium term.

So that job is the same. But what is true is, if you like, the going from 10.7 now back to 2%. A lot of this will be the fading out of the supply shock. But then we have to make sure the job is completed with monetary policy. Whereas if you have demand-driven inflation, then essentially you need to squeeze the economy harder because the way demand falls back does require probably more of a monetary policy tightening.

As I said to you earlier, we have both a supply dynamic and now a demand dynamic to some degree in the European situation. So there is a role for monetary policy, but we should also be clear that the origin of the 10.7 inflation rate has a big energy component, has a big supply component. This is why we do think inflation will fall back next year, and our focus is on making sure in a timely manner, it doesn't just fall back to a more moderate number, it falls back all the way to our target of 2%.

Bruce Edwards:

Okay. So the ECB just published this paper very recently about consumer expectations in the eurozone. I guess that that was also an effort to try and get a better understanding of what the risks are in terms of de-anchoring inflation expectations from the Central Bank target. How do consumers feel about inflation in the Euro area these days? I mean, what did that paper tell you?

Philip Lane:

So that paper is, if you like, a periodic report on data that we look at basically all the time. We have a big now European survey of consumers, which we look at every month. And we do find it very important. Let me say that this is one set of indicators. We also look at the indicators from the expert surveys and from market participants.

But across all of these different indicators, I think there's a very good appreciation that a lot of the inflation we see is not expected to persist. So the one-year ahead expectations have gone up quite a bit. But when you ask the consumers, we ask them about three years ahead. Or if you look at the market or the experts who take a longer view as well, there's a lot of reversing back towards our targets.

Now what is true is we do want to see the consumer expectation turn around. So the three-year ahead expectation did go up around February, March, this year. It hasn't started to reverse. Whereas in the US data there has been a reversal of that pattern, which happened late last year in the equivalent American survey.

So we definitely look at this, but let me emphasize, we have to integrate the signals about expectations from a wide range of sources. It's not about any individual survey that we look at.

Bruce Edwards:

Okay. So the pandemic, one of the legacies of the pandemic is debt. And many European countries are having to deal with very high levels of debt right now. And while the pandemic is slowly subsiding, people, and I'm thinking here especially low-income households are now dealing with high inflation, which is essentially proving a pay cut to these low-income households, especially who are already teetering on the edge.

How do you fund the policies that will help those who are being hardest hit by inflation within this high debt environment?

Philip Lane:

So let me try to build out that context a little bit. So absolutely, the governments in 2020, '21 did have to borrow a lot of money. And everywhere that was essential that that happened. It was essential that there was large-scale support for households and for firms that could not operate normally because of the pandemic. And that I think has been very important in preserving the European economy.

It kept firms open. It kept many people employed in Europe and protected their incomes. So coming out of that, in fact, many households saw their financial position improve because they received support from the government. And like everywhere, in the pandemic, the ability to consume was less. So for many people, they've had more ability to withstand this energy shock because they had more savings.

That's not true for the group you mentioned, so the lowest quintiles. And this may be where the European approach was a bit different to America. By and large, they don't have savings. They're much more exposed, as you say, because they spend more of their income on energy and food. And this is why it is so important that now there's a new fiscal challenge for governments to support that group.

So what we would say is essentially, absolutely, the most vulnerable groups do have to be supported. But the way to reconcile supporting those groups with maintaining, if you like, prudent public finances is as far as possible to make sure that the fiscal measures are targeted and contained. So targeted and temporary. What we've seen this year in the European Commission report that came out this year collectively it's been about one percentage point of GDP has been allocated to energy supports. So that's a big number in many ways... Just think about it as compared to defense budgets or overseas aid budgets. But what is also true is a lot of it has not been targeted to the most vulnerable.

So there is an inefficiency here where essentially they could deliver the same degree of protection with probably less public spending. So this is going to be obviously a very big topic to make sure these supports remain temporary, to over time, very important to improve the targeting of this so it's not such a blunt instrument.

But also to recall, if you like, that the recovery from the pandemic has meant that revenues have gone up and the fiscal positions of many countries have actually been improving. At the start of the pandemic, there was many conjectures that ratios would go up and would remain permanently high. In fact, they've come down, they're projected to come down more.

So by no means is this a kind of situation where we can be relaxed about it, but I think the Euro group and the whole European system very much knows that the way fiscal policy can be most effective is to be absolutely committed to debt sustainability, to making sure that when the conditions are right, the debt ratios will come down further, while also doing what is necessary to protect the most vulnerable during this energy crisis.

Bruce Edwards:

And sticking with that thought, many economists and analysts have been bemoaning the fact that fiscal and monetary policies seem to be out of sync in many countries. How would you respond to that? And what do you think the impact of that misalignment might be to Eurozone economies?

Philip Lane:

So let me more- phrase this as a risk factor rather than as an absolute reality. I mean, when we have this very major energy shock, it is necessary for fiscal to respond, not just from a kind of ethical point of view to protect the most vulnerable, but these are also the parts of society which basically do not have savings. And if their income falls in an unprotected way, it will reduce their consumption and that will have macro consequences.

So for macro stability, it is important that there is a government response, but as we just talked about, the sweet spot is to make sure that these are temporary and targeted. Because if they're too extensive and they're too indefinite in duration, then there's a risk that it will add to overall demand conditions, which would mean that inflation falls back to target more slowly. And that dimension would be a risk factor for the ECB.

But at this point, I would phrase it as a risk factor because of the fact that a lot of these supports are designed to be temporary. And the projections from the European Commission this morning do have, for the Euro area, on the assumption that there is a follow to with the announced policies continued, if you like, stabilization of the European fiscal situation, where by 2024, the aggregate budget deficit for the Euro area will be 3.3%.

So still more work will need to be done after that point in order to make sure that ratios come down. But compared to at the start of the pandemic, if you like, that there is a kind of baseline scenario here where that ratios will continue to come down. So again, this morning in the European Commission projection, compared to the euro area in the aggregate being at 97% debt ratio in 2021, they project it will be down to 91% in 2024. Still high, but on that basis still progress over these years. But again, this all depends on execution and on maintaining the balance between that sustainability and responding to the shock we face.

Bruce Edwards:

And just to wrap up here, people respond to inflation, these high inflation rates, differently depending on what their circumstances are. But as inflation rises, so does speculation as to where it's all going. We talked about expectations earlier on, but how do these expectations really play into the dynamics of inflation, and what can the ECB, or any central bank for that matter, do to keep that under control?

Philip Lane:

So what's fundamental is we protect the confidence of everyone that inflation will come back to our target of 2% in a timely manner. So in the near term, inflation can be high- as it is, but what would be really a major failure by us would be if households believed that inflation would remain at these levels.

So for us, it's important not just to explain, but also to take action. So we've taken already this year, we stopped the quantitative easing. We've now raised interest rates by 200 basis points, two percentage points already. And we've said we expect more to do. And so this obviously makes headline news. Everyone can see that the ECB is taking action and therefore when someone says, "Well, tell me why inflation's going to come back down towards target?" It's a combination of explaining that some of the forces on the supply side will kind of level out the data, but the ECB has a clear mandate and we're proving by our actions that we will make sure that monetary policy delivers our 2% target in a timely manner. And I think we will be closely monitoring the expectations data in order to really assess- is that message loud and clear.

Bruce Edwards:

Philip Lane, Chief Economist for the European Central Bank. Thanks so much for joining us today. I know the ECB has their own podcast that I would encourage listeners to check out. But I appreciate you taking the time to speak with us today. Thank you.

Philip Lane:

It's my pleasure.

Bruce Edwards:

So again, that was ECB Chief Economist Philip Lane.

Visit the ECB website, that's ecb.europa.eu to read their research and listen to their podcast. And look for more IMF podcasts on Apple Podcasts or wherever you get your podcasts. You can also follow us on Twitter at @IMF_podcast. I'm Bruce Edwards. Thanks for listening.