EDITORIAL

HIGH INFLATION, OPTIONALITY AND CENTRAL BANK PATIENCE

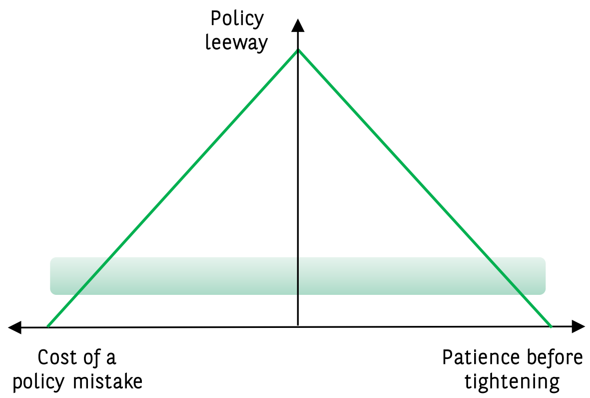
The ECB insists on the need for patience before considering a policy tightening, despite current elevated levels of inflation. It believes that inflation will decline next year and that a wage-price spiral is unlikely to develop. Moreover, inflation expectations remain well anchored. Demand in the euro area is suffering from the headwind created by the jump in energy prices. Reacting to this type of inflation by tightening monetary policy would create the risk of reducing demand even more. To avoid such an outcome, it makes sense for the central bank to wait for more information to arrive, thereby adopting a risk management approach of monetary policy. When policy leeway is limited, central banks, confronted with a high degree of uncertainty, will opt for a patient stance considering the potential cost of a policy mistake. The higher their credibility, the more they can be patient.

Recent speeches of the ECB president and several governing council members have referred to the need for patience before considering a policy tightening, despite current elevated levels of inflation. Several factors explain this stance. First, a high conviction that, as of early next year, inflation will start to decline under the influence of favourable base effects. Two, a view that despite an expected pick-up in wage growth, a wage-price spiral is unlikely to develop. Three and related to the previous point, the observation that market-based and survey-based inflation expectations remain well anchored. This anchoring reduces the likelihood of a wage-price spiral developing. Recently, ECB officials have insisted on the specific nature of, at least part of, the current high inflation. The pace of price increases has picked up strongly due to a negative supply shock, whereby the jump in energy prices weighs on households' spending power and company profits. This 'bad inflation' represents a headwind to demand.[1] Reacting to the supply-driven increase in inflation by tightening monetary policy would create the risk of reducing demand even more. Moreover, given the considerable lags between monetary policy decisions and their impact on the economy, there is a genuine and understandable concern that, by the time official interest rates would start to influence demand, the reason behind the policy tightening would have vanished because energy prices would have declined.[2] With the benefit of hindsight, the monetary tightening could turn out to have been premature. To avoid such an outcome, it makes sense for the central bank to wait for more information to arrive in order to take a better-informed decision. This risk management approach of monetary policy has been made popular by Alan Greenspan during his tenure as Federal Reserve chairman. *"Given our inevitably incomplete knowledge about key structural aspects of an ever-changing economy and the sometimes asymmetric costs or benefits of particular outcomes, a central bank needs to consider not only the most likely future path for the economy but also the distribution of possible outcomes about that path. The decision makers then need to reach a judgment about the probabilities, costs, and benefits of the various possible outcomes under alternative choices for policy."* [3]

At present, this approach is reflected in the frequent use of the word 'optionality' in statements of ECB governing council members.[4] The approach is reminiscent of the literature on corporate investment

1. Patient monetary policy amid a rocky recovery, speech by Fabio Panetta, member of the Executive Board of the ECB, at Sciences Po Paris, 24 November 2021.
2. From an inflation perspective, a mere stabilization of energy prices is sufficient for inflation, over time, to decline due to base effects.
3. Risk and Uncertainty in Monetary Policy, Remarks by Chairman Alan Greenspan at the meetings of the American Economic Association, San Diego, California, 3 January 2004, Federal Reserve.
4. *"While an increase in the upside risks to inflation had to be acknowledged, it was deemed important for the Governing Council to avoid an overreaction as well as unwarranted inaction, and to keep sufficient optionality in calibrating its monetary policy measures to address all inflation scenarios that might unfold."* Source: ECB, Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 27-28 October 2021.

INFLATION UNCERTAINTY AND MONETARY POLICY TIGHTENING



SOURCE: BNP PARIBAS

> A rate hike followed by an equivalent cut would still leave the economy worse off. When policy leeway is limited, central banks, confronted with a high degree of uncertainty, will opt for a patient stance considering the potential cost of a policy mistake.

under uncertainty. Back in 1980, Ben Bernanke[5] showed that, when investment is irreversible, uncertainty increases the value of waiting for new information. The latter implies companies are able to make a better-informed judgment, so the risk of taking the wrong decision is reduced. However, such behaviour may retard the current rate of investment: uncertainty is bad for business capital formation. Transposing these concepts to the conduct of monetary policy, the ECB and several other central banks in advanced economies are faced with uncertainty about the inflation outlook. This is to a large degree related to the question whether the high inflation triggered by the negative supply shock could lead to a wage-price spiral. What complicates matters is that the policy leeway of the central bank is very low: official interest rates are negative and years of QE have influenced the pricing of financial and also real assets, such as real estate. As a consequence, the effectiveness of additional easing may be quite limited. For the central bank, it is important to avoid creating the conditions that would require further easing[6]. In addition, it seems likely that activity and demand would react more quickly to a policy tightening than to an easing of an equivalent size, because in the latter case, uncertainty would have increased and confidence declined. It takes time to reverse these negative 'animal spirits'. As a consequence, a rate hike followed by an equivalent cut would still leave the economy worse off. This represents the cost of a policy mistake. When policy leeway is limited, central banks, confronted with a high degree of uncertainty, will opt for a patient stance considering the potential cost of a policy mistake. The higher their credibility, the more they can be patient, because inflation expectations should remain well anchored. It is for this reason that the ECB strongly insists on its decisiveness to act when circumstances require so.[7]

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5. Ben Bernanke, Irreversibility, uncertainty, and cyclical investment, NBER working paper 502, July 1980.
6. As shown in the exhibit, if there is a lot of room to ease policy (policy leeway is high), a central bank could afford taking some risk by tightening. Should it turn out to be an ill-timed decision, there would be enough room to cut rates to boost the economy.
7. In a recent interview, Christine Lagarde was asked *"So can you assure us that you will raise interest rates when necessary?"* Her answer was very clear: *"Of course, we will act when necessary."* Source: ECB, Interview with Christine Lagarde, Frankfurter Allgemeine Sonntagszeitung, 26 November 2021