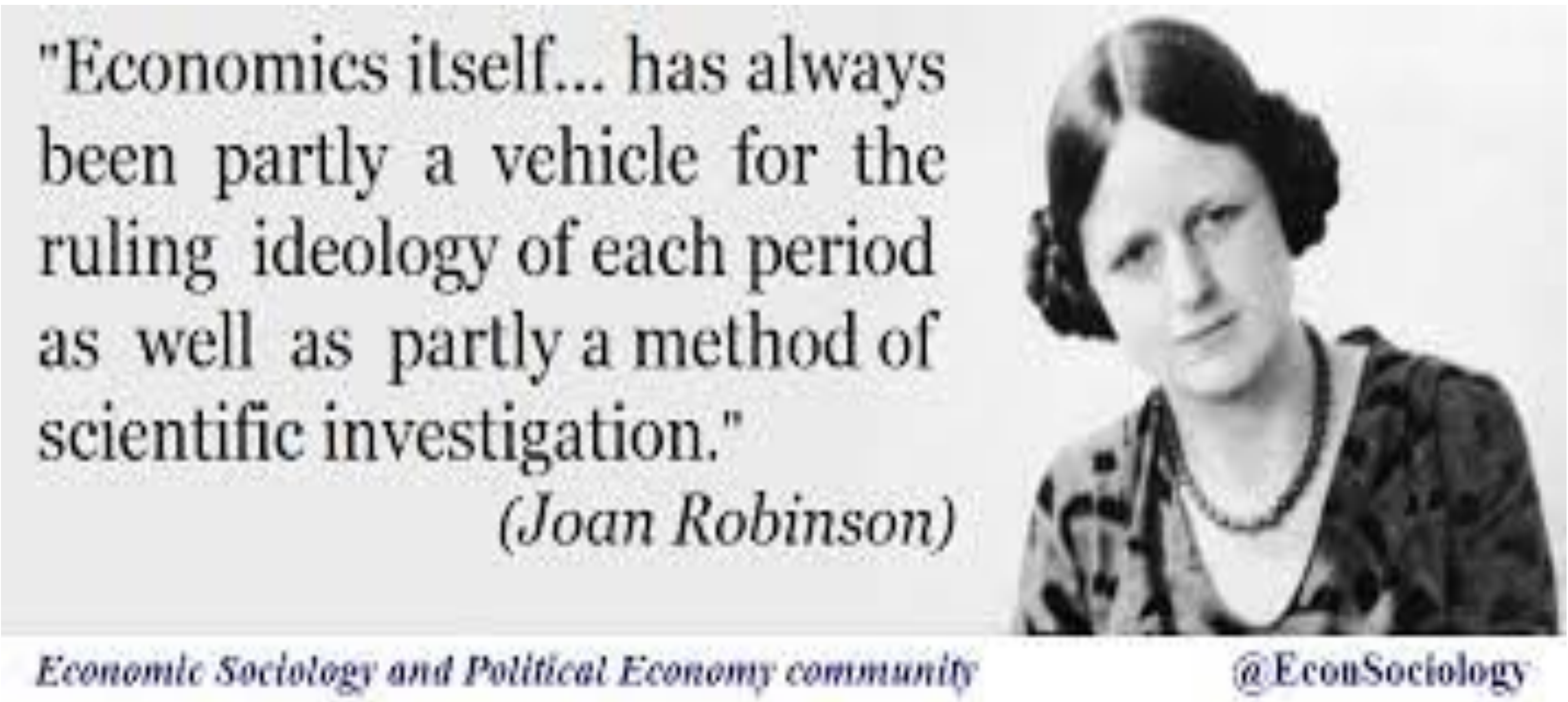
28th Annual Workshop of the EuroMemo Group
2 - 4 September 2022, King’s College London

“The EU and the political economy of global disorder
Struggles for survival, climate and energy justice”

# The return of inflation –The case of the EU

Marica Frangakis

# Narratives matter



# Outline

- The inflation ‘scare’ and the inflation ‘narrative’ – expectations/perceptions, fears (wage/price spiral) and warnings (aggressive rise in interest rates)
- Facts and figures – The return of inflation in the EU; components – Who hurts the most?
- Expectations – Is a wage/price spiral imminent in the EU? State of the EU labour market/movement
- The 1970s inflation analogy – ‘Volcker Shock’
- Central banks to the task – The notion of ‘independence’
- The ECB response
- Outlook and alternative proposals

# The mainstream narrative

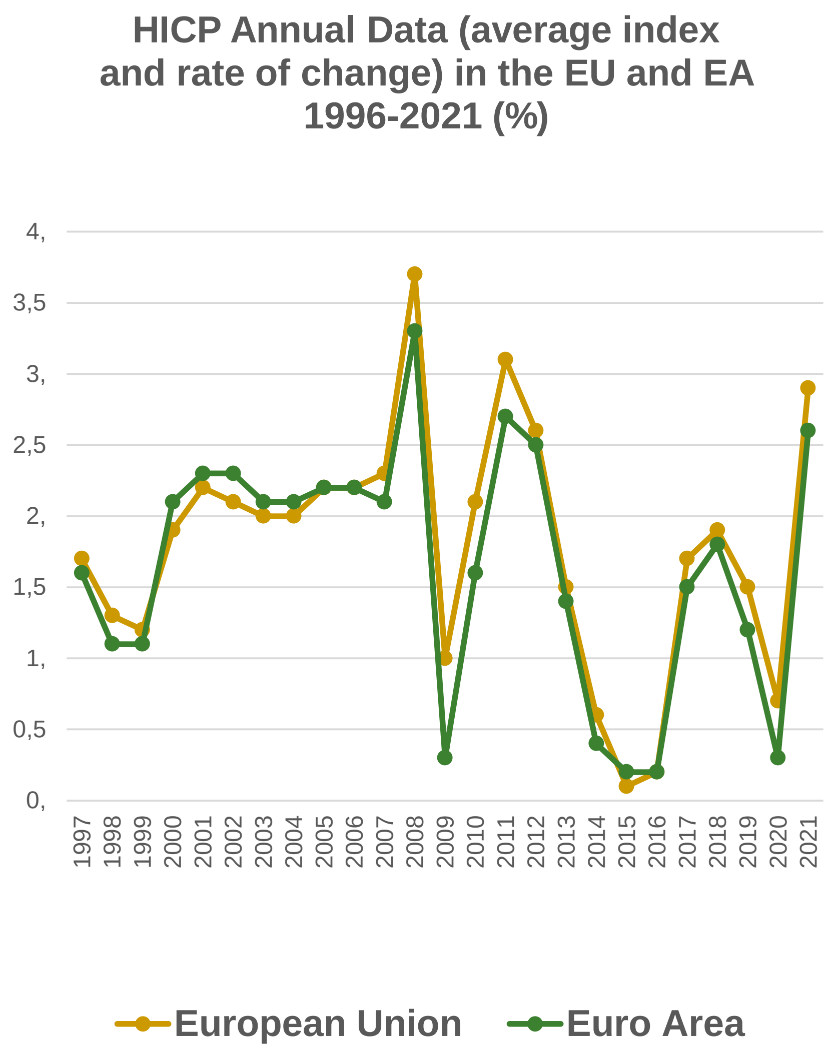
- *Surprise at the return of inflation*. This went along with the question whether inflation would be a transitory phenomenon or a more permanent feature of the post-covid era.

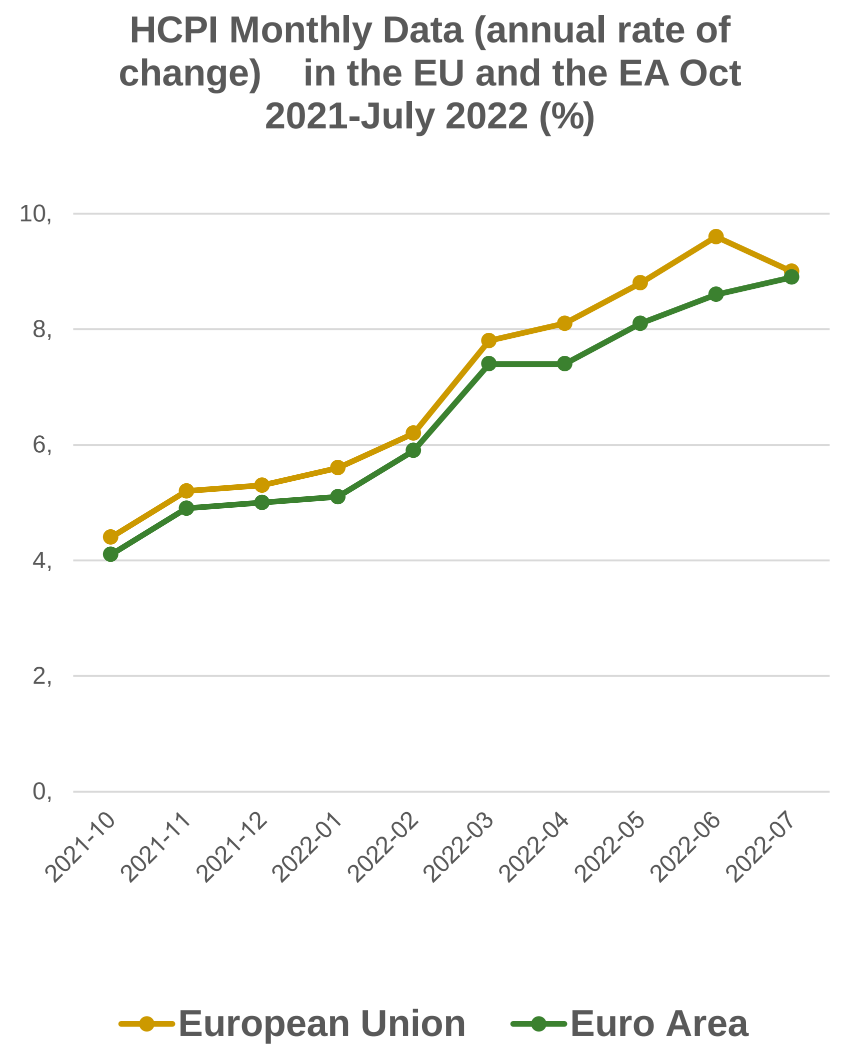
- *Concern over the ‘un-mooring’ of expectations*; fear that a wage-price spiral would take effect.
- *Monetary tightening*. Heeding the lessons of the inflation episode of the 1970s, the central banks of the western advanced countries rose to the task of fighting inflation through monetary tightening and especially a rapid and significant increase in their interest rates, even at the cost of inducing a recession, hoping it might be a ‘soft landing’.

# Our argument

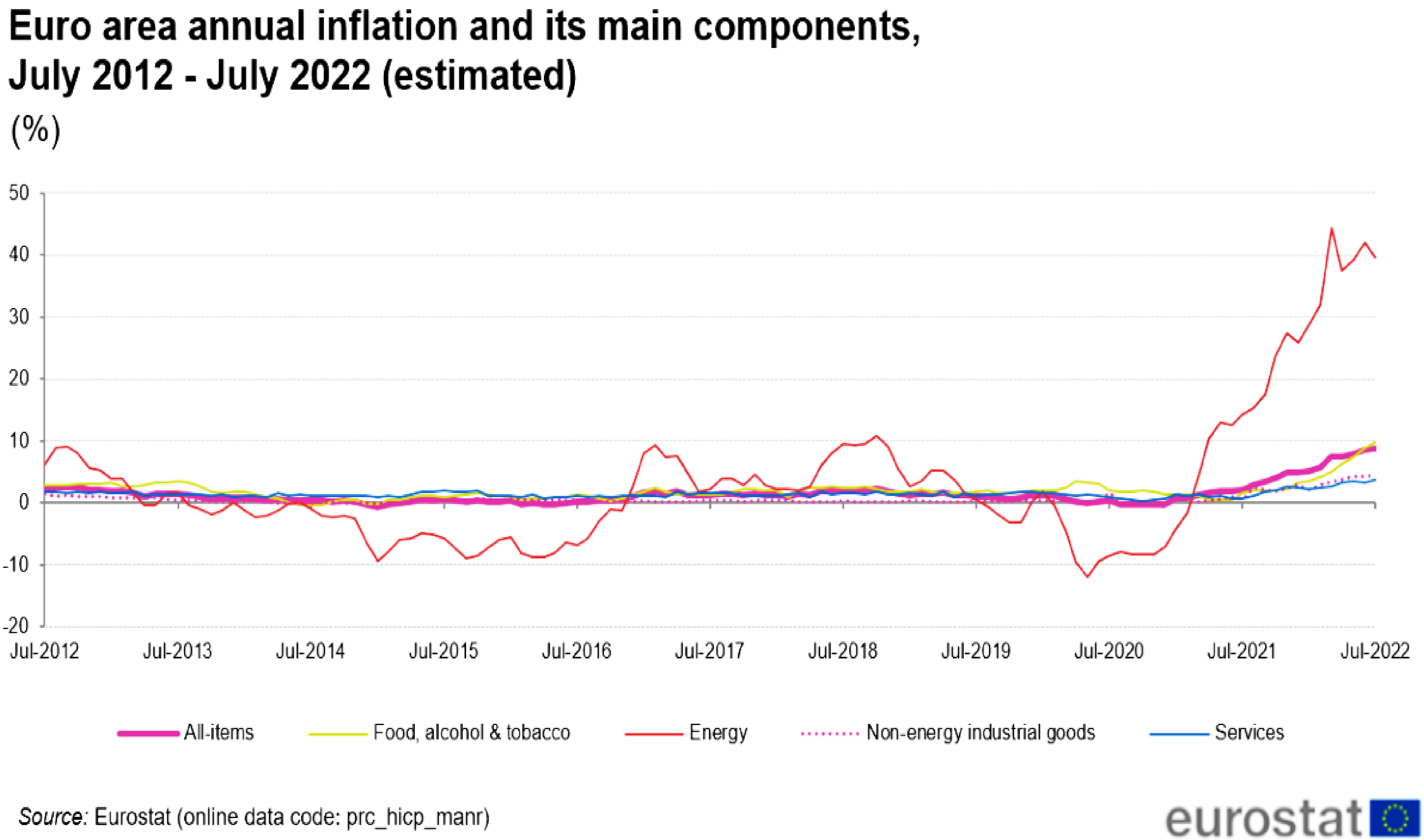
- **(a)** Given the seismic implications of the covid pandemic and the near-simultaneous lockdowns of economic activity globally, the return of inflation should not have been a surprise
- **(b)** the notion of ‘expectations’ in gauging the course of inflation is at best dubious. The concern about the ‘unmooring of expectations’ refers to the distributional aspect of inflation.
- **(c)** The 1970s experience of inflation is presented as an occurrence to be avoided at all costs. Indeed, at the surface, the analogy between the 1970s and the 2022 inflation is uncanny. However, at a deeper level, there are significant differences.
- **(d)** Having challenged the prevalent narrative of modern-day inflation, an alternative view emerges. This calls for alternative proposals in dealing with the problem of inflation.

# The rate of Inflation in the EU and the Euro Area (EA)

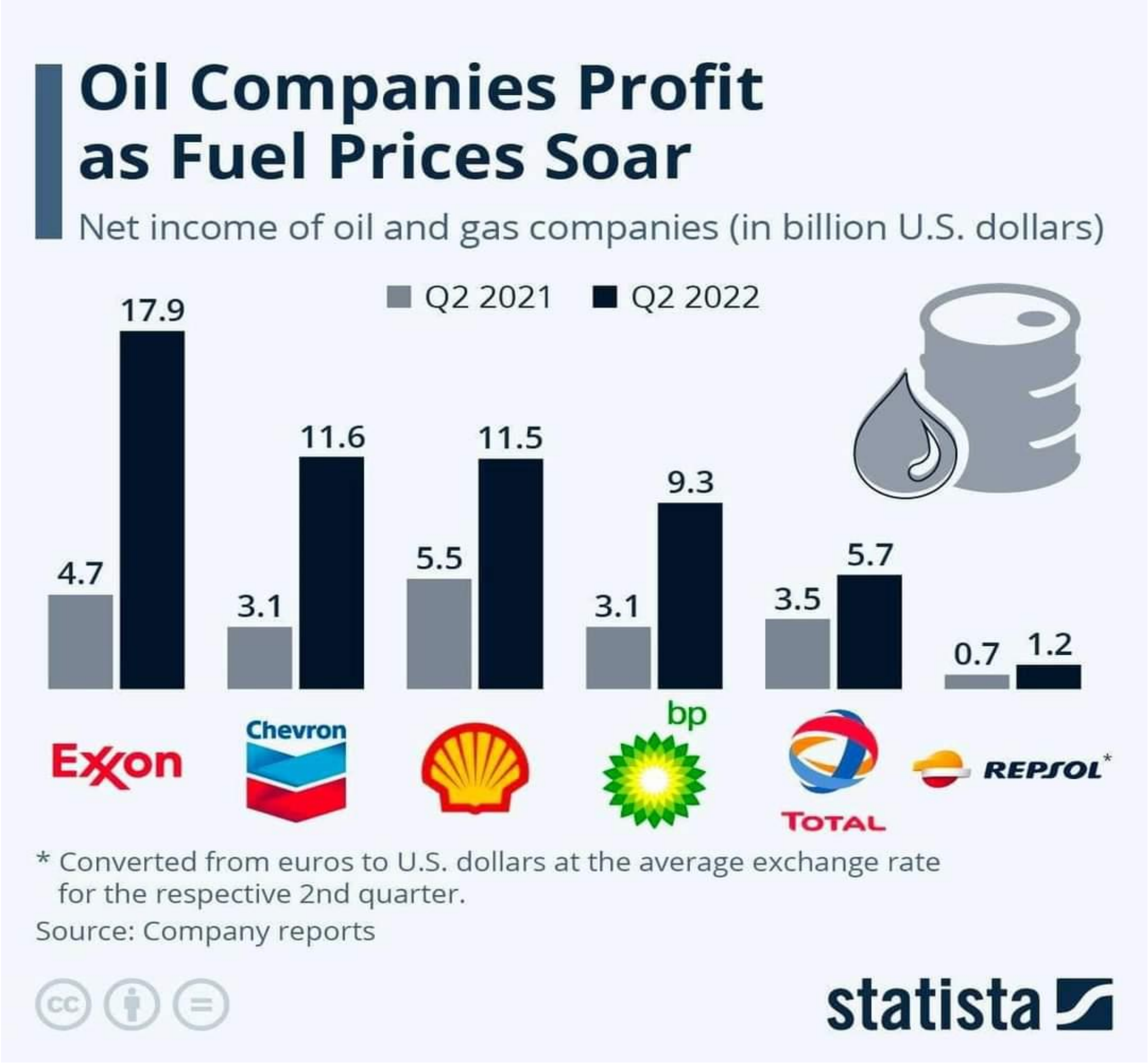


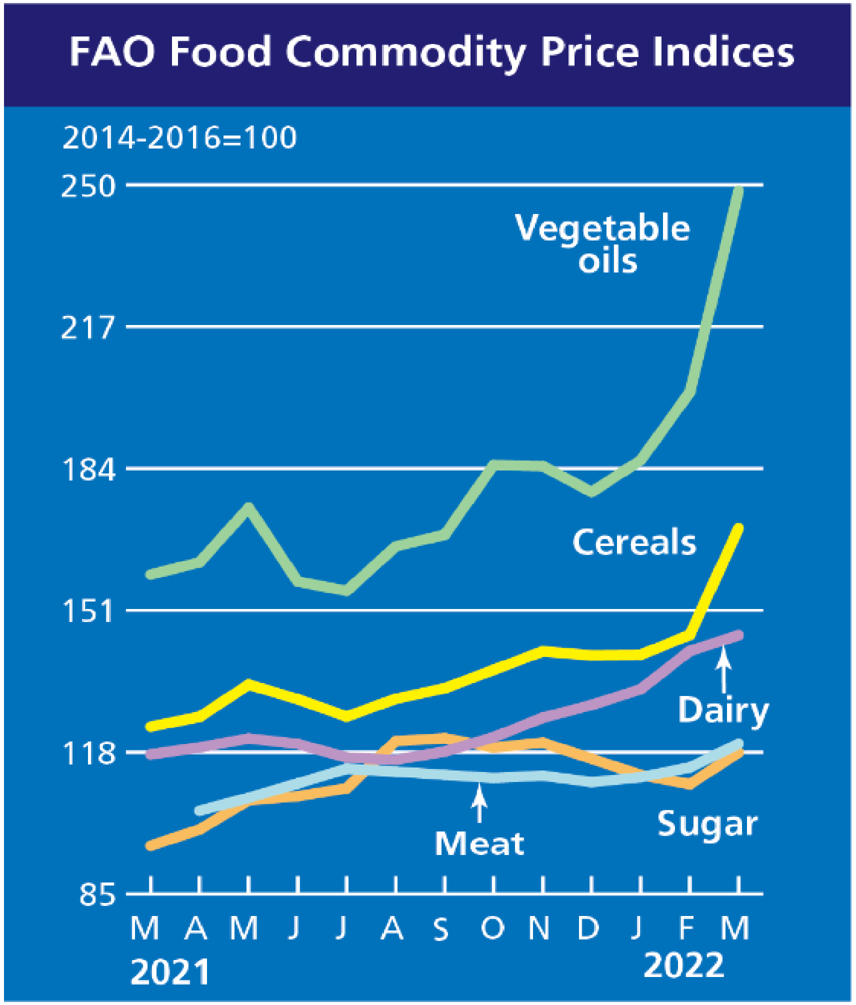
# … and its components

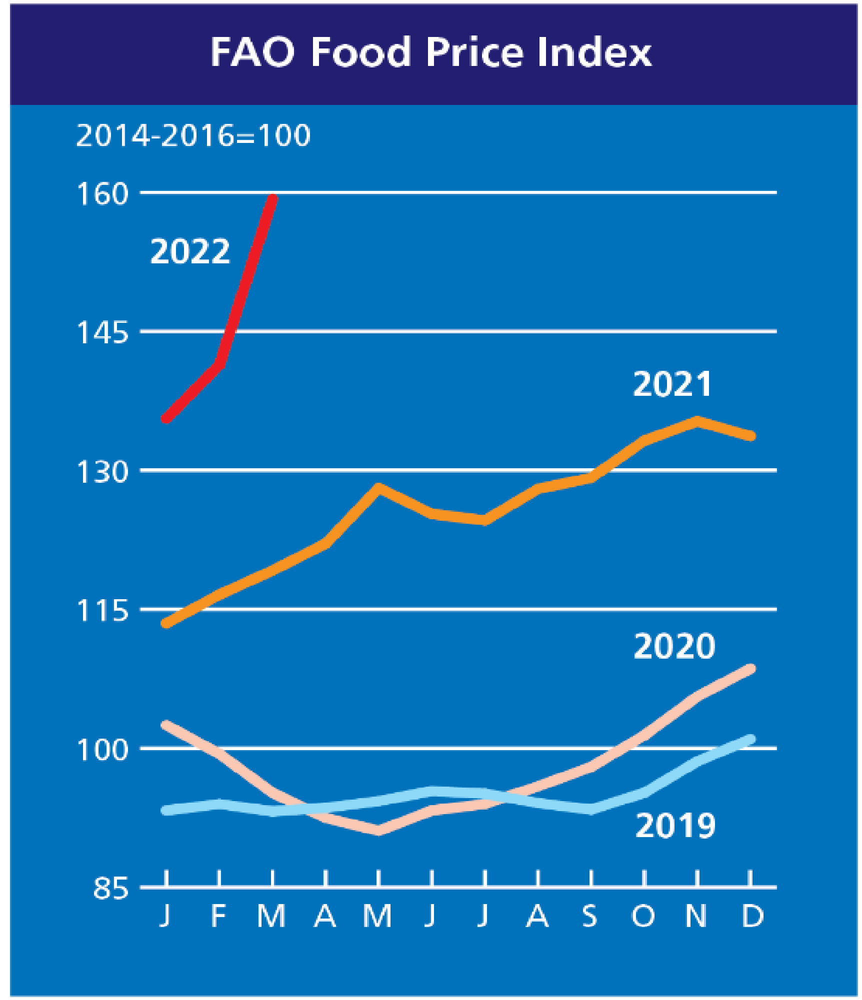


# Energy – corporate profiteering



# Commodities



# Inflation and Inequality

- **Rich-poor inflation gap** due to different income, assets and spending patterns.  Low- and middle-income households tend to rely more heavily on wage income and transfer payments than wealthier households. More importantly, poorer households spend a larger part of their income on foodstuffs and on energy than their richer counterparts.

- **Lack of Data** – HICP only tracks the price of the average consumer basket; Eurostat’s Household Budget Survey published every 5 years (latest in 2015);

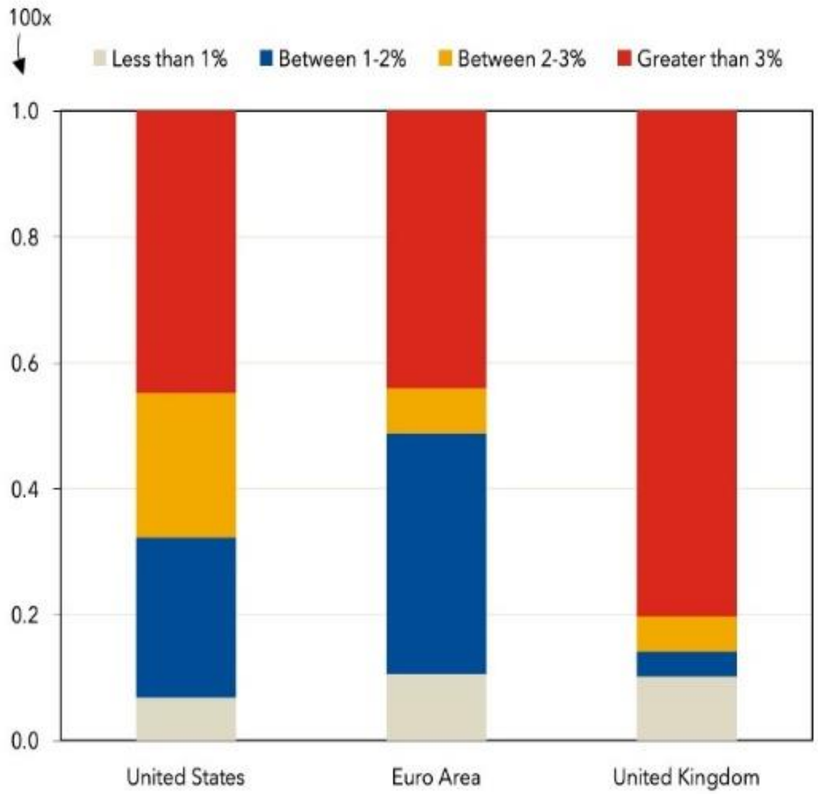
- **Harmonized EU-wide consumer survey until June 2022** - Consumers’ assessment of the past and expected financial situation of their household has been deteriorating for all income quartiles since July 2021. Worsening is more pronounced for the lower-income households.

# The ‘unmooring of expectations’

**Mounting expectations**

Markets see a sizable risk that inflation will run high in coming years.

(latest, percent, over five years)



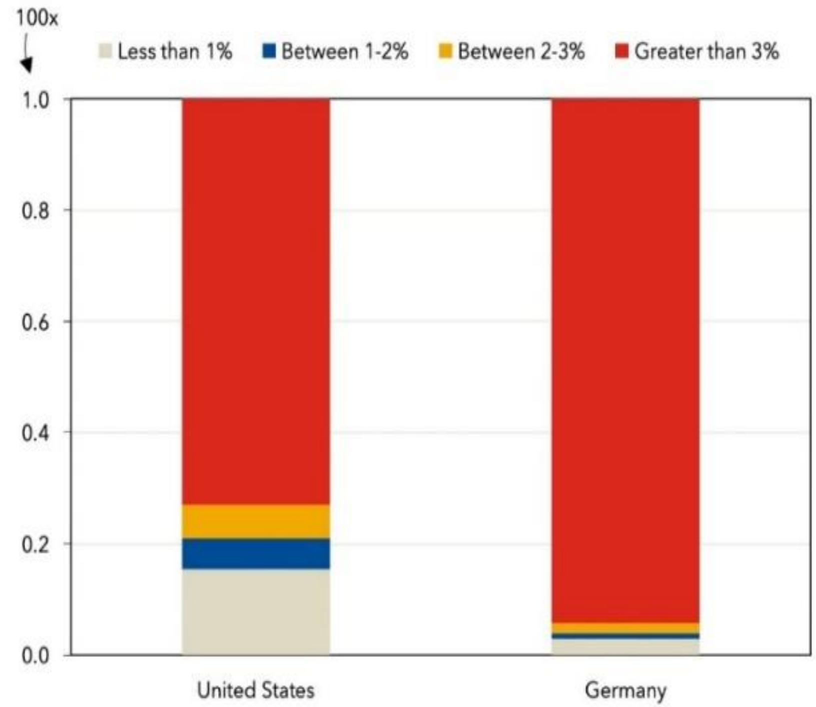

Source: IMF staff calculations.

IMF

**Household expectations**

Most households in the United States and Germany expect high inflation over the next year.

(latest, share of respondents, percent)

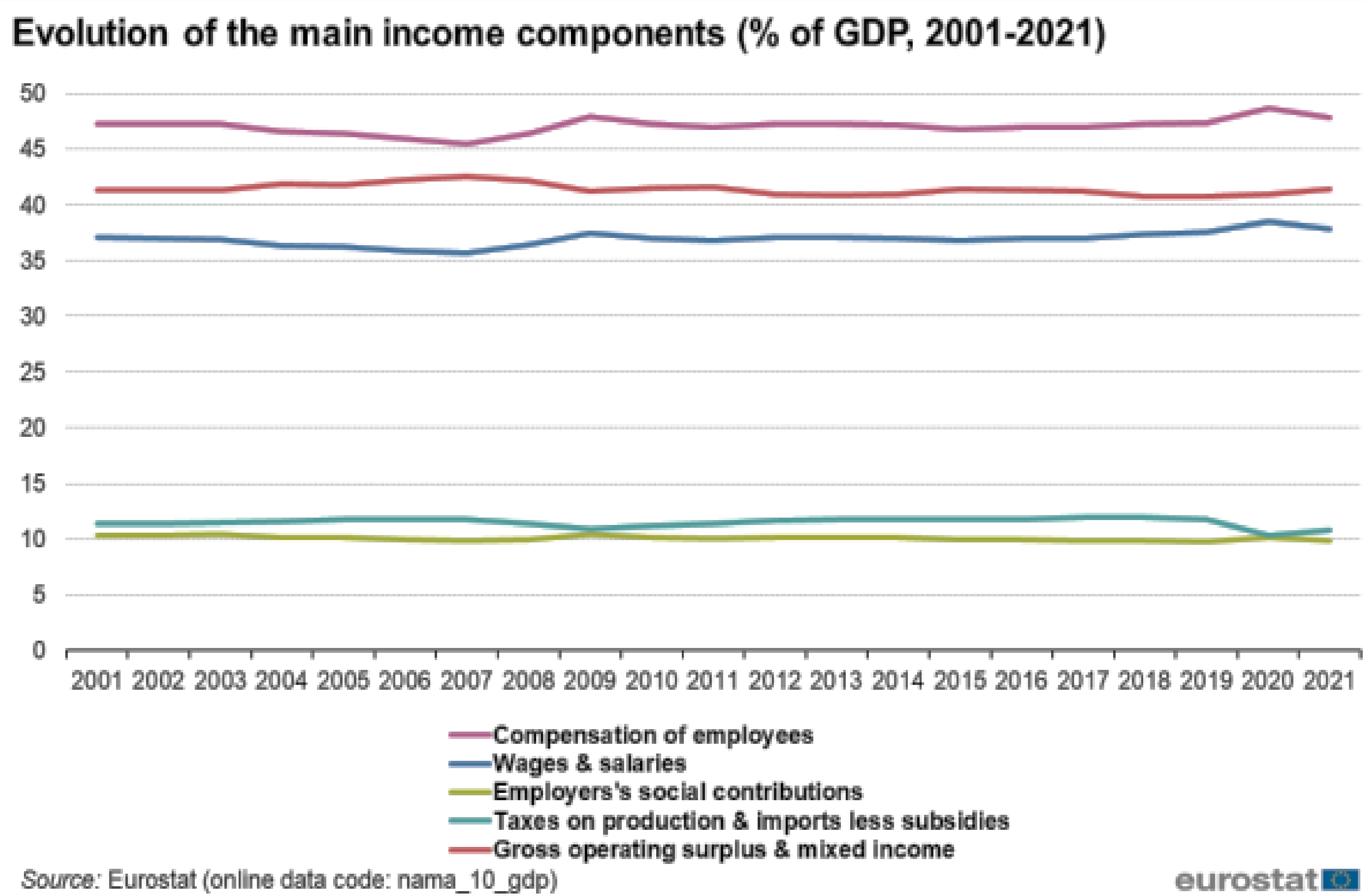



Source: University of Michigan, Bundesbank consumer surveys

Note: Share of respondents is based on kernel densities fit on micro-data, with methodology described in Gelos and others (forthcoming).

IMF

# Is a wage/price spiral imminent in the EU?



# The EU labour market

- Reduction in the **wage share** of GDP in 2021 by comparison to 2020, from 38.5% to 37.8%; nominal wages increased by 1,5% in 2021 falling behind the 5% inflation rate
- Army of unemployed, still - **unemployment** has declined from 7.2% of the EU labour force in June 2021 to 6.0% in June 2022, or from 15.2 mn to 12.9 mn; especially high amongst the under 25s; great variation amongst EU member states,
- EU **job vacancy rates** increased from 2% of total posts in Q1 2021 to 2.9% Q2 2022. Differences across EU member states are wide.
- Bargaining power of the **trade unions** has declined; company-level bargaining dominant in low union membership countries

# Summer 2022 - Airport and airline staff strikes

# The 1970s inflation – 'Volcker Shock'

- Inflation episode in the USA, from **late 1960s to early 1980s**. In 1973, more than doubled to 8.8%; by 1980, inflation was at 14%.
- Acceleration of inflation due to **rising food prices, rising mortgage interest rates, soaring energy prices**, end of 'gold convertibility' for dollars and **devaluation of the dollar** in 1971, **Vietnam War**, **oil embargo** by OPEC (Organization of the Petroleum Exporting Countries)
- **Paul Volcker** took office as Fed Chair in Aug. 1979. He set the Fed on a much tighter course of monetary policy ('Volcker Shock'). The Fed's interest rate spiked near 20% by 1981 while unemployment peaked at 10.8% in December 1982
- **Kenneth Arrow, Paul Samuelson, and James Tobin** rejected the idea of an induced recession as unnecessarily harsh.
- *Volcker's tight monetary policy is believed to have set off a wave of financialization in the US; and a debt crisis in Latin America*

# The 1970s inflation analogy

- At a superficial level, analogy is striking. However, significant differences below the surface.
- **Adam Tooze** *“To view the 1970s as a data set from which to draw technical lessons is to mistake for a laboratory experiment what was, in fact, a historic power struggle.”* The struggle ended with the *‘conclusive victory of the forces of disinflation’* from which labour has not yet recovered.
- The reference to the 1970s inflation experience and to Volcker’s Shock is today made by **monetary hawks**.
- However, the current situation is different to that in the 1970s in view of the state of the labour market/movement in the EU.
- *No evidence that the current inflation is being driven by rising wages; inducing a recession will produce unnecessary hardship for large sections of the population both in the USA and in EU.*

# Central banks to the task

- In the aftermath of the 1970s inflation episode, renewed emphasis was given to **central bank independence** from government. The notion of CB independence underpins much of current discussion
- *Independent central banks are not truly above politics*. Rather, they are "the extension of conservative politics by technocratic and nondemocratic means" (Tooze)
- **IMF**: "The costs of bringing down inflation may prove to be markedly higher ……. In that event, central banks will have to be more resolute and tighten more aggressively to cool the economy, unemployment will likely have to rise significantly
- Financial Times, "*a rate hike feeding frenzy*"
- Fed raised its benchmark overnight interest rate by 225 basis points to a target range of 2.25% to 2.50% until July 2022. This was the fourth increase in 2022.

# The ECB response

- *ECB discontinued its QE programmes; raised its interest rates; put in place a new instrument*
- **PEPP** - discontinued at the end of March 2022
- **APP** - discontinued as of 1 July 2022
- On 21 July 2022, the ECB increased for the first time in eight years the **three key ECB interest rates** by 50 basis points
- **‘Transmission Protection Instrument’** (TPI) - Eurosystem to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. Purchases are not restricted ex ante.
- **TPI, a ‘wet bullet’** (Francisco Saraceno) – A conditional shield, which may not deter speculators from testing the ECB’s lender-of-last resort resolve

- Overall, the ECB has been late in following the lead of the Fed and other central banks in raising its base rate.  For example, the Bank of England increased its base rate for the first time in December 2021 and the Fed in March 2022.
- Indeed, at its June meeting, the ECB explicitly recognized the *special factors making for the current inflation*, expecting "moderating energy costs, the easing of supply disruptions related to the pandemic and the normalisation of monetary policy to lead to a decline in inflation". It also announced its 'intention' to raise interest rates by 25 bp.
- *At its July meeting the ECB raised its base rate by 50 bp by way of "strengthening the anchoring of inflation expectations and by ensuring that demand conditions adjust to deliver its inflation target in the medium term", thus submitting to the monetary hawks on its Governing Council*

# Outlook and alternative proposals

- *EC forecasts for 2022 &2023* repeatedly revised downward for growth and upward for inflation.   This is a cost-push type of inflation. *Fighting the wrong problem will produce more harm than good.*

- **Fiscal policy** can battle supply problems. Governments can make cuts that will reduce prices, while raising taxes on the well off. Taxation of excess profits - e.g. in the energy sector – would further enhance regulatory action to curb monopoly power and financial speculation; governments can influence prices. Specific actions to control prices of strategic commodities have a role.

- **Social policy**, to shield most vulnerable sections of the population

- **Climate policy** , taxing extraordinary profits by energy companies so that they are not used to create further fossil-based assets.

# To conclude

- *Overall, fighting inflation is a distributional conflict. In this sense, inflation is a political economy issue.*
- **Michał Kalecki**: higher unemployment acts as an essential disciplinary device for workers.
- Getting trapped in '**sado-monetarism**', whereby the orthodoxy demands higher interest rates and fiscal austerity, regardless of the state of the economy and of society, is real. This makes the task of alternative, heterodox views all the more necessary.
- *There are different ways to fight inflation. The will to do so in an equitable and climate-friendly way is missing from the establishment and from the leadership of the EU at the present time.*