BANCA D'ITALIA
EUROSISTEMA

"There has been an awakening": inflation, disinflation and ECB's monetary policy

Stefano Neri

Banca d'Italia

Quali lezioni dopo un biennio di politica monetaria antinflazionistica?

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Outline

1. The 2021-22 inflation
2. The 2023 disinflation
3. Lessons for the ECB’s monetary policy

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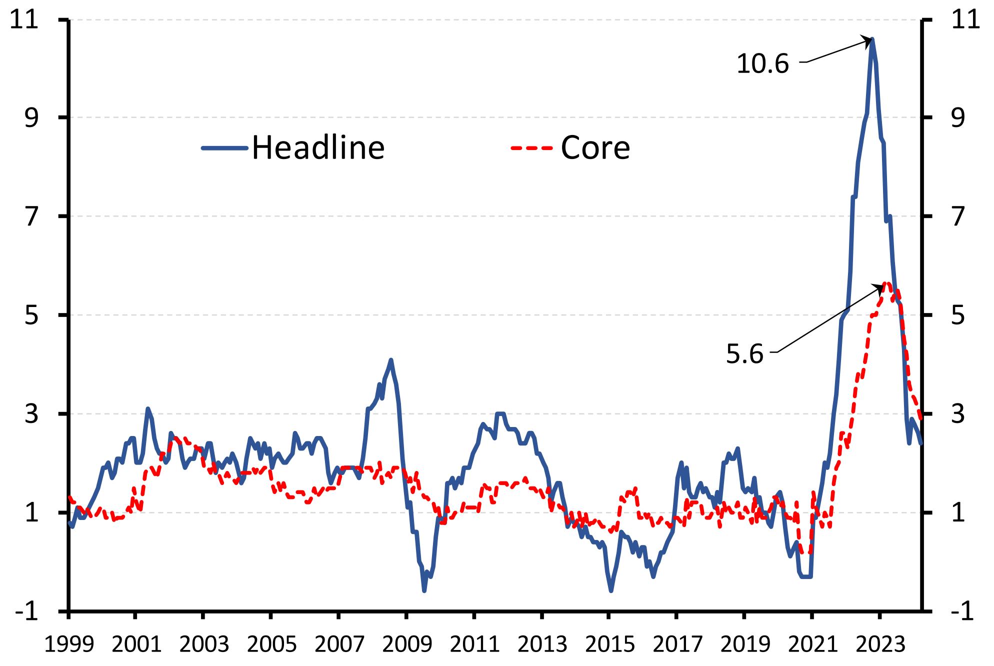
The 2021-22 inflation

Euro-area headline inflation reached double-digit figures…

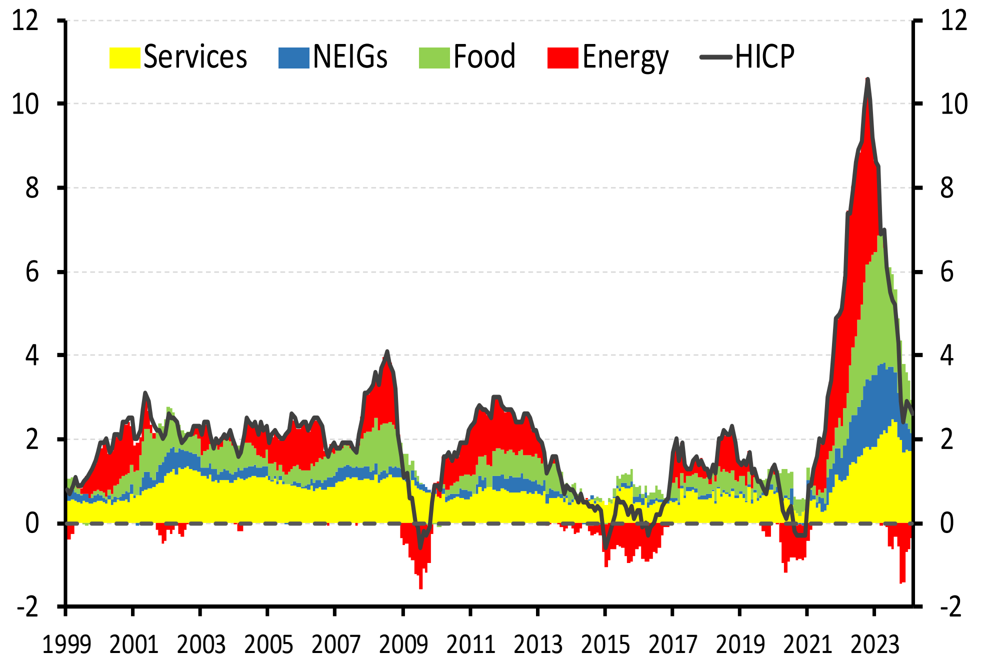
Headline and core inflation

(per cent)



Headline inflation: by component

(per cent and percentage points)



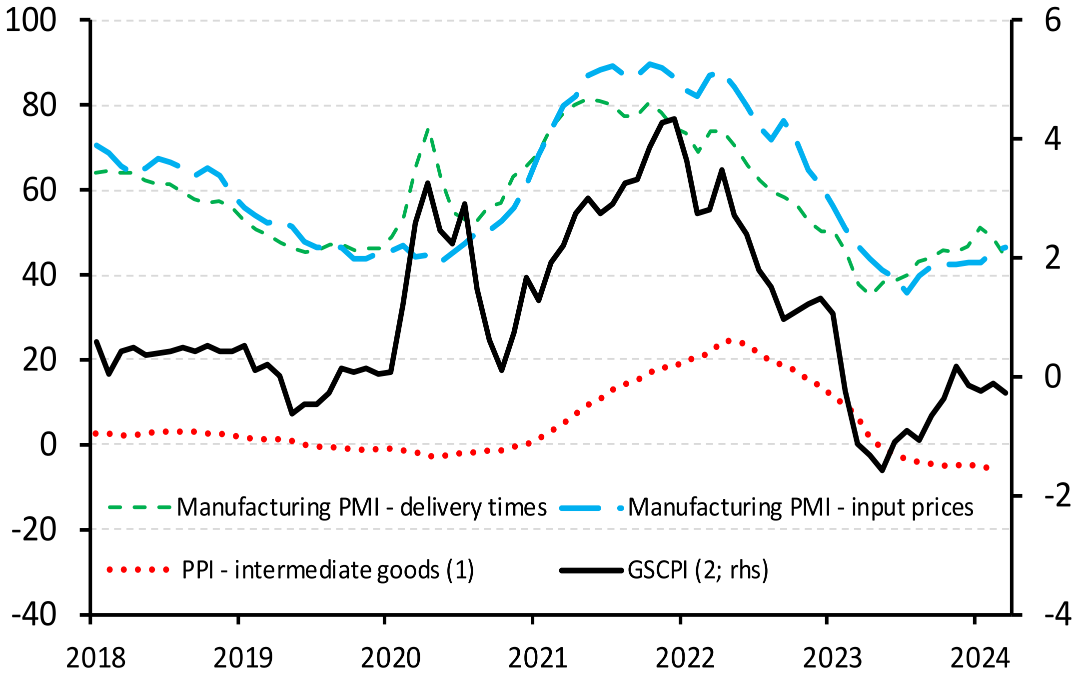
Source: Eurostat. *Note*: latest observation March 2024.

- Inflation increased markedly in 2021 and 2022, reaching a historical record in October 2022
- Core inflation reached unprecedented levels in spring 2023
- All main categories contributed to raising inflation; supply shocks played largest role (Neri et al., 2023)

… driven by reopenings, supply bottlenecks and energy prices

Indicators of supply bottlenecks and producer prices

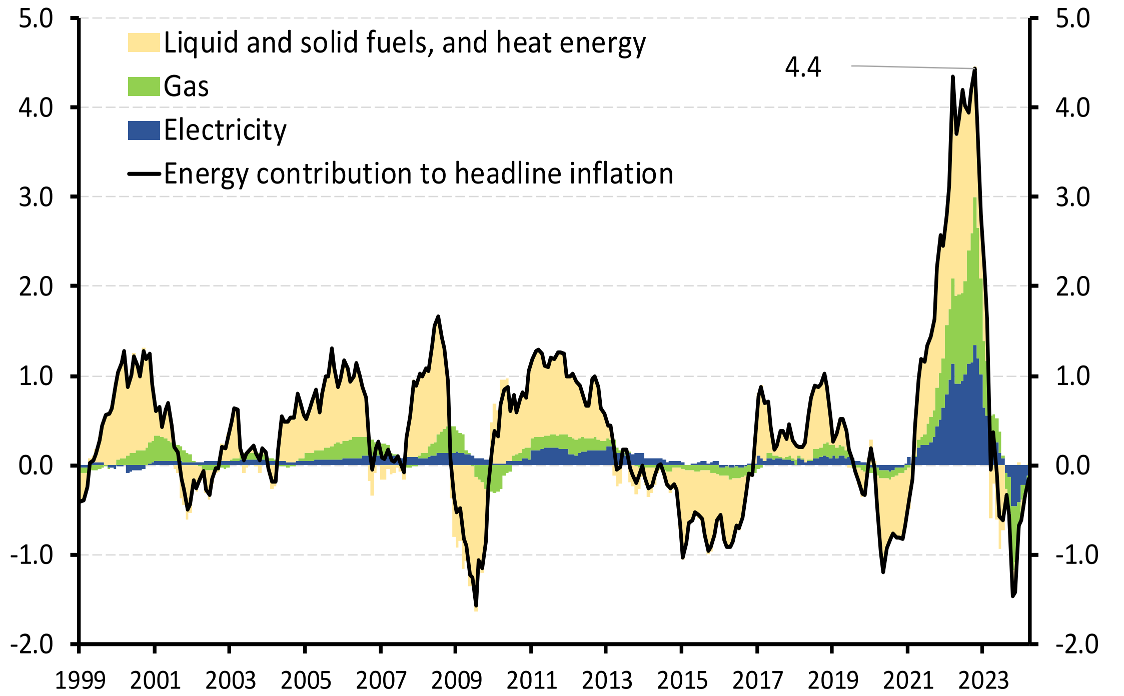
(percentage points)



Source:: Eurostat, Federal Reserve Bank of New York and S&P Global. *Note*: (1) Annual percentage changes. (2) Standard deviations from the index's historical average. Latest observation March 2024 for all but PPI – intermediate goods (February 2024).

Energy contribution to headline inflation

(percentage points)



Source:: Eurostat. *Note*: latest observation March 2024.

- Post-pandemic reopenings and global supply bottlenecks led to a strong increase in services and goods inflation in advanced economies
- Strong global demand for energy commodities and Russia's invasion of Ukraine led to an unprecedented increase in cost of energy (gas, electricity and fuels) in euro area

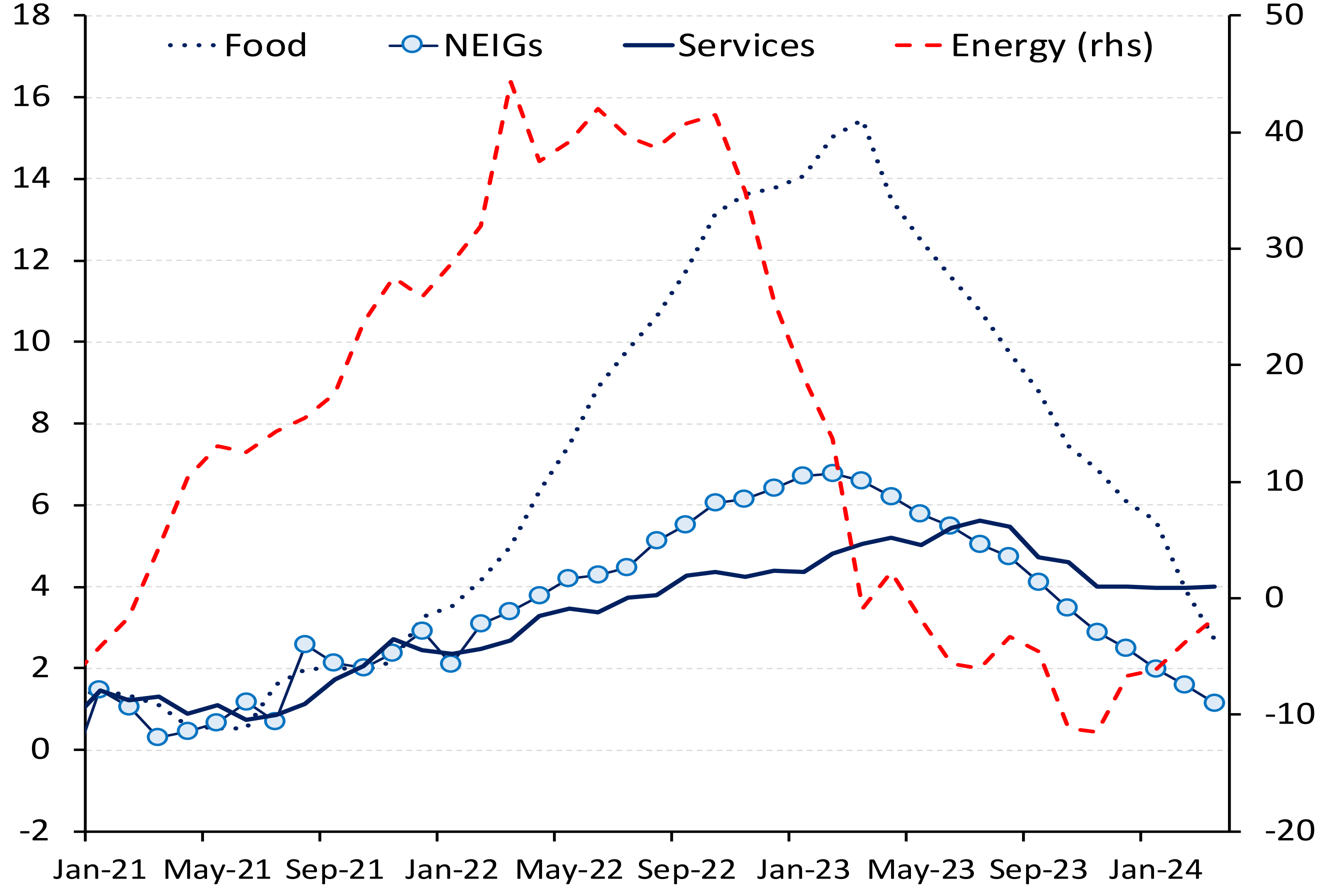
The 2023 disinflation

A heterogeneous disinflation

- Energy disinflation started in late 2022, as gas and oil prices fell from summer peaks
- Food and NEIGS inflation peaked in spring 2023 as commodity prices decelerated and supply restrictions eased
- Services inflation peaked later, its fall stalled in November 2023
- Rapid inflation and disinflation consistent with high frequency of price adjustments after large shocks (“*Large shocks travel fast*”; Cavallo, Lippi and Miyahara, 2023)

HICP inflation: main categories

(per cent)

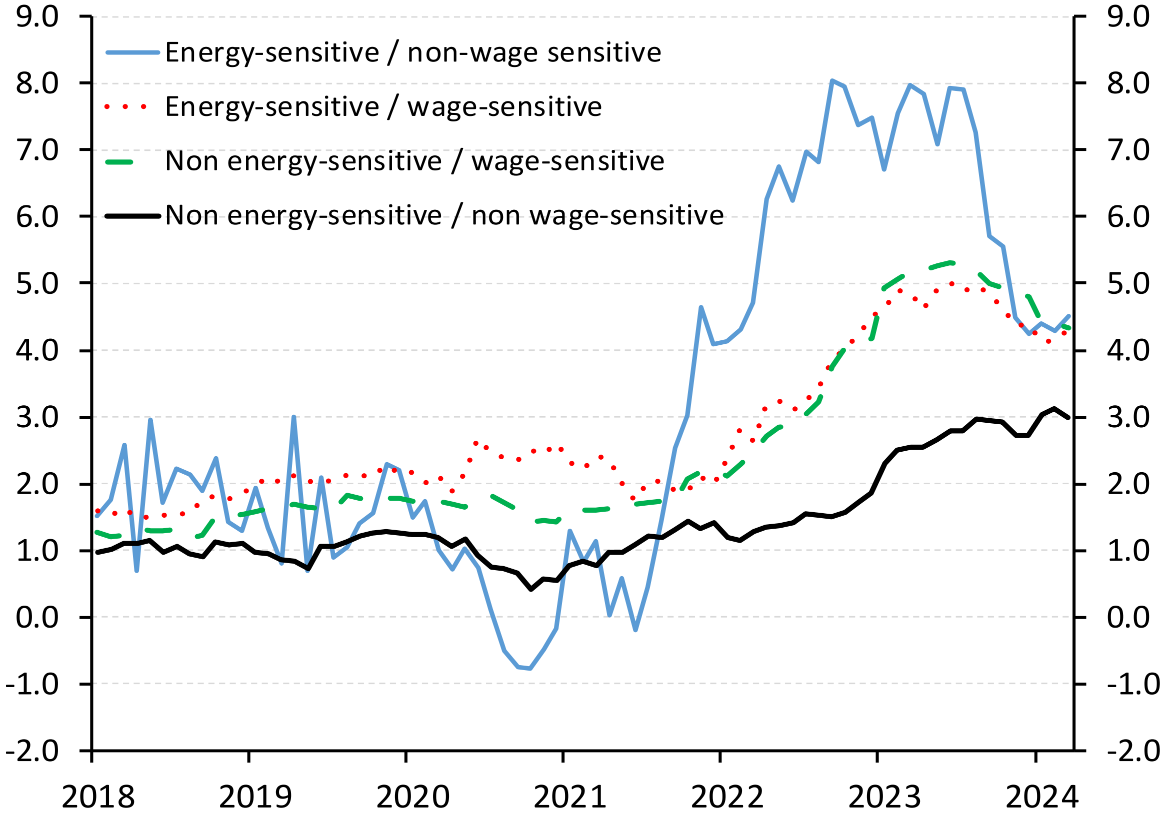


Source:: Eurostat. *Note*: latest observation: March 2024.

Services inflation: the last hurdle

- In recent months, disinflation in euro area has been held back by services inflation
- Narrative on stickiness of services has recently focused on contribution of wage-sensitive sectors
- However, services inflation remains high due to acceleration of prices of items neither wage- nor energy-sensitive
- Prices of these items are non-cyclical, staggered and backward-looking ("late-comers")
- They are partly administered (e.g. postal, hospital and education services), reset infrequently (e.g. insurance and financial services), and often adjusted for past inflation (e.g. rents)

Services inflation
(per cent)



Source:: Eurostat. *Note*: latest observation March 2024.

Lessons for the ECB’s monetary policy

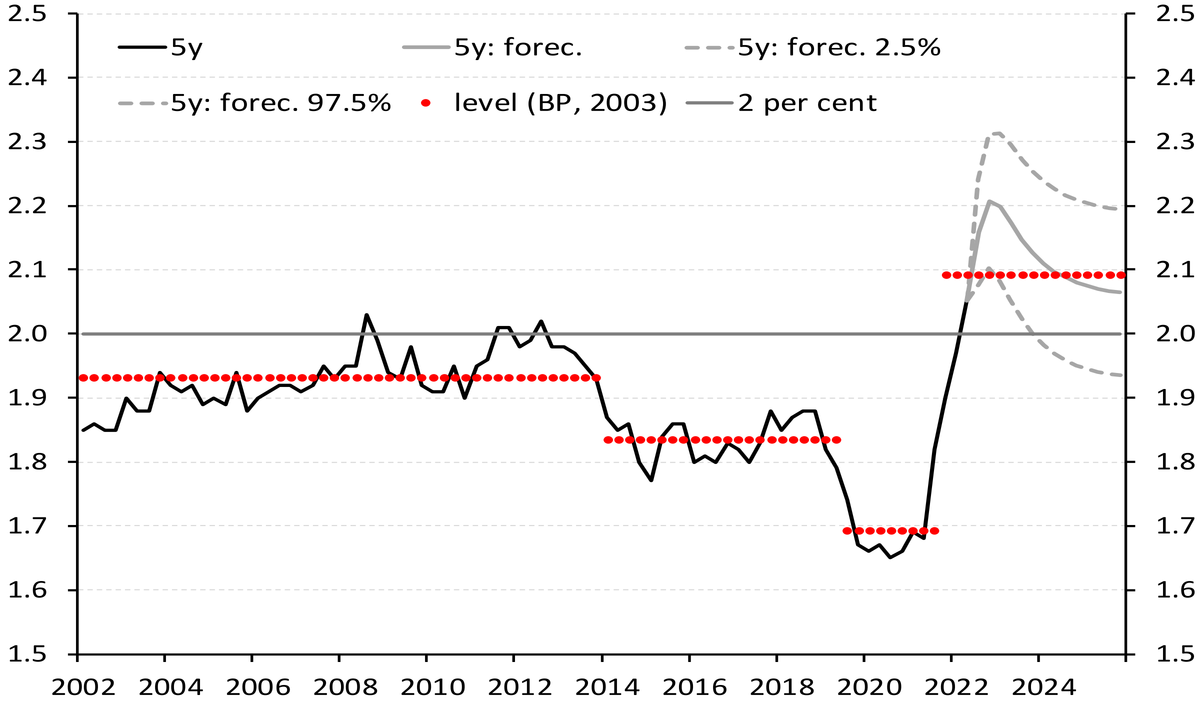
ECB faced an extremely complex environment

- ECB has faced an extremely complex environment in last couple of years (Panetta, 2023a)
- Unprecedented sequence of shocks made it difficult to disentangle supply and demand shocks in real time and assess their role in raising inflation
- Exceptional circumstances called for an exceptional response
- Was response of ECB's monetary policy:
  - necessary?
  - timely?
  - adequate?
- Was a data-dependent and meeting-by-meeting approach useful?

Was ECB's response necessary?

Risk of de-anchoring

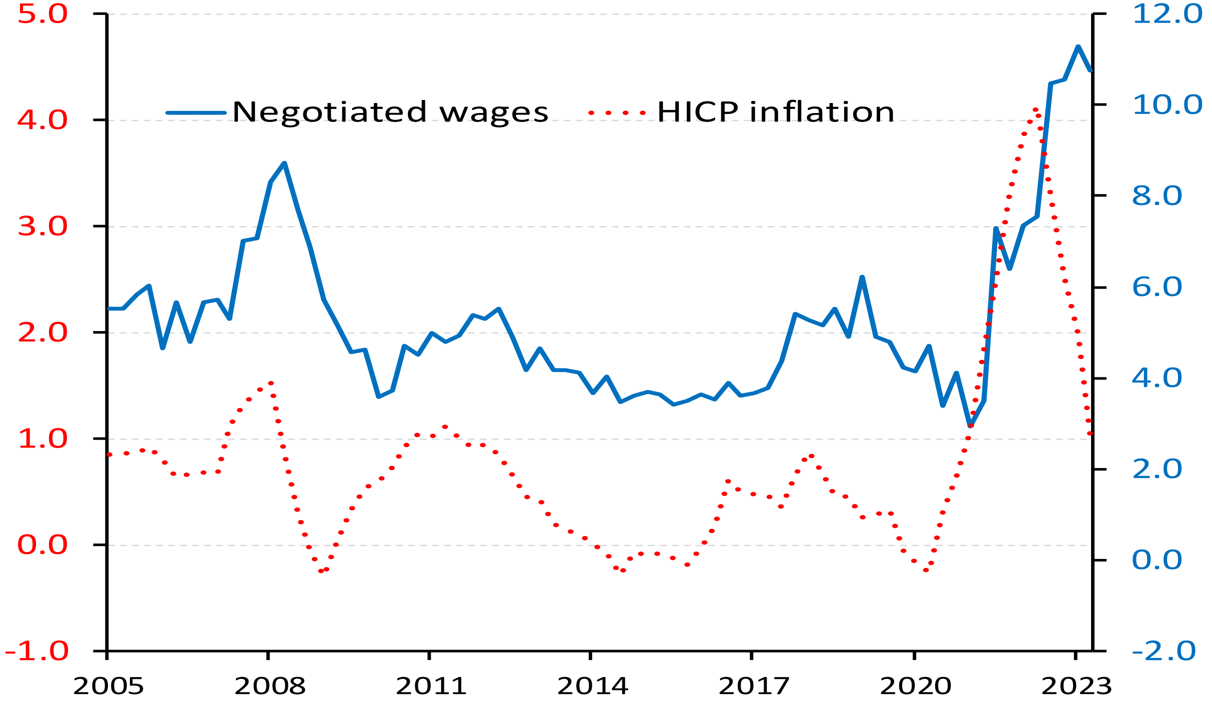
(per cent)



Source:: Neri (2024). Latest observation: April 2022 Survey of Professional Forecasters.

Negotiated wages and inflation

(per cent)



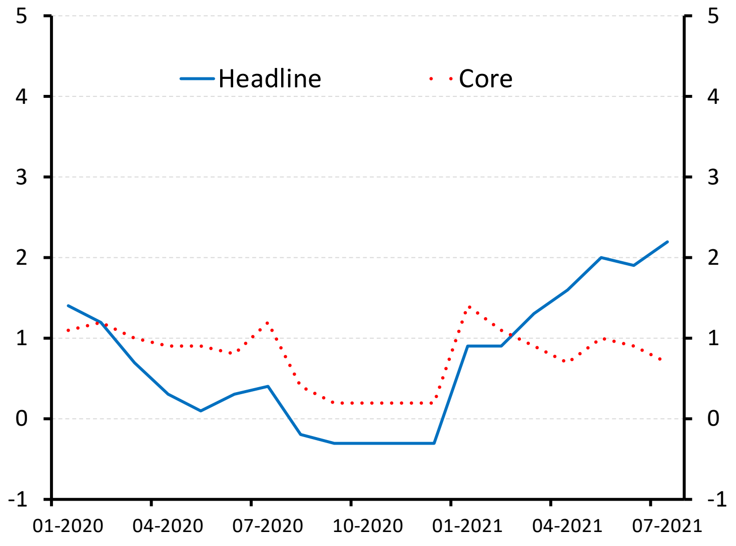
Source:: ECB and Eurostat. *Note*: latest observation 2023:Q4.

- **Was ECB's response necessary?**
- Surge in inflation could risk an upward de-anchoring of long-term inflation expectations and fueling a wage-price spiral, even if supply shocks were dominant drivers of inflation

Was ECB's response timely?

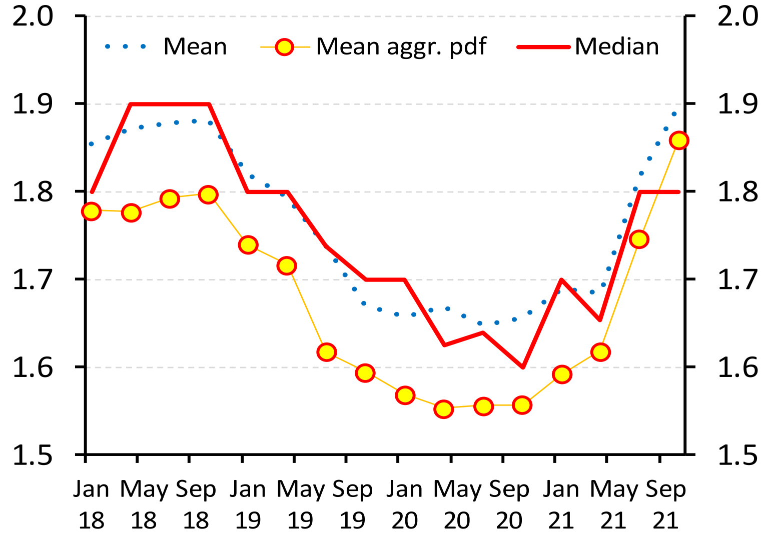
- ECB began normalization in December 2021
- **Was ECB's response timely?**
- Progress in recovery and expected convergence of inflation to new 2% symmetric target allowed ECB to reduce net asset purchases
- After Strategy Review, headline inflation was converging to 2%, core was still below 1 (Visco, 2023)
- Special October 2021 ECB SPF: 2% symmetric inflation target as key element of review
- Sharp increase in gas prices in Autumn 2021 was perceived as temporary
- Counterfactual simulations show limited gains from earlier tightening

Headline and core inflation
(per cent)



Source:: Eurostat.

Long-term inflation expectations
(per cent)

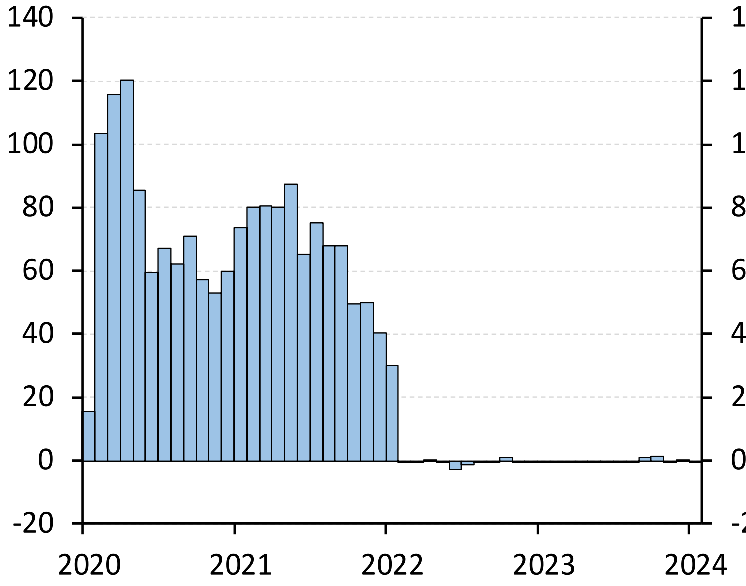


Source:: ECB SPF.

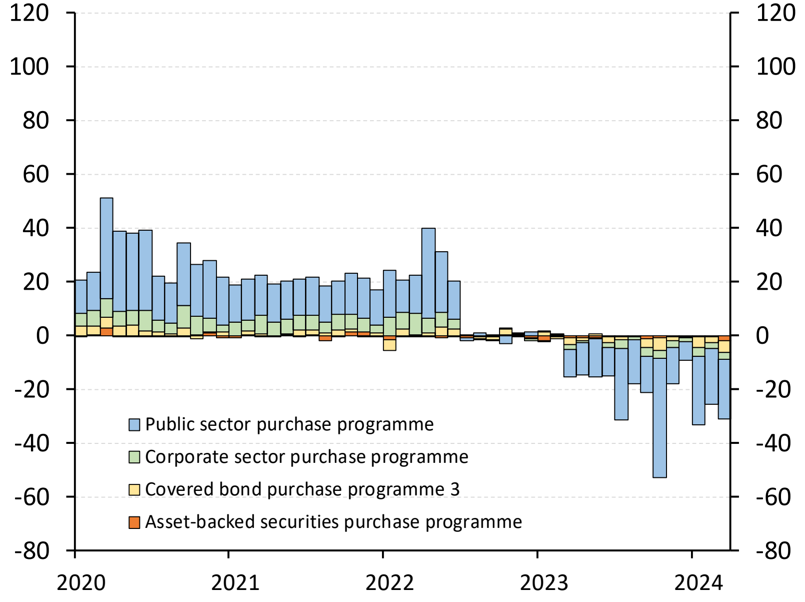
Was ECB's response adequate?

- In late 2021, rate on deposit facility was in negative territory (-0.5%; MRO at 0) and Eurosystem was purchasing private and public assets (PEPP and APP)
- **Was ECB's response adequate?**
- ECB rapidly reduced net asset purchases and raised key rates rapidly and by an unprecedented amount
- Markets anticipated beginning of tightening cycle already in 2021

Net asset purchases: PEPP
(billions €; monthly data)

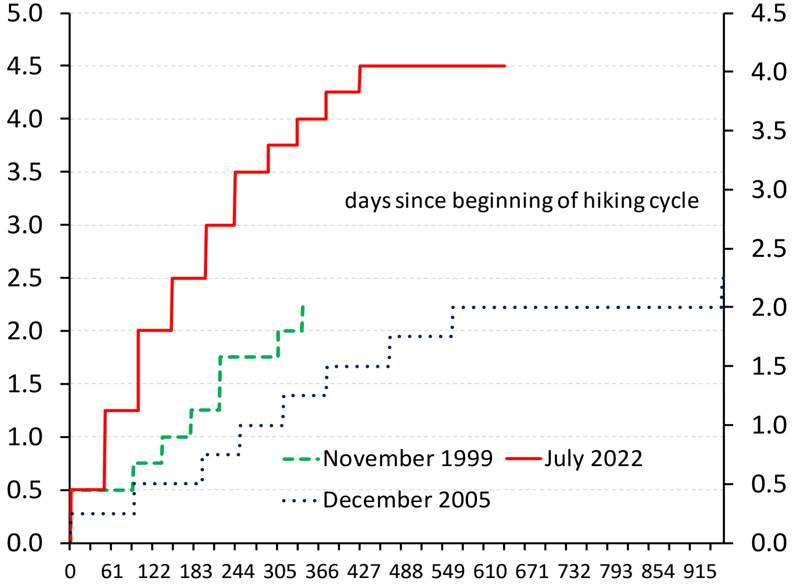


Net asset purchases: APP
(billions of €; monthly data)



Source:: ECB. *Note*: latest observation March 2024.

Cumulative change of ECB' MRO rate
(percentage point; t= 1 time of the first hike)



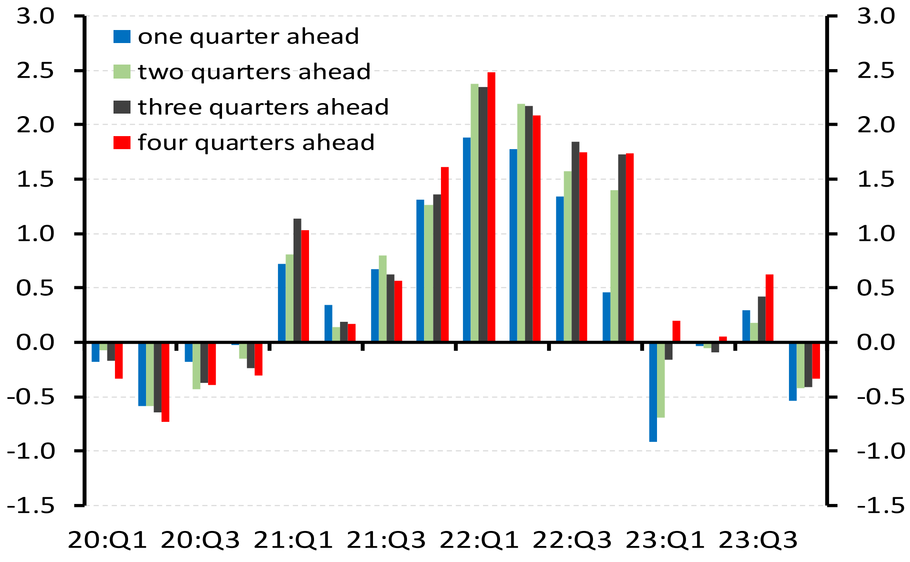
Source:: ECB. *Note*: latest observation 17 April March 2024.

Was a data-dependent and meeting-by-meeting approach useful?

- Forecasting inflation has become challenging since outbreak of Covid-19. However, large and persistent errors in forecasting inflation were not due to failure of models
- *"In view of the uncertainty […], it is no longer appropriate for monetary policy to give detailed forward guidance. Given the complexity [….] we are facing, being able to respond to the incoming data is a major advantage."* Lagarde, 4/11/2022
- **Was a data-dependent and meeting-by-meeting approach useful?**
- More focus on incoming data allowed ECB to flexibly adjust the policy stance
- **Is it still useful?**

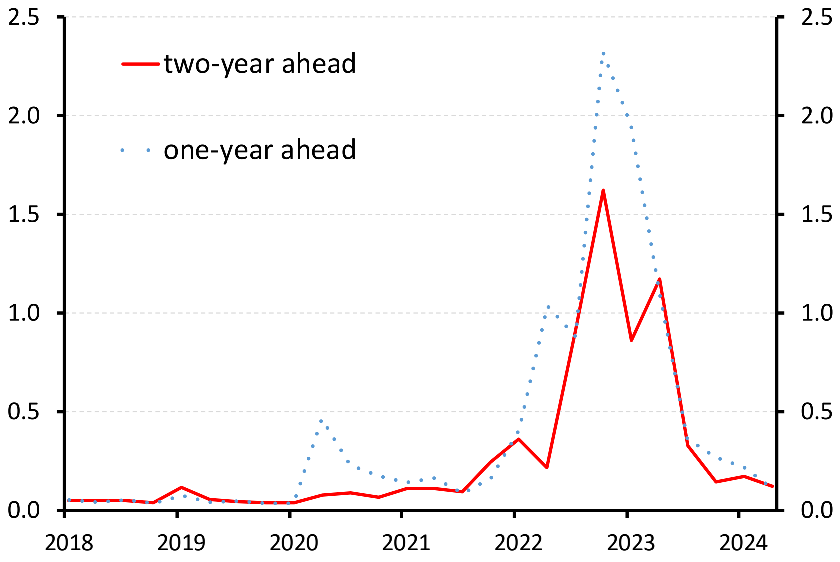
  Confidence in projections has increased and outlook is less uncertain

ECB/Eurosystem inflation projection errors
(percentage points)



Source: ECB MPE and Eurosystem BMPE.

Disagreement among SPF participants
(percentage points)



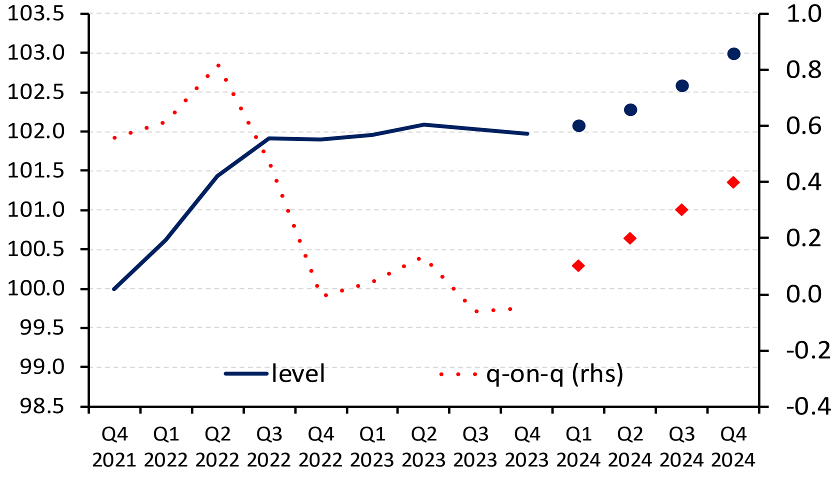
Source: ECB Survey of Professional Forecasters.
Note: April 2024 Survey of Professional Forecasters. Standard deviation of aggregate probability distribution.

Looking forward: mind downside risks

- Economic activity in euro area has been stagnating since 2022:Q4 (six consecutive quarters)
- Projected path for growth in 2024 is subject to downside risks, risks to inflation are balanced
- Tightening of financing conditions is stronger than in past; impact on economic activity is larger
- Tight monetary policy stance will continue weighing on demand and inflation throughout 2024 due to transmission lags (Panetta, 2024)
- With inflation projected to reach target in mid-2025, time has come to reduce downward pressure on aggregate demand and minimize unnecessary costs (Panetta, 2023b)

Euro-area real GDP

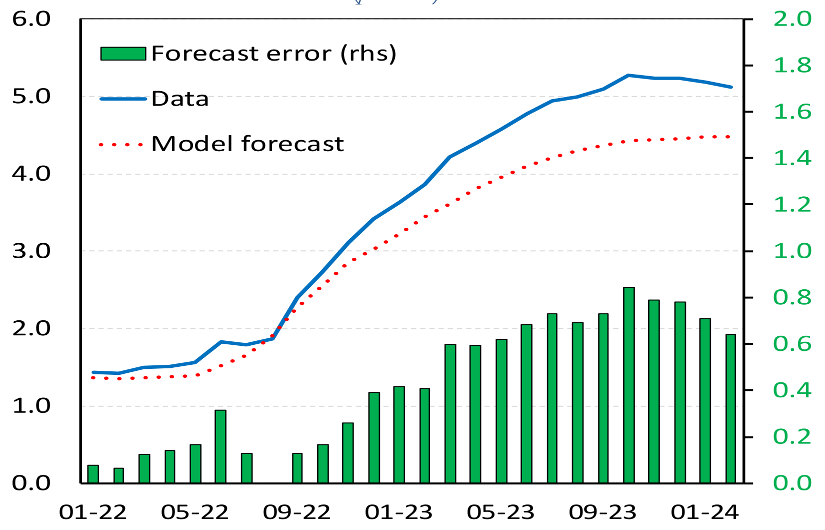
(per cent; index: 2021:Q1 = 100)



Source:: Eurostat and ECB March 2024 MPE.

Lending rates: euro-area firms

(per cent)



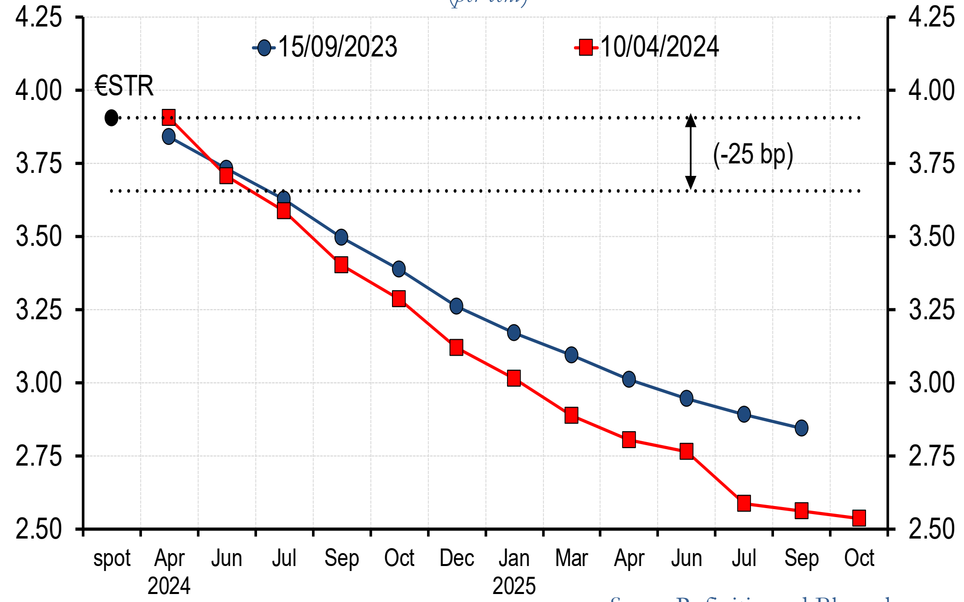
Source:: Bottero and Conti (2023).

Monetary policy stance is expected to remain restrictive

- Rate on deposit facility is expected to remain above long-run "equilibrium" level throughout 2024 and until end-2025
- Analysts expect 3 rate cuts this year, starting next June; markets are pricing a similar path

€STR forward curve

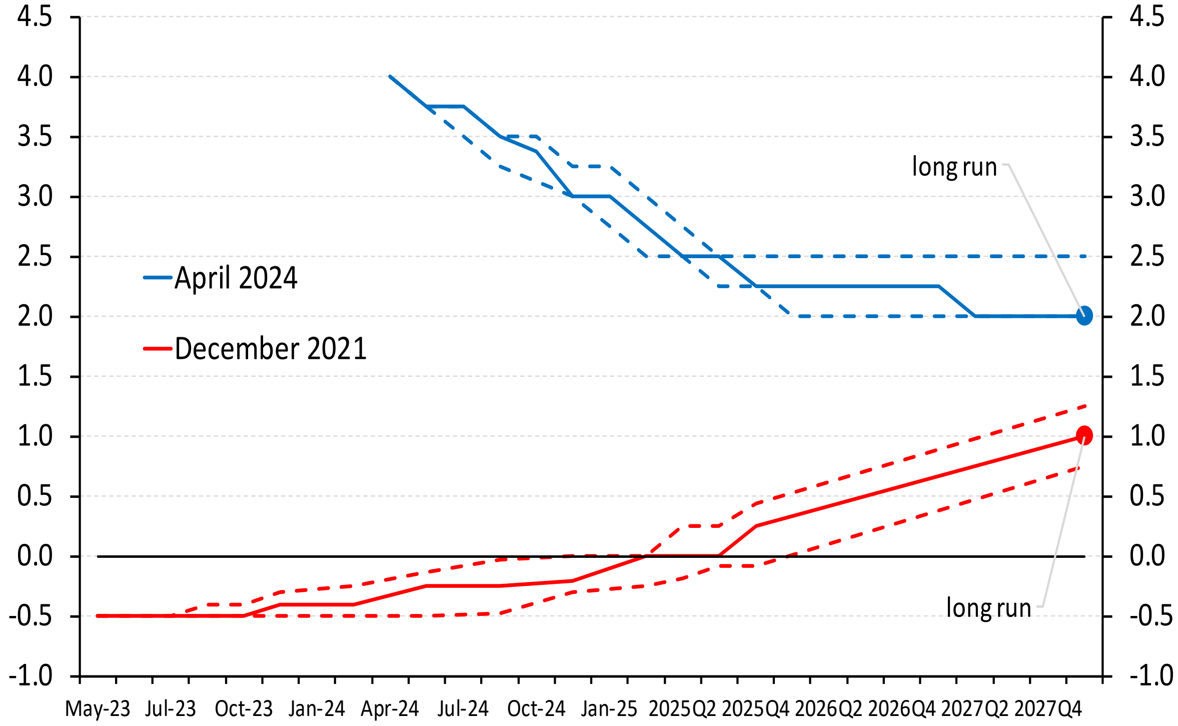
(per cent)



Source: Refinitiv and Bloomberg.

Expected rate on deposit facility

(per cent)



Source: ECB Survey of Monetary Analysts. Latest observation: April 2024.

Key lessons for ECB'S monetary policy

- In summer of 2021, euro-area inflation woke up for first time in many years
- Facing a sequence of exceptional supply shocks, **monetary policy must stand ready to act timely and forcefully** to prevent a de-anchoring of inflation expectations and materialization of second-round effects
- Once monetary policy stance is sufficiently restrictive and confidence on inflation convergence to its target strengthens, **monetary policy should aim at minimizing its impact on economic activity**
- 2022-23 tightening cycle is different from past episodes: Eurosystem's balance sheet is shrinking

Thank you for your attention!

stefano.neri@bancaditalia.it

https://sites.google.com/view/stefano-neri/home

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