

# Global factors and ECB monetary policy





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## **Abstract**

The euro area's current high inflation rate is due to both internally generated demand pressures and external shocks that have raised food and energy prices. This paper argues that the latter element is more important than the former. Central banks need to tighten monetary policy to address high inflation but, with central banks around the world under pressure to restore their anti-inflationary credentials, it is possible that there is going to be too much tightening of global financial conditions.

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## EXECUTIVE SUMMARY

- **Inflation in the euro area is currently very high, with the HICP rising 10.7% over the year ending in October.** Core inflation, excluding food and energy prices, was 5% in October.
- **For central banks, it is important to understand how much of the euro area's current high inflation rate is due to internally generated pressures versus external shocks.** The former can be influenced by the domestic monetary policy while the latter can not.
- **While there has been a lot of focus on global economic factors as a determinant of recent inflation, global factors have long played a key role in inflation in individual countries or regions.** This paper presents evidence that inflation in Europe has not been more influenced by global factors over the past decade relative to previous decades going back to the 1970s.
- **There are signs that the euro area economy is overheating.** The unemployment rate is at its lowest level since the founding of the euro and there is evidence of labour shortages.
- **Combined with high inflation, this overheating is leading to higher rates of wage increases over the past year.** But the euro area is not going through a classic wage-price spiral in which wage increases play a key role in driving price inflation. Wage inflation is clearly responding with a lag to the high rates of price inflation that have been prevailing for some time.
- **The evidence suggests that the increase in food and energy prices due to the war in Ukraine is the main factor driving euro area inflation.** Beyond the direct effect of food and energy prices on the HICP, this paper describes how these price increases have induced increases in other prices. A simple procedure is presented which suggests that without the increase in food and energy prices, core inflation in the euro area would be about 2%.
- **The ECB needs to tighten monetary policy to address high inflation.** Whatever the sources of the current inflation, the ECB's mandate for price stability means it has no choice but to tighten monetary policy now.
- **But there are signs that the euro area economy is moving into recession.** Food and energy price increases are reducing real incomes and this will impact spending on many consumer items. Business sentiment is worsening and the housing market is likely to weaken once the ECB's monetary policy tightening starts to have its full impact.
- **And euro area inflation is likely to fall soon.** With most of the euro area's inflation due to once-off increases in food and energy prices and labour market over-heating likely to ease in the coming months, inflation is set to fall even without a significant additional tightening of ECB monetary policy.
- **It is possible that there is going to be too much tightening of global financial conditions.** Inflation-targeting central banks around the world are under pressure to restore their anti-inflationary credentials and their wish to demonstrate their commitment to low inflation could result in a collective over-tightening of global monetary policy.

## 1. INTRODUCTION

The globalised nature of modern economies makes implementing monetary policy more complicated for central banks than if they operated in the closed economies of elementary textbook macroeconomics. For example, when inflation is high, central banks need to evaluate how much of the inflation is generated by sources within their domestic economy (and is thus open to being directly influenced by monetary policy) versus how much is related to global factors. In assessing the latter, central banks must assess the likely future evolution of these global factors and the extent to which the actions of other central banks will influence them.

Inflation in the euro area is currently very high, with the harmonised index of consumer prices (HICP) rising 10.7% over the year ending in October according to Eurostat's current flash estimate. Global factors have played an important role in this inflation. The global pandemic produced a series of shocks that influenced all the major economies in a similar way. The initial phase led to many restrictions on business operations and there was a huge monetary and fiscal policy effort to stabilise the global economy and financial markets. There was then a common pattern across the world of increased demand for goods rather than services, combined with shortages of parts and shipping problems partly due to supply disruptions. In most parts of the world, the enforced period of reduced consumer spending meant that households emerged from the pandemic with stronger balance sheets which boosted post-pandemic spending. Finally, the war in Ukraine has had an impact on food and energy prices across the world.

This paper discusses the role of global factors in current euro area inflation and their implications for the European Central Bank's (ECB's) formulation of its monetary policy. The rest of the paper will be structured as follows. Section 2 describes how inflation has had a significant common global element long before the current period or indeed the period after the mid-2000s when discussions of the increased importance of global factors for inflation became a common theme in research and central banking circles.

Section 3 discusses the sources of euro area's current inflation problem. There are signs the euro area economy is overheating due to strong demand but the evidence points to supply shocks as the key factor underlying the current inflation. The war-related energy shock has had a far greater impact on Europe than the United States (US). Energy price inflation for euro area consumers in October was 42%, compared with a latest reading of 20% for the US. Core inflation in the euro area (excluding energy food, alcohol and tobacco) was 5% in October, well above the ECB's target. However, higher food and energy prices have clearly played an important role in driving up other prices. I present some simple evidence indicating that food and energy prices have played a key role in determining the current high rate of core inflation.

Section 4 focuses on how monetary policy has responded around the world to high inflation and whether national central banks each pursuing their own domestic inflation targets could lead to overly tight financial conditions and a more serious global recession than necessary.



## 2. GLOBAL FACTORS IN INFLATION: NOT A NEW THING

Rising globalisation in international trade and the simultaneous impacts of the pandemic and its aftermath have produced a highly globalised set of inflationary forces in the world economy. However, common forces affecting inflation across the world are not a new thing. For example, research by Ciccarelli and Mojon (2010) demonstrated that 70% of fluctuations in inflation across Organisation for Economic Co-operation and Development (OECD) countries going back to the 1970s could be explained by a common global component.

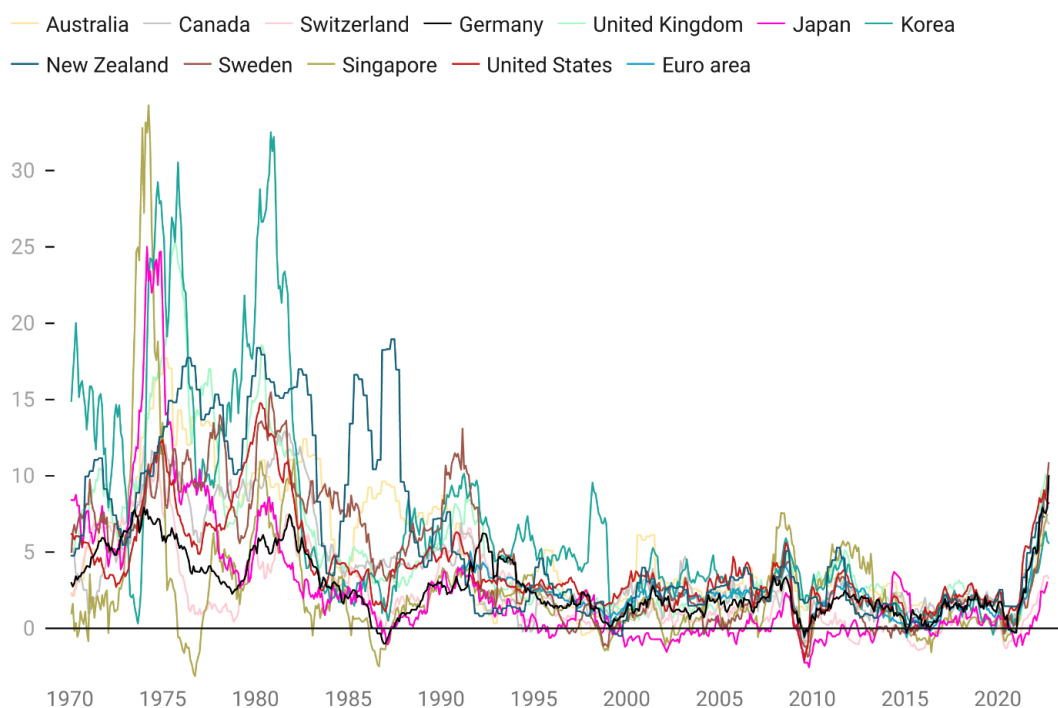
To give an updated (but simplified) assessment of the importance of co-movements in inflation, I obtained monthly series on year-over-year inflation rates for 11 advanced national economies and the euro area from the Bank for International Settlements (BIS). Figure 1 displays the data. The common element across the world in the current surge in inflation is clear. Explanations that focus only on conditions within one country or area will clearly not explain what has been happening. However, the figure also shows there has been a lot of co-movement in the inflation rates of major economies going well back in time. Advanced economies all had jumps and declines in inflation associated with the two Organization of the Petroleum Exporting Countries (OPEC) shocks in the 1970s. While the pace of disinflation in the 1980s differed across economies, the overall pattern was of lower inflation and the period from 1990 onwards saw most advanced economies experiencing low average inflation rates with limited ranges of fluctuations.

To give an example of how much global factors have influenced European inflation over time, I examined how much of the variation in Germany's inflation rate could be predicted by the other ten national inflation series using a set of moving windows each with ten years of data.<sup>1</sup> Figure 2 shows the results, displaying a measure of fit known as the R-squared statistic. If the R-squared is zero, the other inflation rates do not predict movements in Germany's inflation rate at all and if it is one, they fully explain them. The figure shows the predictive power of the various international inflation rates has moved up and down over time but has not changed much over the past 50 years, with a typical R-squared being about 0.8. This is a simple way to illustrate that there has long been a common international element to the determination of inflation rates.

This is not to say that the increased globalisation associated with higher trade and financial flows since the early 1980s has had no impact on inflation. It seems very likely that the increasing supply capacity of the world economy as China implemented its business reforms and opened to international trade exerted downward pressure on global inflation from the mid-1990s onwards. Researchers such as Forbes (2019) have argued the "Phillips curve" models in which the amount of extra capacity or "slack" in domestic economies was a key driver of inflation were no longer as relevant in the modern era, with the level of slack in the global economy being more relevant. At the same time, research by ECB economists Attinasi and Balatti (2021) suggests that increased globalisation did not play an important role in the steady reduction in inflation during the decades prior to the pandemic.

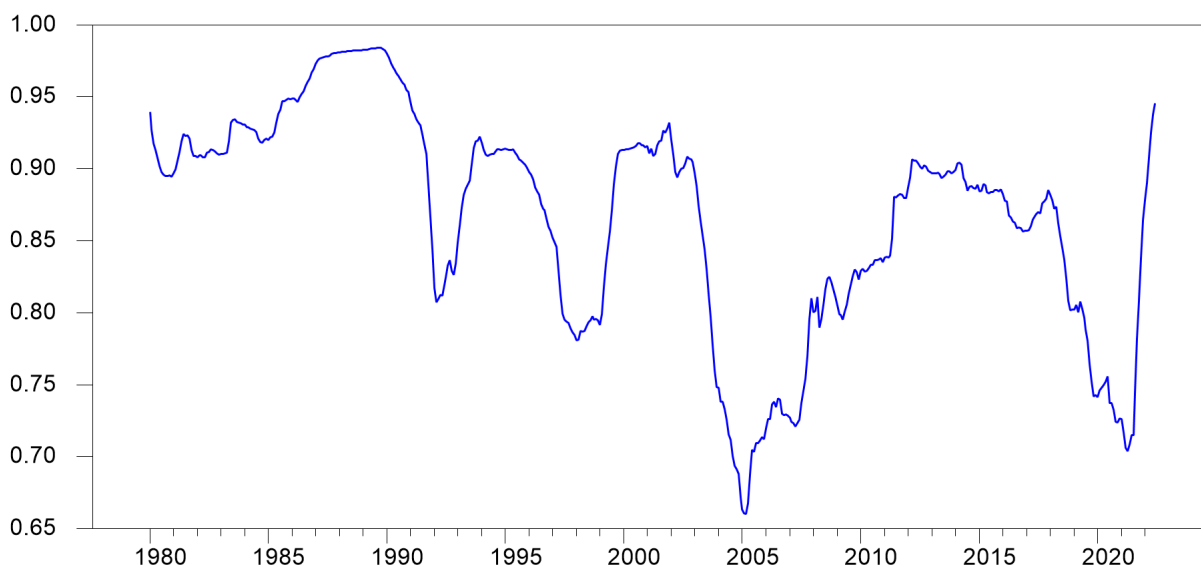
<sup>1</sup> To give an example, the number in the graph for 2020:Q4 shows the R-squared for the model using data from 2011:Q1 to 2020:Q4, while the number on the graph for 2021:Q1 shows the fit for data from 2011:Q2 to 2021:Q1.

Figure 1: Inflation rates in selected advanced economies



Source: Authors calculations based on data from the Bank for International Settlements  
<https://www.bis.org/statistics/cp.htm>

Figure 2: Measure of fit from ten-year moving window regressions of German inflation on selected other advanced economy inflation rates



Source: Author's calculations based on data from the Bank for International Settlements.  
<https://www.bis.org/statistics/cp.htm>

Notes: The measure of fit is the R-squared statistics. Each datapoint here shows the R-squared associated with the regression using the data for the ten-year period ending with the date for that datapoint.

### 3. AGGREGATE DEMAND, ENERGY PRICES AND INFLATION

The simultaneous rise in inflation around the world over the past year clearly suggests that common global factors are playing an important role but this doesn't necessarily imply that the determinants of inflation are exactly the same in each economy. For central banks, understanding the extent to which external factors are influencing inflation rather than excess domestic demand is important. Central banks have the tools to influence excess domestic demand but have no control over external events, so it is important in designing the correct policy to understand how important each element is in determining a high rate of inflation.

My interpretation of the evidence is that current inflation in the euro area is somewhat less driven by excess domestic demand than in the US and somewhat more driven by food and energy prices. This difference reflects the lingering impacts of the different macroeconomic policy responses to the pandemic and the differential exposure to the war-related energy shock.

The US response to the pandemic focused more on discretionary fiscal stimulus based on large tax rebates, while Europe was able to use its better-functioning welfare state and more targeted job protection programmes to protect people from much of the negative impact of restrictions on business. This difference in policy response has left US households with a lot more spending power and this has continued to fuel US aggregate demand. The difference in the exposure to the war-related energy shock reflects both the large direct reliance prior to the war of some European countries on Russian gas supplies and the fact that Europe differs from the US in being a large net energy importer.

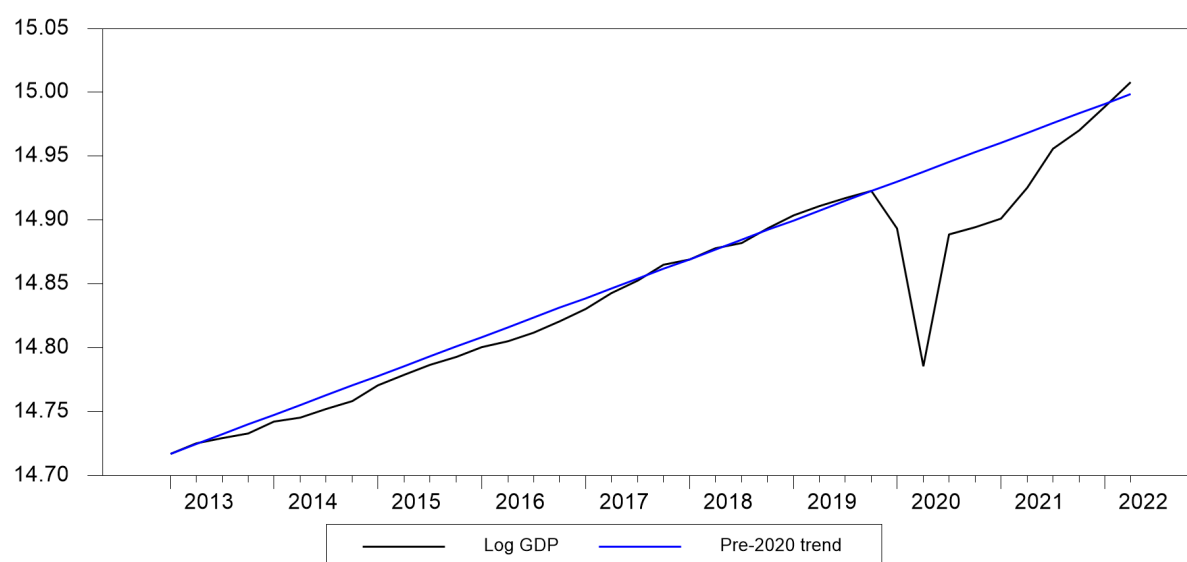
One measure that indicates how aggregate demand has been much stronger in the US than in Europe is nominal GDP, which measures exactly how many dollars or euros are being spent in the economy. Figures 3 and 4 show nominal GDP for both the US and the euro area compared with a trend based on the pre-pandemic growth rates.<sup>2</sup> As of the second quarter of this year, US nominal GDP was 5.2% above its pre-pandemic trend level while in the euro area it was only 0.9% above.<sup>3</sup> This suggests a more significant "overheating" in the US economy than in Europe.

This said, internally generated demand is clearly playing a role in the inflation in the euro area. The euro area unemployment rate is at its lowest level ever (see Figure 5) and there are increasing reports of labour shortages. The European Commission has been running a manufacturing business sentiment quarterly survey since the mid-1980s and it contains a question on the factors that are limiting production. Figure 6 shows that in this year's surveys, about one quarter of firms have reported a shortage of labour as a factor limiting production, the first time in the survey's history that this issue has been reported by more firms than a shortage of demand for their product.

<sup>2</sup> I use the period 2013:Q1 to 2019:Q4 to estimating this trend, starting the estimation at the point where the euro area economy began to recover from its euro-crisis-related recession.

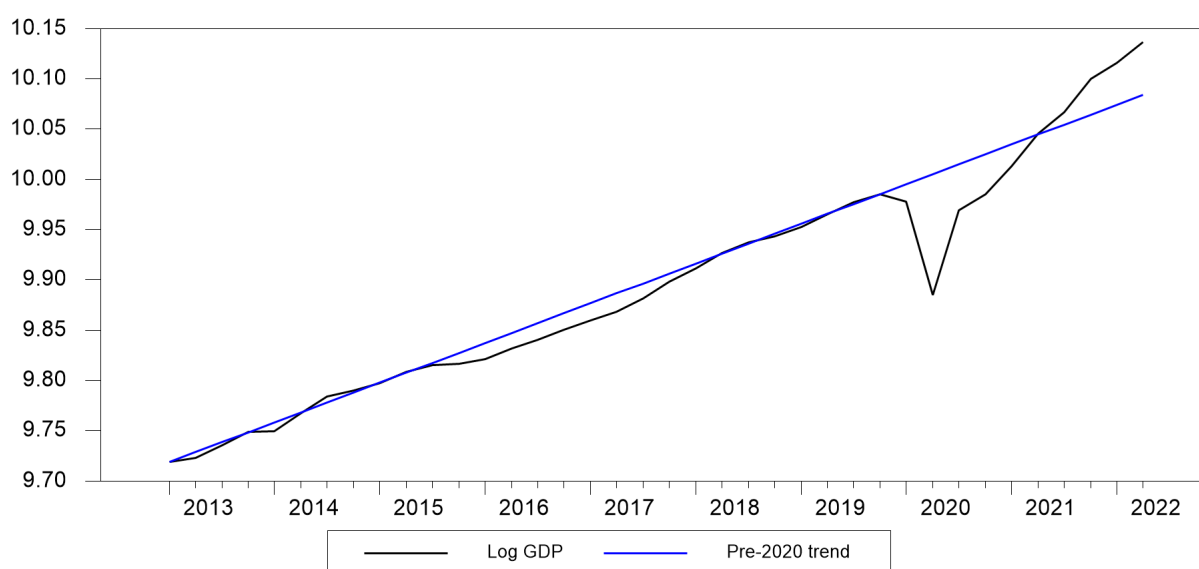
<sup>3</sup> See Beckworth (2022) for more discussion of using nominal GDP gaps to assess inflationary pressures.

Figure 3: Log of euro area nominal GDP and its pre-2020:Q1 trend



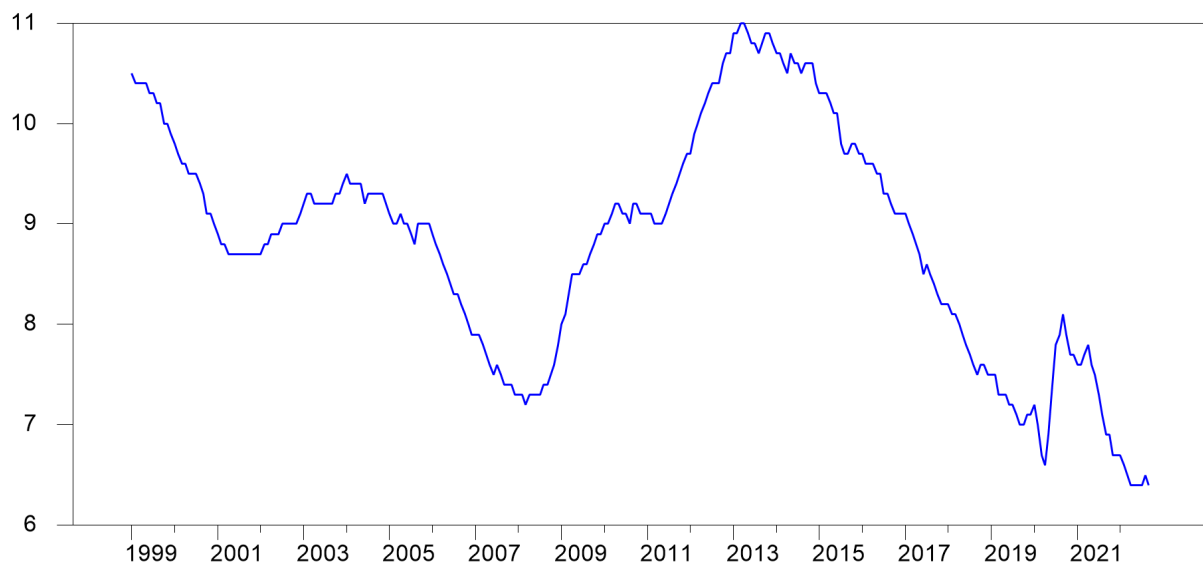
Source: Author's calculations based on data from Eurostat.

Figure 4: Log of US nominal GDP and its pre-2020:Q1 trend



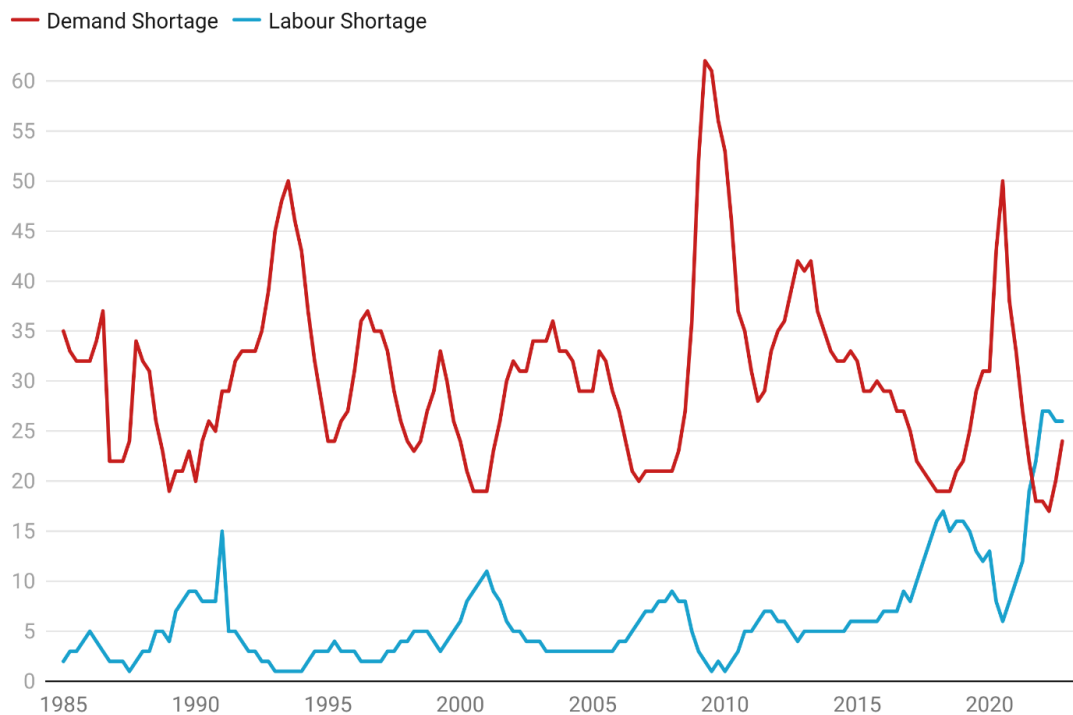
Source: Author's calculations based on data from Eurostat.

Figure 5: Euro area harmonised unemployment rate



Source: Author's calculations based on data from Eurostat.

Figure 6: Fraction of euro area manufacturing businesses reporting demand shortages or labour shortages as limiting production



Source: Author's calculations based on data from the European Commission  
[https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys/download-business-and-consumer-survey-data/time-series\\_en](https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/business-and-consumer-surveys/download-business-and-consumer-survey-data/time-series_en)

Unsurprisingly, the high inflation rate and a tight labour market has meant that the growth rate of wages has been increasing. Figure 7 shows an estimate of the annual growth rate of wages in the euro area from a joint project between recruitment advertising firm Indeed and the Central Bank of Ireland (Adrjan and Lydon, 2022). The estimate is derived from salaries listed in job postings on Indeed's website. It is a more timely estimate than other measures based on national accounts data or negotiated job settlements. This series has shown increased wage growth since early 2021 and is now running at about 5% at an annual rate.

This evidence points to excessive domestic demand as source of inflation and the ECB's current approach of deliberately trying to slow the economy is justified by these developments. Still, it should be clear that the euro area is not going through a classic wage-price spiral in which wage increases play a key role in driving price inflation. Wage inflation is clearly responding with a lag to the high rates of price inflation that have been prevailing for some time. Indeed, wage growth has been well behind price inflation over the past year, so workers are experiencing declines in real wages. Given the high rate of inflation and the tight labour market, the current pace of wage growth is lower than might have been expected. This likely reflects expectations on the part of workers that inflation is going to fall over the next year.

The key additional factors beyond excess demand that have been driving euro area inflation are food and energy prices, which have been driven upwards by the war in Ukraine. As noted above, October HICP inflation is estimated to have been 10.7% while HICP inflation excluding energy, food, alcohol and tobacco (the traditional "core inflation" measure used by the ECB) was 5%. So, in a mechanical sense, these non-core factors accounted for a majority of the euro area's inflation over the past year. But rising food and energy prices have also had an impact on non-core prices by increasing costs for direct inputs and raising wage pressures.

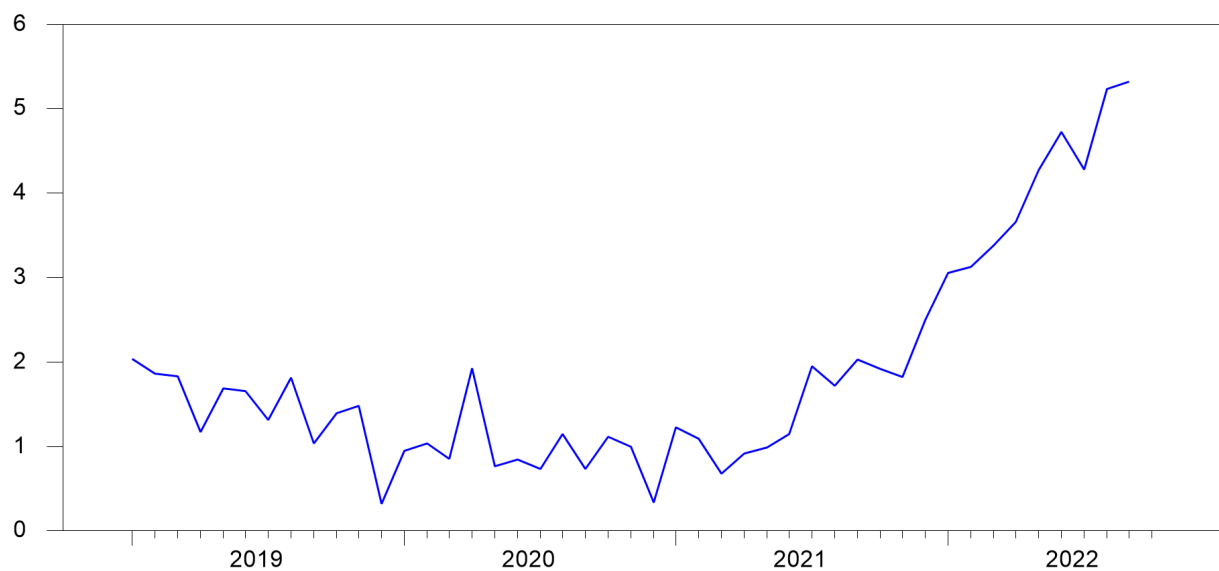
To evaluate the role that food and energy prices are playing in driving up core inflation, it is instructive to examine cross-country inflation patterns in Europe. The rise in food and energy prices has been unevenly distributed across the EU with some countries being much harder hit than others. Figure 8 shows how current non-core HICP inflation (meaning combined food and energy price inflation using the relevant HICP weights) ranges from a low of 12% in France to a high of almost 50% in Netherlands. Figure 9 shows a scatter plot where each EU Member State is represented by a dot showing both non-core inflation and total HICP inflation.<sup>4</sup> There is, of course, a high correlation between non-core inflation and total HICP inflation across EU states.

More importantly, however, Figure 10 shows a positive relationship between non-core inflation rates and core inflation rates, showing that food and energy prices have been affecting all other prices. The slope of a line fitted to the data in Figure 10 suggests that each additional 1% of non-core inflation adds 0.14% to core inflation. Applying this calculation to the euro area as a whole, which had non-core inflation of 23% in the year to October, this suggests non-core inflation has added 3.15% to core inflation over this period, meaning core inflation would have been below the 2% target without the rise in food and energy prices.

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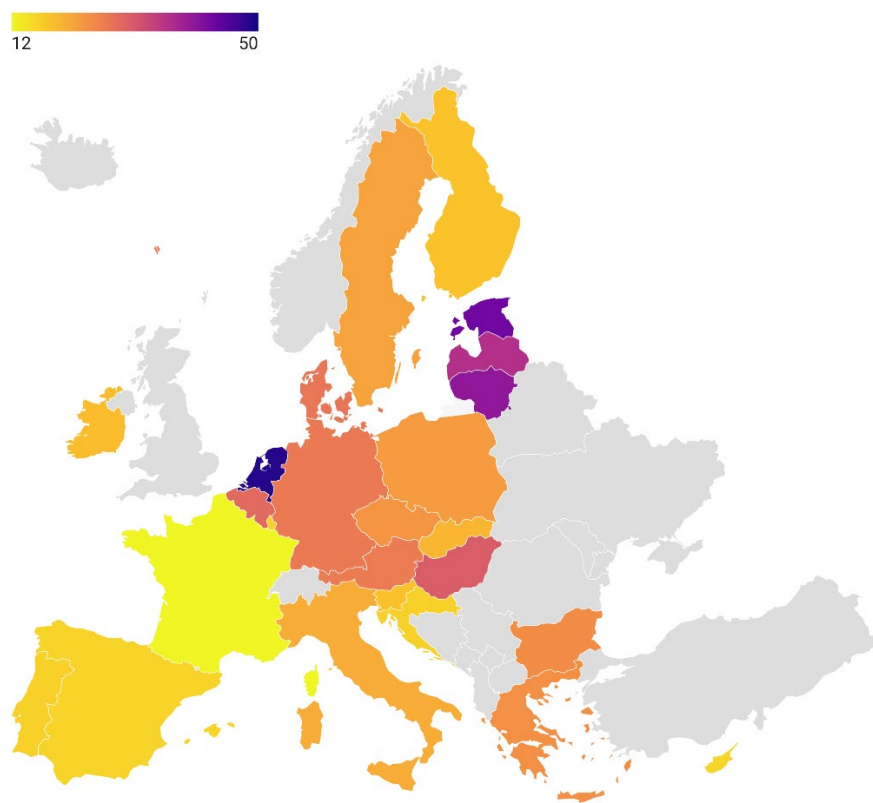
<sup>4</sup> Malta is excluded due to missing data.

Figure 7: Estimated year-over-year wage growth for the euro area



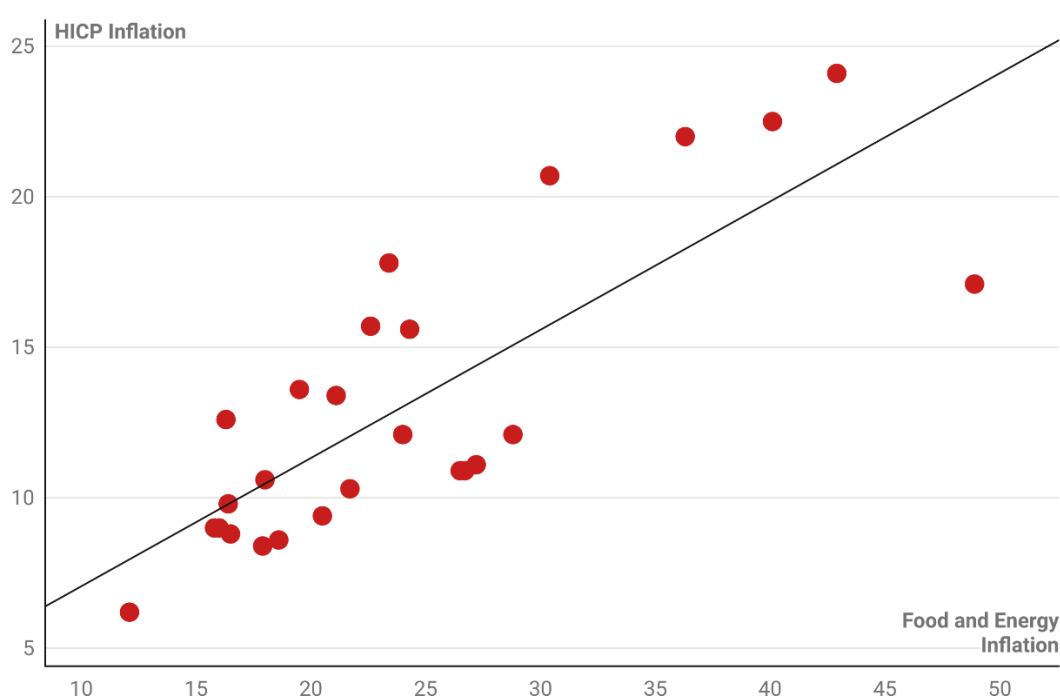
Source: Author's calculations based on data from the Indeed wage tracker  
<https://github.com/hiring-lab/indeed-wage-tracker/tree/main/data>

Figure 8: HICP food and energy price inflation in EU Member States



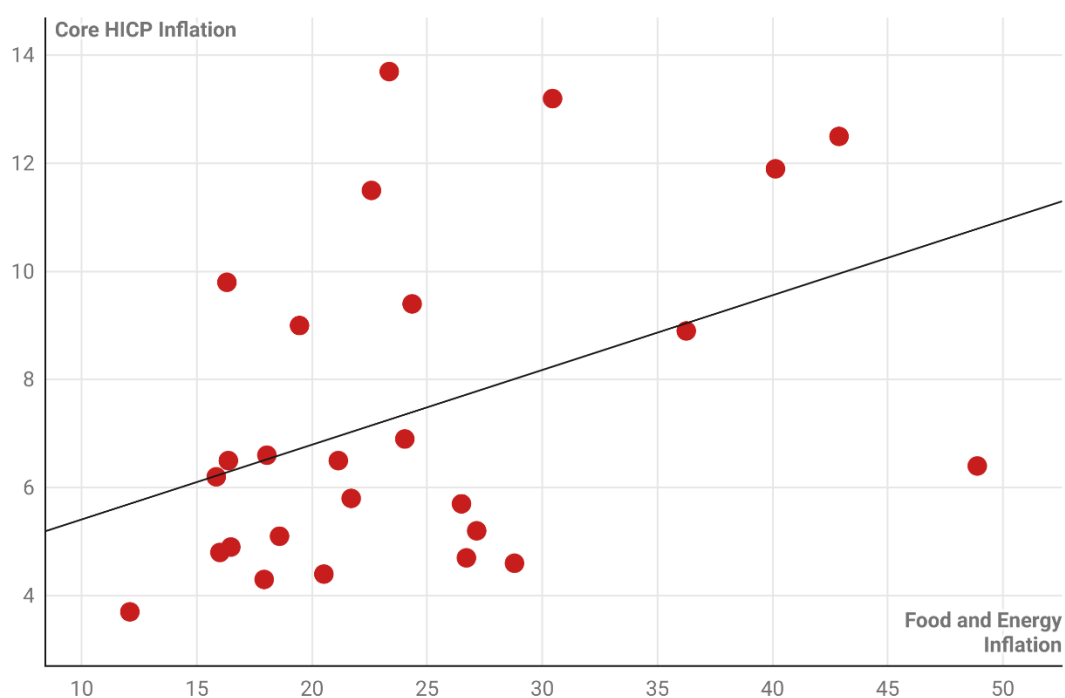
Source: Author's calculations based on data from Eurostat.

Figure 9: HICP inflation and food and energy price inflation in EU Member States



Source: Author's calculations based on data from Eurostat. Food and energy inflation is calculated as the combined inflation rate for energy, food, alcohol and tobacco using country-specific HICP weights.

Figure 10: Core HICP inflation (excluding energy, food, alcohol and tobacco) and food and energy price inflation in EU Member States



Source: Author's calculations based on data from Eurostat.

Notes: Food and energy inflation is calculated as the combined inflation rate for energy, food, alcohol and tobacco using country-specific HICP weights.



Why does it matter what the underlying sources of inflation are? The ECB's mandate for price stability relates to the total HICP, not just the component of it that excludes volatile prices. Given this, it is clear that with inflation so high now, the ECB has no choice but to do everything it can to slow the economy and get inflation down. However, this leaves open the question of how high interest rates need to go. Like all central banks, the ECB needs to be forward-looking when calibrating their monetary policy and for this reason the composition of current inflation determinants matters.

Food and energy prices are likely to remain high in Europe over the coming years but the ECB is explicitly an inflation-targeting central bank. It does not target the overall price level. If food and energy prices stabilise at something close to their current high levels, then the impetus from these factors to inflation will fall away and year-over-year inflation could fall quite quickly as soon as next spring, returning inflation towards its target levels.

There are also signs that conditions in the euro area economy are starting to deteriorate so the current over-heating is going to end. High food and energy prices are squeezing household incomes with, as noted, wage increases not keeping up with inflation. Moreover, as recent ECB research has acknowledged, the effective inflation rates for poorer households have been higher than average because of their heavier reliance on essential goods and services.<sup>5</sup> These households already do not have much ability to save and the higher cost of living will translate directly into reduced spending on other consumption items.

Business sentiment is also weakening with increasing pessimism about the months ahead showing up in purchasing manager surveys and the European Commission's business surveys. And these signs of slowing are visible prior the ECB's current tightening of financial conditions having yet had much effect. For example, we can expect to also see housing market conditions deteriorate soon as falling real incomes and higher financing costs combine to reduce house prices and slow residential construction.

Given this set of circumstances, the ECB will need to assess policy carefully so that it does not end up tightening more than is necessary to restore price stability.

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<sup>5</sup> See Charalampakis, Fagandini, Henkel and Osbat (2022).

## 4. GLOBAL MONETARY POLICY TIGHTENING

The global nature of the modern economy means central banks need to pay close attention to economic events elsewhere when formulating their own monetary policies. In particular, they need to monitor the monetary policy actions of other central banks. The monetary policies of other central banks affect euro area inflation through their influence on global demand and thus the demand for euro area exports. They also influence inflation in the rest of the world, some of which is passed through via higher import prices in Europe.

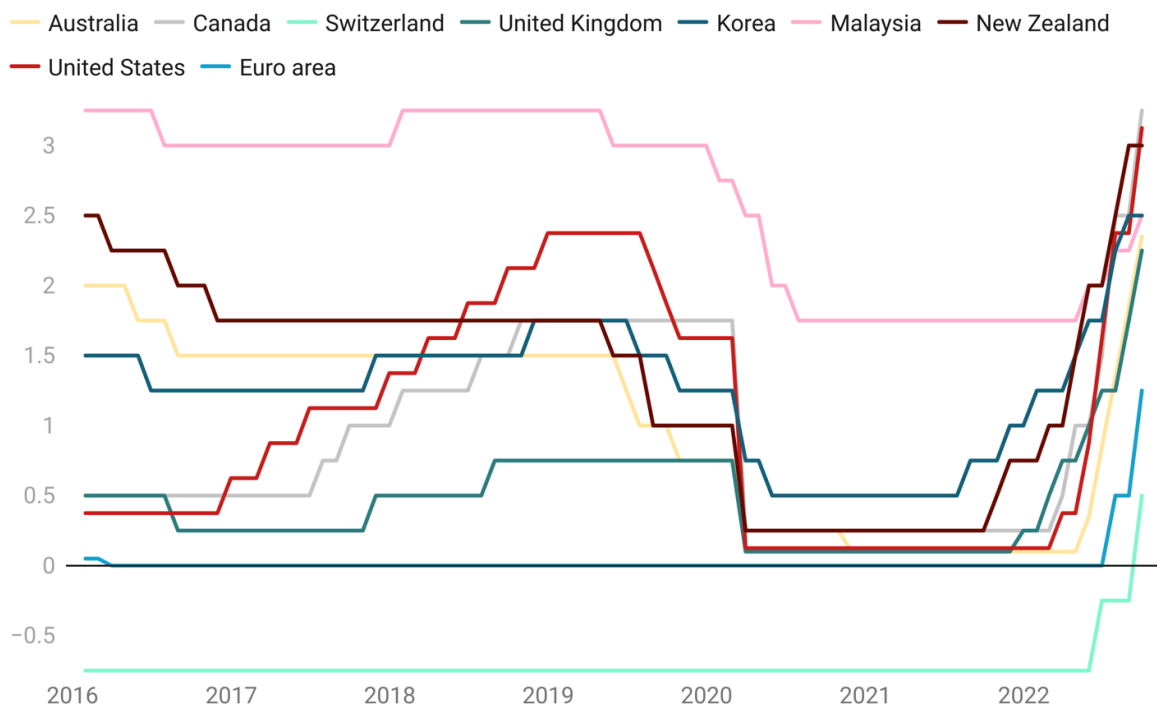
Another channel is the influence of foreign monetary policies on the euro exchange rate. As illustrated in Figure 11, while central banks around the world are now all tightening monetary policy, the Federal Reserve has raised interest rates faster than the ECB and by a larger amount. This has likely had an influence on the decline in the euro's exchange rate against the dollar from approximate USD 1.20 in summer 2021 to approximate parity now, as shown in Figure 12. With the US economy still expanding and adding jobs at a healthy rate while the euro area economy is apparently weakening, there may continue to be a gap between Federal Reserve and ECB policy rates for some time which could lead to further depreciation of the euro.

The decline in the euro has played a role in the high inflation of the last year but it is unlikely it played a major role. The official account of the July ECB Governing Council meeting reported that Executive Board member Isabel Schnabel told her colleagues that the ECB staff estimated that *"around half of the 10% depreciation of the euro vis-à-vis the US dollar since the start of the year could be attributed to the divergence in monetary policies."*<sup>6</sup> Research by Ortega and Osbat (2020) estimates that a 1% depreciation in the euro raises the HICP by around 0.04%. Assuming that differential monetary policies have accounted for half of the drop in the broad euro exchange rate since summer 2021, this estimate implies euro depreciation has added about one third of one percent to inflation this year. So this has not had a big impact. The ECB will have to factor in this effect if its monetary policy continues to diverge from the Federal Reserve's but it is unlikely that this effect will have an important influence on how the Governing Council sets monetary policy.

The simultaneous timing of interest rate hikes around the world illustrated in Figure 11 has raised concerns from former IMF chief economist, Maurice Obstfeld (2022), that the combined effect of simultaneous tightening of financial conditions across the world may be too severe. Obstfeld has said: *"The present danger, however, is not so much that current and planned moves will fail eventually to quell inflation. It is that they collectively go too far and drive the world economy into an unnecessarily harsh contraction."*

<sup>6</sup> See <https://www.ecb.europa.eu/press/accounts/2022/html/ecb.mg220825~162cfabae9.en.html>

Figure 11: Monetary policy rates from a selection of central banks



Source: Author's calculations based on data from the Bank for International Settlements.

<https://www.bis.org/statistics/cbpol.htm>

Notes: For the US, the chart shows the mid-point of the Federal Reserve's target range for the federal funds rate. For the euro area, it shows the deposit rate.

Figure 12: Euro-Dollar exchange rate



Source: ECB Statistical Data Warehouse

In theory, a solution to this potential problem is for the major central banks to co-ordinate their monetary policies but this is not likely to play a big role in practice. While there are regular meetings amongst central bankers at various forums, each central bank ultimately has its own mandate focused on inflation and the real economy in their own region. This places strict limits on the extent to which central bankers can announce that domestic conditions might call for one policy but global co-ordination calls for something else.

A more realistic expectation is just that central banks take full account in their forecasts of the effect of monetary policy tightening in other parts of the world. As Obstfeld has put it *"Now is the time for monetary policymakers to put their heads up and look around. They should take into account how the forceful actions of other central banks are likely to reduce the global inflationary forces they jointly face."*

Will this be sufficient to produce the right outcome? Will the usual processes by which central banks construct their forecasts contingent on expected monetary policies in the rest of the world be sufficient to avoid an unnecessarily strict tightening? I am not sure.

One factor that may play a role in producing an overly severe global recession is the concern that central banks have with establishing their inflation-fighting credentials. This is the ECB's first time having to cope with high inflation and thus the most serious test of its commitment to its primary objective of price stability. Similarly, for many of the central banks who adopted an inflation targeting strategy back in the 1990s, this is the first time since this strategy was adopted that they have faced a sustained period of above-target inflation. They will feel the success of their institutions is going to be judged on their ability to get inflation back to target and the perception that they played a key role in achieving this.

Central bankers and academic macroeconomists have long believed that establishing the credibility of a central bank's commitment to fight inflation is crucial to good macroeconomic performance. Central bankers will also have heard a lot of criticism of their failure to prevent the current high inflation. This has come from politicians and the general public but also from influential academics. A good example was the discussion at the Committee's previous Monetary Dialogue preparatory meeting from Ricardo Reis, academic from the London School of Economics (LSE)<sup>7</sup>. In his comments, Reis argued forcefully that ECB's monetary policy was far too loose and was fuelling high inflation. He recommended that the ECB implement an immediate large increase in policy rates rather than stick with its more gradualist approach.

Economists believe that people respond to incentives. Given their current legal and institutional structures, most major central banks are now heavily incentivised to focus on reducing inflation and to be seen to have done so effectively. A central bank that implements a severe tightening now and puts the economy into recession can claim to have "taken the tough but necessary decisions" and once inflation has fallen, it can argue that it played a key role in this successful outcome. In contrast, a central bank that concludes that an upcoming global recession will reduce inflation anyway and thus decides not to tighten further will find it more difficult to make such an ex post claim. On balance, I think there is a significant risk that we will get more global monetary tightening (and a more severe recession) than would be necessary to return inflation to its target levels.

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<sup>7</sup> See [https://multimedia.europarl.europa.eu/en/webstreaming/event\\_20220915-0900-COMMITTEE-ECON?start=20220915082700&end=20220915084935](https://multimedia.europarl.europa.eu/en/webstreaming/event_20220915-0900-COMMITTEE-ECON?start=20220915082700&end=20220915084935).

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The euro area's current high inflation rate is due to both internally generated demand pressures and external shocks that have raised food and energy prices. This paper argues that the latter element is more important than the former. Central banks need to tighten monetary policy to address high inflation but, with central banks around the world under pressure to restore their anti-inflationary credentials, it is possible that there is going to be too much tightening of global financial conditions.

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