

Is the best monetary policy the one that does not control inflation? What does the ECB say?

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Recent statements by Christine Lagarde, President of the European Central Bank (ECB), say that post-confinement inflation remains outside their influence. Its sources are the recovery of demand and border upheavals, she says. The ECB, like the Fed, combats the economic effects of the pandemic with large injections of liquidity into the markets and improvements in financial conditions. However, the latest monetary policy statement left aside price stabilisation, its only mandate. Does this mean that the ECB will sit back and watch inflation decimate purchasing power? What will monetary policy in the euro area be?

The European and the US economies felt the effect of the pandemic at the same time. When European stock markets plunged in mid-February 2020 and the downturn in the real economy was imminent, the ECB implemented two emergency programmes. Both significantly expanded its balance sheet: the [Pandemic Emergency Purchase Programme](#) (PEPP) and the [Asset Purchase Programme](#) (APP). The liquidity injected into the markets was EUR 1,850 billion under the PEPP. A further EUR 120 billion, plus monthly purchases of EUR 20 billion under the APP, reduced the cost of funding and supported increasing lending in the euro area. The result was an increase in the ECB's balance sheets, as shown in the chart.

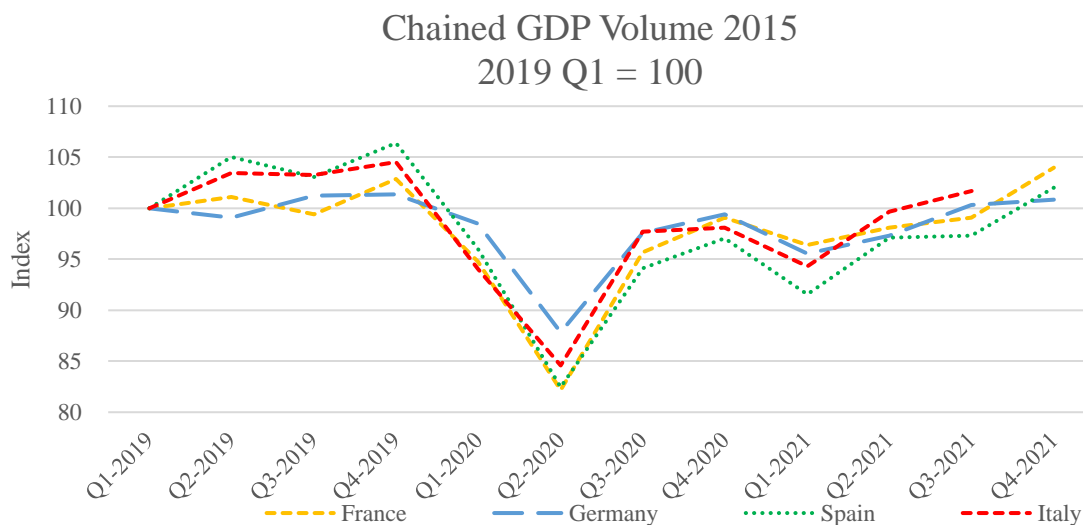
BCE Total Assets



Source: OBELA with data from ECB
19 Euro Zone countries

Following the Fed's [announcement of liquidity tightening](#) in January 2022, the [ECB announced](#) its tightening in February, which summarises decreases in asset purchases from both programmes. Net asset purchases under the PEPP framework will end in March 2022. Still, APP purchases have increased to €40 billion per month for the first two quarters of 2022, €30 billion per month in the third quarter, and €20 billion from October onwards. The result is at least EUR 350 billion injected this year. It means that no interest rate hikes will happen until the last quarter of 2022.

Quantitative easing contributed to the recovery in euro area countries, but growth has been uneven. By the end of 2021, according to OECD data, the Netherlands was already above pre-pandemic levels, as were Finland and Lithuania. Germany, France and Italy expect to recover in the first quarter of 2022, while Spain is still far from its pre-pandemic level (see graph). European member countries experienced the same contractionary business cycle phase due to the pandemic. Still, not all countries enjoy the same growth phase. Some economies have more obstacles in their recovery than others, leaving the euro area with output and employment levels below 2019, as shown in the chart below.



Source: OBELA with data from OCDE

The problem with this slow recovery is that the economic reopening brought [high inflation](#), which theoretically forces the ECB to raise interest rates and implement a restrictive policy. In the [interview with Christine Lagarde](#) on 11 February 2022, the President said she does not

believe that gradually raising interest rates is the solution to high inflation in the euro area. The source of the price increases stems, first, from the high costs of oil, gas and electricity, inputs that the euro economy imports, and second, from bottlenecks in production chains. Conversely, raising the rate weakens the European recovery, raises unemployment and increases rising household and corporate debt pressures.

ECB policy, therefore, remains unchanged on interest rates, currently at 0.00%, and will not rise in the short term. The only measure in place is a gradual decrease in net asset purchases. Economic growth has priority, and the price stability mandate shifted to the background, expecting

inflation to decelerate in the medium term. The challenge for the ECB over the year will be to normalise its monetary policy away from demand-driven inflation and prevent interest rate adjustments from damaging euro area growth.

The ECB will monitor inflation developments, expected at 2% down from 5.1%, and maintain an expansionary monetary policy. The institution has stated that it cannot contain inflation. It has roots beyond the monetary sphere because it is subject to geopolitical conditions and economic recovery. Three questions remain: the first is whether passive monetary policy can offset the loss of purchasing power and thus fuel income growth. The second is how much inflation will affect income distribution. The third is if inflation will slow down on its own.