Interest rate hikes are not the answer to Europe’s inflation problem

Rising inflation throughout 2022 has resulted in central banks substantially increasing interest rates. **Patrick Kaczmarczyk** *argues that rate hikes are the wrong response to the challenges currently facing the European economy.*

Inflation rates across the Eurozone are putting the European Central Bank (ECB) under pressure to raise rates – whilst economic indicators continue to nosedive. The ECB seems nonetheless determined to do “whatever it takes” to bring down inflation, even if “whatever” were to imply a severe recession and permanent damage to the European economy.

When we look at the history of rate hikes by the ECB, we may expect that the story will not end well. In 2006, the ECB started to increase its interest rates throughout the troubling years of 2007-08. The cause of the inflationary pressures back then was a sharp increase in oil prices, which peaked at close to $150 per barrel in early 2008. The tightening of monetary policy by central banks triggered the bursting of the bubble on financial markets, which was followed by the then largest crisis of modern capitalism. Central banks were forced to take a U-turn in monetary policy to accommodate policymakers in their efforts to halt the meltdown of the global economy.

After the financial crisis and the crash of commodity prices, a reverse cycle set in, and commodity prices started to shoot through the roof again. Oil prices almost tripled between January 2009 and April 2011, food prices joined the rally (wheat prices, for example, doubled in the same period). Inflationary pressures re-emerged, whilst the Eurozone found itself in the deeply troubled waters of the Eurozone crisis. ECB president Jean-Claude Trichet, along with certain members of the Governing Council, prioritised the fight against inflation over financial and economic stability – and the ECB started to raise interest rates amidst another crisis. We know in hindsight that the ECB had to step in again – this time under the leadership of Mario Draghi – with another U-turn to prevent the Eurozone falling apart.

This time is different?

Today, the ECB finds itself between a rock and a hard place. Throughout 2021, it argued that inflation would be transitory. The data at the time were clear: wage growth was subdued, inflation was driven largely by broken supply chains, and, from the autumn of 2021 onwards, also by rising energy prices.

In 2022, the energy price rally continued to new record heights, triggered by shortages due to Russia's invasion of Ukraine and amplified by financial speculation. Additionally, still broken supply chains and recurring Covid-lockdowns have continued to disturb global production. Hence, we ought to conclude that the *sui generis* and transitory factors creating inflationary pressures in 2021 have increased in strength and now drive inflation in 2022. As Martin Sandbu put it earlier this year, "the fact that we have had one unforeseen supply shock after another — which nobody disputes — is not a reason to think each of them is not transitory."

However, the longer high inflation rates persist, the more it appears they may have become somewhat permanent. As a consequence, the ECB finds itself under increasing pressure from policymakers, the media, and the public. Although energy prices are pushing many firms to the verge of closure, and virtually all economic indicators are in freefall – partly indicating that we are heading towards a crisis of a larger scale than 2008 and the Covid-19 pandemic – the ECB finds itself cornered to take a tough stance.

Based on a sober assessment, we would have little reason to expect inflation rates to continue to rise next year. Wage growth remains subdued in the Eurozone and given that firms are under high pressure due to extremely high energy prices, there is little room for negotiating large wage increases. The outlook for energy prices, the main driver of the current inflation, also appears to have a smoothing effect on inflation next year, as energy futures point towards a gentle decline of prices from Q2 2023 onwards.

At this point, it is hard to see where further momentum for similar inflation rates next year should come from. However, even if inflation rates were to slow down in 2023, it is unlikely that we will have overcome the current shortages, and the overall high price level will continue to squeeze households and businesses. Considering how badly the interest rate hikes in previous periods turned out in the Eurozone, interest rate hikes in the current environment promise to add fuel to a fire we are struggling to contain.

Different times require different approaches

In Europe, most economists acknowledge that inflation is not driven by expansionary fiscal or monetary policy. It is not an overheating of the economy that requires some cooling. Quite the contrary: the current inflationary pressures spread throughout an economy that is freezing cold. In such a context, monetary policy tightening is the least suitable tool to address the current challenges.

If we compare the figures in two structurally similar economies, the Czech Republic and Slovakia, we come as close to a difference-in-difference experiment as possible for examining the effectiveness of monetary tightening. The Czech Republic increased its interest rate from 0.5 percent to 7 per cent between the summers of 2021 and 2022, whilst inflation continued to climb from less than 5 to over 17 per cent. Slovakia, as a member of the Eurozone tied to the monetary policy of the ECB, had no similar increases in interest rates, yet its inflation went – during the same period – from similar levels of less than 5 percent to around 14 per cent. This confirms in a way what Isabel Schnabel, member of the Governing Board, recently admitted, in that the "[ECB's] monetary policy has little impact on what is happening on global commodity markets".

If the ECB has little impact on what happens on global commodity markets, the only way in which monetary policy can bring down inflation is via introducing an economic downturn. The likelihood of such a downturn is further exacerbated by a widespread turn to austerity. Adam Tooze has pointed out that currently, there are more countries tightening the fiscal screws than there were during the global turn to austerity in 2010. The very recent announcement of the German government of its €200 billion package to bring down energy prices as well as the slightly softer stance of the EU towards debt reduction are two hopeful indicators that governments will turn away from such a dangerous shift towards austerity.

Despite the latest shift, some economists continue to argue that if there is a supply shock, we need to adjust the level of demand downward. However, this logic is akin to flooding an entire house to extinguish a fire in the kitchen. What this peculiar type of inflation requires, indeed, is *investment* to overcome the existing shortages. Instead of bringing down demand in a fragile economy, we need to expand the supply. In the 200 years of capitalism, if there is one feature that cannot be denied, it is that investments and innovation have always been the key to overcoming real shortages.

In the current environment, this is of course not simple and could mean that, in the short

run, inflationary pressures could persist. In the medium to long run, however, when the investments and innovations start to bear fruit, Europe would be a lot better off as a society and economy. Opting for a strategy of austerity, by contrast, offers no solution – neither short-term nor long term – to the problems we face.

How we should proceed

The most urgent investment needs concern the scaling up of renewable energy and other alternative forms of energy that we can use in the short run. The primary goal of economic policy must be to expand the energy supply to bring down energy prices. At the same time, the state must take the lead and incentivise the private sector to invest in innovations that increase energy and resource efficiency as well as the circularity of production and consumption.

Such investments must complement short-term measures to stabilise household purchasing power and halt the meltdown in demand that we are currently observing. Otherwise, the political and economic fallout from this crisis will increase the cost beyond values that we can put a price tag on.

Finally, the perfect storm we are facing underlines the need for international economic cooperation. The response to this global crisis so far has been uncoordinated and risks wrecking the global economy. During the Great Depression in the 1930s, countries embarked on widespread beggar-thy-neighbour policies, where each state tried to increase its competitiveness vis-à-vis a currency depreciation. Today, we are witnessing the opposite, as countries pursue an uncoordinated race to the top in interest rates to lower imported inflation by halting currency depreciation.

The tightening by the Federal Reserve has forced other countries to follow suit as the high interest rate differentials and the status of the US dollar as the world's reserve currency prompt capital flight to the US. The consequence has been a strong appreciation of the US dollar, generating more expensive import bills for the rest of the world, which the latter, in turn, have tried to halt by raising interest rates themselves. The Global South, in particular, is now facing financial disaster as interest rates go through the roof and the burden of dollar-denominated debt threatens to suffocate already struggling economies.

In 1985, the US took the initiative to rectify some of the emerging imbalances in foreign

exchange markets and subsequent trade imbalances. The result was the historic “Plaza Accord”, following which Germany and Japan allowed for significant currency appreciation. This time, central banks and policymakers from around the world ought to get together and intervene in foreign exchange markets in a similarly coordinated way. This would reduce the pressure to compete over who can offer the fastest and highest rate hikes. Unfortunately, there are no signs that such a coordinated approach to solving the crisis is on the horizon. International cooperation appears to be at its lowest point, right at the time when it is so desperately needed.

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