SEE – proposal

After several years below target, the inflation rate in the euro area surged in 2022, reaching levels close to those observed in the 80s.

a) What drove the low inflation in the last decade in the euro area and the sharp increase in inflation in 2022?

In the last decade inflation stood stubbornly low for a series of reasons. Firstly, aggregate demand growth was slow due to deleveraging processes and contained public expenditure after the sovereign debt crisis. Secondly, the strong competition in international markets associated with an increasing globalization kept prices low. Thirdly, technological progress prompted the containment of process of several goods (e.g., electronics and telecommunications). Fourth, inflation expectations were very low.

The sharp increase in prices observed in 2022 was due to supply disruptions in several goods and, mostly a burst in energy prices (mostly gas), because of the conflict in Ukraine. The conflict also affected the prices of cereals and other food items. Moreover, the accumulated savings during the pandemics made it possible to sustain consumption growth, which contributes to inflation.

b) Compare the monetary policy stance of the ECB before 2022 with the present one. Which policy actions materialized the current stance?

From the aftermath of the sovereign debt crisis in the euro area until mid-2022–monetary policy took a strongly expansionary stance. Initially, this was due to low GDP growth during the sovereign crisis, then it was a way to push inflation above values dangerously close to zero and finally to provide unlimited liquidity in a context where the pandemics lead to high uncertainty and strain in financial (and sovereign bond) markets.

The current reversion is the necessary response to higher inflation rates, which seem to persist and spread to different classes of goods and services, as well as to wage updates.

Nowadays, the reference interest rates have increased and there was a break in the creation of liquidity through non-conventional methods.

c) What would be the consequences of a persistently high inflation rate in the euro area and across its member countries?

Persistent high inflation erodes real wages and thus it lowers the purchasing power of households. The follow up increase in interest rates puts strain on investment decisions by firms and on debt service by households, firms, and governments. This is particularly relevant for highly indebted agents and may contaminate the banking sector. If inflation differentials become significant across euro area economies, this will be another problem. High inflation also increases uncertainty and transaction costs, which is negative for long-term economic growth.

On a positive note, high inflation decreases the debt ratios as the denominator (e.g., nominal GDP) increases faster.

Current account crises and sudden stops in external financing are reflections of significant macroeconomic imbalances. These crises are particularly hard to correct in monetary unions.

a) What led to the surge of current account crisis in some euro area countries after the global economic and financial crisis of 2008-2009?

The reduction in interest rates associated with the nominal convergence process (lower inflation rates) represented a change in macroeconomic regime that prompted stronger consumption and investment and thus higher imports. Moreover, fiscal policy adopted an expansionary stance due to the perception that lower interest payments on public debt would continue indefinitely. Moreover, the inability to drive up productivity, the rising labour costs and the inability to increase the competitiveness of exports up made it impossible to avoid a current account deficit. The continuation of the process in a scenario where euro area participation made it easy to access external financing at low rates led to a sharp increase in private and public indebtedness.

b) How was the 2010-2012 European sovereign debt crisis controlled?

The crisis, which was a sudden stop in external financing in some euro area countries, was addressed though adjustment programs that included emergency lending under conditionality, notably in terms of fiscal consolidation, recapitalization of banks and structural reforms. The underlying monetary policy was expansionary, but markets kept a premium on riskier countries, which limited the effectiveness of such actions (fragmentation of the monetary policy).

The doom loop that was feeding sovereign debt risk and banks solvency (due to the loss of value of public bonds in the balance sheet of banks and higher likelihood of public intervention that increased again the risk of sovereign bods) was only stopped with the "whatever it takes" speech by Mario Draghi and the underlying possibility to activate the OMT (illimited financing, under conditionality)

c) Is the euro area prepared to address a possible repetition of such a crisis? Is it likely to happen in the short run?

There are new mechanisms in place that should reduce the risk of such crisis (e.g., the European Stability Mechanism, the European Systemic Risk Board). Moreover, private debt levels are lower, and banks has increased their capital ratios. However, these mechanisms have never been put to test. Fiscal rules have not been applied since the pandemic began because the public response to this shock required a large fiscal stimulus. This is a weak spot. Markets seem to have stayed calmer than in the sovereign debt crisis, partly because the EU institutions have acted swiftly and broadly (especially compared to before) to intervene in case of fragmentation risks (pressure on sovereign bonds yields of specific countries). Nevertheless, if the countries with high public debt don't put it on a firm downward path, we

might witness a new debt crisis, especially considering the increase in yields for government bonds.

The EU project has embodied the spirit of multilateralism, which contributed to economic globalization in the last decades.

a) What has characterized economic globalization, and how has the EU contributed to it?

Globalization is characterized by larger trade, larger international capital flows, and stronger movement of workers. In addition, the paradigm of production is the fragmentation of the production chain, with strong international trade of parts and components. This process is accompanied by strong FDI flows typically managed by multinational corporations that operate the global value chains. As a "single market" (described by the prevalence of four main freedoms, goods, services, capital, and labour) the EU has strongly contributed to this process. In its essence the EU is a trade agreement (a customs union) that has deepened and contributed to globalization. The EU enlargements and its cooperative stance in terms of trade policy have also shown the spirit of multilateralism that underlies globalization. The enhances interdependencies that come with globalization are quite visible in the EU.

b) How is economic globalization evolving, and what are the main forces shaping its future?

Nowadays, globalization has stagnated, mostly due to higher political and economic barriers, notably tariffs. The urge to increase autonomy from foreign suppliers is an example. The gains from lower transport costs have probably been exhausted. These are features related with goods trade. However, technological progress is boosting the international trade of services (AI, 3D printing, customization).

Climate change and the pricing of emissions, as well as populist trends and geopolitical competition will probably affect trade pattern in the next decades.

c) How does globalization interplay with competition and labour market policies in the EU?

Globalization puts a premium on highly skilled workers (at upstream and downstream tasks in the production chain, i.e., the smile curve on the distribution of value added along the production chain) and hurts blue-collar workers. This has caused changes in labour markets and increased inequality that also led to social tensions. The increased international competition in services markets, which is expected to materialize as this type of trade evolves, is likely to increase pressures in the labour market of advanced economies. To ease these tensions, which also fuel populism and anti-EU ideas, since there is an overall net gain from trade, redistribution towards losers should be activated.

As for competition, a stronger EU (internal) enforcement of such principles (which are enshrined in the Treaties) is warranted to counteract increased state-aid-driven decisions, fueled by domestic industrial policy decisions. This is the way to preserve a level playing field in the internal market.

Labour market characteristics and developments are essential for short and long-term economic analysis.

a) What is the relevance of the labour market in the European integration process?

The existence of labour mobility is a basic criterion for an optimal currency area to be in place. Nevertheless, mobility may accentuate divergences between core and peripheral countries. Moreover, the labour market can be both the source of imbalances - if wages growth above productivity and cause significant unit labour cost differentials - or the mechanism to correct those imbalances in a monetary union - given the absence of exchange rate depreciations. There have been discussions about adopting common EU labour market features (e.g., common unemployment system) to facilitate the absorption of shocks. On a different note, mobility of workers (and students) across the EU is another force towards deeper integration.

b) What role does the labour market play in the current euro area inflation developments?

Labour market was not the trigger in the recent inflation increase. Although employment has been growing and unemployment rate are historically low, the surge in prices did not occur through higher costs for labour. It occurred through higher prices of intermediates, notably energy. During the pandemic, wages (and jobs) were preserved due to the layoff programs. Therefore, there was a protection of households' income, which has been supporting consumption. However, higher inflation is eroding purchasing power and will dampen consumption soon. In any case, tight labour markets combined with the current inflation, will likely lead to upward wage pressures that may pass-through to firm's costs and then to prices. This could cause an inflationary spiral if not contained.

c) How do education, aging, and migration patterns impact labour markets in the medium and long run?

Aging brings GDP down due to the lower labour supply, which in turn pushes wages up. This is a long-term trend at play in most EU countries. The lower labour supply dampens economic growth. However, higher education compensates for this effect as productivity increases. Education also turns the economy more flexible and able to adjust to shocks. Higher participation rates (female) in the labour market also mitigate the economic costs of aging. Immigration is another mitigant of labour shortages, but it brings its own challenges, including the integration of lower-educated foreign workers. Conversely, it brings All these effects interplay in a complex way with the legislation that regulates the labour market.