Seminar in European Economics
Midterm Correction Topics - S1 24-25

High inflation has been one of the major concerns of EU economic policymakers in the last three years.

a. What drove the surge in euro area inflation observed in 2021 and 2022?

- Supply Side Reasons:
  - Supply chain disruptions: Global supply chains, already stretched due to the pandemic, continued to experience significant disruptions. These bottlenecks led to shortages of raw materials and intermediate goods, which further pushed up costs for manufacturers. Semiconductor shortages, shipping delays, and rising transportation costs particularly affected the prices of durable goods and industrial components.
  - Energy market: Soaring energy prices were one of the most significant drivers of inflation in the euro area. The sharp increase in oil, gas, and electricity prices began in 2021. In 2022, the situation worsened dramatically due to the Russian invasion of Ukraine, which led to severe disruptions in energy supply, particularly natural gas, as Europe was heavily reliant on Russian gas imports. This led to a surge in gas prices and overall energy costs, which fed into higher production costs across many industries.
  - Food market: Food prices also surged, driven by higher energy costs, supply chain disruptions, and climate-related issues like droughts affecting agricultural output. The war in Ukraine further aggravated food inflation, as both Russia and Ukraine are major global exporters of grains and fertilizers.
- Demand Side Reasons:
  - Monetary Stimulus: Monetary policy stimulus played a significant role in the surge in euro area inflation during 2021 and 2022 by supporting economic recovery and boosting demand, while also maintaining accommodative conditions for an extended period, with low interest rates and unconventional monetary plolicy packages, which drove up the central bank's balance sheet.
  - Fiscal Stimulus / Accumulated Savings: Accumulated savings played a significant role in fueling inflation in the euro area during 2021 and 2022, particularly by contributing to strong consumer demand after the initial COVID-19 lockdowns. Generous fiscal measures helped cushion incomes during the pandemic. Uncertainty about the future, including fears of job losses and economic downturns, prompted households to save more as a precautionary measure against future financial difficulties.

b. Please elaborate on the European policy response to this situation, and discuss its risks, costs, and benefits.

- Monetary Policy Response: Tightening by the ECB
  - Interest Rate Hikes: Starting in July 2022, the ECB began raising interest rates for the first time in over a decade. By late 2022, the ECB had raised its deposit facility rate (which had been negative) to a significantly high level.
  - Reduction of Asset Purchases (Quantitative Tightening): The ECB ended its Pandemic Emergency Purchase Programme (PEPP) in March 2022 and began to reduce purchases under the Asset Purchase Programme (APP).
  - These measures aim at controlling inflation by reducing liquidity and depressing aggregate demand, as the costs of financing increase. However, they may come at the cost of slower economic growth and incrasing debt servicing costs.
- Fiscal Policy Response: Government Measures
  - Energy Price Caps and Subsidies: To combat soaring energy prices (which were a major driver of inflation), many euro area governments introduced energy price caps or subsidies.
  - Direct Income Support: Many governments rolled out direct payments to vulnerable households, including pensioners and low-income families, to help offset the higher cost of living.
  - These measures aim at mitigating social hardship, by trying to target the most vulnerable households. However, they may come at the cost of increasing the public debt, in a moment of higher debt servicing costs, or even becoming counterproductive with the monetary policy goals.

c. What is the role of expectations and labour market in inflation developments?

- Role of Inflation Expectations:
  - When the public believes that inflation will remain stable and close to the central bank's target (2% for the ECB), inflation expectations are said to be anchored. In this scenario, households and businesses do not drastically change their behavior in response to short-term inflationary shocks. When inflation expectations become unanchored, people start to believe that inflation will remain persistently high or even increase further. This can lead to changes in behavior that exacerbate inflationary pressures.

  - Inflation expectations are also shaped by the credibility of the central bank. If the public trusts that the ECB will take appropriate action to bring inflation back to target, expectations are more likely to remain anchored, even if inflation rises temporarily due to shocks.

- Labour market:
  - A wage-price spiral occurs when rising prices lead workers to demand higher wages, which in turn increases businesses' costs. To maintain profitability, businesses raise prices further, creating a feedback loop. This can result in persistent inflation if wages and prices continually chase each other upward.
  - Tight labor markets (when there is low unemployment and high demand for workers) tend to put upward pressure on wages. Businesses facing difficulty in hiring are forced to offer higher wages to attract and retain employees. This was evident in several euro area economies in 2021 and 2022 as post-pandemic labor market recoveries coincided with labor shortages in certain sectors, such as hospitality, construction, and logistics.

d. Does high inflation challenge the good functioning of the euro area? Why it has always been a concern?

- The eurozone comprises 20 member countries with very different economic structures, fiscal policies, and economic cycles, but they share a single monetary policy implemented by the ECB. Stable inflation is essential to ensure that this one-size-fits-all policy works for all member states. To function smoothly, eurozone countries need relatively similar inflation rates. Diverging inflation rates can cause imbalances that are harder to correct within a currency union, since countries cannot use national monetary policy tools (like interest rate adjustments or currency devaluation) to address them.
- When inflation rates differ, some countries in the euro area become less competitive than others. For example, if one country's inflation rises faster than others, its goods and services become more expensive relative to its eurozone peers, potentially reducing its export competitiveness. These imbalances can widen trade deficits and lead to uneven economic growth across the region.
- High inflation erodes real incomes, especially for households on fixed incomes or low-wage earners. This leads to a cost-of-living crisis, as the prices of essential goods and services, like food, energy, and housing, rise faster than wages. Inflation that disproportionately affects poorer households or economically vulnerable regions can fuel social and political instability.