Synopsis

#1: IMF Annual Meetings 2022 pre-briefing Progressive Economics Network
Digital invite-only online session took place on 6 October,
14.00-15.00 CEST // 1.00-2.00 PM BST // 8.00-8.30 AM EDT

Author: Carsten Jung (Das Progressive Zentrum)

I. The Background

This synopsis summarises the main threads of discussion of the invite-only online session kick-off event of the Progressive Economics Network (PEN). This synopsis is based on inputs provided during the meeting by Prof Moritz Schularick (Sciences Po / Bonn), giving his take on the current macro situation, and by **Prof Ulrike Malmendier (Berkeley)**, discussing the behavioural aspects of inflation and how it intersects with currently discussed price cap policies. The inputs were followed by discussion among participants. The session was chaired by **Carys Roberts**, executive director of IPPR.

PEN aims to bring together senior economic advisers and decisionmakers from multiple European countries and the US and Canada. The goal of the series is to build upon the political momentum on both sides of the Atlantic to put into place an economic plan that is fit for the huge transformational challenges posed by the conflict in the Ukraine, Covid-19, and the climate crisis.

The network seeks to build long-lasting relations between economic advisers and decisionmakers and **offers a space to strategise, exchange best-practices, and form a progressive economic policy strategy** on how to tackle some of the most pressing economic challenges in the areas of fiscal and monetary policy as well as regional development and industrial policy.

Das Progressive Zentrum e.V. (DPZ), the Foundation of European Progressive Studies (FEPS) and the Friedrich-Ebert-Stiftung (FES) are hosting the Progressive Economic Network – **this was the first in a series of online roundtables and in-person gatherings on progressive macroeconomics.**

II. Synopsis: IMF Meetings 2022 pre-briefing

The IMF Annual Meetings are taking place this week. Prominent on the agenda will be the ongoing high inflation crisis, the energy crunch and what G7 countries' appropriate macro stance should be in response. Building on the recent international roundtable hosted by Das Progressiove Zentrum (DPZ) together with FEPS and FES, in this snyopsis, we summarise DPZ's current thinking on the issue. Speakers at the roundtable were Ulrike Malmendier (Berkeley) and Moritz Schularick (Bonn / Sciences Po), comments from Steffen Meyer (German Chancellery) and it was hosted by Carys Roberts (IPPR).

We structure this snyopsis into 'four learnings'.

<u>Lesson 1:</u> There is a risk of tightening monetary policy too much.

Interest rates have risen strongly across central banks. In the US and Canada they have increased them by 3 percentage points, the UK by 2 and the Eurozone by 1.25 percentage points. There are two sides of the argument of whether to tighten much further:

On the one hand, some argue that rates need to keep rising if historical relationships are anything to go by. Key arguments here are:

1. Core inflation - i.e. stripping out food and energy - is significantly elevated across countries, but especially in the US and the UK. Those arguing for continued tightening of monetary policy say that such high core inflation today will mean higher inflation expectations tomorrow;
2. With inflation high, real interest rates will still be negative into next year, meaning monetary policy can still be seen as relatively loose in aggregate (though interest rate increases are already hitting sectors of the economy hard);
3. Building on standard macro models that are calibrated based on past inflation episodes, market expectations are that further interest rate increases are needed in order to quell inflation. Accordingly, markets expect them to rise to about 3-6 percent. This is putting some pressure on central banks to act on this to safeguard their credibility.

On the other hand, others argue that this could be going too far. There are broadly five arguments for this side:

1. Given central banks across the world are all tightening at the same time, the aggregate tightening of financial conditions is amplified.
2. Medium-term inflation expectations are still relatively anchored. And, as the IMF has argued, the risk of a wage-price spiral at the moment is limited.
3. There are significant financial stability risks from tightening too quickly. With economies still as or more leveraged than they were before the financial crisis this is a serious risk, as academic research shows. We already have seen this materialise in some emerging economies.
4. Some indicators of imported high inflation are starting to fall, including global shipping and oil prices. This *could* soon, with a lag, be reflected in lower headline inflation.
5. Monetary policy too works with a lag of a year or so. Hence *contemporaneous* (core) inflation is an imperfect indicator for judging its future effects.

DPZ´s take: given some price pressures seem to be plateauing, it is probably wise for central banks to slow their tightening for the reasons given above – and to see if a 'soft landing' scenario is in train. They have proven that they are willing to act swiftly and aggressively. But the next moves should be guided by careful assessment of incoming data over the next months.

<u>Lesson 2:</u> Fiscal policy, in the current inflationary environment, should do more to support low and medium earners, while avoiding a full blown stimulus. But the exact balance depends on a range of factors.

With regards to the right fiscal policy stance, on the one hand, some argue that in this high inflation period there is no room for further fiscal stimulus, without risking further inflation. There are some good reasons for this. The IMF, for instance, argues that monetary policy and fiscal policy should pull in the same direction, implying countries should seek to reduce their budget deficits. The tension here is that central banks are aiming to ease inflation by slowing the economy to break second round effects that could bake in higher inflation expectations. This approach, however, means that if governments stimulate the economy too much, central banks might well push interest rates up further.

On the other hand, it is true that we are already seeing a significant weakening in aggregate demand too. Many countries fear they are going into recession, so they regard some fiscal stimulus as potentially good to balance this out. This side of the argument stresses that significantly slowing economic activity is not needed to bring inflation down. Supply chains will unblock, the argument goes, fuel prices will plateau and thus inflation will naturally come back down. Inflation expectations seeming to be anchored at around 3% in the US/EZ/UK give some credence to this.

DPZ´s take: We cannot ignore the fact that (1) labour markets are historically tight, especially in the US and the UK; that (2) short-term inflation expectations are high; and that (3) current core inflation is still high – driven by rising profits in some industries and wages. While the risk of a price-wage spiral is low (partly thanks to strong monetary policy responses), there is still a risk of over-stimulating the economy in a time where multiple equilibria are possible. As a result, our take is that:

- The overall macroeconomic stance should add limited amount of overall stimulus.
- Still, fiscal policy should be used to stabilise incomes of low and middle income households. And well-designed price caps, too, can contribute to macro stabilisation, as argued below.
- Accordingly, we think tax increases now have a bigger role to play in getting the right overall fiscal policy stance. We discuss this in the next section.

<u>Lesson 3:</u> Tax reforms are needed to ensure ongoing cost of living support measures are based on a strong revenue base.

Given large upcoming challenges for policy and elevated spending pressures, there is a strong case for strengthening the tax system. Cost of living support measures will likely have to continue well into 2023; ageing and net zero put further pressures on budgets. Now is thus the time to engage with tax reform. This could start with closing the unfair gap between the taxation on working and investing – a huge unaddressed problem in the US, the UK and many European countries (including Germany). And it could happen through strengthening the effective tax rates, e.g. through closing loopholes. Windfall taxes on energy companies as well as broader corporation tax reform should be a crucial part of this.

Encouragingly, the debate in a range of places is going in the right direction:

- In Germany, a debate has been started on windfall profits and wealth taxes as a fair way of financing support programmes.
- In the US, the Inflation Reduction Act is reducing the deficit by increasing corporation taxes and significantly improving enforcement.
- The European Commission is developing a joint approach to taxing windfall profits by energy companies.
- France, Italy, Germany, Spain and the Netherlands are considering steps to implement the global minimum corporate tax deal, even outside an EU regulation (if the process there remains stalled).

Some countries are going the opposite way, and this is thus far not seen as bad policy by markets. Italy and the UK are planning to reduce taxes at a time where, as argued above, the opposite would be required – and have seen their borrowing costs increase.

DPZ´s take: Tax reform should feature prominently at the IMF meetings, as a crucial tool for macro stability. They need to form part and parcel of a response that is socially just while keeping any additional inflation risks low.

Lesson 4: ***There is a tricky trade off between price caps and direct subsidies. But clever behavioural design can square the circle.***

There has been an active debate in many European countries regarding whether an energy price cap is the right policy to address the problem of high energy prices.

One of the main arguments in favour of price caps, in our view, is its potential benefit for controlling inflation expectations. While monetary policy is the traditional policy tool to manage inflation expectations, fiscal policy, too, can reduce prices directly through price caps**.** It can thus have an effect on forward looking expectations. France, for example, has almost entirely limited increases in energy prices through such measures. Doing so could be beneficial for keeping inflation low not just now, but also in the future.

Recent research backs this up. The Bank of International Settlements (BIS) has shown that when inflation reaches a high level, prices move more in tandem. This means that price and wage setting in one industry responds more to what is happening in other industries. Particularly high levels of this occur in advanced economies when inflation exceeds about 5 per cent. Different economic players at this point increasingly form joint high inflation expectations. In other words, this research suggests that the higher inflation is today, the higher the likelihood that it will spread across the economy and remain high.

Keeping prices low can also reduce scarring. Academic research shows that prolonged exposure to high and rising prices can have significant long term effects on people, lasting for years and even decades. Economic insecurity caused by prolonged high inflation for instance impacts people's housing decisions for years to come and significantly affects their risk perception.

The big drawback of a price cap is the worry that with price caps 'from the first Euro of consumer spending' there would be a potentially inefficient incentive to over-consume energy. There might, in turn, be a huge untapped potential for saving energy that might only be realisable if consumer are faced with higher energy prices. Critics of price caps thus highlight that cash transfers for households would be better in alleviating economic pain, while keeping incentives to save intact. Cash transfers for example could be paid to compensate households based on past consumption, but they could reduce energy demand and instead use the money for other consumption. This, on the other hand, might be hindered by the lack of systems that can reach even the majority of citizens even if desired by policy makers. Moreover, there is at least some uncertainty around how much households can actually reduce their energy consumption in the short term. Price caps could thus be seen as a tool for 'buying time' for advancing home insulation.

DPZ´s take: We think that, if well designed, the best aspects of two approaches (price caps and cash transfers) can be combined. The elements of the price cap that should be kept is to limit the energy price inflation that people encounter – i.e. limit the prices people 'experience' and that in turn impact their future inflation expectations. The exact design and communication of the policy will be key for achieving this intended behavioural effects regarding inflation expectations. Announcing a fixed price path can help with this. But, on the other hand, ensuring that this price path only applies to a limited amount of consumption (e.g. 80% of previous year's consumption) can give the sufficient incentive to reduce energy demand where this is easy. Encouragingly, this seems to be the solution that Germany is coming towards and this could form part of the solution elsewhere too. Finally, any approach should attempt to set an upper limit of overall support per household to ensure that large energy consumers (which tend to be better off households) do not benefit excessively.