

# Policy mix and inflation: shifting to a new paradigm?

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# Motivation & outline

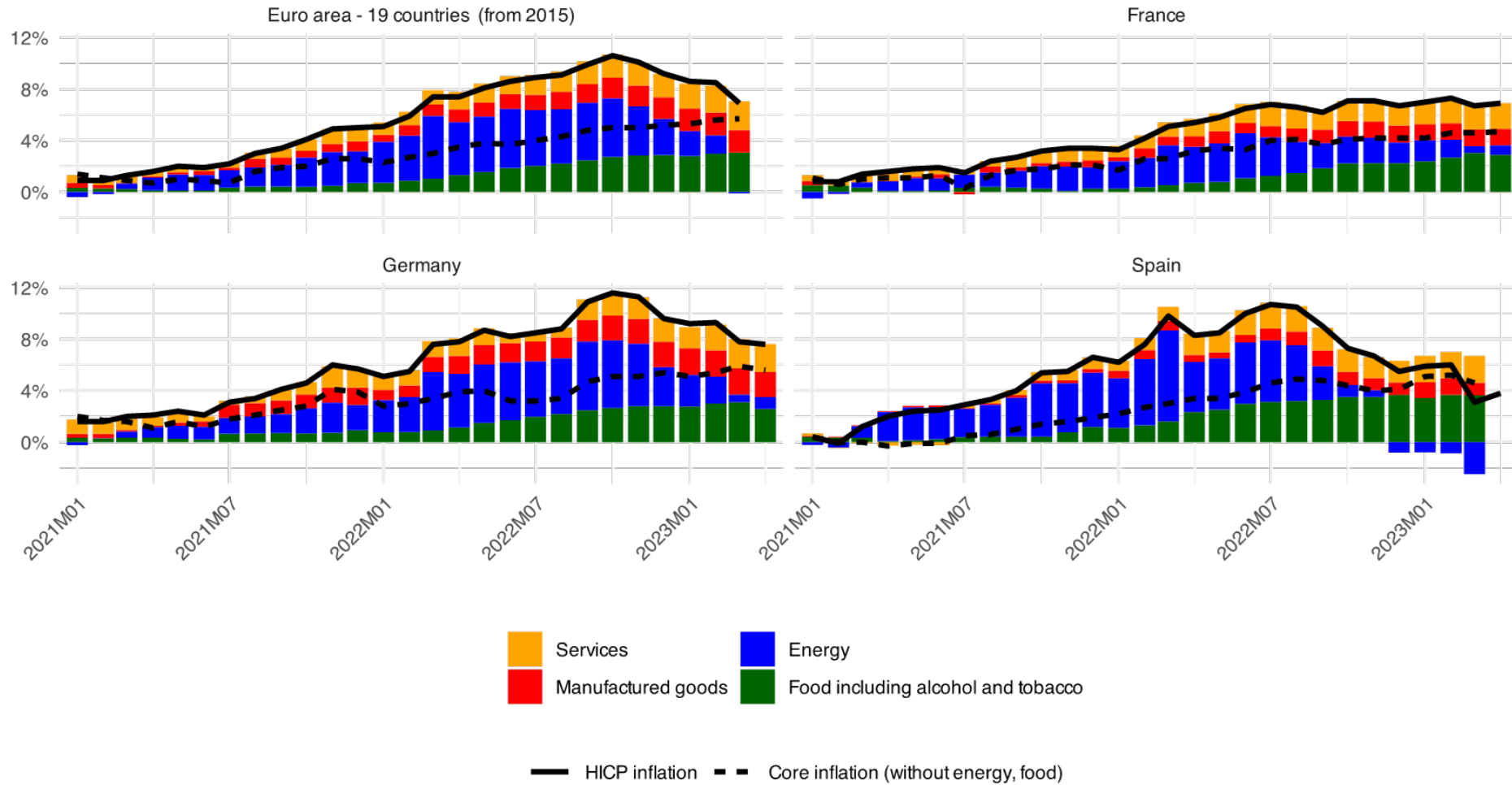
## □ Motivation

- The sudden rise in inflation has spurred rather unconventional policies, e.g. price caps and government subsidies
- These policies seem at odds with the long-standing paradigm of the Tinbergen principle, where monetary policy alone suffices to achieve price stability while fiscal/tax policies limit distributional effects
- Is the current change in policy allocation intended to continue? Will a new paradigm emerge from the recurrence of large macroeconomic shocks?

## □ Outline

- Inflation and (government) policies
- Inflation and redistribution
- The limits of monetary policy
- The Inflation Reduction Act: part of the toolbox?
- Towards a new paradigm?

# Inflation in the euro area



Source: Eurostat, prc\_hicp\_inw, prc\_hicp\_manr, authors' calculations

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# How has inflation been curbed?

## ❑ 3 complementary examples cases:

- ❑ France: protect households' purchasing power and industry (price caps and rebates), but tax inframarginal rents as well (windfall profits)
- ❑ Germany: keep the price signal as long as possible (only late price caps), prioritize industry while incentivize energy saving (thanks to the price signal)
- ❑ Spain: "Iberian exception" with a decoupling of the domestic price on electricity from the international gas market price (marginal pricing with a price cap, no windfall profits), and cuts in indirect taxes and "Bono Social Electrico" (price discounts)

## ❑ Discretionary response also driven by previously identified political priorities

- ❑ France: avoid "yellow vests" at all costs (also elections in Spring 2022)
- ❑ Germany: subsidize green transportation and allows to decrease inflation and satisfies the Greens
- ❑ Spain: subsidize green transportation and protect the most vulnerable

# The burden of inflation reduction

	Price Cap		Subsidies/Tax Cuts	Indexation	
	<i>Wholesale</i>	<i>Retail</i>		<i>Wages</i>	<i>Pensions</i>
Who pays?	Firms	Government	Government	Firms/ Government	Government
Examples	<ul style="list-style-type: none"> <li>• EU Oil Price Cap</li> <li>• Iberian Exception (lower windfall profits for infra-marginal prices)</li> </ul>	<ul style="list-style-type: none"> <li>• French gasoline subsidy</li> <li>• Spain's "Bono social Eléctrico" discounts</li> </ul>	<ul style="list-style-type: none"> <li>• French gasoline check</li> <li>• Spain's VAT rate cut</li> <li>• Public transportation discounts (Spain - Germany)</li> </ul>	<ul style="list-style-type: none"> <li>• Minimum wage in France (firms), pension (gvt)</li> </ul>	<ul style="list-style-type: none"> <li>• Italian pension revalorisation</li> </ul>

**Notice:** Government => Today's taxpayers, or increase in public debt (tomorrow's taxpayers?)

# Inflation, disinflation and income inequality

## ❑ Inflation hurts the poor who hold money

- ❑ Lower capacity to protect savings through portfolio diversification
- ❑ Fixed incomes eroded by inflation (unless real wages are sticky)
- ❑ Higher share of informal economy (not protected by government measures)
- ❑ Higher weight of food and energy in lower income households consumption bundles (in this episode)

## ❑ Disinflation hits the poor

- ❑ Lower growth hits the poorest more
- ❑ Higher  $r$  yields higher servicing costs of debt (that hits the poorest) and higher returns on bonds (owned by the wealthiest)
- ❑ Lowest fiscal space and hence potential cuts of welfare spending
- ❑ (contrarian effect: negative impact of monetary restriction on stock markets)

## ❑ The bottom line: “When you're a (poor) worker, it 'rains stones' seven days a week”. (J. Allen, 1993)

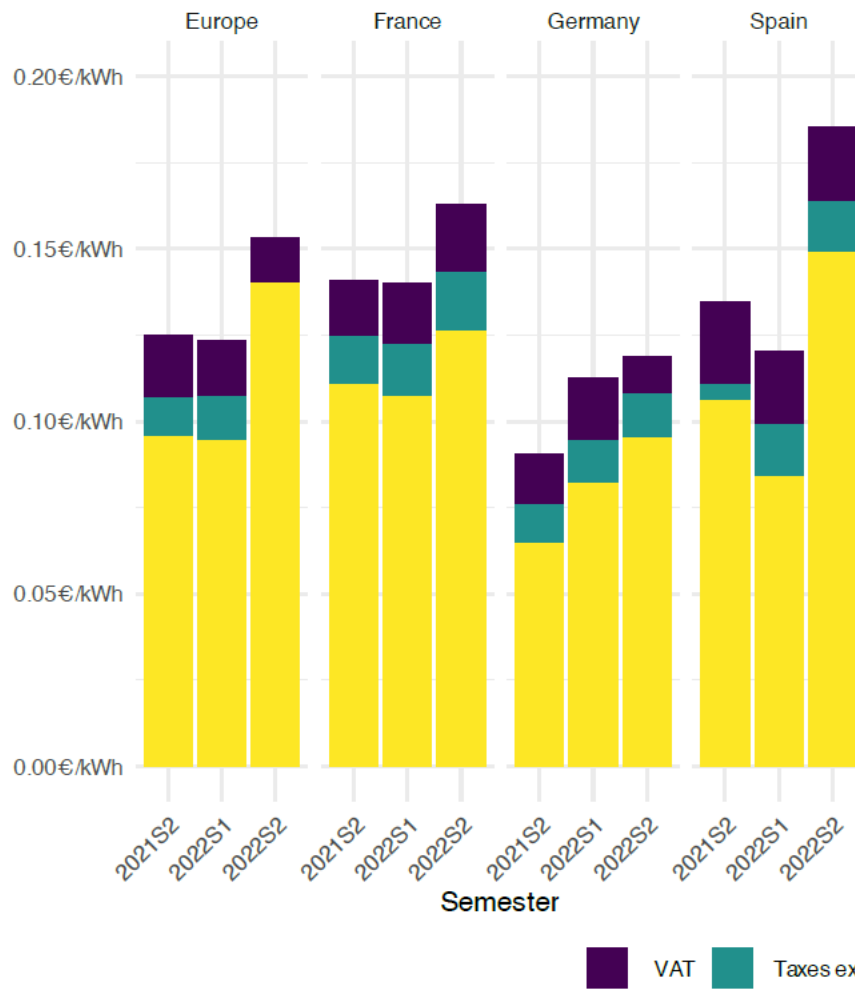
## ❑ Notice that a similar conclusion could be drawn after the boom & bust cycle of the early 1990s.

- ❑ Even then, inequality increased both during the boom and then the bust

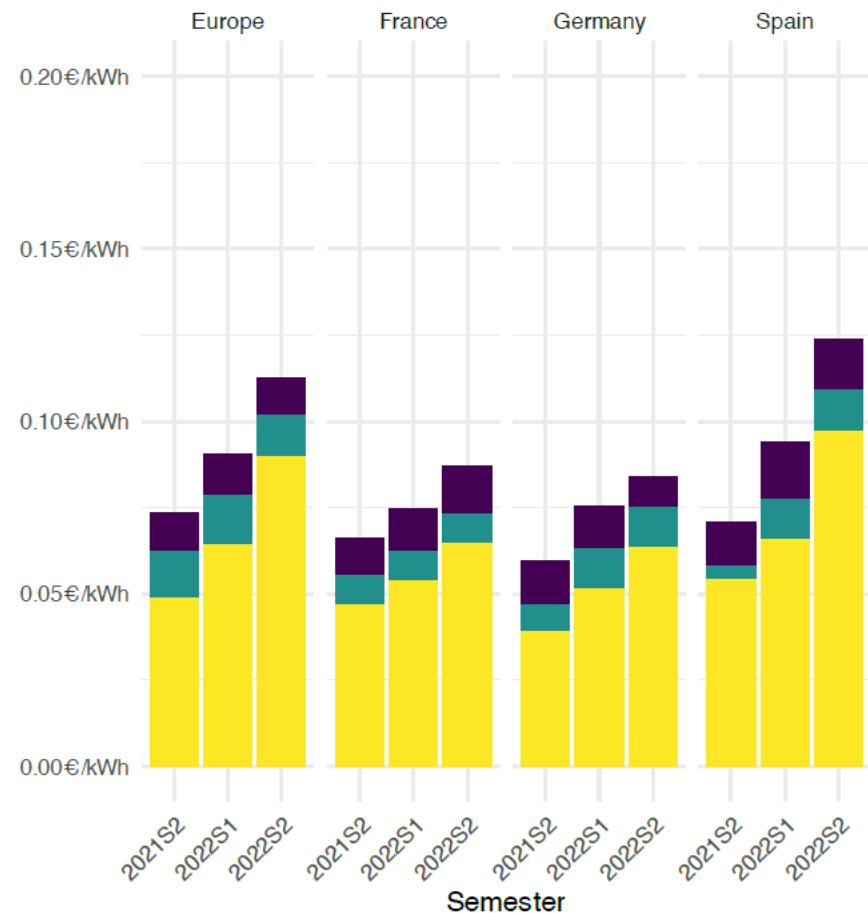
→ The issue of inequality (market and ex-post alike) needs to be tackled with public policies, as markets are manifestly incapable of taking care of it

# Natural gas prices

Natural gas price  
LOW Consumption (< 20 GJ)

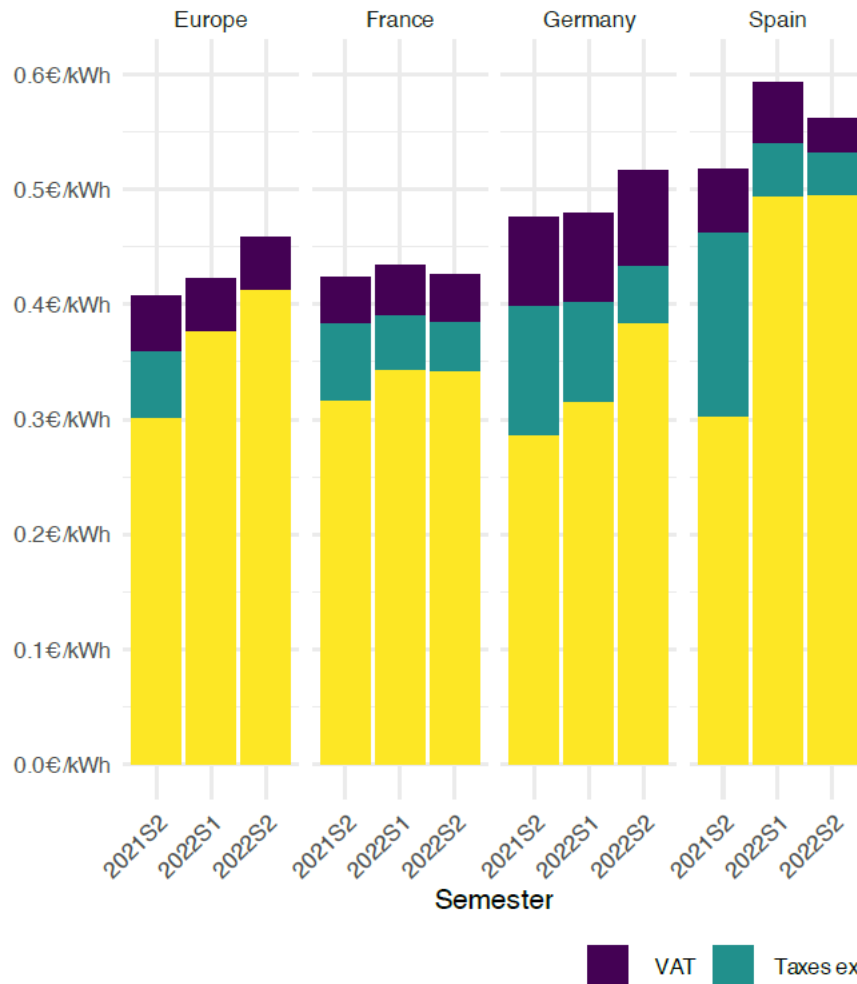


HIGH Consumption (> 200 GJ)

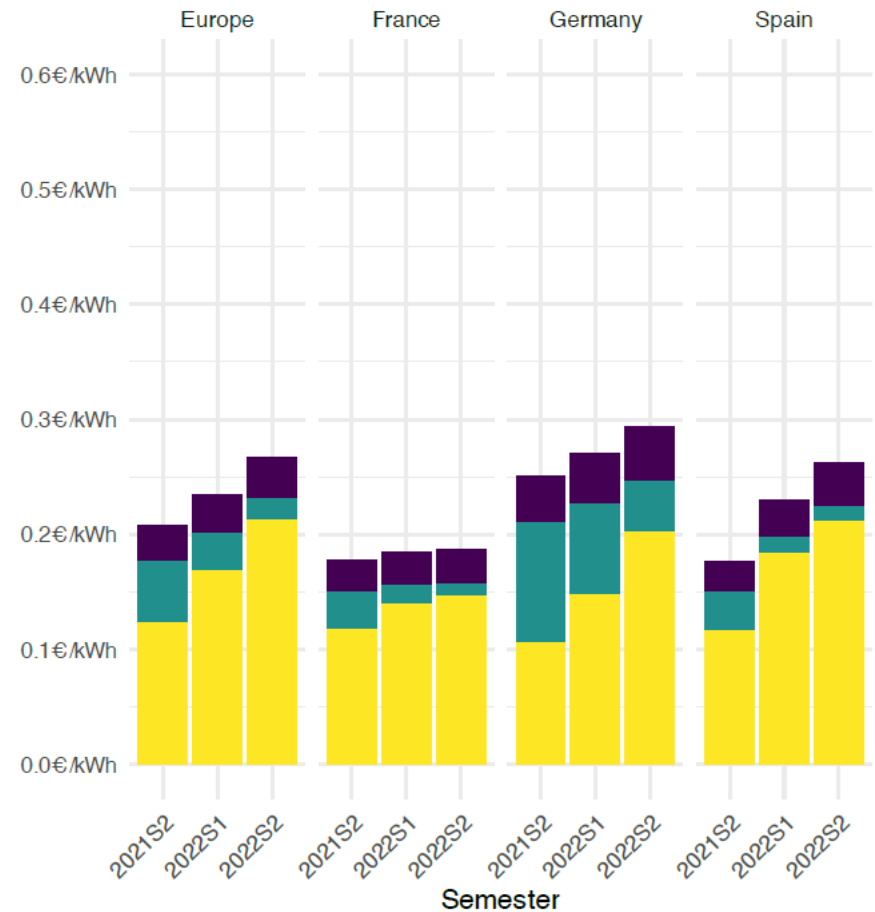


# Electricity prices

Electricity price  
LOW Consumption (< 1 MWh)

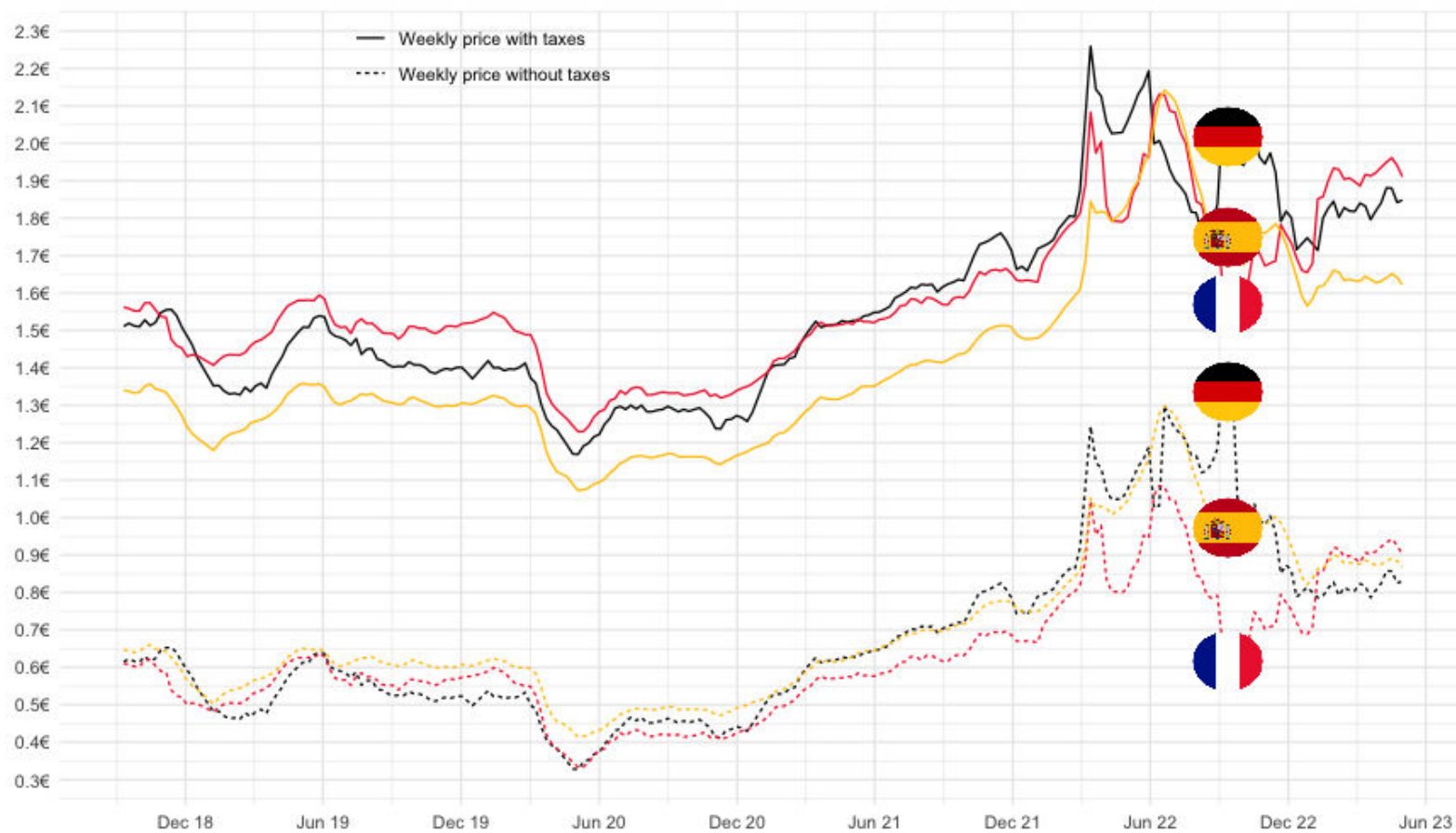


HIGH Consumption (> 15 MWh)

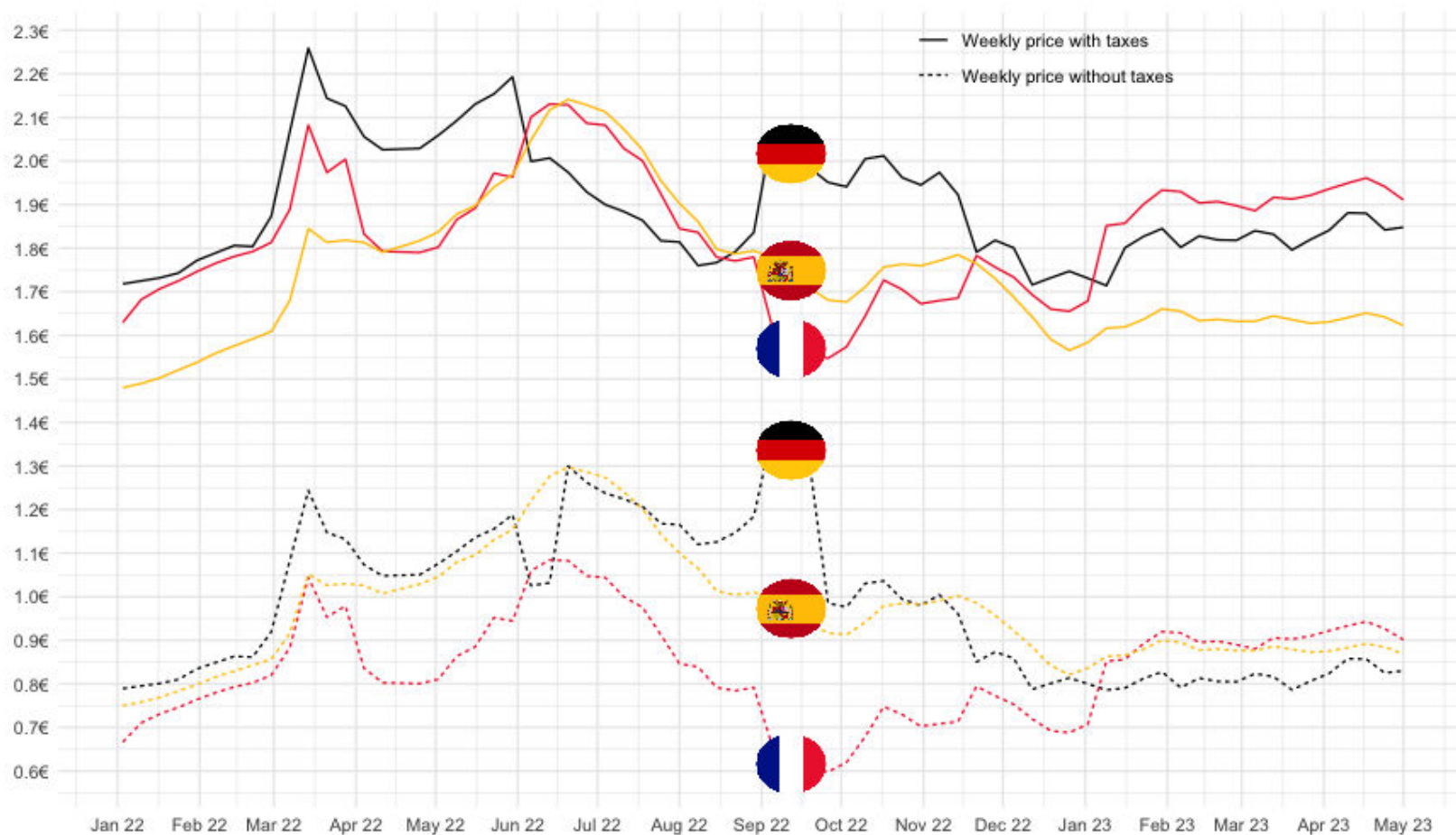




# Gasoline prices (since 2018)



# Gasoline prices (since 2022)



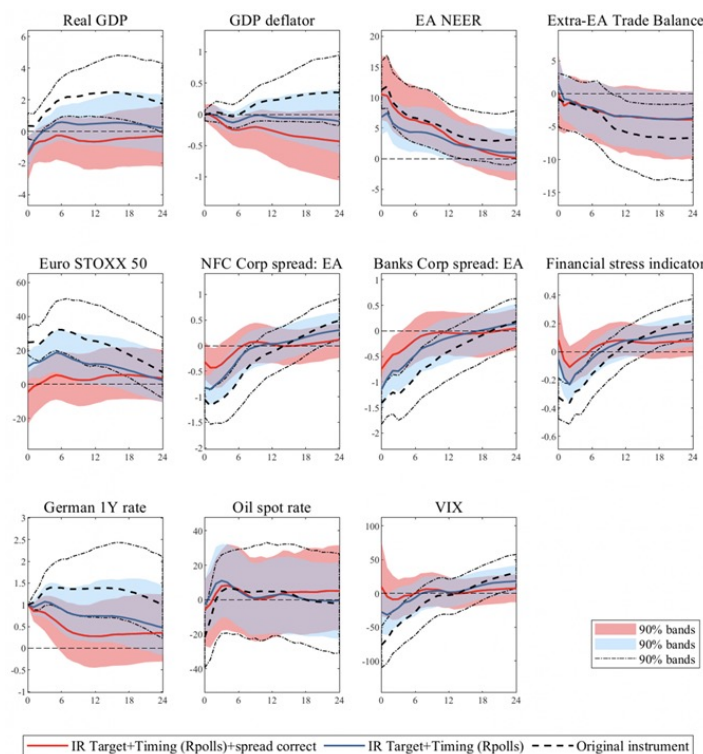
# The limits of monetary policy

## ❑ The EA is an imperfect monetary union

- ❑ Flight to safety movements and self-fulfilling fiscal crises can disrupt the transmission of monetary policy, and even undermine the monetary union itself, hence the Transmission Protection Instrument
- ❑ But moral hazard risk makes it potentially controversial to implement

## ❑ The transmission of conventional MP is complex

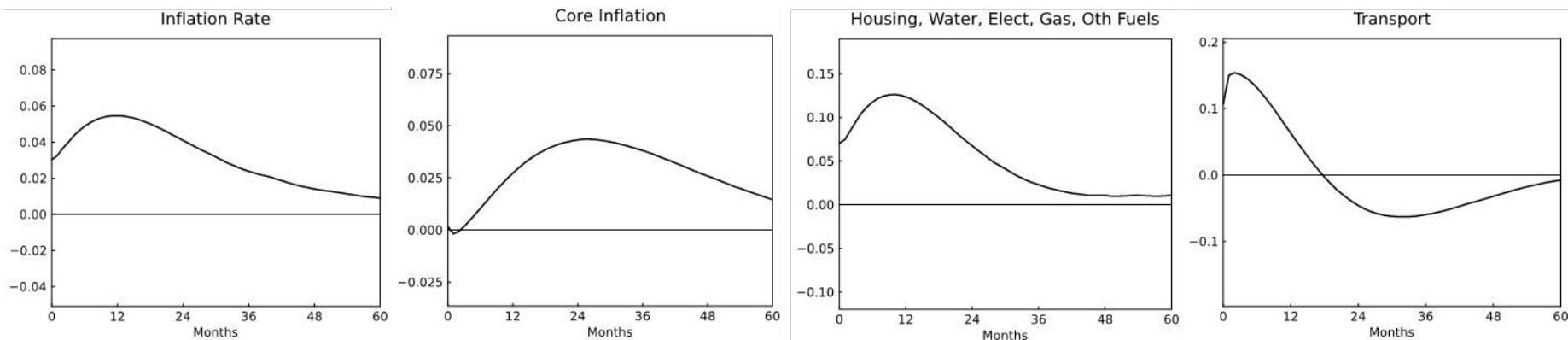
- ❑ The ECB needs to control both the position of the 'risk-free' yield curve and of sovereign spreads
- ❑ Ricco et al. (2022) show that by controlling for the spreads the ECB stance transmits with conventional effects to the economy, and provides a justification for the creation of the TPI



# The limits of monetary policy

## ❑ There are many possible drivers of inflation:

- ❑ loose monetary policy, excess demand, energy prices shocks coupled with disruptions of the supply chains and tight labour markets
- ❑ In the EA it is difficult to detect excess demand both in private consumption and when looking at the sum of private+public consumption expenditure.
- ❑ A plausible explanation for the EA is a combination of spillovers of US demand in the early phases, the dislocation of supply chains, and the transmission of the large energy price shocks from energy sensitive sectors to the others
- ❑ Indicators of supply chain tightness, and energy prices have gone back to pre-pandemic level and HICP has declined steadily
- ❑ Core inflation remains stubbornly high
- ❑ Expectation remain anchored
- ❑ This is compatible with the transmission of a large energy price shock

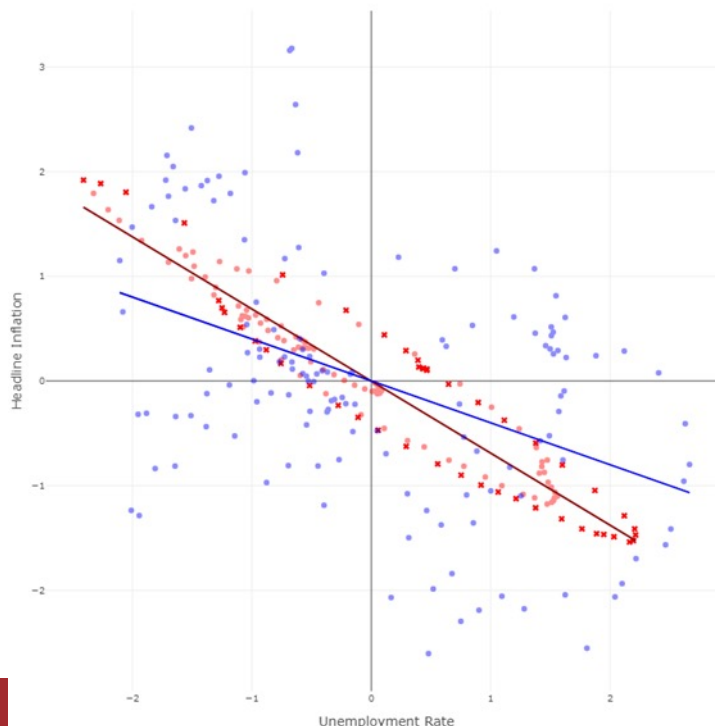


Source: Ricco (2023), energy price shock identified with the IV of Kanzig (2021)

# The limits of monetary policy

## Tradeoffs in inflation stabilisation

- Large supply shocks/terms of trade shocks entail difficult tradeoff between output and price stabilization (large output costs)
- Policy actions are likely to have lags and the tightening may start affecting the economy when supply shocks have dissipated. They may not be even able to bring down inflation immediately while producing contractionary effects at mid-horizon
- ... and induce too sharp contraction in investments with growth losses
- The Philips curve may be steeper than recently assumed
- After controlling for energy price shocks the PC is quite steep



Source: Ricco et al. (2019)

Note: The blue points are a scatter plot of inflation vs unemployment. The red dots are the unemployment and prices components connected by the PC and Okun's law to the output gap, as identified by the model of the authors

# The US Inflation Reduction Act: part of the toolbox?

- ❑ **Main goal of IRA: mitigation of climate change & create good paying jobs**
  - ❑ Secondary goal: lowering health care costs (temporary expansion of Affordable Care Act + limits to price growth of certain drugs)
- ❑ **Main measures (IRA budget)**
  - ❑ Tax credit for clean energy investment and production (electric power generation)
    - Uncapped (expiring only after emissions targets are reached) + Bonuses for meeting labour and domestic sourcing req.
  - ❑ Tax credit for electric vehicles and residential appliances
    - \$7500 tax credit subject to sourcing/income req.
  - ❑ New taxes on certain businesses and wealthy, high-income taxpayers
  - ❑ Prescription drug pricing reforms (less government outlays through Medicare)
  - ❑ Better tax collection (through greater efficiency of IRS)
- ❑ **10-year net impact on deficit reduction (+) or increase (-) by items, in billions of \$**

	CBO	PWBM	Differences
Extension of Expanded ACA subsidies	-64	-70	6
Climate and energy provisions	-368	-369	1
Minimum tax on book income of certain corporations	313	260	53
Carried interest tax reform	13	13	0
Prescription drug pricing and other health provisions	288	266	22
IRS funding	124	147	-23
Total	305	248	57

# Impact of the US Inflation Reduction Act on inflation

- ❑ **The IRA is found to have (almost) no impact on inflation (whatever the horizon) (1)**
  - ❑ CBO/JCT (“negligible impact on inflation”)
  - ❑ PWBM (“the impact on inflation is statistically indistinguishable from zero”)
- ❑ **J. Biden himself has referred to potentially lower prices in individual categories rather than to lower inflation as a whole**
  - ❑ Distributional effects from high to low incomes and across generations (from current to not yet born generations)
- ❑ **Impact of IRA incentives on annual retail electricity price:**
  - ❑ Bistline et al. (2023): - 2.2 % in 2030 and -5.4 % in 2040 relative to a counterfactual scenario without IRA
  - ❑ Roy et al. (2022): between -5.2 % and -6.7 % over the next decade
- ❑ **Many uncertainties in the estimates**
  - ❑ Uncapped tax credit: fiscal costs may be understated due to greater deployment of IRA-supported technologies
    - Bistline et al. (2023): estimates of tax credit expenditures range from \$780 to \$1,070 billion over the 10-year budget window (that’s 2.9-4.0 times higher than the CBO/JCT score for comparable credits)
  - ❑ Input and labour requirements: some firms might be unable to fulfil requirements
    - Higher tax credits for firms adopting certain labour practices and buying inputs manufactured in the U.S.
    - Some of the electric vehicle tax credits only available if the vehicle meets battery sourcing requirements and North American assembly.

# Possible EU responses to the US IRA

## ❑ **Appealing to the WTO?**

- ❑ US input requirements are in contradiction with WTO rules... but the WTO is a moribund (at least the Appellate Body in dispute settlement)

## ❑ **Passing a European IRA?**

- ❑ With EU input requirements... but the impact on inflation would not be enormous if US estimates are correct

## ❑ **Creating a sovereignty fund?**

- ❑ To finance EU industrial projects (“European public goods”) while re-establishing stricter State aids to avoid a subsidy race within the EU... but it would resemble a permanent Next Generation EU that the German Minister of Finance has opposed

## ❑ **Or should a new paradigm emerge?**

- ❑ Remember from Ken Loach’s movie when Jimmy said: “When you're a (poor) worker, it 'rains stones' seven days a week”
- ❑ Jimmy then continues: “We never invented the system, son, but it's up to us to change it”



# Conclusion: Towards a new paradigm?

- ❑ **Reassessment of the role of monetary policy: more limited than often assumed**
  - ❑ Keep the inflation target, but explain it can take longer than previously thought (keep credibility)
- ❑ **We rediscover fiscal policy to stabilize economic activity and inflation (Blanchard)**
  - ❑ At the effective lower bound (critics of austerity)
  - ❑ During energy crisis: price caps and subsidies
- ❑ **The main question: How can we use actively fiscal policy, without inducing a positive trend in public debt?**
- ❑ **Are the currently discussed European Fiscal rules a sufficient move?**
  - ❑ Focusing on debt sustainability, in an environment where  $r < g < m$  and high uncertainty (Reis).
  - ❑ What is the size of the Central Fiscal Capacity we need (vs national budget, cf. IRA)?
  - ❑ How to finance it?
- ❑ **We need stronger fiscal institutions in Europe (European Fiscal Board?), and also accepting more discretion?**

# Simplified macro mechanisms at work in CBO/JCT and PWBM (1)

