EconoFact Chats: Macroeconomic Challenges in the Eurozone
Philip Lane, European Central Bank
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I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of the Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org.

Michael Klein
This has been a challenging time for central bankers. Inflation is at a 40-year high. The tool that central bankers have to combat this, raising interest rates, could bring about a recession. Rising interest rates could also threaten banks and financial institutions, and if these are imperiled, that too could lead to a recession. Higher interest rates also make government debt more expensive to service, at a time when debt is already high in the wake of the COVID pandemic. Finally, the ongoing war in Ukraine presents its own set of economic challenges. Listeners to the podcast will recognize these challenges facing the United States. But less parochially, these challenges face other countries and regions as well. And today, I'm speaking with one of the leading policymakers outside of the United States, Philip Lane. Philip is the Chief Economist of the European Central Bank and a member of its executive board. He began these roles in 2019, after having served as Governor of the Central Bank of Ireland beginning in 2015. Before that, Philip was a professor at Trinity College Dublin, following a stint at Columbia University in New York. Philip, it's very good to have you as my guest on EconoFact Chats. Welcome to the show.

Philip Lane
It's my pleasure to be here, Michael.

Michael Klein
So, Philip, let's start out with some basics. The European Central Bank is the central bank for 20 of the 27 members of the European Union. Why is there this pan-European institution when the United States, Great Britain, Japan, and other countries have their own independent central banks?

Philip Lane
So, I think the European Union, as you say, has 27 member countries, but very much the Euro is the currency for the EU. So, it is true not all countries are a member of the Euro, but I do think that the way to think about it is we do have a pan-European political framework, which is the European Union, and rather than have 20 extra currencies in the world, the decision, now 25 years ago, it's 25 years since the Euro started, was that Europe would be better off with a single central bank making a single monetary policy for all of the member countries, and I think over these 25 years, the case for that is getting stronger. So, of course, Michael, the US is a very large continental-sized economy, Japan is a continental-sized economy, and, of course, the UK has a unique history, but from the point of view of Europe, even though it is an innovation, it is

something unique in the world, I think that these 25 years have shown that this is sustainable, and it makes sense in the European context.

Michael Klein
How is the ECB set up to take into account different national preferences?

Philip Lane
That's a very interesting question, but I suppose I would challenge whether that's the way to think about the goal of central banks, which is price stability. So, all of the governing council members are there as Europeans. You leave your nationality at the door, so it is most definitely not set up to reflect differences in preferences across countries, because I think all Europeans want to see low and stable inflation, but what is true, and very, very explicit, is the mentality has to be you are there to serve the general European interest, not to represent any particular national point of view, and this reconciles with your original question, which is that the only way to run a common currency is to focus on the overall picture rather than to think of it as some kind of bargaining among individual member countries.

Michael Klein
Well, before that, there was, of course, national currencies. Why did the Euro area move from having their own national currencies to a single currency, and how did this come about?

Philip Lane
So, this year, in addition to being 25 years of the Euro, it's also 50 years since the end of the Bretton Woods system, and maybe on your podcast, you've talked about that at some point. And really, if you like, it's not the case that Europe had a long history of each country running a separate monetary policy. And those years after 1973, through the early 90s, demonstrated that essentially two systems do not work. Having systems of pegged exchange rates, which are prone to occasional crises, and also having a system where every country makes its own decision in the context of trying to have an integrated economy in Europe – remember, with open capital markets, open labor markets, a single market for goods and services, the assessment was it was better to have a common currency to reinforce all these other dimensions where Europe was trying to act as one, rather than act as individual member countries. So really, I think now 25 years later, this is, in retrospect, becoming normalized, that it is, in a European context, kind of a sensible approach to go.

Michael Klein
Of course, there was controversy about this decision beforehand, and researchers, including yourself, looked to the United States as an example of a large area with a single currency, and there are some similarities, but also some differences. After 25 years, Philip, looking back at what people were writing in the late 90s or early 2000s about the comparisons between the United States as a single currency and the Euro area as a single currency, what have we learned, and what modifications would you make to what people might have thought, or you yourself even might have thought, at the outset of the Euro area?

Philip Lane
So I think that's a good question, and the Euro had definitely its test of fire between the period of 2008, really through 2012-2013, when we did have not just a global crisis, but then a Euro area sovereign crisis after that. And some of the main lessons, which would have, I think, been identified as risk factors in the 1990s, but were not implemented from the word go, is, number one, if you do give up a national currency, you have to take a lot less risk in terms of financial systems and in terms of fiscal policy. So, with financial systems, that first decade of the Euro before 2008, there was very, if you like, we had a credit boom, a housing bubble in some European countries, which was basically, if you like, amplified, I think, by having the same monetary policy for all member countries. And the answer to that, which has been implemented since then, is having very strict banking supervision, and also what we call macro-prudential policy. So essentially, to avoid having these national credit booms and bust cycles in a monetary union. Second, it is the case panics can happen. It can, I think, especially happen in a monetary union because you can move your money across borders without taking currency risk. And so for that reason, it's important to have backstops. So the European Stability Mechanism was set up to provide a fiscal backstop to the member countries. And in turn, with the ESM providing that backstop, the ECB has been able to develop its own backstops, the famously, Mario Draghi in 2012 saying, 'whatever it takes.' And what we've seen since then is essentially a pretty stable Euro. So what I would say is the first decade did lead to, if you like, problems that could have been foreseen. But with the very painful episode from '08 to 2012, 2013, a lot of those lessons have been learned. And I think these days there's a recognition that this common currency area can work in a stable way. But I would also say there's more to do. So, we at the ECB would say there needs to be a deeper banking union, a deeper capital markets union. And it's not necessary to have a federal government the size of the US, but a bit more in terms of essential fiscal capacity can help. Let me emphasize, Michael, it's not the case that the way to go is to say, well, the US is a perfect monetary union, and all of the features of the US should be replicated. But there's definitely some minimum requirements for a monetary union to work in a stable fashion.

Michael Klein
Yeah, it was very dramatic in the period from the financial crisis to about 2012 or 2013. People were talking about the possibility of 'grexit,' of Greece leaving. Many people, I guess myself included, thought that was a real possibility, and probably would occur, but it didn't. And then, as you said, Mario Draghi said 'whatever it takes,' and that really changed the landscape in some very important ways. And really, I think, moved, as you mentioned, the Euro to a different footing. So, Philip, I'd like to move from the history of the Euro and the European Central Bank to some of the challenges it faces today. What's happened to inflation in the Euro area over the past few years since the beginning of the Covid pandemic, say? Has the experience with inflation in the Euro area been similar to that in the United States?

Philip Lane
What I would emphasize is the origins of the inflation in the Euro area are somewhat different. So we know in the US, I think by now, there's a well-understood narrative for the US, where essentially the strong recovery, reinforced by significant fiscal support in the US, did lead to a strong recovery in demand. So consumption, especially of goods in America, rose far above the pre-pandemic level. We're only now returning to the pre-pandemic level of consumption and investment. So we have not had the demand boom the US had, but the supply side issues, supply

bottlenecks at the global level, played a role. And then, more recently, the surge in energy prices, which was kind of compounded by the Russian invasion in Ukraine, was essentially a second inflation shock. But at this point, Michael, after the original shocks, I think both the US and in Europe now are very definitely in this second round. That it's not so much that the inflation can be viewed as a shock, but now it's been propagated that, of course, workers are looking to raise wages to compensate for the loss of living standards. Firms are trying to protect their profitability. And this is why monetary policy in Europe is now, over the last year, has raised interest rates quite a bit. For the same reason the Fed has raised. No matter what the origin of inflation is, to get inflation back down in a timely manner does need a significant monetary policy response, which is what we've been doing.

Michael Klein
And I think it's really worth noting for our American listeners how much more the Ukraine shock hit Europe than the United States, because Europe was much more dependent upon energy from Russia. And so as bad as things got in the United States, they're much worse in Europe, right?

Philip Lane
Yeah. So I think there's two levels of that. One is mechanical, very high dependence on oil and gas from Russia in the energy mix. And then second, I'm sure your listeners would appreciate, Europe is a big net importer of energy. So when energy prices go up, it's what's called a terms of trade loss. Essentially, more money is flowing out of the European economy, which is essentially quite contractionary. So there's an income loss from that. Whereas in America, more or less, your energy balance is reasonable. And in fact, I think America has been exporting a lot of liquid natural gas to Europe over the last year. So high energy prices affect the American economy very differently to the European economy.

Michael Klein
The Federal Reserve, Philip, as you well know, has been seen as late to the game in fighting inflation. In fact, in one of his recent news conferences, Jay Powell quoted Frank Sinatra, the famous economist Frank Sinatra, when he said, 'regrets, I have a few.' Is there a similar view that the ECB may have acted a little bit too slowly to attack inflationary pressures?

Philip Lane
I mean, let me give two views on that. One is with the benefit of hindsight, I think it's fair to say in terms of the philosophy, we definitely had a philosophy of we should wait until we're pretty sure that this inflation shock is going to be persistent and substantial, before having a full-scale monetary response. I think any future review will probably look again at the balance between being preemptive and being, if you like, patient or persistent before responding. But I think the larger point is the medium term focus we have meant that, or means that, essentially even with a response that was cautious and gradual in its initial stages, a lot can be achieved by essentially then moving with determination once you start to move. So, in other words, at the time, the pros and cons were, OK, should we move early, but at the risk of overreacting, what at the time could have turned out to be a temporary inflation shock? Or should we wait, but recognizing if we do wait, then once we move, we will have to move with conviction. And essentially that's what's happened. I think people who simulate alternative histories of the last couple of years would not find at a macro level that being one or two quarters delay in raising rates would make

a massive difference to the inflation rate or to the overall outcome. So, I do think in our macro models, delays of one or two meetings, one or two quarters do not make a massive difference. And again, maybe going back to the 1970s, which people carry around as their frame of reference, it was the kind of consensus that maybe monetary policy underreacted in the 1970s. That played out over many years. It was not a question of being late by three months or six months. It was basically underreacting on a persistent basis over several years. And that's not the scenario we have.

Michael Klein
Philip, you have spent time in the United States, so you're familiar with the term "Monday morning quarterbacking." Maybe that's a term you want to introduce into European policy circles as well.

Philip Lane
Definitely, retrospective, but I think it's fair, honestly. Of course, given the scale of the inflation we've seen, given the fact we did have, I think, an expressed philosophy of being patient, if you like, before we would raise interest rates after many years of being close to the lower bound, it's reasonable for others and for ourselves to ask questions, to do self-reviews. I would differentiate between, if you like, a casual 'Monday morning quarterbacking' versus the fact that everyone should learn and review from these episodes.

Michael Klein
Well, you're particularly well placed to review because before you went into public service, you were one of the world's leading researchers in international macroeconomics. Philip, in what way has your research and that of others contributed to your work as Governor of the Central Bank of Ireland, and now in your role at the European Central Bank?

Philip Lane
Maybe here I'll make some points. I mean, it's also true in the US, there's quite a flow from academia into policymaking. And I think for a lot of reasons that can bring a lot to the policymaking process. I mean, essentially in the end, for me and for other policymakers, the information flow is really high. Every day, there's a lot of data releases, a lot of internal analyses, a lot of pieces of information to analyze. So having, if you like, the frameworks that we developed as academics, I think is quite important in understanding and filtering what's important, what's not important. Let me also emphasize, maybe, empirical work is quite important because many, many conjectures, every day there's many ideas. Most of the time, they all have some value. But what you have to think about is, okay, at a quantitative level, is this a material issue or is it an issue that's true, but it's so small that it's not going to move the dial for policymaking? And so, I think the trend in macroeconomics over the course of my career and your career of having a lot more empirical work is really helpful for policymaking to really get a sense of what's important. So, I do think that the skills that you learn in academia do carry over to a large extent to the kind of basic analytical challenges that are the main challenges facing central banks.

Michael Klein
Finally, Philip, it's been a really tumultuous few years and the world has faced huge challenges that probably inform your approach to your current job. What do you think you and other central bankers have drawn in terms of lessons from the events over the last few years?

Philip Lane
Again, when the history books are written, clearly there'll be a sharp distinction between years before the global financial crisis of what was called a great moderation, where everything looked fairly stable, fairly calm, inflation was not moving very much. And now we've got these repeated shocks, very large-scale events, and maybe more to come. As you know, there's a lot of discussion of geopolitical developments. To name one issue, digitalization, the climate transition. And essentially, coming back to my work as a central banker, working out how to navigate that, to provide an important foundational stability, which is price stability, in a world which could be unstable in many directions, I think is very important. And what does that mean? It means trying to be as alert as possible, as agile as possible. And I think we have an expressed philosophy, which lots of central banks have these days of being very much data dependent. Rather than believing that your projections for the next two years have 100% accuracy, being open-minded about what every day or every month can bring you in terms of new developments in the economy is very important. And also, to reconcile that with, as you said earlier on, which is essentially monetary policy has to be forward-looking. If we raise interest rates, the interest rates increases we've made will affect the economy for the years to come. The peak of these effects are only now working their way through the pipelines of the European economy. And so, this is essentially the reconciliation we need to make, that you have a lot of shocks hitting the economy. You have to understand the impact, to respect what the data tell you. On the other hand, to combine that with recognizing that monetary policy works with a lag. And so, you also have to be forward-looking and judgment-based, model-based to a large extent.

Michael Klein
Philip, if I know in your current position, you're incredibly busy and drawn in many ways in many different directions. And I very much appreciate you taking the time to speak with me today. I've always enjoyed our conversations and today is certainly no exception to that. So thanks very much.

Philip lane
Thank you, Michael.

Michael Klein
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