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WHY RAISING INTEREST RATES TO FIGHT OFF ENERGY INFLATION IS COUNTERPRODUCTIVE

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These are challenging times to be a central banker. After more than two decades of stubbornly low inflation, advanced economy (AE) central banks had to abruptly switch from monetary easing to monetary tightening in order to contain newborn inflationary pressures propelled by the pandemic and Ukraine war related supply disruptions and energy price spikes. Whereas in the past, central banks were struggling to bring inflation up to target (2 percent), they are now confronted with the opposite task of trying to curb it. Around the world, inflation-targeting central banks are under pressure to demonstrate their commitment to low inflation and restore their anti-inflationary credentials. To cool inflation, most of them are resorting to aggressive interest rate hikes. During its December meeting, the European Central Bank's (ECB) Governing Council, for example, decided to raise its key interest rates by another 50 basis points, expecting to further raise them significantly in the coming months 'to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target'.[1]

When central banks hike short-term interest rates, they raise the cost of borrowing for households, businesses and states alike. The imagined causal chain of how higher interest rates work to cool inflation is the following: interest rates are raised, credit becomes more expensive and harder to get, businesses and consumers spend less, reducing demand for goods and services (and ultimately the workers producing these), unemployment rises, economic activity slows, and, over time, prices fall. It is clear from this, however, that raising interest rates comes at a significant cost. Higher interest rates inflict suffering on the economy by reducing employment and investment opportunities and by lowering economic growth. In addition to raising unemployment and stifling growth, the climate policy agenda will be particularly affected. Cumulative interest rate hikes would undermine important European Union (EU) goals such as energy security and decarbonization.

Rate hikes, moreover, are a blunt tool: they do not target the specific and underlying causes of the current inflationary spike directly. Essentially, rate hikes are geared towards diminishing excessive demand in the economy by slowing the entire economy (instead of targeted sectors) and curtailing both public and private expenditures. What is overlooked in all of this is that inflation is a multidimensional and multifaceted phenomenon that often has many other causes than excess demand or an economy 'running hot'. As such, interest rate hikes will not address the root causes of today's inflation.

Different causes of inflation require different responses

Today's inflation is not an excess aggregate demand story, especially in Europe. Most of theEurozone's inflation comes from volatile energy, food, and core goods components that are largely outside the influence of monetary policy.[2] Most of the drivers of the current inflationary upsurge come from disruptions in the supply of key commodities and inputs such as oil, gas, food, and microchips. Most of these disruptions resulted from the COVID-19 pandemic and its associated lockdowns and shutdowns in many industries. The effects of pandemic shortages were further aggravated by the inherent fragility of most of the global supply chains. Years of 'just-in-time' inventory management, focusing unilaterally on cutting costs while ignoring risks of fragmentation, had left most supply chains intrinsically vulnerable to interruptions and bottleneck problems. Until the pandemic hit, stocking up on raw materials, resources and intermediary products was deemed inefficient and pointless.[3] Further compounding this inflationary episode was the sharp increase in fuel and food prices stemming from the Russian invasion of Ukraine and the ensuing sanctions and countersanctions by the EU and Russia.

The Euro area's current high inflation rate has therefore less to do with internally generated demand pressures than with external shocks that have raised food and energy prices in important ways. What we are seeing is inflation due to a succession of negative supply shocks that have raised food and energy prices and simultaneously depressed economic activity.[4] It is estimated that without these increases in food and energy prices, core inflation in the euro area would still be around 2%.[5] Food and energy prices are clearly the main drivers of inflation in Europe. These sectors and prices are therefore 'systemically significant', meaning that negative shocks to these specific sectors have a disproportionate effect on overall price stability.[6] At the same time, however, monetary policy has notoriously little control over these prices. What the ECB and other central banks are currently trying to do is fighting cost-push inflation with an instrument designed to fight demand-pull-inflation. However, when the main causes of inflation are supply-side factors and, especially, those occurring abroad, the potency of interest rate increases to fight inflation is mild at best. The costs, in contrast, will be substantial: more pain will need to be foisted on workers to extract the same gains in terms of lower inflation.[7]

Hiking rates will only mean more trouble in the long run

Today's inflation is in essence a problem of 'fossilflation', driven by the 'legacy cost of the dependency on fossil energy sources, which has not been reduced forcefully enough over the past decades'.[8] Accelerating the energy transition should be an important part of the answer to controlling both today's fossilflation challenge and in contributing to longer term price stability. To preempt future inflationary shocks, governments, firms and households should be massively investing in clean energy production, energy efficiency and adaptation to increasingly extreme weather events.[9] Current central bank actions, however, work against the goal of rapidly transitioning away from fossil-based energy production by disincentivizing the necessary new green investments.

Monetary tightening raises the cost of capital, and this hits renewable technologies excessively hard.[10] Sustainable technologies are more capital-intensive than fossil-based technologies, requiring larger upfront investments, and, as such, become comparatively more expensive when central banks use monetary policy to raise the cost of financing. The higher capital-intensity of renewables makes them more vulnerable to interest rate hikes. Raising interest rates across the board therefore risks derailing the transition by inflicting a form of 'green collateral damage' on the economy.[11] By making credit more costly, central banks risk delaying the necessary investments in energy efficiency by both households, businesses and governments. Because of central bank actions, private actors are now faced with a higher cost of credit for renovation loans and a higher cost of materials and services (due to

supply-induced inflation).[12] Higher interest rates also raise the borrowing costs for governments, constraining the state's fiscal capacity for long-term investments in improved mobility, green technologies and sustainable infrastructure.

Hiking rates in a macroeconomic environment of rising energy prices therefore risks aggravating the economy's carbon lock-in and prolonging its dependence on outdated and polluting carbon technologies.[13] Interest rate hikes are not only counterproductive in the long run —as they exacerbate both the climate change challenge and undermine central banks' primary objective of securing long-term price stability—, they are also in direct conflict with the 'REPowerEU' plan tabled by the Commission in which it seeks to 'fast forward the green transition' by means of 'an increase in energy savings, a diversification of energy supplies, and an accelerated roll-out of renewable energy'.[14] Moreover, the ECB riskshiking rates at a time when inflationary pressures are seen to be easing.[15] Inflationary tailwinds may then quickly turn into deflationary headwinds. Martin Sandbu has likened this effect to a 'ketchup bottle', where shortages can quickly turn into gluts.[16] This risk is especially real when a sudden ease in price pressures coincides with a zealously overtightening central bank, possibly pushing the Eurozone into a recession. In that case demand will falter just when supply capacity is picking up, driving prices down instead of up.

What central banks are overlooking in all of this is that the biggest risk today might not just be inflation but stagnation. There is a real danger that excessive tightening will leave long-lasting scars on the productive capacity and economic potential of the Eurozone's economy. Aggressively hiking rates now will act as a fundamental drag on efforts to decarbonize the economy, rule out any transformative green agenda and put a strain on the necessary investments and innovation. It puts monetary policy at cross-purposes with other policy priorities (such as investing in renewables and energy-efficiency) and risks further entrenching years of public and private underinvestment. In this way prohibitive interest rates will further exacerbate the trend of secular stagnation (defined by low rates of growth, productivity, and investment) that has plagued advanced economies for at least a decade (with some even dating the onset of the declining trend back to the 1970's).[17]

There *is* an alternative

Raising the interest rate is only one way to combat inflation. Monetary policy used to, and could again, mean more than just interest rates: e.g., qualitative and quantitative credit regulations to manage effective demand and steer investment towards specific sectors.[18] Throughout history central banks have always coordinated with ministries of finance (and other government agencies) to proactively steer credit and support major structural change of the type required by the climate crisis, complementing active fiscal and industrial policy regimes.[19] This broader policy approach is generally referred to as 'credit guidance' (while 'window guidance', 'credit controls' or 'moral suasion' are also used). Credit guidance is a technique in which central banks 'manipulate' and 'shape' the flow of credit in line with pre-established monetary and industrial policy goals. It allows for a selective macro-level direction of credit across the economy, meaning that central banks can proactively direct finance towards supporting certain 'desirable' sectors of the economy while simultaneously repressing others.[20] This approach would enable central banks to provide a targeted stimulus to the economy by offering preferential discount rates for green lending. In a fairly recent example, both the Japanese and Chinese central bank accorded quantity-based quotas to commercial banks to make them lend to particular sectors (including for sustainability purposes).[21]

As such, credit guidance policies could inform an alternative policy framework that articulates a more 'market-shaping' role for public policy, driven less by financial market incentives and more by mission-oriented economic and industrial policies geared towards structurally transforming energy, food, housing and transport systems in accordance with a rapid green transition.[22] It would allow central banks to help expand the capacity frontier of certain critical commodities and technologies, and would help speed

up the roll-out of renewable and more energy-efficient technologies. Such an approach would lead to a double win for central banks: it would allow them to better safeguard long-term price and financial stability (by preventing new upshots of 'fossilflation' in the future) and help them curtail short-term inflation (by reducing fossil-based energy demand here and now).

Conclusion

By focusing unilaterally on price stability and ignoring other threats (such as climate change and secular stagnation), central banks are woefully unprepared to face today's 'polycrisis'.[23] By refusing to take on board other concerns than simply protecting price stability, central banks have trapped themselves into a corner where the only option they have is to raise rates in a desperate attempt to restore their credibility as inflation-fighters. As Daniela Gabor rightfully notes, their situation can be compared to a particular situation in a game of chess (known in German as 'Zugzwang') where a player is forced to make a move, while this move will only worsen the initial position the player is in.[24] The same holds for interest rate hikes in an environment of inflation predominantly driven by supply shocks and energy prices: the benefits will be trivial at best, while the costs will be large. Not just for central banks but for all of us.

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