Miriam Pozen Address

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Cambridge, Massachusetts

Ladies and Gentlemen,

It is wonderful to return to MIT among so many friends.

And it is a great honour to receive the Miriam Pozen Prize.

In 2020, the inaugural Miriam Pozen Prize was awarded to Stan Fischer.

Stan has been a true giant of policy making, thanks to his poise, his sharpness, his experience.

To me, he has also been a friend, a mentor, a role model.

I feel immensely privileged to follow in his footsteps.

My lecture today will draw from my experiences as central banker and prime minister of Italy.

I would like to reflect on the two events that, together with the ever increasing tensions with China, have dominated international relations and the global economy over the last year and a half: the war in Ukraine and the return of inflation.

These events have caught policy makers by surprise.

We assumed that the institutions we had built, together with the economic and commercial ties, would be sufficient to prevent a new war of aggression in Europe.

And we believed that independent central banks had mastered the ability to cap inflation expectations, to the extent that we worried about a secular stagnation.

With the benefit of hindsight, I will argue that these two momentous events did not come out of nowhere and they are not disconnected.

They are rather both a consequence of a paradigm shift which over the past two and half decades has quietly moved global geopolitics from competition to conflict.

This paradigm shift may lead to lower potential growth rates and would require policies leading to higher budget deficits and interest rates.

In the 1990s, many believed that the process of globalization was unstoppable, and that it would spread liberal and democratic values across the world.

The development of the private sector, the good functioning of markets, the extraordinary growth of foreign direct investment and the expansion of world trade were objectives seen as conducive not only to prosperity for all, but also to democracy for all.

The dominant view was that global values would converge and that this convergence would reshape international relations for decades to come.

And it was assumed that international institutions would be sufficient to correct the distortions stemming from globalization – for example on climate, competition and property rights – and that domestic institutions would correct inequality.

Two examples revealed the shortcomings in this consensus view of globalization.

The first one, perhaps the most symbolic and consequential was letting China into the World Trade Organization, even though it was not (and is not) a market economy, in the assumption that it would become one.

Though this decision led to a historic reduction in global poverty and benefitted Western consumers and corporates, it had a major social, political and environmental impact. The WTO proved incapable of containing it.

Second, the pretension that the spread of free markets would also spread the values of liberal democracy was shattered by the example of Russia.

The West saw the rise of Vladimir Putin as a sign of the inevitable modernization of Russia, and welcomed Moscow into multilateral fora, starting with the G7 and the G20.

We assumed that the economic and commercial ties which we created with Russia would be a guarantee of prosperity, an engine of democratisation, a prelude to a long-lasting peace.

However, President Putin never accepted the political and territorial changes that had followed the demise of the Soviet Union.

From Georgia to Crimea, the Russian government violated repeatedly the sanctity of international borders, as it pursued a premeditated plan to restore its imperial past.

The contracts we had signed with Russia, in particular over the supply of natural gas, would become an instrument to blackmail us.

While we were busy celebrating the end of history, history was preparing its return. Our own domestic institutions also proved to be surprised by this challenge.

The revolt against the multilateral liberal order gathered strength, due to its perceived unfairness and lack of safeguards.

In 2016, the election of Donald Trump in the US and the Brexit referendum in Europe showed widespread dissatisfaction with the existing economic and political model.

Voters demanded greater protection and greater control.

They wanted a more central role for the State, which came back to the fore.

The Covid-19 pandemic accelerated the trend away from the primacy of markets.

In Europe, we quickly realised that too many supply chains were outside our domestic control at a critical time.

The clearest and most dangerous example was the supply chain of essential medical goods – from protective equipment to vaccines – where governments had to take a more assertive stance.

The public sector also took a central role in supporting the economy during the lockdowns and kickstarting the recovery when the re-opening occurred.

Government budgets protected jobs, wages, firms – a move that proved wise in limiting the damages of the pandemic shock.

But just as we thought we had won the war against Covid-19, a new conflict came to threaten our collective prosperity and security: Russia's brutal invasion of Ukraine.

This was no unpredictable act of folly. It was the premeditated next step of President Putin's agenda, and a determined blow to the EU.

The European Union's existential values are peace, freedom and respect of democratic sovereignty. They are the values that emerged after the bloodbath of World War II.

And that is why there is no alternative for the US, Europe and its allies to ensuring that Ukraine wins this war.

Accepting a Russian victory or a muddled draw would fatally weaken other bordering states and send a message to autocrats that the EU is ready to compromise on what it stands for, on what it is.

It would also signal to our Eastern partners that our commitment to their freedom and independence – a pillar of our foreign policy – is not so unwavering after all.

In short, it would deal an existential blow to the EU.

Winning this war for Europe means having a stable peace, and today this prospect looks difficult.

Russia's invasion is part of a long-term, delusional strategy from President Putin: recouping the Soviet Union's past influence, and his government's existence has now become intimately linked to its success.

It would take domestic political change in Moscow for Russia to abandon its objectives, but there is no sign that such a change will occur.

The geopolitical consequences of a prolonged conflict at Europe's Eastern border are highly significant.

The quicker we realise them, the better prepared we'll be.

First, the EU must be willing to strengthen its defence capabilities.

This is essential to help Ukraine for as long as it takes and to provide meaningful deterrence against Russia.

Second, we must be prepared to begin a journey with Ukraine that leads to its membership of NATO.

The alternative is to send ever more weapons, and build an agreement between Ukraine and all its allies in this war with elements of mutual defence reminding the Treaty that links the US to South Korea.

But such an agreement would be difficult to achieve, and hard to implement. It would not have equal power with respect to Russia, and, as Henry Kissinger observed would not bind Ukraine's national strategy into a global one. Furthermore, I believe that the historical and political context is different from the Korean one.

If this proves to be the most probable course of events, the ensuing uncertainty and instability could be great.

Third, we must prepare ourselves for a prolonged period in which the global economy will behave very differently from the recent past.

And it is here that geopolitical shifts and inflation dynamics intersect.

The war in Ukraine has contributed to the rise of short-term inflationary pressures – but it is also likely to trigger lasting changes that herald higher inflation in the future.

In the short run, the spike in energy prices, the worsening of supply-side bottlenecks due to the interruptions of value chains, and the disruptions in markets such as cereals and other food products, pushed inflation to levels that had not been seen in decades.

These supply-side factors were initially the dominant source of inflation in Europe, as companies had to raise prices in response to the increase in energy and other costs. In the US, successive waves of fiscal stimulus made it predominantly a demand-side phenomenon.

But in both cases, central banks had to intervene to push the inflation rate back towards their targets – a course of action they had almost forgotten after a decade of low inflation.

With the benefit of hindsight, it is likely that monetary authorities should have diagnosed the return of persistent inflation early. But especially in Europe, given the supply-driven nature of the shock, it is not clear that acting faster would have stemmed much the acceleration of prices.

The inability of governments to agree in a timely manner on a price cap for natural gas made the job of the European Central Bank much more difficult.

In any event, when central banks intervened, they showed a strong commitment to keeping inflation under control and have mostly made up for lost time.

Higher rates are now filtering through the economy and there are signs of a slowdown in the manufacturing sector.

However, services and especially tourism remain strong, and labour markets remain generally tight by historical standards.

Inflation is proving more resilient than central banks had initially assumed.

The fight against inflation is not over and will probably require a cautious continuation of monetary tightening, either through still higher interest rates or through lengthening the time before their course can be reversed.

However, the different sources of the inflation shock in different jurisdictions have implications for the task ahead for central banks.

In the US, inflation has been largely driven by a surge in household disposable income during the pandemic and an associated rise in saving, which has since been progressively drawn down.

And a key factor behind this was fiscal transfers during and after the pandemic, which more than accounted for above-trend disposable income growth in 2020 and 2021.

However, disposable income has now largely returned to trend and fiscal policy has retreated to a less expansionary stance.

This suggests that the current consumption impulse – and the pressure on prices it has produced – will fade once the drawdown of excess saving has played out.

Moreover, even though US job creation remains strong, there is some doubt whether wages will take over as a driver of inflation pressures once spending normalises.

Nominal wages have risen strongly, but the evidence that wage growth has been leading price growth is lacking. Rather, wages appear to have been responding to the same common factor of excess demand and should therefore ease as demand softens.

In the euro area the challenges are different.

Inflation so far has not been driven by excess demand. Differently from the US, total real consumption in the euro area is still below its pre-pandemic level and well below its pre-pandemic trend.

This stark contrast reflects the fact that the euro area has endured a huge terms-of-trade shock from the energy crisis that has at the same time raised costs and transferred income to the rest of the world.

Firms have reacted to date by changing their pricing behaviour: rather than absorbing higher costs in margins, as they had done for most of the previous decade, they have passed on those costs to consumers – maintaining or even increasing their profits.

Workers, on the other hand, have not been able to prevent a loss in real income. Real wages at the end of last year were still around 4% below their pre-pandemic levels.

And, given the inertial nature of most wage bargaining in Europe, this process would play out over time until real wage losses have been recouped.

A longer period of rising wages naturally comes with higher risks of inflation becoming persistent, especially if firms continue the pricing behaviour that we have observed so far.

So, to eliminate those risks, demand has to be contained enough to reduce pricing power and prevent firms from passing on future wage increases to consumers.

On the other hand, as demand decreases, firms may well absorb some of the wage increases implicit in the labor contracts for the next 1-2 years.

Net of other factors, the degree of future monetary tightening depends on the interaction between firms and labor, and on how profound are the effects of past monetary decisions.

In general, I do not expect financial stability concerns to stand in the way. The current banking troubles are in no way comparable with the financial crisis, and should be addressed with ad hoc measures, as it has been done so far.

Given the limited size of these crises, governments should finance, when needed, any necessary interventions, and avoid creating a conflict for central banks between pursuing the objectives of monetary policy and those of financial stability.

The experience of the 1970s is still very clear in all our minds, and today neither governments nor central banks want to see a de-anchoring of inflation expectations.

Eventually, central banks will succeed in bringing the inflation rate back to their targets.

But as the long-term consequences of the war become visible, the economy will look very different from what we have been used to.

A prolonged war between Russia and Ukraine, and continuing geopolitical tensions with China, will continue to weigh on the rate of potential growth of the global economy.

Furthermore, the desire to ensure that supply chains are resilient to geopolitical shocks means that countries will be more willing to buy goods from reliable and like-minded suppliers, even if they are not the cheapest, and to invest in reshoring critical production at home.

This will lead to some increase in capacity in Western economies, but not necessarily of the scale and efficiency required to ensure that inflation remains as low as in the past.

At the same time, I expect governments to run permanently higher budget deficits.

The challenges we face – from the climate crisis, to the need to shore up our critical supply chains, to defence, especially in the EU – will require substantive public investment that cannot be funded via tax increases alone.

These higher levels of government spending will put additional pressure on inflation, on top of other possible supply-side shocks from energy and other goods.

Over the long run, it is likely that interest rates will stand higher than they were in the past decade. At the same time, low potential growth, higher rates and high post-pandemic debt levels are a volatile cocktail – and central banks tolerating inflation will not be the resolution.

Central banks certainly need to be very mindful of their impact on growth, so as to avoid any unnecessary pain. But the task will fall primarily on governments to redesign fiscal policies in this new environment.

They will have to learn to live again in a world where fiscal space is not infinite, as seemed to be the case when growth rates substantially exceeded borrowing costs.

And, if some of the lessons of the last thirty years have been understood, much more attention will have to be put on the composition of fiscal policy.

This should be designed to raise potential growth, while at the same time protecting and including those who most need help.

Of course this picture could radically change if a wave of powerful innovations, like AI, were to shake the world and raise global growth.

Though it is difficult to foresee all the implications of such an event, one thing is clear: Governments, States and institutions must respond pro-actively to ensure the inclusion and protection of all who would be negatively affected by these developments.

In all this, the EU will have to cope with unprecedented supranational challenges. The EU was in many ways at the centre of the globalization experiment, but to view the creation of the single market and the euro as only an extension of this process would be a partial reading. The project has always been more ambitious.

The EU was exceptional in two important dimensions.

The European social model ensured there was a more robust safety net for those left behind than in the rest of the world.

And the EU had strong collective rules and institutions that – while imperfect – ensured greater protection against the side effects of free markets.

But the EU was not designed to leverage economic weight into military and diplomatic power.

And that is why the European response to Russia represents a watershed.

Now, the war in Ukraine, as never before, has demonstrated the unity of the EU in defending its founding values – going beyond individual countries' national priorities.

This unity will be crucial in the years to come.

It will be crucial in redesigning the Union to accommodate Ukraine, the Balkan countries and the Eastern European countries into it; in organising a system of European defence that is complementary and accretive to Nato; and in overcoming all the other supranational challenges that we collectively face: first and foremost the climate transition and energy security, in adapting our institutions, and especially the decision-making process, to the new context.

And all this, without weakening the social protection that makes the EU unique.

I insist on unity because it is the only way forward: individual European countries, no matter how strong they are, are too small to master these challenges on their own. And the bigger these challenges are, the more the path towards one political, economic and social entity, though long and difficult, becomes unavoidable. Our journey that started many years ago, and accelerated with the creation of the euro, is continuing.

Today I have talked about our difficult times. But times were never easy. I arrived here in August 1972. While I was a student, we had the war of the Yom Kippur, several oil price shocks, the collapse of the international monetary system, terrorism was raging worldwide, and inflation was out of control, just to mention a few events of that time, and of course we were in the cold war.

We have been able to overcome those challenges, as I am confident we will be able to do so in the future, thanks to women and men that were prepared and inspired.

I want to pay a tribute of gratitude to MIT and more generally to all scientific and educational institutions alike for their immense contribution in preparing and inspiring generations of similar women and men in their service to the world.

Thank you.