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Monetary policy in the euro area: where do we stand?

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I would like to thank the organisers for inviting me to take part in this event and giving me the chance to share with you some reflections on euro area monetary policy in the current juncture.

In a context of very high and persistent **inflation, the ECB Governing Council has taken decisive actions** to ensure that inflation returns to our medium-term target of 2% in a timely manner.

- The policy rate rise has been the biggest and swiftest in the history of the monetary union, taking the deposit facility rate up to 4% in our September meeting. Since July 2022, when we raised our interest rates for the first time in more than a decade, the cumulative ten consecutive increases in interest rates amount to 450 bp.

- The speed of reduction of the balance sheet so far has been extraordinary, also in comparison with other central banks. Since TLTRO borrowing peaked at the end of 2021, the outstanding volume of TLTROs has fallen by €1.65 trillion. This is in addition to the decline in the asset purchase programme portfolio of almost €110 billion since reinvestments were ended in June.

In this context, let me focus today in detailing my assessment of the economic and inflation outlook, including in particular the dynamics of underlying inflation, and the strength of monetary policy transmission. I will then explain what may be expected from our monetary policy going forward.

The economic growth outlook

Economic activity in the euro area was very subdued in the first half of 2023. Real GDP grew by only 0.1% in Q2, as little as in the previous quarter and well below the June Eurosystem staff projections. The most recent economic indicators suggest that this weakness may have intensified during the summer months. The deceleration is broad based across sectors and countries, and it is starting to be reflected in employment indicators. Consequently, the September projections have significantly revised real GDP downwards for the second half of 2023. GDP growth is expected to broadly stagnate in Q3 and Q4, in contrast to the quarterly increases of 0.3% and 0.4%, respectively, anticipated in June.

The new projection exercise is also based on an updated set of assumptions about the evolution of the international economy, commodity prices, exchange rates and financing conditions.

- Global real GDP moderated in the second quarter of 2023, after strong growth in the first quarter, and is projected to expand by 3.2% in 2023, 3.0% in 2024 and 3.2% in 2025, broadly in line with the June projections but with a different composition. China's growth outlook for this year has been revised down substantially, while the growth outlook for major advanced economies has been revised up, largely reflecting stronger expected growth in the United States.

- Crude oil prices increased by more than 15% over July and August, following Saudi Arabia's and Russia's extension of their production cuts, while European gas prices have increased by 7%, in a context of great volatility.[1] As a consequence, the level of composite energy prices is assumed by the end of 2025 to lie around 60% above the level observed at the start of 2021. On the contrary, international food commodity prices reacted only marginally to the cancellation of the Ukrainian grain deal.

- Financing conditions are now expected to be tighter than anticipated in the previous projection exercise, mainly owing to higher interest rates, but also to a potential stronger role of credit supply restrictions.

- The euro exchange rate has appreciated both against the US dollar, and more so in nominal effective terms.

All told, annual average real GDP growth is expected to slow down to 0.7% in 2023 (from 3.4% in 2022), before recovering to 1.0% in 2024 and 1.5% in 2025. Compared with June, the staff projections now expect cumulative growth for the period 2023-2025 to be 1% lower.

GDP is projected to return to a growth path from the beginning of 2024, underpinned by strengthening foreign demand and a recovery in real disposable income, thanks to the expected easing of inflation, buoyant nominal wage growth and still low unemployment. However, the impetus from these tailwinds will be mitigated by the tightening of monetary policy, together with the gradual withdrawal of fiscal support.

The labour market is projected to slow down in the coming quarters, in line with the weaker growth outlook, with unemployment edging up slightly to stand at 6.7% in 2025. The resilience of employment growth in 2023 reflects some labour hoarding, which is expected to gradually unwind over the medium term, and therefore suggests a recovery in labour productivity.

In any case, uncertainty remains very high and the risks to economic growth projections are tilted to the downside. In particular, growth could be slower if the effects of monetary policy are more forceful than expected, or if the world economy weakens, for instance owing to a further slowdown in China.

The inflation outlook, including the dynamics of underlying inflation

Headline inflation has declined significantly decline since its peak in October last year, to 5.2% in August 2023, mainly as a result of lower energy prices. Food price inflation has come down from its peak in March but was still almost 10% per cent in August.

[1] Gas prices have oscillated greatly during the summer due to several temporary factors, such as the impact of strikes in Australian liquefied natural gas (LNG) facilities (which may have reduced world supply of LNG by up to 10%) or the increase in energy consumption during heatwaves.

As for underlying inflation (which excludes energy and food prices), since the all-time high of 5.7% reached in March it has started a very gradual decline, decreasing by just 0.4 pp up to August. This is the result of the different dynamics of its components.

- Non-energy industrial goods inflation has declined after reaching its peak at the beginning of this year.

- The services component edged down slightly to 5.5% in August, although it remained high owing to strong spending on holidays and travel and high wage growth.

- Within services, the inflation rate of "labour cost-intensive" items – i.e. those produced by sectors in which labour costs have a high weight in the overall cost structure – showed a noticeable steady increase until July and decreased very slightly in August, standing at close to 5%.

- The inflation rates of other items that experienced very high price increases up to March this year – such as household equipment and maintenance, transport, and activities involving more social contact, or those whose production is more energy intensive – have moderated since then, but remain at very high levels above 6.5%.

Most measures of underlying inflation are starting to fall as demand and supply have become more aligned and the contribution of past energy price increases is fading out.

And domestic price pressures have stabilised recently but remain strong. Annual growth in the GDP deflator stood at a high level (6.2%) in 2023 Q2, unchanged from the previous quarter, as a result of slight increases in the contributions from unit labour costs and unit taxes[2], which were offset by a decrease in the contribution from unit profits[3].

Importantly, after two years of very high inflation, the medium-term inflation expectations of consumers, professional forecasters and market participants alike are still well anchored around our 2% target. On longer-term inflation expectations, there is an apparent disconnect between survey-based and market-based metrics, with the former converging to target and the latter remaining somewhat higher. The disconnect, however, essentially disappears if one removes the inflation risk premium embedded in market-based measures. The genuine inflation expectation component incorporated in the observed 5-year 5-year forward inflation compensation derived from inflation swaps is essentially 2%. One would expect the inflation risk premium to increase in times like this, when inflation is still high and growth is subdued and therefore there is still much uncertainty about inflation dynamics.

Against this background, the September ECB staff projections point to a gradual reduction in inflation over the forecasting horizon owing to the expected moderation of energy and food prices and their progressive pass-through to underlying inflation, as well as the impact

[2] The stronger contribution of unit labour costs reflects weaker than expected productivity growth, since compensation per employee grew by 5.5% in 2023 Q2, a similar pace to Q1.

[3] Annual growth in unit profits dropped from a record high of 9.6% in 2023 Q1 to 6.9% in 2023 Q2, most likely reflecting the impact of the economic slowdown.

of monetary policy tightening, the unwinding of supply bottlenecks and the normalisation of demand after the post-pandemic catch-up.

Headline inflation is forecast to average 5.6% in 2023, and to ease subsequently to 3.2% in 2024 and 2.1% in 2025. This is a slight upward revision for 2023 and 2024, mainly reflecting a higher path for energy prices. On the contrary, headline inflation has been revised down slightly for 2025 as the effects of the euro appreciation, tighter financing conditions and the weaker demand outlook drag down underlying inflation**.**

Unlike in previous exercises which successively revised it upwards, the underlying inflation outlook for 2023 has remained unchanged in comparison with June, while that for 2024 and 2025 has been revised down.[4] Underlying inflation is expected to remain well above its historical mean of 1.6% over the forecasting horizon, on account of strong growth in unit labour costs, mainly due to high nominal wage growth, which will only partly be accommodated by profit margins.

- Wage growth is expected to remain around double its historical average, driven by increases in minimum wages and inflation compensation, as well as the tight labour market (which is cooling down somewhat though recently). This will allow workers to recover their pre-energy shock purchasing power by the end of the forecasting horizon.

- Profit margins, which expanded notably over the past year, have receded recently and are expected to provide a buffer to the pass-through of these costs to final prices in the medium term.

- Rising productivity growth is also expected to help absorb the impact of strong labour cost growth on inflation.

As in the case of growth, uncertainty surrounding the inflation outlook is high and we will have to continue monitoring the different sources of risk which are, in my view, now broadly balanced.

- Inflation could be higher than expected if renewed upward pressures on energy and food costs materialise. In this regard, economic analysis has shown that the magnitude and persistence of last year's energy price shock resulted in stronger indirect effects on underlying inflation[5]. Moreover, it has been found that the energy price rises of last year may have had stronger indirect effects than the decreases registered this year, thus increasing the persistence of inflationary pressures.[6]

- Higher than anticipated increases in wages or profit margins could also drive inflation higher, including over the medium term. Especially as wage

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[4] In the September staff projections, underlying inflation is expected to recede from 5.1% in 2023 to 2.9% in 2024 and 2.2% in 2025.

[5] González Mínguez, J.M., S. Hurtado, D. Leiva-León and A. Urtasun (2023) "The spread of inflation from energy to other components", article 02, Bank of Spain Economic Bulletin 2023/Q1.

[6] Burriel, P., F. Odendahl and S. Párraga (2023) "Asymmetric pass-through of energy in the euro area and Spain", Bank of Spain Economic Bulletin forthcoming.

negotiations are taking place in a tight labour market, with the unemployment rate at a historical low and labour shortages remaining high, despite the fact that labour participation has grown robustly since last year.

- By contrast, weaker demand – for example due to stronger than anticipated monetary policy transmission or a worsening of the economic environment outside the euro area – would lead to slower growth, as well as lower price pressures, especially over the medium term.

The strength of monetary policy transmission

The evolution of bank lending rates, credit standards and financing volumes in the euro area points to a strong pass-through of monetary policy tightening.

- From the end of 2021 up to July 2023, interest rates on new loans to households for house purchase rose by 2.5 pp and the increase in other segments was even larger: 2.9 pp in the case of consumer credit and other lending and 3.7 pp in the case of non-financial corporations.[7] These increases in euro area bank loan rates are very sharp when compared with past hiking cycles, in terms of speed and magnitude.[8]

- Bank lending rates have risen in step with a reduction in credit supply. This tightening appears attributable to, among other things, banks' greater risk perception and has tended to be above banks' own expectations. In fact, the latest projection exercise assesses the tightening of credit supply to weigh more heavily on real GDP growth than envisaged in the June projections.

- Likewise, credit demand has fallen sharply during the current cycle, due to higher interest rates, the worsening macroeconomic environment and heightened uncertainty. In fact, the latest Bank Lending Survey (BLS) results, corresponding to the second quarter of 2023, revealed a record fall in loan applications from firms since the survey began in 2003.

All of the above has led to a marked slowdown in new lending to households and firms, which has been more pronounced for housing loans. Net flows of total loans to households have been negative since April 2023, leading to the lowest annual growth rate since 2015 (1.3%) in July. In the case of firms, net loan borrowing has been subdued and the corresponding year-on-year growth rate has continued to decline, standing at 2.2% in July.

[7] Note, however, that the change in loan rates could underestimate the intensity of the current pass-through to the extent that credit flows have shifted towards safer borrowers. In that case, the average cost of new lending would be lower due to a composition effect. The rebalancing of banks' portfolios towards more capital-efficient assets will automatically lead to lower interest rates.

[8] See, for example, Lane (2023) The banking channel of monetary policy tightening in the euro area or S. Mayordomo and I. Roibas. (2023). La traslación de los tipos de interés de mercado a los tipos de interés bancarios. Documentos Ocasionales - Banco de España, 2312.

Financial conditions indices (FCIs) provide additional evidence of the stronger transmission of the current monetary policy tightening.[9]

- If we consider the evolution of a standard FCI,[10] we could conclude that the transmission of the current rise in policy rates to the increase in the FCIs is estimated to be around twice as much as that in the 2005 and 1999 hiking cycles.

- However, it should be kept in mind that most FCIs are based on financial market prices and do not take into account information on the evolution of credit quantities, for instance the credit supply restrictions reported in the BLS. In this sense, FCIs are likely to underestimate the true strength of monetary policy transmission in the current context.

Regarding the transmission of the monetary policy tightening to the real economy, it is complex and comes with significant lags.

- Its dampening impact on demand is already being felt but it´s not yet complete, with a significant part of it still in the pipeline[11].

- Alternative model-based estimates point, in some cases, to the pass-through potentially being stronger than expected in our staff's projections.[12]

- Amplifying effects could also occur if the scale and speed of the current cycle give rise to non-linear effects. These effects might also be driven by the unequal impact of monetary policy on the different types of households and firms, depending on their indebtedness and their financial situation.[13]

All these elements warrant the transmission of monetary policy being monitored closely.

What can we expect going forward?

The above assessment suggests that **the current level of the key ECB interest rates, maintained over a sufficiently long duration, would be broadly consistent with achieving our 2% inflation target in the medium term.** In other words, this means that, if we keep rates at these levels long enough, there are very good chances that we will be able to reach our 2% target in a timely manner. This is also in line with the view of most analysts

[9] An FCI is a synthetic indicator that summarises the evolution of different financial variables. They are not an indicator of the monetary policy stance because they usually include variables outside the control of the central bank – such as risk premia or exchange rates. But they can be useful to assess the effectiveness of monetary policy.

[10] I am referring to an FCI which is based on six asset price variables (the stock exchange index, short and long-term interest rates, corporate and sovereign spreads and the exchange rate) and takes into account the size of current tightening.

[11] For example, the pass-through of higher interest rates to the average cost of debt takes time because it hinges on debts being renewed at maturity or updated with the reference rate in the case of flexible rate contracts.

[12] See Darracq-Paries et al. (2023), A model-based assessment of the macroeconomic impact of the ECB's monetary policy tightening since December 2021, ECB Economic Bulletin, Issue 3 /2023.

[13] See Section 4.3.2 in Chapter 3 of the Annual Report 2022 of the Banco de España.

and financial markets, which expect a rapid decline in inflation over the course of this year and the next.

But let me emphasise that this is a conditional statement. We have come to this conclusion on the basis of today's information and the level of uncertainty about the future evolution of the economy remains high and subject to geopolitical risks, the course of which is difficult to anticipate. There could be further shocks, and our response to them will depend on their origin and scale and on their impact on the inflation outlook.

In this context, our future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary and we will continue to follow a data-dependent approach to determining the appropriate level and duration of monetary restriction**. This approach is particularly important to avoid both insufficient tightening**, which would impede the achievement of our inflation target, **and excessive tightening**, which would unnecessarily damage economic activity and employment.

And I believe the market is understanding this well. What you see in current rate pricing, for example, are two things: persistence, as a lot of inertia is priced into the curve of forward rates; and inversion, as policy rates (despite the inertia) are seen to decline steadily to much lower levels.

- Inertia is a reflection of our statement that "key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary".

- The inversion reflects markets' conviction that inflation will continue to fall and that, in the face of inflation returning to the target, rates will also be adjusted. They see that the current level of our policy rates is restrictive: in other words, measurably higher than neutral. As inflation falls, it is realistic to expect the policy rates to be eased back to neutral.

- Both persistence and inversion, I would say, are comforting features of rate expectations today, in that they demonstrate that markets believe what we say: if nothing changes, interest rates will be held at sufficiently restrictive levels for as long as necessary to get the job done. Incidentally, this is precisely an automatic adjustment mechanism of market conditions that was absent in the 1970s. Then it took years for market interest rates to rise to levels restrictive enough to help reduce inflation.

And let me finally emphasise that, in the current context, it is important that other policies also make their contribution.

- As energy prices fall, governments must roll back their energy support measures.

- Should a renewed energy crisis necessitate new fiscal support measures, these should be much more targeted.

- Authorities should also undertake structural reforms to strengthen the supply side.

- Fiscal policy for 2024 should be rather restrictive across the euro area, in line with the July Eurogroup statement and the September ECB staff projections.

This is essential to avoid additional price pressures, which would otherwise call for an even stronger monetary policy response.