

Yannis Stournaras: The role of the ECB monetary policy in achieving a soft landing in the euro area

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Brussels Hellenic Network, Argo, in honour of new MPEs for Greece and Cyprus, Brussels, 10 July 2024.

* * *

Introduction

I would like to thank my friend Spyros Pappas for inviting me to discuss the role of the monetary policy of the European Central Bank (ECB) in achieving a soft landing in the euro area.

As you know, in the past few years, the Governing Council of the ECB has followed a meeting-by-meeting, data dependent approach to monetary policy.

Therefore, I will start with a brief overview of recent economic developments that have paved the way for entering the "dialling back" phase of our monetary policy. I will then explain the rationale behind our recent monetary policy decisions. Finally, I will touch upon the challenges faced by the monetary policy of the Eurosystem (which includes the ECB and the national central banks of the euro area).

My speech comprises seven sections:

1. Inflation outlook in the euro area

- Inflation in the euro area has fallen sharply since hitting a peak of 10.6 per cent in October 2022, to stand at 2.5% last June.
- At the same time, core inflation also decelerated substantially from its March 2023 peak, when it had reached 7.5% as measured by the HICP excluding energy and unprocessed food.¹
- Since our last rate hike in September 2023, we have seen a stronger-than-anticipated decline in inflationary pressures.

Consider the following:

- Inflation declined from 5.2% last August (the month immediately prior to the last rate hike at the September meeting on monetary policy), to 2.5% in June 2024.
- Underlying inflation has also eased, reinforcing the signs that price pressures have weakened.
- Core inflation has sharply decreased from 6.2%² in August 2023 to 2.9% in June 2024³.
- In June, the highest contribution to the inflation rate came from services. Services inflation remains elevated, but it has followed a broadly declining path since last summer (from 5.5% last August to 4.1% in June 2024).

- Inflation expectations have declined at all horizons. Longer term market-based measures of inflation compensation have come down notably, from an average of 2.7% last August to 2.3% in June 2024.
- Our June 2024 projections show inflation coming down towards our 2% target over the second half of next year, as inflationary pressures are expected to subside. Headline inflation is projected to average 2.5% in 2024, 2.2% in 2025 and to fall below our target, to 1.9%, in 2026.
- Over the coming quarters, inflation is expected to fluctuate around current levels, due, *inter alia*, to energy-related base effects.
- In fact, excluding these base effects, a decline in inflation would have materialised over the respective period.
- Base effects are expected to fade out at the beginning of 2025, while, at the same time, fiscal support measures are unwound.
- Wage developments are also important, as they are a key driver of inflation at the current juncture.
- The latest data, pointing to an increase in negotiated wage growth to 4.7% in the first quarter of 2024, from 4.5% in the fourth quarter of 2023, have surprised on the upside.
 - Still, one-off payments in the public sector in Germany, have largely affected this outcome, whereas developments in other euro area countries are more encouraging.
 - The German public sector wage increase reflects the fact that negotiated wages in that sector had not been raised since 2021.
- Wage growth is expected to remain elevated in 2024, and to show a bumpy profile. These developments reflect the staggered nature of the wage adjustment process as workers continue to recoup real wage losses from past price shocks.
- However, leading indicators suggest that data on wages earlier this year may have been the peak, and that wage growth will ease during the remainder of 2024.
 - According to the ECB wage tracker data for the first few months of the year, when most agreements take place, negotiated wage pressures are moderating. This is supported by other indicators of wage pressures such as the Indeed wage tracker⁴ based on job postings, which has materially decelerated in recent months (from a peak of 5.4% in October 2022 to 3.7% in June 2024.)
 - The impact of higher wages on price pressures depends on the rate of labour productivity growth. A recovery in productivity growth should support the moderation in labour cost pressures.
 - An ongoing decline in profit margins also reinforces the confidence that domestic inflation will continue to normalise, effectively "buffering" the pass-through of wages to prices.
 - Overall, the disinflation process is proceeding. Our latest projections reinforce our confidence that we are getting consistently closer to our inflation target. Although the process may be slow and bumpy, these fluctuations should not affect the projected disinflation.

Economic activity

- The euro area economy grew by 0.3% in the first quarter of 2024, after five quarters of stagnation.

- Incoming information suggests continued growth in the short run, at a somewhat higher pace than previously foreseen.
 - Specifically, according to the June projections, economic growth is expected to rise to 0.9% in 2024, 1.4% in 2025 and 1.6% in 2026.
- Nevertheless, the recovery remains fragile.
- There are several reasons why I am cautious about the growth outlook.
- First, global developments and geopolitical tensions are weighing on confidence and economic activity.
- Second, monetary policy affects the economy with long and variable lags. The impact of past policy tightening continues to be transmitted strongly to broader financing conditions and the real economy.
- The restrictive policy stance at a given point in time continues to affect inflation and output about one to two years after that. In this regard, a significant dampening effect on growth and inflation is still in the pipeline from past monetary policy tightening.
- This explains why credit dynamics remain weak and will remain so for some time to come.
- I will now turn to our monetary policy response during the last couple of years.

2. Monetary policy response

- In the past few years, we faced an unprecedented series of supply-side shocks – the kind of shocks not easily amenable to monetary policy measures – and we succeeded in bringing inflation down to near our objective within 18 months of the peak inflation, while avoiding putting the economy into a contractionary territory.
- We raised interest rates to sufficiently high levels to tame inflation without inducing a recession – which was the first arm of our policies – while, at the same time, we adopted a gradual approach to reducing the size of our balance sheet – the second arm of our policy toolbox.
- Our monetary policy response has proved to be pragmatic, flexible and highly effective.
- As inflation approaches the 2% target, while economic recovery and credit growth remain weak, we decided that some layers of restriction are no longer appropriate. As you know, at last month's Governing Council meeting we took the first step to lowering rates from their all-time highs.
- We cut the key ECB interest rates for the first time in almost five years (since September 2019).
- However, our monetary policy remains in restrictive territory, and it will continue to be restrictive for some time into the future.
- Financing conditions, especially at the long end, have tightened significantly since the beginning of the year, and will remain tight even after several rate cuts.
- The ongoing decline in our balance sheet, i.e. the aggregate balance sheet of the central banks that comprise the Eurosystem, due to the run-off in our asset purchase programmes and the repayment of TLTROs over the course of this year, will also represent an additional tightening of financing conditions.
- The challenge ahead is to ensure that inflation continues to fall and approaches our objective in a timely way, while at the same time growth strengthens to reach sustainable levels ensuring full employment.
- In these circumstances, the Governing Council faces a balancing act:

- We want to bring inflation to our objective by the end of next year. This will call for policy restraint in the months ahead.
- But we don't want to undermine the incipient economic recovery and risk bringing inflation to levels below our 2% target.
- Indeed, according to the June projections, inflation is expected to undershoot our target in every quarter of 2026.
- I will not comment on possible further rate cuts this year other than to say that, first, we need to wait and see how the data develop and, second, even with additional rate cuts, monetary policy will remain well in restrictive territory.
- In this journey, maintaining gradualism and flexibility will remain key in mitigating unwarranted economic volatility and financial stability risks, while ensuring the efficiency and proportionality of monetary policy measures and preserving our credibility.
- We will continue to be data-dependent, assessing all incoming information in each of the forthcoming monetary policy meetings. Amid elevated economic and geopolitical uncertainty, we will remain cautious and vigilant to adjust our policy stance in stepwise cuts of our interest rates as warranted.

3. Global uncertainty challenges and geopolitical developments

- No one could have predicted the series of supply shocks that struck the euro area economy in the past few years. Therefore, no one could have predicted – and no one did before the fact – the rise in inflation that followed.
- Some 40 years ago, Nobel Laureate James Tobin said that we know little about predicting inflation. That remains true today. In a world prone to supply disruptions and susceptible to political uncertainties, monetary policy can only try to buffer the effects of external shocks on the real economy and on inflation.
- The past two years have seen an escalation of violence, with Russia's unjustified war against Ukraine and the unfolding of the Middle East crisis last autumn.
- 2024 is a year of increased electoral activity.
- There are five months to go to US elections, the outcome of which could alter the course of the global economy.
- Nationalist parties made major gains across the euro area in the European Parliament elections, challenging leaders in Germany but also France, where snap elections have been called.
- Monetary policy has navigated in the turbulent waters of heightened uncertainty in the past several years. It will continue to navigate in those turbulent waters in the period ahead.

4. Climate change challenges

- At the ECB we have a very clear mandate, which is enshrined in the Treaty and has a focus on price stability.
- We also have an important role to play in addressing the challenge of climate change, always within the limits of our mandate.
- Physical and transition risks can threaten price stability, but also become a source of instability and vulnerability for the financial system, thereby also affecting the transmission of monetary policy.
- At the same time, in addition to the risks created by climate change, adapting to climate change can bring opportunities, as required investment will bring new,

more efficient and more sustainable forms of development, towards a more resilient and green economy.

- The financing of these investments is also an opportunity for the financial system and the more efficient use of the savings of European citizens.
- At the ECB we have different sets of actions, from risk management to better macroeconomic modelling and to including climate change risks and mitigation measures in many aspects of our work.

5. Policy challenges related to recent political developments

- Monetary policy has a single anchor in price stability, and that anchor is immune to political influence.
- As an independent institution, the ECB will continue to conduct its monetary policy to attain its price stability objective. The ECB has earned its credibility by focusing on this objective, and not being diverted by political pressures. It will continue to be led by its mandate in the future.
- The economic agenda of some of political parties is disconcerting, because it includes such policies as increased protectionism and highly expansionary fiscal policies.
- We have learned over the years – and sometimes the hard way – that to maximise our citizens' welfare we need free trade policies and a sustainable fiscal stance.

6. Decoupling between the ECB and FED monetary policy decisions

- The euro area monetary policy stance needs to be differentiated from that in the U.S.
- The two economies are at divergent positions, with inflation falling faster in the euro area.
- Two reasons why inflation has fallen faster in the euro area than in the U.S. are: (1) the U.S. inflation cycle was mainly demand driven, whereas the euro area has been hit more severely by supply side shocks (the energy prices surge and Russia's invasion of Ukraine) and (2) the U.S. fiscal stance since 2020 has been highly expansionary.
- In particular, the U.S. fiscal deficit stood at 8.8% of GDP in 2023, up from 4% in the previous year, after having reached about 14% in 2020 and 11% in 2021. By contrast, in the euro area the fiscal deficit stabilised at around 3.5% of GDP in the previous two years, from 7% in 2020.
- On the other hand, economic growth in the euro area is more sluggish and fragile than in the U.S.
- Due to the differing macroeconomic situation, the monetary policy actions of the Fed and the ECB might turn out to be different.
- The way forward for the Eurosystem should only have to be based on what serves our price stability mandate and our domestic economy.
- We need to focus firmly on domestic conditions, taking into account any impact from the expected path of U.S. interest rates. Domestic conditions provide the guideposts on our decisions.
- Furthermore, as Philip Lane, Chief Economist of the ECB, said in a recent interview with the Financial Times,⁵ delays in the expected timing of Fed

rate cuts have pushed up U.S. bond yields and this has also lifted long-term yields of European bonds, creating some extra tightening from the U.S. conditions".

Philip indicated that the ECB might have to offset this with extra cuts to its policy rates.

- Of course, a divergence of interest rate paths of the euro area and the largest economy in the world could impact on the exchange rate and on trade. These effects are difficult to predict. Our gradual and data-driven approach will allow us to respond to any undesirable developments.

7. The forecasting performance of the ECB

- Although the accuracy of the ECB's economic forecasts diminished in the past few years, forecasting performance worsened to a comparable degree in other central banks and by private sector forecasters.
- The decline in forecasting performance reflected a series of shocks, including the pandemic, along with the economic and policy consequences of those shocks (e.g. the enormous fiscal expansion in the U.S. beginning in 2020), the sharp rises in oil, gas, and other commodity prices which were exacerbated following Russia's invasion of Ukraine, and the sustained disruption of global supply chains during and after the pandemic.
- The deficiencies experienced in the forecasting performance of the ECB were characteristic of the central banking community in general and have also been emphasised in Ben Bernanke's report on forecasting at the Bank of England. No forecaster could have foreseen the outbreak of Covid-19 or the war in Ukraine.
- We appear to have entered a new period of higher uncertainty, with shocks originating from both the demand and supply sides. Our models need to be reviewed and further upgraded to account for this uncertainty. This has also been the finding of the Bernanke Report.
- We constantly assess the status of our forecasting and modelling infrastructure, and strive to improve on it in close co-operation within the Eurosystem.
- We will never be able to accurately forecast the outbreak of epidemics and wars, but we should ensure that our models are able to detect those shocks soon after they occur, and to predict their effects as accurately as possible.
- Our projections are very useful and comprehensive tool that analyses the data that we receive and helps to make decisions.
- Having said that, it is also important to point out that no central bank is entirely model-dependent. In our projections, the staff always incorporates a good amount of judgement, so that forecasts better guide our assessments of the most recent economic and geopolitical developments.
- In concluding my speech, I would like to highlight the following factors which, in my view, explain the success of the ECB's monetary policy, so far, in bringing inflation back very close to the 2% target, despite a series of shocks, mainly on the supply side, but also on the demand side, which started with the pandemic and continued with Russia's unjustified and violent invasion of Ukraine.

First, the institutional independence of the ECB and the national central banks comprising the Eurosystem.

Second, the commitment to the 2% inflation target, using key interest rates as the primary monetary policy tool, together with non-standard measures, when required by macroeconomic and monetary conditions.

Third, a pragmatic, flexible and gradual approach, in an environment of heightened uncertainty.

Fourth, clear and effective communication from the ECB.

Note: The speech was published on July 19, 2024 due to the "quiet period" observed by members of the Governing Council before key meetings.

¹ Core inflation as measured by the HICP excluding energy, food, alcohol and tobacco had peaked at 5.7 per cent in March 2023.

² As measured by the HICP excluding energy and unprocessed food; core inflation as measured by the HICP excluding energy, food, alcohol and tobacco stood at 5.3 per cent in August 2023.

³ Based on the flash estimate by EUROSTAT, released on July 2nd, 2024.

⁴ The Indeed tracker is a monthly wage growth tracker, developed by the Central Bank of Ireland (CBI) in collaboration with the Indeed online platform, and examines trends in wages posted in online job ads. It is based on data from millions of online job postings on the Indeed platform across France, Germany, Ireland, Italy, the Netherlands, Spain and the U.K.

⁵ Interview with Financial Times on 24 May 2024.