

Philip R Lane: Monetary policy and the disinflation process

Speech by Mr Philip R Lane, Member of the Executive Board of the European Central Bank, at the Banking & Payments Federation Ireland (BPFI) National Banking Conference, Dublin, 11 June 2024.

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[Slides](#) accompanying the speech

Let me begin by offering some comments on the economic outlook, before discussing our decision last week to cut the key ECB interest rates by 25 basis points.¹ The latest Eurosystem staff macroeconomic projections foresee economic growth at 0.9 per cent in 2024, 1.4 per cent in 2025 and 1.6 per cent in 2026, while inflation is projected to average 2.5 per cent in 2024, 2.2 per cent in 2025 and 1.9 per cent in 2026. Relative to the average annual inflation rates in 2022 and 2023 of 8.4 per cent and 5.4 per cent respectively, considerable disinflation has already occurred, with the latest inflation figure at 2.6% in May. For inflation excluding energy and food (often termed core inflation), staff project an average of 2.8 per cent in 2024, 2.2 per cent in 2025 and 2.0 per cent in 2026. Since core inflation stood at 3.9 per cent and 4.9 per cent in 2022 and 2023 respectively, the outlook for 2024-2026 also indicates considerable core disinflation is in train. The current task for monetary policy is to ensure that full disinflation is secured, with inflation returning to our two per cent target in a timely manner and settling at this level on a sustainable basis.

Rather than provide a full analysis of all the factors that determine inflation dynamics, let me briefly discuss wage dynamics, which play an especially important role in the final stages of the disinflation process.² Wage growth is still elevated, primarily driven by the ongoing adjustment to the past inflation surge. The growth rate of compensation per employee ticked up from 4.9 per cent in the fourth quarter of 2023 to 5.0 per cent in the first quarter, largely reflecting an increase in negotiated wage growth from 4.5 per cent to 4.7 per cent. This stronger growth in the first quarter includes very large one-off payments in the German public sector.³ More broadly, the design of some multi-year wage settlements specify large increases in 2024 (to compensate for the lack of earlier pay adjustments to the inflation surge) but much smaller increases in 2025. The set of forward-looking wage trackers also signal that wage dynamics will remain elevated in 2024 but will decelerate in 2025. The Indeed wage tracker declined to 3.4 per cent in April; similarly, firms participating in the Corporate Telephone Survey expect wages to rise at a rate of 4.3 per cent in 2024, compared to 5.4 per cent in 2023.

This negatively-sloped profile for wage growth helps to underpin the projected decline in inflation in 2025, with less pressure from labour costs next year. Over time, disinflation will also continue to be supported by the restrictive monetary policy stance and the fading impact of past inflation on ongoing price pressures, while the countervailing impact from the reversal of fiscal support measures will fall out of the inflation data.

While wage growth is set to be a primary driver of inflation in 2024, the net impact of labour cost increases on prices is being buffered by a lower contribution from profits. In particular, by dampening demand and containing inflation expectations, our restrictive

monetary stance is constraining the ability of firms to pass through cost increases to consumer prices. This is evident in the data for the first quarter, which show unit profit growth turning negative. In turn, this contributed to the decline in the "GDP deflator" inflation rate (which reflects the prices of goods and services produced in the euro area economy, net of the value of intermediate inputs) from 5.1 per cent in Q4 2023 to 3.6 per cent in Q1 2024. The ongoing compression of unit profits will play an important role in keeping the disinflation process on track, even while the final stages of catch-up dynamics mean that wage growth remains elevated this year.

Let me now turn to last week's monetary policy decision. After nine months of holding the deposit facility rate (the primary policy rate that steers money market conditions) at 4.0 per cent, we cut it to 3.75 per cent.⁴ Over the interval since our September 2023 monetary policy meeting, the projected timely return of inflation to our target has been reconfirmed in the December, March and June projection rounds.⁵ For instance, over the last four forecast rounds, the projected fourth quarter-on-fourth quarter HICP inflation rate for 2025 has oscillated within the very narrow interval of 1.9 per cent to 2.0 per cent. As 2025 draws closer, the timeliness of the projected return to target looms larger on the horizon. In addition, in terms of the sustainability of maintaining inflation at the target, the inflation outlook for 2026 has been reconfirmed over the last three projection rounds.

Moreover, the overall speed of disinflation has been faster than expected. Over this period, inflation has come down by 2.6 percentage points. While at the start of the holding phase, staff saw inflation averaging 5.6 per cent in 2023 and 3.2 per cent in 2024, inflation turned out to average 5.4 per cent in 2023 and, for 2024, it is expected at 2.5 per cent in the latest projection exercise (0.7 percentage points lower than projected last September). The set of underlying inflation indicators also shows considerable progress compared to the start of the holding period, with most gauges drifting lower towards two per cent.

This improvement in the inflation profile has reduced the risk to the stability of inflation expectations posed by "too high for too long" inflation, including through its impact on future price and wage resets. Compared to last September, measures of shorter-term inflation expectations have declined, while measures of longer-term inflation expectations have remained broadly stable, with most standing at around two per cent.

In parallel, the evidence indicates that our monetary stance has been clearly restrictive. Mortgage rates are measurably lower compared to their autumn peak but indices of affordability of mortgage credit still point to restrictive conditions. In particular, compared to the start of the holding period, real lending rates to firms and households have risen markedly and are expected to remain significantly higher than assumed in the September 2023 projections, suppressing demand for external finance. Activity is recovering, although not sufficiently in those segments of demand that are most sensitive to interest rates, such as construction – beyond the temporary factors supporting construction activity in Germany and Italy – and business investment. In addition, consumer confidence, while gradually recovering, remains subdued. Overall, the incoming data on financing conditions signal that the monetary stance remains restrictive, which will help maintain the disinflation process.

An interest rate decision should be robust across a wide range of scenarios. The baseline projections reflect the market yield curve, which envisages a set of rate cuts in 2024 and 2025. However, at a still clearly restrictive level of 3.75 per cent for the deposit facility rate, the realisation of even a substantial margin of upside shocks to inflation could be addressed by a slower pace of rate reductions compared to the baseline rate path embedded in the projections.⁶ At the same time, a policy rate level of 3.75 per cent also offers more protection against downside shocks compared to remaining at 4.0 per cent.

It should be clear that the high level of uncertainty and the still-elevated price pressures that are evident in the indicators for domestic inflation, services inflation and wage growth mean that we will need to maintain a restrictive monetary stance, following a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. Over time, the incoming data should be informative about the balance between backward-looking price level adjustment dynamics (that should gradually die out) and the more problematic and persistent underlying component in inflation. In connecting the inflation data and the broader economic and financial data, the evolution of cost dynamics and domestic pricing power will depend on the strength and composition of the cyclical recovery.⁷

That is to say, our data-dependent approach requires us to carefully analyse and interpret the incoming information in the context of our three-part evaluation framework in order to assess the implications for the inflation outlook (both in terms of the baseline and risk scenarios), the dynamics of underlying inflation and the state of monetary policy transmission.

We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner, and we will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. We are not pre-committing to a particular rate path and will continue to take a meeting-by-meeting approach to determining the appropriate level and duration of restriction.

¹ See also Lagarde, C. (2024), "Why we adjusted interest rates", *The ECB Blog*, 8 June. In addition, a set of [background slides](#) is available on the ECB website.

² For instance, see more detailed inflation analysis in Lane, P.R. (2024), "Inflation in the euro area", Speech at the Institute of International and European Affairs, Dublin, 27 May.

³ For details see Holton, S. and Koester, G. (2024), "[Tracking euro area wages in exceptional times](#)", *The ECB Blog*, 23 May.

⁴ The other key policy rates are the rates on the main refinancing operations and the marginal lending facility at which banks can borrow from the ECB.

⁵ Each projection round takes into account the prevailing market view of the future path of interest rates, as embedded in the market yield curve.

⁶ In addition to the occurrence of new shocks (including geopolitical events), inflation surprises could also be generated by higher-than-expected persistence in domestic inflation and services inflation or weaker-than-expected monetary transmission. The risk assessment section of our monetary policy statement elaborates on the set of risks to the economy and inflation.

⁷ For instance, productivity growth is intertwined with cyclical recovery. See Arce, Ó. and Sondermann, D. (2024), "[Low for long? Reasons for the recent decline in productivity](#)", *The ECB Blog*, 6 May.