Monetary policy to promote growth and stability in the EU

Introduction

The first part of the panel looked at the evolution of disinflation, inflation dynamics and views on monetary policy, including what needs to be done in the coming quarters to bring inflation back to the 2% target. The second part looked at the medium term, taking a step back for a broader perspective, including to think about the future of the European Central Bank's (ECB) balance sheet and Quantitative Tightening (QT). With the ECB's strategy review coming up the timing was opportune to reflect on what has been learned in terms of the conduct of monetary policy and the challenges it is likely to face in the future.

1. Monetary policy and the outlook for the euro area economy

1.1 Disinflation has been accelerating in recent months

The Chair set the scene by observing that following synchronised global monetary tightening, disinflation is progressing, reverting from the high levels seen after the twin shocks of the pandemic and the Russian gas cut-off to Europe. At the same time, the labour market remains resilient, with the unemployment rate at very low levels, and the recovery is expected to accelerate next year. Financial stability risks, which are usually imminent in such a situation, have not materialised. From a macroeconomic perspective, the situation could be described as a "goldilocks" moment – will it last?

Core inflation, excluding energy and food, fell to 2.8% in August, but services inflation has been stick around 4%. At the same time, ECB staff reaffirmed their inflation projections which continue to show inflation reaching the 2 percent target in the second half of 2025. The US is also beginning a gradual easing cycle.

1.2 A weaker economic outlook

A central bank official confirmed that the unanimous decision for a further 25 basis points change was driven by new data and the confidence that the transition mechanism continues to work. Despite the increase in real incomes due to past wage increases, consumers and households are holding back their spending, consequently saving rates are increasing. Decisions will continue to be made on the basis of data, including forecasts and not just actual data. The current path will lead to the medium-term inflation target by the end of 2025. However, the world is facing uncertainty and there is a lot of downside risk.

1.3 Risks and uncertainties in the global macroeconomic situation

The Chair pointed out that ECB projections are predicated on profit margins being compressed and labour productivity starting to grow. A central bank official reported that there is a lot of comfort in the inflation and general macroeconomic outlook, as well as in the transmission of the ECB policy moves. Before the ECB decided to change the course of its policy and started to remove some restrictions, it clarified the three main criteria that will be in focus when making further decisions.

There was enough certainty for yesterday's decision, but looking ahead, there are many risks and uncertainties surrounding the overall macroeconomic situation, especially in terms of inflation developments. The main risks to growth come from the international environment, partly due to macroeconomic developments and the geopolitical situation. A worsening of global tensions would have an almost immediate impact on the macroeconomic situation, both globally and in the euro area.

Some favourable data is being received on inflation, but, looking forward, there is insufficient certainty that the positive trends will continue. This is especially true for labour markets, which are reacting very slowly to developments in the real economy. However, in many parts of Europe, labour market tightness is easing from month to month. The main uncertainties are coming from higher wages and developments of profit margins.

The Chair suggested that it is reassuring to see improved confidence in our understanding of the disinflation process. As inflation spiked, economic models performed poorly for several quarters, increasing uncertainty. In the ECB staff projections, forecast errors have been greatly reduced. Turning to the panel, the chair asked what the implications for the balance of risk and policy are.

A central bank official agreed that uncertainty has decreased, as evidenced by the accuracy of the ECB's forecast, but this does not mean that uncertainty has completely disappeared. For example, the forecast for wage growth has improved, and it was right to emphasise that profits will absorb much of the wage growth. Looking ahead, however, there are still risks and uncertainties. For example, profit margins and profits have now fallen to a level where they are much less likely to absorb wage pressures in the future. Inflation in services is sticky, partly due to the cost-push element and wage growth, especially in wage-sensitive services, but to a large extent it is also a demand effect.

The ECB has long been forecasting that productivity will grow and that the overall recovery in output will be faster than it has turned out to be. This is still the forecast, but there is uncertainty about the outcome, which then affects unit labour costs as the main driver of inflationary pressures.

Given the data dependency, it is not possible to give a path for the next 12 months. The current situation is good; there is a soft landing, with inflation falling and output recovering, but there are still risks to this outcome over the next 12 to 24 months. The forecast horizon for inflation to reach the medium-term target is only 12 months. There needs to be a sustained change in the data stream before the reaction changes. There has not yet been any discussion of the neutral rate on the way down, but that will come relatively soon.

1.4 Lessons need to be learned about how to manage supply shocks

The Chair emphasised that we have seen a World with multiple supply shocks, and more is likely to come. This includes the green transition and geopolitical fragmentation; and of course, there was the pandemic and the Russian gas cut-off. There will be more supply shocks in the future. One central bank official noted that the EU is doing relatively well given all the shocks it has experienced in recent years. Lessons have been learned on how to deal with the shocks. The pandemic and the energy shock after the Russian invasion of Ukraine confirmed that supply shocks, if they are temporary, can be looked through, but if they are not temporary and have a longer lasting impact, they cannot be looked through. They require a response from monetary and fiscal policy. In the case of very large shocks, such as the one in 2020, very decisive fiscal and monetary policy responses can be effective.

With hindsight, it may be said that too much was done, and that the outcome could have been achieved with less, but that is probably not fair. In March and April 2020, some people thought it was almost the end of the world and feared for their lives. In such situations, people tend to overreact.

The events of the past few years provide useful guidance for the future responses of both monetary and fiscal policy. There are likely to be new supply shocks. It is difficult to say what kind of supply shocks they will be. No one could have predicted the last two shocks, but the geopolitical situation is much more tense and much more complicated than it has been in the last 25 years. Work is being done to try to assess the potential impact of different outcomes for this geopolitical situation, particularly in terms of trade policy for monetary policy. There is a need to learn along the way and to react accordingly.

1.5 The ECB's decision was premature and motivated by level of debt in Europe

A public representative stated that the results of monetary policy in terms of falling inflation were not surprising. However, the latest ECB decision to cut the policy rate was somewhat premature. Headline inflation is now at 2.2%, down from 2.6% last month, the difference being due to volatile energy prices. Core inflation is still at 2.8% and has stubbornly remained at that level. This means that real interest rates are now below 1%, which is not enough.

In the US, real interest rates are close to 3%, which is probably too high. The case for a rate cut in the US is clear. In Europe, the ECB's primary objective is price stability, and only a few days before Thursday's Governing Council meeting the ECB's chief economist said that the path to the target was not yet assured, so there should have been caution about further interest rate action.

There has been monetary accommodation, probably often too much, for 25 years. Sometimes it has been justified, as in the financial crisis or Covid. But overall, it has contributed to a huge increase in private and public sector debt. It has also led to very leveraged positions. Debt and leverage may look quite reasonable and sustainable at 1% interest rates, but they look very different at 5%. In yesterday's deliberations, the debt situation in the private and public sectors played an important role in the decision. However, the primary objective of the ECB is price stability, and this is not served by the decision because the signal given is that this cycle of increasing debt and high leverage can continue.

1.6 Persistently low real interest rates disincentivise productive investment and should be openly discussed in Frankfurt

One market expert emphasised that it is very difficult to forecast inflation over the medium term and that caution is called for. Inflation in services prices remains stubbornly high, partly due to nominal wage increases and slowing productivity gains.

The ECB lowered its interest rate yesterday to reduce the restrictive aspect of monetary policy. However, it is doubtful whether monetary policy is restrictive today. Wages are rising and catching up in a labour market that is quite tight. Productivity growth is lagging. This combination does not bode well for the prospect of lower and lower inflation. One should be sceptical about the idea that monetary policy is too restrictive and needs to be loosened. If you look at the liquidity overhang created by years of quantitative easing (QE) and the size of the ECB's balance sheet, the amount of liquidity created by the central bank in recent years is still there. QT is very modest. There is a large liquidity overhang.

Europe is widening the interest rate gap with the US. Experience has shown that lower interest rates in Europe than in the US tend to encourage capital movements towards the US. In the medium term, if real interest rates are too low for too long, instead of encouraging investment, they discourage productive investment and encourage short-term placements and asset bubbles. Savings that would normally have been invested in long-term assets are diverted to capital appreciation. Capital gains become more important than growth and the contribution of these placements to real investment.

This is not the view of the ECB governors. They believe that the lower interest rates are, the more favourable the investment outcome will be. It is very difficult for the ECB to counter the alternative position, given that real investment has fallen in real terms during the last 20 years of zero interest rates. It is very difficult to explain that monetary policy has favoured investment, because investment has not been favoured. There will be a repetition of the liquidity trap by going to short-term placements and avoiding long-term concerns. Yesterday's 0.25 percentage point is a prelude to a return to zero interest rates for a long time to come. The main risk is that real investment will be attacked again.

In the medium term, there should be an open mind. There is a very clear contradiction to the ECB's view that the more interest rates are cut, the more long-term investment is favoured. The ECB's view is wrong. It is not borne out by the events of the last 25 years. It deserves to be discussed. If the alternative view is correct, and long-term very low interest rates are conducive to less investment, then monetary policy and the desire of central banks to cut interest rates more and more should be reconsidered.

2. The medium-term outlook for monetary policy

2.1 Excess liquidity unwinding process started without stress

The Chair highlighted that following the period of QE, the ECB's balance sheet remains large with continued excess liquidity in the financial system. At the same time, the broader macroeconomic environment under which monetary policy has to operate is changing – be it high debt levels, global fragmentation, the green transition. QT has been on autopilot so far and will accelerate, but no financial stability risks have emerged so far. What is the outlook for the ECB balance sheet and what are the risks?

One central bank official emphasised that the ECB decided to take a very careful and attentive approach to the balance sheet normalisation, taking into account vast amounts of assets purchased during and after Covid. This is important for the good functioning and behaviour of the financial market, including the banking sector. The ECB decided to start the relatively slow process of removing this excess liquidity, with the aim of accelerating it in the later stages. Markets are responding positively and there has been little stress. Banks are slowly shifting from a heavy reliance on programmes such as TLTRO to more market operations. The Transmission Protection Instrument (TPI) was designed to be used in case of unwarranted market stress. There is vigilance about what is happening in the markets and the possible risks, but at the moment there is nothing of particular concern.

2.2 QT will be a long process

A central bank official explained that repeating unconventional monetary policy e.g. QE, as used in the past, would not remove the problems with respect to the balance sheet of central banks. Projections show that it would take many years, probably until 2030 or 2040, before central banks could build up their reserves again. There are interventions such as reserve requirements to improve the balance sheet. It is also important that central banks are cautious if QE has to be applied again.

There is a need to consider what can be done to raise the equilibrium interest rate r*. The discussion on capital markets union is part of this as a dynamic capital market could raise r*. Another aspect is demography as raising the retirement age can make a significant contribution to r*. Further, capital flows from the global North to the global South should be used to finance investments in renewable energy. This may unlock productivity gains.

The Chairman noted that the ECB implemented a new operational framework. Liquidity will be tightened. We are also entering a period in which the ECB will undertake a new strategy review of its instruments, taking into account the lessons of QE and the disinflation period.

2.3 National structural reforms and effective progress towards the capital markets union (CMU) are essential for restoring growth

A public representative said that central banks and the ECB are in a unique situation with the balance sheets they have, which have ballooned enormously, especially during the Covid. It would be irresponsible to try to unwind these balance sheets quickly. It would destabilise not only the financial system but the whole economy.

After the Second World War, when debt was very high and central bank balance sheets were also inflated, they were brought down without destroying the economy or the financial system. The main factor that allowed that to happen was economic growth. President Lagarde has rightly said that it is time for the political world to wake up and start making the necessary reforms to achieve a structurally higher rate of growth and productivity growth. Central banks cannot do this alone. They need an environment in which they can use the appropriate instruments. One thing that is absolutely crucial for this environment is to work on the CMU, which is essential for economic growth.

The Draghi report gives a very precise list of what needs to be done to at least take important steps towards the CMU. 10 years ago, Jonathan Hill, who was then Commissioner for Financial Services in the then new European Commission, drew up a list of steps to be taken on the way to the CMU. Not surprisingly, Jonathan Hill's list and Mario Draghi's list are exactly the same. This is a disgrace for politicians. It has not been possible to take serious steps to complete this CMU. Such steps are necessary to allow central banks, including the ECB, to bring their balance sheets back to what should be considered normal levels.

2.4 Fiscal discipline must be restored in the euro area

The Chair agreed that monetary policy takes place in a specific context and cannot replace structured policies to generate growth. This is one of the issues that needs to be discussed among the lessons learned from QE. There was a lack of action on the supply side, and that was crucial. There is another related issue, which is fiscal policy. Monetary policy cannot be a substitute for fiscal policy, because monetary policy first and foremost has a price stability objective.

A market expert said that in Europe there is a group of countries that, more or less follow the prescriptions of the Stability and Growth Pact. Their public debt is around 60% of their GDP. Another group of countries has percentages closer to 110% or 120%. The main rules of the Stability and Growth Pact are not followed by very large players. Instead of having a cooperative system, we have an uncooperative system.

It is very difficult to have a stable monetary policy when a number of very important states have very strong deficit-oriented fiscal policies. It is very difficult to combine a stable monetary policy with a very unstable fiscal policy. There has to be some convergence. We have yet to see the beginning of that convergence.

Discipline has to be restored in the system, and particularly in those parts of the system that are hovering around 110% or 120% of GDP and running deficits of 5-6% a year. If this is not done, the system will become increasingly uncooperative, and the future of the Union will be at stake.

The Chair suggested that there is a consensus that when it comes to investment opportunities, what matters is whether the returns and productivity will be there. That is the key question. There is also the importance of fiscal policy in a monetary union. At the end of the day, it is a union and a cooperative effort is required. Countries cannot go in opposite directions.

2.5 Chair's wrap-up

The Chair summed up the need to work on inflation. Monetary policy must stay the course. An important lesson is that monetary policy is part of the policy mix, and by itself will not generate sustainable growth. This requires political will on the supply side. On the fiscal side, a cooperative environment is needed to support growth and also to allow monetary policy to operate without undue constraints. Draghi has provided a blueprint, but what is needed is action and political will.