Monetary policy in times of multiple challenges

Keynote at the annual reception of the Association of German Pfandbrief Banks (vdp)

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1 Introduction

Ladies and gentlemen,

Many thanks for your invitation and your kind welcome. It gives me great pleasure to be with you today.

Tomorrow, it will already be time to open the first door of our advent calendars. The run-up to Christmas is a relaxed and peaceful time for some, with activities such as visiting a Christmas market or baking biscuits. For others, however, it involves more stress. For many, as the turn of the year approaches, it is also a time to reflect on the year that is coming to a close and to think about the year to come.

Here at today’s annual reception, I would like to join you in looking back on monetary policy in 2023 before looking ahead to 2024. And, as the title of my speech suggests, we will address “multiple challenges”.

2 Key challenge: excessively high inflation

Of the many challenges facing the Eurosystem’s monetary policy, one is clearly key: inflation in the euro area has been too high for far too long. We in the Governing Council of the ECB (European Central Bank) must fulfil our mandate. We need to bring inflation back in line with our target of 2% over the medium term.

Developments observed over the past few months are encouraging: in September and October, inflation eased substantially – both in Germany and in the euro area. According to preliminary estimates, inflation rates as measured by the Harmonised Index of Consumer Prices fell further in November, down to 2.4% in the euro area and 2.3% in Germany. By comparison, they had peaked in October of last year at 10.6% and 11.6%, respectively.

In view of past price dynamics, the findings of a multi-year study on Germans’ fears are hardly surprising, but they are alarming.[1] This year, the cost of living going up was Germans’ number one concern (65% of respondents) for the second year in a row. As central bankers, our mandate in the ECB (European Central Bank) Governing Council is to bring inflation back under control and restore price stability. That way, people will no longer have to worry about inflation.

It is particularly inflation expectations that are important for monetary policy because they influence the way in which economic agents behave – for example, influencing households’ purchasing and saving decisions, employees’ and wage bargainers’ actions in wage negotiations and firms’ price-setting behaviour.

If economic agents expect price stability and behave accordingly, it is easier for monetary policy to achieve its objective. Conversely, monetary policy's job is made more difficult if higher inflation expectations lead, say, to higher wage increases or stronger price growth. A Bundesbank survey, for example, has shown that the Eurosystem's medium-term inflation target of 2% became significantly less relevant as an anchor in wage negotiations in Germany over the course of 2022. This is especially true with regard to trade unions' wage demands.[2]

As inflation has fallen since November 2022, the short-term inflation expectations of households in Germany and the euro area have moved in the right direction. As surveys by the Bundesbank, the ECB (European Central Bank) and the European Commission have all shown, the highs recorded in the second half of 2022 were followed by a downward movement. Since this summer, however, households' inflation expectations have tended to move sideways or, in some cases, even go back up, despite inflation rates continuing to fall at the same time.

There remains major uncertainty on the financial markets regarding longer-term price developments. While the markets are pricing in a further decline in inflation over the coming months, long-term market expectations are still a long way off from 2%. Market participants are continuing to hedge against the risk of excessively high inflation over the long term. And the war in the Middle East war has rekindled inflation risk.

The Eurosystem's 2% target serves as an anchor for inflation expectations, to be sure. However, what has been achieved is not something that monetary policy can be satisfied with.

3 Monetary policy: the year in review

Looking back, we tend to ask ourselves: What was good? What was bad? What could I have done better?

Ladies and gentlemen, through its interest rate hikes, the Governing Council of the ECB (European Central Bank) has made it crystal clear how determined it is to fight inflation. I am most satisfied with this as things stand today. In September, we increased the key interest rates for the tenth time in a row. Overall, interest rates have gone up by 4½ percentage points in a space of just 14 months.

As well as raising policy rates, we are scaling back the Eurosystem's balance sheet. So far, the fact that banks are repaying their loans under the longer-term refinancing operations has made a major contribution to reducing total assets. What's more, we first reduced reinvestments under the largest asset purchase programme, the APP (Asset Purchase Programme), and then discontinued them altogether in July. This is shrinking the Eurosystem's balance sheet by an average of around €25 billion per month.

Compared with just over a year ago, the balance sheet of the Eurosystem is around €1,700 billion smaller. However, its total assets still stand at roughly €7 trillion. So from my point of view, we could step up the pace. Because – and I will go into more detail here in a moment – a leaner central bank balance sheet is still desirable.

4 Outlook for 2024

And now it's time to look forward. In two weeks, the Governing Council of the ECB (European Central Bank) will meet for the last time this year. That is also when the new Eurosystem staff projections will be published. So far, inflation rates in the euro area are expected to remain well above 2% this year and next. In 2025, they will hopefully then be very close to target.

On the one hand, upstream prices are falling noticeably, and this will probably gradually be passed through to consumers. And the dampening effects of monetary policy tightening are having a lagged impact on prices. On the other hand, wage growth will probably remain robust, so the underlying price pressures are expected to ease only slowly. In October, the Governing Council of the ECB (European Central Bank) carefully weighed up the risks of inflation and decided not to raise policy rates any further.

Where will interest rates go from here? I won't try to answer this question because the right course of action now is to make data-driven decisions on a meeting-by-meeting basis. In my opinion, inflation risks are tilted to the upside, not least because of the current geopolitical situation. So I wouldn't rule out a further interest rate hike. At the same time, I believe it is considerably too early to even think about potentially lowering policy rates.

And looking ahead to next year, I assure you that we will remain persistent in the fight against inflation. The general public should have one less major issue to worry about. They should be able to sleep more soundly again and trust in price stability. So key interest rates must remain at a sufficiently high level for as long as necessary.

Another item on the ECB (European Central Bank) Governing Council's agenda is a review of the operational framework by the spring. It will focus on how we intend to manage short-term market interest rates in future and will involve various decisions that influence the future size and composition of the Eurosystem's balance sheet.

In my view, a leaner central bank balance sheet is desirable, especially because it creates additional space. It would give the market mechanism more leeway again, allowing resources to flow to where they can be used productively. And monetary policymakers would regain room for manoeuvre, enabling us to continue taking all the monetary policy measures necessary to ensure the primary objective of price stability.

We need to bring individual elements of the operational framework together to create a coherent overall package. For example, there are various ways of influencing the monetary policy stance via short-term interest rates. In other words, the framework for conducting monetary policy and the monetary policy stance are two very different things.

Potential losses in the central bank's balance sheet are also separate from the monetary policy stance. This topic will probably be back in the spotlight by the end of the winter at the latest, when the Bundesbank presents its annual accounts for 2023. The Bundesbank is carrying financial burdens created by the extremely expansionary monetary policy of previous years and the exceptionally sharp rise in interest rates that followed. But central banks neither seek to maximise profits, nor can they fail like commercial banks.

If the Bundesbank's financial buffers are no longer sufficient in the next few years, we will report a loss carryforward. Even in this event, the Bundesbank's balance sheet is sound. The Bundesbank has considerable assets above and beyond its financial buffers. What's more, a loss carryforward would be nothing new for the Bundesbank and would not prevent it from fulfilling its monetary policy mandate as part of the Eurosystem.

5 Multiple challenges

The exceptionally strong rise in interest rates is also associated with challenges for the financial system. At this point, I would like very briefly to touch upon the key messages contained in the recently published Bundesbank's Financial Stability Review.

The abrupt rise in interest rates has caused the market value of interest-bearing assets to drop. So far, the German banking sector has coped well, thanks not least to a good capital base. In mid-2023, vdp (Verband deutscher Pfandbriefbanken) member institutions likewise held just under €40 billion more common equity tier 1 capital than required by supervisors. (This equates to approximately 3.4% of risk-weighted assets.)

However, going forward, banks' net interest income is likely to be less of a support for earnings than in the current year. This is because German banks have so far benefited from having been slow in part to pass through the higher interest rate level to their customers' deposit rates. This interest rate pass-through is likely to accelerate if rates remain elevated. Households and firms have already begun to shift funds from low-interest sight deposits into higher-yielding time deposits.

On the credit side, the pass-through or transmission of the unprecedented rise in interest rates has so far been significantly stronger than on the deposit side. However, this does not mean that the transmission on the credit side is undesirably strong. All in all, our analyses conclude that the extent to which the tighter monetary policy is passed through is normal by historical standards.

Higher financing costs, a lower supply of credit and weaker demand for loans are intentional monetary policy effects. This is a necessary interim step in order to dampen aggregate demand and, ultimately, price pressures.

One area in which the interest rate reversal is having a clear impact is the real estate market, which you Pfandbrief banks also always monitor very closely. You are a step ahead with your vdp (Verband deutscher Pfandbriefbanken) real estate price index; roughly six weeks ahead of the Federal Statistical Office, to be precise. Your index, which is also widely used at the Bundesbank, suggests that prices continued to drop in the third quarter. According to vdp (Verband deutscher Pfandbriefbanken) statistics, prices for residential real estate are currently just under 6% below their mid-2022 peak. Commercial property prices have meanwhile fallen by just over 12% from their peak in the second quarter of 2022.

The Bundesbank's economists believe that the decline in residential real estate prices is likely to help bring down still-existing overvaluations. This will reduce the risk of strong price corrections in the future.[3] Nevertheless, I have no doubt that lenders will remain vigilant – not least because their collateral is losing value.

The Bundesbank sees elevated risks in the commercial real estate market. Here, a slight increase in credit defaults is already in evidence – albeit from a low level. The downturn in the commercial real estate market is being accompanied by structural challenges stemming from e-commerce, working from home and energy standards.

All in all, the effects of the rise in interest rates are not yet fully feeding through to banks' balance sheets. In addition, there are risks from structural change and heightened uncertainty. In this environment, institutions should maintain, and if possible strengthen, their ability to cushion negative developments without external assistance. Profits should therefore be used to strengthen their resilience.

This brings us to the next and final part of my speech. The interest rate reversal is not the only phenomenon that is making adjustments necessary. At the same time, there are fundamental transformation processes that undoubtedly pose challenges – for both the economy and society as a whole. These are, first and foremost, deglobalisation trends, decarbonisation, digitalisation and demographics – in a nutshell: the four Ds.

5.1 Deglobalisation trends

Let's start with possible deglobalisation trends. In principle, it makes no sense to forego the advantages of an international division of labour. However, the experiences gained during the pandemic have prompted a rethink, with the need seen to make supply chains more stable. And what has happened with Russian energy commodities since the start of the Ukraine war is grist to the mill of critics of unilateral international ties.

"Geo-economic fragmentation" is the catchword here. This refers to political efforts to disentangle economic relations with certain countries and to limit dependencies. At least in the case of strategically important goods, some enterprises might well reshore parts of their production and the associated supply chains over the next few years: by homeshoring, nearshoring or friendshoring them.[4]

From a monetary policy perspective, it is important to note that more security for supply chains is likely to come with a price tag. Greater inflationary effects could be expected, in particular, if supply relationships had to be abandoned abruptly. By contrast, a gradual adjustment of supply chains is likely to have only limited effects on inflation. This naturally depends on the size of potential cost increases and the extent to which they are passed on to customers. In any case, scientific studies have found only limited effects on headline inflation during the era of globalisation[5] though we have probably all felt the price-lowering effects of globalisation on individual products. As a central bank, we will be keeping a close eye on these developments.

5.2 Decarbonisation

The second D, decarbonisation, also represents a far-reaching restructuring of the economy. The ever-higher record temperatures and the increasing frequency of extreme weather events such as drought or heavy rainfall, coupled with the consequences of such events, show just how essential and urgent the ecological transformation is.

An appropriate price for each tonne of CO_2 emitted is the most efficient means of climate action. It creates market incentives to consume less, to invest more in green technologies and thus to generate lower emissions. There is also the scope for spending created by revenue – to mitigate social hardship, for instance. Carbon prices are likely to rise significantly on the path to net zero. In addition, measures mandating or prohibiting certain actions may come into consideration. However, these can selectively lead to even stronger cost increases in certain areas.

It is not only the transition to a greener economy that entails costs, but also climate action and the increasing damage being caused by climate change. Imagine, for example, that drinking water were to become increasingly scarce and expensive.

Monetary policymakers must therefore expect a trend increase in price pressures over a given transitional period. How things will progress from there is still highly uncertain. If the wind and sun are sufficient, the electricity produced by wind and solar power is unrivalled in terms of affordability – meaning that electricity prices could even fall, under certain conditions.[6]

The extent to which the transition poses challenges for the economy and monetary policy will crucially depend on how climate action and economic policy are set out. For example, model analyses by the Bundesbank show that, in the event of a disorderly climate policy transition, the economy might experience considerable additional burdens.[7]

If climate and economic policy measures are aligned with the long-term objective in a coherent and efficient manner, they can make a significant contribution towards reducing risks and uncertainties. Our experts' calculations, for instance, show that reliably predictable carbon price pathways are likely to generate, at most, moderate inflationary pressure – something that monetary policymakers would have to take into account.

5.3 Digitalisation

The third D, digitalisation, is in full swing. All-purpose technologies such as artificial intelligence are developing at breakneck speed. It must be questioned whether digital change will make firms more efficient, and whether the productivity of the economy as a whole will ultimately increase. This is crucial to economic growth and prosperity.

Productivity growth has been low in many industrial countries for some time now, even though digital technologies are spreading rapidly. This comes as something of a surprise, because digitalisation is said to be capable of sustainably increasing labour productivity.

Our economists at the Bundesbank examined the period between 1997 and 2018 and deduced the following for the large euro area countries:[8] efficiency gains in the digital sectors were significantly higher than in the rest of the economy. And although the digital sectors account for only a relatively small share of the economy as a whole, they have had a decisive impact on the macroeconomic development of labour productivity.

Without efficiency gains in these sectors, productivity growth in the large euro area countries would have been considerably lower, or productivity would have even stagnated. However, the efficiency-enhancing power of digital change appears to have diminished over the period under review (up to 2018). While the pandemic did subsequently boost the use of digital technologies, it is not yet possible to say precisely whether this will lead to measurable efficiency gains. That being said, surveys of firms on this subject are yielding optimistic results.

Where digital transformation processes increase labour productivity, this, taken in isolation, drives down firms' unit labour costs, easing price pressures under otherwise equal conditions. This would relieve some of the work of monetary policymakers, as otherwise price pressures would be even higher.

5.4 Demographics

However, there is a growing body of evidence suggesting that the ageing of society is reducing innovation and the proliferation of new technologies.[9] The fourth D, demographics, can be summed up quite easily: the population is getting older. And, without significant immigration, it will contract. As things stand, more than one-fifth of people in Germany are aged 65 or above – and this trend is on the rise.

A topic that is now becoming increasingly significant is the fact that demographic developments are likely to lead to a decline in the labour supply. In Germany, the number of baby boomers going into retirement will probably, in just a few years, already outnumber the number of young people entering the labour market, despite net immigration.

There is already a widespread shortage of staff today. Businesses are not only frantically searching for highly qualified specialist staff – labour is in short supply across the board. This is particularly the case in structurally expanding sectors of the economy that have greater staff requirements, such as health and social services and IT (Informationstechnologie). In other areas, however, even in times of economic difficulty, firms are often loath to dismiss employees for fear of not being able to replace them once the situation improves again. This hoarding of workers is also probably one reason why unemployment remains relatively low at present.

As labour shortages increase, competition for workers is likely to become even stronger. Policymakers can counteract labour shortages by improving the framework conditions to create a greater supply of labour. However, it is my responsibility as a monetary policymaker to be aware of the potential consequences of permanently tight labour markets.

Persistently higher wage pressures could amplify domestic inflation. Bear in mind in particular that the price of services is heavily dependent on wages. Monetary policy would have to respond to such wage-driven inflationary pressures by tightening monetary policy accordingly.

6 Conclusion

Ladies and gentlemen, we can either rise to meet challenges or be overcome by them. This is true of many situations in life, but also applies to the economy. More specifically, the challenges an economy has weathered can make it more efficient, resilient and future-proof. Here, price stability creates a sound foundation for all economic activity. Monetary policy has made substantial progress in its key challenge of combating excessive inflation in the euro area. We must be wary of slackening our efforts too soon.

For 2024, which will soon be upon us, I have four wishes for you, though they do not begin with D: good fortune, health, happiness and every success in rising to the challenges of the future! Above all, I hope that the global situation will become more peaceful and that timely progress will be made in addressing climate change.

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