Luis de Guindos: The economic outlook and monetary policy in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 14th edition of Spain Investors Day, Madrid, 10 January 2024.

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Over the past two years, economic developments in the euro area have been shaped by the easing of pandemic-related supply constraints and by the energy price shock in the wake of the Russian invasion of Ukraine. Before that, inflation had been low and monetary policy accommodative, but the surge in inflation to unprecedented levels in 2022 prompted the ECB to normalise and tighten monetary policy. In December 2021 we announced a gradual reduction in our asset portfolio and in July 2022 we increased our key interest rates for the first time in 11 years. This was followed by nine consecutive hikes that raised interest rates by a total of 450 basis points by September last year. In 2023 a lot of progress was made in curbing inflation. However, more needs to be done to ensure a timely and sustainable return of inflation to our 2% medium-term target.

In my remarks today I will provide an overview of the latest economic developments and the rationale behind the monetary policy decisions that we took in December. I will then discuss the outlook for the euro area economy for the coming months.

Inflation

2023 ended with an inflation rate of just below 3% in December, which was good news. The uptick from November was widely expected, reflecting base effects and the withdrawal of energy support measures. Euro area inflation had been above 10% in October 2022 and at 8.6% at the start of 2023. The decline in 2023 affected all the main components of headline inflation, confirming a broad-based disinflationary process that gained momentum in the second half of the year.

Food inflation has declined substantially from its peak of over 15% in March 2023, but remained high at just above 6% in December. Energy inflation remained deep in negative territory in December, recording the eighth consecutive decline since May 2023.

Another important aspect is that core inflation entered a clear downward trajectory, continuing to decline to 3.4% in December. Services prices have been slower to recede, but they fell sharply in November and remained stable in December. Taken together, these trends reflect the indirect effect of falling energy prices, the easing of supply bottlenecks and the increasing pass-through of our monetary policy tightening to demand. However, high wage pressures, the outcome of upcoming wage negotiations and intensifying geopolitical tensions add on uncertainty around the future path of inflation.

The rapid pace of disinflation that we observed in 2023 is likely to slow down in 2024, and to pause temporarily at the beginning of the year, as was the case in December

2023. Positive energy base effects will kick in and energy-related compensatory measures are set to expire, leading to a transitory pick-up in inflation, similar to what has happened with Spanish headline inflation in recent months. Inflation in Spain peaked in July 2022, reaching 10.7%, and disinflation set in earlier than in other euro area countries, with the rate coming down to 1.6% in June 2023. Since then, the large drop in energy prices has fallen out of the calculation and inflation increased by an average of 3% between July and December.

Economic activity

By contrast, growth developments are more disappointing. Economic activity in the euro area slowed slightly in the third quarter of 2023. Soft indicators point to an economic contraction in December too, confirming the possibility of a technical recession in the second half of 2023 and weak prospects for the near term. The slowdown in activity appears to be broad-based, with construction and manufacturing being particularly affected. Services are also set to soften in the coming months as a result of weaker activity in the rest of the economy.

The labour market continues to be particularly resilient to the current slowdown. The euro area unemployment rate stood at 6.4% in November, broadly unchanged from October and close to its historical low.

However, we are seeing the first signs of a correction taking place in the labour market. The latest data on total hours worked show a slight decline in the third quarter, the first since the end of 2020. This is mainly driven by the reduction in the average hours worked offsetting the increase from the rise in employment. The continuous decline in job vacancy rates, which marginally decreased again in the third quarter, suggests that the ongoing labour market adjustment may also weigh on the number of jobs.

Financial and monetary conditions

With regard to financial and monetary conditions, our past interest rate increases continue to be transmitted strongly to financing conditions, with lending rates for business loans essentially unchanged in November, at over 5%, and mortgage rates increasing to 4%. The tight financing conditions are propagating through the economy, dampening demand and helping to push down inflation.

Before taking its December decisions, the Governing Council closely considered their implications in terms of fragmentation risk and financial stability. Government bond markets are stable, sovereign yield spreads have been resilient to the normalisation of the Eurosystem's balance sheet, and investors have been able to absorb the extra securities released by the reduction in the asset purchase programmes. Euro area banks have proven resilient, boasting comfortable levels of capital and strong profitability which make them well equipped to withstand adverse shocks. Despite these strong fundamentals, bank valuations remain compressed, pointing to concerns about the long-term sustainability of bank earnings amid weak growth prospects, increased downside risks from deteriorating asset quality, lower lending volumes and higher funding costs. Direct and indirect links between banks and the lightly regulated non-bank financial sector also pose risks to the financial system as a whole and highlight the need to boost non-bank resilience going forward. The overall outlook thus calls for

vigilance and macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities.

Monetary policy

At its December meeting the Governing Council decided to keep the three key ECB interest rates unchanged. This decision was based on the overall assessment of the economic and inflation outlook, as well as the effects of our monetary policy. We believe that the current level of interest rates, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target.

At the last meeting we also decided to advance the normalisation of our balance sheet. We intend to continue to reinvest in full the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) during the first half of 2024. Over the second half of 2024, the PEPP portfolio will decline by €7.5 billion per month on average. We discontinued asset purchase programme reinvestment of redemptions in July 2023 and we expect to discontinue the reinvestments under the PEPP from 2025.

The key ECB interest rates are our primary tool for setting the monetary policy stance. Our future decisions will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

Conclusion

The events of the last two years have significantly shaped economic developments in the euro area, pushing up inflation to levels not seen since the introduction of the euro. In response, we started a gradual reduction in our asset portfolio and we increased our policy rates by a total of 450 basis points. Our strong reaction was key to prevent a de-anchoring of expectations and to curb inflation. In terms of economic activity, the slowdown has so far been contained and gradual. However, the incoming data indicate that the future remains uncertain, and the prospects tilted to the downside.

The inflationary shock that we were confronted with following the energy crisis has been particularly challenging: it occurred in an already difficult environment, with the world economy recovering from the pandemic and global supply chains still disrupted. Furthermore, supply side shocks are particularly difficult to manage using monetary policy instruments. In this context, sustainable and investment-oriented fiscal policies aimed at promoting the energy transition, strengthening the resilience of supply chains and increasing euro area productivity are supportive of our price stability goal. Structural reforms and investments to enhance the euro area's supply capacity can help reduce price pressures in the medium term.

In this regard, we very much welcome the agreement on the EU's economic governance framework reached a few weeks ago. It is a powerful signal to markets as it reduces uncertainty about fiscal rules in the EU. The reformed framework will help strike a balance between sustainable public finances and sufficient debt reduction on the one hand and room for reforms and investment on the other, while supporting

countercyclicality of fiscal policies. Achieving this balance turned out to be less straightforward than we might have hoped. It is now crucial that the new fiscal framework is implemented properly and without delay.

Thank you for your attention.