Luis de Guindos: Monetary policy, financial stability and medium-term growth in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 8th Annual Conference of Mediterranean Central Banks, organised by the Croatian National Bank, the Bank of Spain, the OECD, the IEMed, and the UfM, Split, 14 February 2024.

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Over the past few years the euro area economy has experienced unprecedented shocks that created exceptional uncertainty and drove inflation to record highs. In response to these inflationary pressures, we embarked on the most forceful rate hiking cycle in the history of the euro. Credibility – very much the focus of today's conference – is a key central bank asset that becomes even more important in times of high uncertainty. Our policy measures are making a substantial contribution to reducing inflation, demonstrating our commitment to ensuring that inflation returns to our two per cent medium-term target in a timely manner.

In my remarks today, I will first review the state of the euro area economy and our latest monetary policy decisions. I will then turn to financial stability considerations, before concluding with some thoughts on why action to support the euro area economy is also needed from other policy actors.

Economic outlook and monetary policy

Our interest rate decisions are guided by three considerations: first, the inflation outlook in light of incoming economic and financial data; second, the dynamics of underlying inflation; and third, the transmission of our monetary policy to financing conditions and the real economy.

Starting with our first criterion, incoming information has broadly confirmed the medium-term outlook from our December macroeconomic projections. Economic activity is likely to have stagnated in the fourth quarter of 2023 and incoming data continue to signal weakness in the near term. At the same time, some forward-looking survey indicators point to a pick-up in growth further ahead. Although headline inflation increased in December to just below 3%, on account of energy base effects reflecting impacts from the fiscal measures a year ago, the rebound was somewhat weaker than expected. Aside from energy, all the main components of inflation fell or remained unchanged. Meanwhile, headline inflation declined again in January. This means that the disinflationary process is continuing. We also expect inflation to ease further over the course of this year amid the fading impact of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy, and as tight financing conditions continue to weigh on demand. The disinflationary trend is also evident in both market and survey-based measures of inflation expectations, which have come down markedly at shorter horizons and are consistent with our target at longer horizons.

The recent shocks not only drove inflation to record highs but also made macroeconomic forecasting especially challenging. Looking at the euro area inflation forecast errors, we have observed two things. First, the absolute size of the errors has declined. And second, the errors have switched sign: inflation is now coming in somewhat below, rather than above, the projections. On the one hand, these developments highlight the lack of bias in the projections. On the other, they reveal a large uncertainty around the baseline projections. It is therefore essential that we do not look at the projections in isolation, but rather alongside incoming data.

Let me now turn to the second criterion. Almost all indicators of underlying inflation are continuing to decline while the range has been narrowing. This confirms that the disinflationary process is under way. Some of the measures are still high, however, as it takes time for the impact of past shocks to fully fade. Domestic inflation – which is more wage-sensitive – has also been moderating but remains elevated and is now at the top of the range amid falling labour productivity and elevated wage growth in the context of a robust labour market. Indeed, the unemployment rate is at its lowest level since the introduction of the euro – despite slowing labour demand and fewer vacancies being advertised more recently. But the impact of higher unit labour costs on inflation is being cushioned by lower unit profits.

Moving to the third criterion, our past policy rate increases continue to be transmitted forcefully into financing conditions. In the course of our current hiking cycle, the increase in bank lending rates has reached levels not seen since the launch of the euro. Meanwhile, the weakening in credit has been stronger and faster than in past hiking cycles. Bank lending conditions remain tight and lending flows are still weak, although the latest bank lending survey showed first signs that the net tightening of credit standards and a decline in loan demand are moderating. Tighter financing conditions are also making their way through the economy by dampening demand, helping to push down inflation. And given the typical lags in monetary transmission, much of the economic impact of our past policy rate hikes will continue to materialise over time.

Financial stability

The pass-through to economic activity poses challenges for vulnerable sectors. Higher interest rates in particular weigh on the debt servicing capacity of highly indebted corporates. For these firms, any potential downside surprises in growth could result in subdued earnings, which could further affect debt servicing capacity. Real estate firms remain particularly vulnerable to losses stemming from the downturn in euro area real estate markets. The ongoing downturn is particularly acute in the euro area commercial real estate market, where both activity and prices declined sharply in 2023. On both sides of the Atlantic, the effects of higher interest rates on this sector have been compounded by structurally lower demand for some real estate assets following the pandemic.

Some non-banks and specialised banks remain heavily exposed to interest rate-sensitive sectors, such as highly indebted corporates and real estate. Further deterioration in these sectors could expose intermediaries to revaluation losses and investor outflows. This is especially relevant for open-ended investment funds with mismatches between asset liquidity and redemption terms, including real estate investment funds with a large market footprint in commercial real estate markets in several euro area countries. Low levels of liquidity raise the risk of forced asset sales if macro-financial outcomes deteriorate.

In fact, despite some recent portfolio rebalancing by non-banks, the sector is still showing high duration, credit and liquidity risk. Entities remain vulnerable to asset price corrections amid macroeconomic uncertainty and volatile markets. Parts of the non-bank financial sector also have significant leverage on and off-balance sheet. Fragilities in the sector pose risks to the financial system, also due to its links to the banking sector. Banks and non-bank financial institutions can be closely interconnected through funding channels, ownership linkages and common risk exposures.

In contrast, the euro area banking system has been a source of resilience, with solid capital and liquidity buffers on the back of strong regulation and robust supervision. Bank profitability has strengthened in recent quarters, supported by higher interest rates that compensated lower lending volumes. However, weak lending growth, rising funding costs and deteriorating asset quality are likely to pose downside risks to profits in the future. While asset quality indicators have been quite robust, there are early signs of deterioration in some loan portfolios, including smaller firms and sectors such as construction and commercial real estate. Nonetheless, the current environment of macroeconomic uncertainty shows the importance of remaining vigilant – banks should be prepared for a possible worsening of economic conditions.

Sovereign funding costs have remained stable and contained throughout the tightening cycle, and as the Eurosystem gradually reduces its presence in the sovereign bond market. However, weak growth developments or fiscal slippage could reignite concerns around sovereign debt sustainability, especially in countries where debt is already high.

Challenges ahead

While inflation is on the right track, we need to keep a close eye on the risk factors at play. On the upside, wage pressures remain high and we do not yet have sufficient data to confirm they are starting to ease. Profit margins could also prove more resilient than anticipated. Heightened geopolitical tensions, especially in the Middle East, could raise energy prices and disrupt global trade.

While we are heading in the right direction, we must not get ahead of ourselves. It will take some more time before we have the necessary information to confirm that inflation is sustainably returning to our two per cent target. That is why we will continue to be guided by data. The next few months will be especially rich in new information on drivers of underlying inflation as we receive data on latest wage settlements and price re-setting by firms. We will also have the benefit of new projections in March. In any case, our future decisions will ensure that our policy rates will be set at sufficiently restrictive levels for as long as necessary.

Adding on to the challenges discussed so far, the unprecedented shocks of the past few years have also had profound effects on the euro area's low and declining medium-term growth. Euro area potential growth is estimated to have mostly recovered from the pandemic, thanks to sizeable policy support measures such as job retention schemes and the expected impact of the Next Generation EU programme. However, potential growth is very likely to slow down in the future. In this context, other policy areas – notably fiscal and structural policies – have a crucial role to play in complementing monetary policy and supporting euro area growth potential.

Potential output is determined by three main factors. First, total factor productivity, which hinges on supply conditions like the state of technology, as well as market structures and regulations that facilitate an efficient allocation of available resources across firms. The outlook for productivity growth, which has been disappointing in recent decades, especially compared with other major economies, depends in part on how the green and digital transitions play out. Although this twin transition is expected to contribute positively in the longer run, there may be an initial cost as companies have to adjust to new technologies. Second, capital accumulation, which has slowed down considerably since the great financial crisis. Furthermore, it continues to face an uncertain outlook given the increased volatility and high frequency of supply shocks, which may have disrupted investment plans for both tangible and intangible capital. Third, the contribution of labour, which has been the main engine of potential growth in the euro area in the past few years due to strong inward migration, increasing participation of women and the elderly in the labour market, and declining trend unemployment. It is however expected to dampen, reflecting negative demographic developments as the euro area population is projected to decline owing to low fertility rates, assuming no further support from migration[1].

Fiscal and structural policies need to address low growth prospects in the euro area, while also gradually bringing down high public debt ratios. Structural reforms and investments that improve the euro area's supply capacity – which would be supported by the full implementation of the Next Generation EU programme – can help to reduce price pressures in the medium term, while supporting the green and digital transitions. In particular, policies to support public and private investment in research and development, digitalisation and sustainable production processes can increase the euro area's competitiveness and productivity, which currently lag behind those of the United States and China. Additionally, structural reforms that promote labour force participation, support and upgrade education, and improve the matching of skills between labour supply and labour demand can help to mitigate the impact of demographics.

Measures of financial integration in the EU also remain stagnant. The financial system has remained stable, and financial integration has proven resilient to the major shocks but has seen limited progress. EU debt and equity markets are still very fragmented along national borders. As we celebrate ten years of banking union, we have to recognise that it is still incomplete. The capital markets union is also still in its early stages of development, with no visible progress on the main obstacles of taxation or insolvency law. Reducing national and EU regulatory barriers[2] and deepening the Single Market are also key to enhance the euro area's competitiveness and attractiveness for investment.

The unprecedented series of shocks experienced in the EU and around the globe forced policymakers to focus on swift short-term responses. Both the pandemic and the energy crisis were met with prompt policy measures. In that context, it was perhaps understandable that attention was temporarily deflected from the medium-term vision on EU growth and its challenges. But it is imperative that policymakers now refocus on the medium-term growth prospects. The findings of upcoming reports on the EU's competitiveness and the future of the European project will need to be taken into account. Structural reforms and investment to address low and declining potential growth require a concerted effort. The cohesion of the euro area and future prosperity of the EU depend on it.

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[1] Although total factor productivity, the capital stock and labour supply are all crucial in any production process, only the first of these elements can sustain economic growth in the long run for two reasons. First, total factor productivity is not a finite resource. And second, increasing productivity incentivises firms to invest further in capital and workers, while making it less costly to do so in an environmentally sustainable way.

[2] According to a 2022 European Investment Bank survey, more than 50 per cent of firms in Greece and Spain and more than one-third of firms in Italy, Portugal and Cyprus consider bureaucracy, restrictive regulations and high tax burdens to be major obstacles to investment.