SPEECH

Play defensively, but be ready to strike back: a gradual easing of monetary policy

'We can continue to, slowly but surely, lift our foot off the brake. In doing so, we will follow a data-dependent and meeting-by-meeting approach.', said Klaas Knot in his speech at Analysis Forum, Milan, today. Knot spoke about the outlook for inflation and monetary policy in the euro area, both in the short and longer term.

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It's great to be back at Analysis, and it's great to be back in Italy. As some of you may know, I've had a love affair with your country ever since my time as a student in Pavia, 34 years ago. Although I must say that it's also a bit of a relief to be away from the Netherlands for a few days. Because, well… this is more or less what my country looks like right now.

I love football, I really do. But this is a bit too much even for me. Thankfully, we always have monetary policy to talk about.

Of course, I realise that most of you are probably preoccupied by tonight's game against Spain. But please spare me your attention for just a few minutes. So let's kick off.

Two weeks ago the ECB decided to lower its policy rate by 25 basis points.

The question everyone is asking: at what pace and up to what point will the ECB continue its descent from restrictive territory? How will our monetary policy evolve in the short and longer term?

The simple answer is that we're sticking to our data-dependent approach. The three criteria that we used when inflation was on the way up will remain relevant on the way down. They are: the inflation outlook in the light of incoming data; the dynamics of underlying inflation, and the strength of monetary policy transmission.

Let me go through these three criteria one by one.

First, the inflation outlook. Looking at our latest forecast, inflation is expected to reach our target of 2% by the end of next year. Forecast errors have also become smaller, which allows us to be more confident in our outlook. Moreover, inflation data show we are well underway in the disinflation process. Inflation has come down from a peak of over 10% to below 3% currently. That being said, the recent uptick in the May inflation figures reminds us that this process is bumpy and will remain so, at the least for the rest of this year.

Wage growth still elevated

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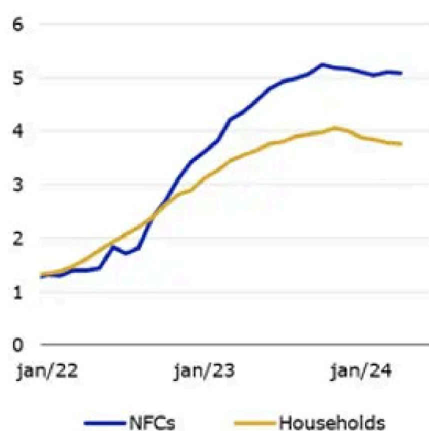
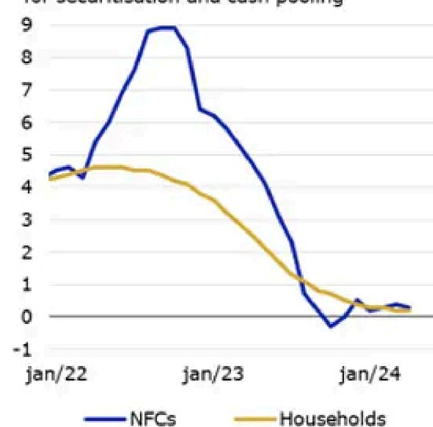
Let me now turn to the second criterion that guides our policy, the dynamics of underlying inflation. Core inflation has come down, again with some hiccups. Meanwhile, most other indicators of underlying inflation have also eased. At the same time, services inflation and, related, wage growth, which you can see on the chart, remain above levels consistent with our 2% inflation target. So here, not all the signs are green yet.

Lending rates and loan volumes point to strong transmission





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Source: ECB

Finally, regarding monetary policy transmission, our 450 basis points of rate hikes have been transmitted very forcefully into lending rates. You can see this in the graph on the left, which shows the interest rate on new bank loans for households and businesses. In terms of transmission there may even still be something in the pipeline, as existing loans are being

refinanced. Also, credit growth has come down substantially and is now hovering around zero, as you can see on the right.

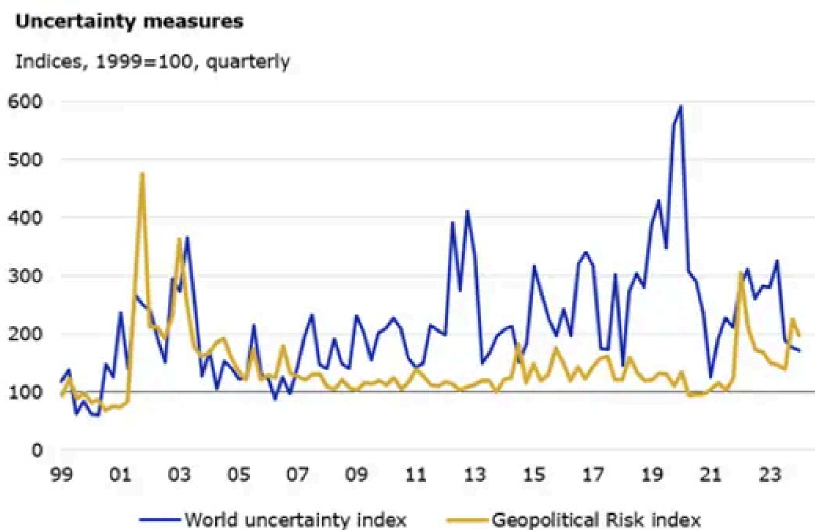
So, based on these three criteria, we reached our decision two weeks ago to cut our policy rate by 25 basis points. And these criteria will continue to guide our monetary policy stance in order to ensure that inflation returns to target in a timely manner and inflation expectations remain anchored.

This way of conducting monetary policy can be summarised in one short sentence: wait for incoming data, including new projections, and then decide accordingly. It sounds really simple. But as Dutch football legend Johan Cruijff once said in his inimitable football Latin: football is very simple, but the most difficult thing there is, is playing simple football. The same is true for monetary policy. Because underneath this seemingly simple framework and its guiding criteria, we are confronted with uncertainties that make forecasting inflation and calibrating policy far from simple.

For one thing, despite 25 years of institutional history, we have little experience with a gradual easing of monetary policy following a tightening cycle.

Moreover, every cycle is different, particularly since the global economy has undergone important structural changes in the macroeconomic, financial and policy domains over the past decades.

Global uncertainty remains elevated



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Source: Ahir, Bloom and Furceri (2022) and Caldara and Iacoviello (2022)

Another reason is that we are currently in an environment characterized by high uncertainty, as you can see in the graph, which makes the assessment of inflation drivers particularly challenging (see Verwey et al., 2023 and Bloom, 2023 Verwey et al., 2021). This high uncertainty reflects the high frequency of large shocks, in particular on the supply side, as well as geopolitical risks and structural changes in the economy that are difficult to

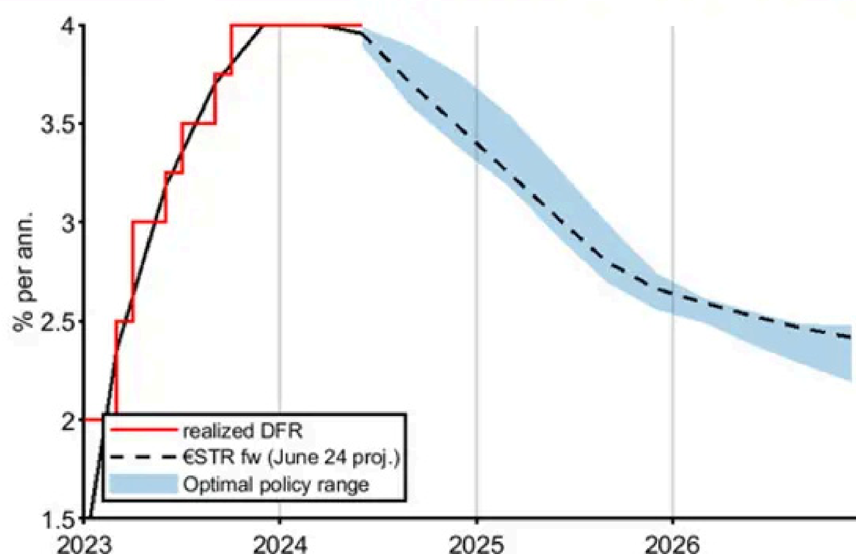
capture in our models. These include de-globalisation, demographics, digitalisation, climate change. In particular, we need to better understand the dynamics of labour markets and their drivers.

So what policy conclusions for the short term can we draw from this?

The inflation projections that I just mentioned imply a “soft landing”: we expect inflation to return to target in a timely manner and without triggering a major economic downturn. Basically, you could say the score is one-nil – we have taken the lead.

With this outlook, monetary policy can “play defensively”. Here I mean that our policy decisions can help facilitate this projected inflation path to materialize, rather than trying to shift this path in any direction. It’s a bit like following the tactics of the legendary Giovanni Trapattoni.

Market pricing in line with optimal policy paths



Source: DNB calculations around the June 2024 Eurosystem staff projections

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At the time of the latest inflation forecast, a little under three rate cuts were priced in for 2024 by financial markets. Would such a path make sense? One way to assess this in a more formal way is to look at so-called “optimal” policy scenarios, shown in the graph, which are based on analysis conducted by DNB. These optimal scenarios are derived from models in which monetary policy tries to minimize deviations of inflation from target and output from its potential. The range in the graph indicates the variation of outcomes depending on the choice of model and different weights that the central bank attaches to inflation relative to growth. As you can see in the graph, the rate path priced in by markets at the time of the forecast (represented by the dashed line), is in fact broadly in line with these optimal policy scenarios (see Knot, 2024 ↓).

Market expectations of the ECB’s rate path have shifted around over the past weeks, reflecting incoming data, but are currently broadly in line with the market pricing at the

time of our projections. These shifts show that the road to our target can be a bit bumpy but that markets understand our data-driven reaction function.

All in all this means that – based on the information we currently have - we can continue to, slowly but surely, lift our foot off the break. In doing so, we will follow a data-dependent and meeting-by-meeting approach. Since the current outlook allows us to reduce rates at a gradual pace, there is a strong case for using projection meetings to recalibrate our policy stance, as these meetings allow us to update our assessment based on a richer set of information. This is particularly the case at the current juncture, given still lingering risks of higher wage growth.

Looking beyond the short term, now that we are deep into the second half, the natural question to ask is: what did we learn from this high inflation episode for monetary policy in the future? How can we best cope with an environment of multiple supply shocks, high uncertainty, and structural changes? How do we decide on looking through versus pushing back against supply shocks?

I do not have the answers to all these questions. But let me offer some initial thoughts that could be explored for monetary policy in the future. The overarching theme connecting my reflections is the desire to retain a sufficient degree of flexibility in the face of new and possibly more frequent shocks.

First, when inflation pressures started to mount in the course of 2021 following a prolonged period of below-target inflation, we decided to wait with tightening our policy until sufficient evidence was available to suggest that the large inflation shocks were not just temporary. Once a second inflation shock hit in the spring of 2022, with the Russian invasion of Ukraine, it became evident that inflation pressures became persistent. Although that meant we started tightening policy a little bit later than we could have, our forceful response prevented high inflation from causing a de-anchoring of inflation expectations.

Inflation expectations broadly in line with target

Source: ECB, Refinitiv and Consensus Economics

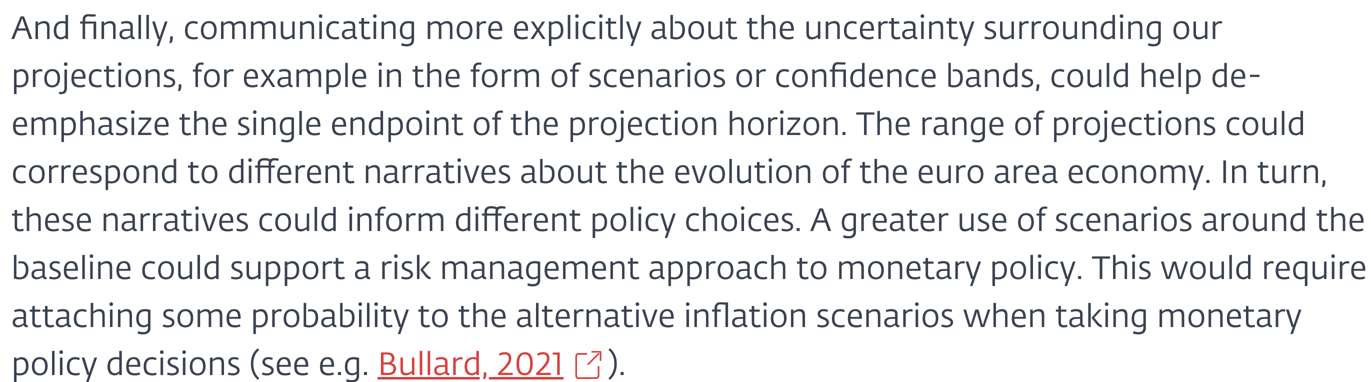
And as you can see in this graph, inflation expectations, based on both financial markets and survey data, have remained broadly in line with our target.

This decision to wait with tightening policy can be seen as reflecting a risk management approach, whereby we weighed the risk of high inflation becoming persistent if we did not react strongly against the risk of triggering a hard landing of the euro area economy (Lane, 2024).

Applying flexibility going forward could allow us to look through small deviations from our target, as long as we respond especially forcefully to larger deviations, either to the downside or to the upside.

In football terms, this means having your defence in order, let your opponent come slightly into your half to see what he's up to, and striking back with force in the counter-attack if needed. Which is exactly what Trapattoni would do.

Second, given the need to counter quickly when shocks do persist, it is important that we retain flexibility in the use of our instruments. In response to the prolonged period of low inflation following the global financial crisis, and the subsequent COVID-shock, we resorted to a combination of low rates and balance sheet policies reinforced by providing forward guidance on both elements. When inflation increased, we made it clear that any rate hike would be preceded by a discontinuation of net asset purchases. While such forward guidance can bolster the effect of our policies and reduce uncertainty for market participants, too much precommitment can also hamper our ability to adjust our stance quickly. This trade-off between forward guidance and flexibility is something to be very much aware of in the future.



And finally, communicating more explicitly about the uncertainty surrounding our projections, for example in the form of scenarios or confidence bands, could help de-emphasize the single endpoint of the projection horizon. The range of projections could correspond to different narratives about the evolution of the euro area economy. In turn, these narratives could inform different policy choices. A greater use of scenarios around the baseline could support a risk management approach to monetary policy. This would require attaching some probability to the alternative inflation scenarios when taking monetary policy decisions (see e.g. Bullard, 2021).

Some of these topics could return in our interim strategy review, which will take place in 2025.

I hope that you are still with me, and that your minds haven't drifted too much to tonight's match. Although you would be forgiven if they have. In any case, the most important takeaway is that, given the current environment we still have to avoid any commitments on a specific future rate path. We may be one-nil up, but we are playing a tough opponent, so it's still too early to declare victory. Or as 'il Trap' put it: "Non dire gatto se non ce l'hai nel sacco." Our data-dependent approach allows us to assess the incoming data and inflation outlook moving from one meeting to the next and to adjust our policy stance accordingly.

I think I just heard the final whistle so let me just say that I am looking forward to an insightful discussion. Thank you!

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