Joachim Nagel: Current monetary policy topics

Speech by Dr Joachim Nagel, President of the Deutsche Bundesbank, at the Commerzbank AG event "Geldpolitik in Zeiten der Inflation", Frankfurt am Main, 18 September 2024.

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1 Words of welcome

Ladies and gentlemen,

I hope you have recharged your batteries after the summer and a holiday break, despite the eventful days we can look back on. Perhaps you are still relishing the sporting highlights you experienced from the comfort of your own armchair: the thrill of watching the Olympic Games and the Paralympics on TV at home.

A "sports programme" of a somewhat different variety now awaits us: a broad repertoire of topics to cover in a short allotted speaking time. Let's begin by discussing three questions that are always of crucial importance: Where is economy activity heading? Where is inflation heading? And where is monetary policy heading? These will be followed by three topics specific to monetary policy: balance sheet reduction, the changed operational framework for monetary policy, and monetary and fiscal policy interactions.

2 Economic activity

Let's kick off with the economic situation as well as the outlook for the economy. German economic output shrank by 0.1% in the second quarter of this year, after expanding slightly at the beginning of the year. The main drags on activity were weak investment and the construction sector, but exports and private consumption contracted somewhat as well.

Increased financing costs continued to squeeze investment activity, thus crimping domestic demand for industrial goods and construction work. Private investment also faced headwinds stemming from the intense uncertainty surrounding economic policy. On top of that, there was a countereffect in construction activity following the mild weather conditions in the first quarter. Moreover, industry in Germany is still feeling the pinch of weak foreign demand. Capacity utilisation in industry is now significantly below average, and that, too, is depressing investment.

All these factors combined mean the domestic economy has been treading water since the start of Russia's war of aggression against Ukraine more than two years ago. Stagnation might be more or less on the cards for full-year 2024 as well if the latest forecasts by economic research institutes are anything to go by.

Hopes that industrial activity might pick up in the second half of the year have dimmed considerably according to the sentiment indicators observed in recent months. And consumer restraint is looking more stubborn than our Bundesbank experts were expecting when we published our Forecast for Germany in June. For all this, though, it is still true to say that sharply rising wages, easing inflation and robust labour market developments are opening up more and more scope for spending. Households could leverage that scope to gradually step up their consumption. Looking ahead to next year, the economic research institutes are expecting to see tentative economic growth of between ½ and 1%. The Bundesbank will be publishing its new Forecast for Germany in December.

Ladies and gentlemen, one point I have stressed on multiple occasions in the past is that we should not talk our country down as a business location. That is not to say, of course, that we should not pinpoint weaknesses and resolutely tackle problems. An overly pessimistic mindset can be damaging. But what can also be damaging is viewing a situation through rose-tinted spectacles or blindly trusting that everything will somehow fix itself of its own accord. There is no doubt that Germany is not seeing as much investment as we would like. And industry is struggling with a difficult competitive environment. Barriers need to be dismantled here.

At this point, allow me to make a passing remark in light of recent events: if businesses are to get to grips with–and finance–their future challenges, we will need banks that are strong and robust. In any possible mergers, what matters is that the institution that comes about as a result is one that fits that bill in the best possible way.

As far as the topic of barriers is concerned, I do not wish to go beyond my allotted time. Allow me, then, to run through just some of the initiatives that could boost the attractiveness of a business location: cutting as much red tape as possible, and speeding up administrative procedures like approval processes. As for greening the economy, policymakers should ensure greater planning security. Digital infrastructure and education, in particular, are in need of improvement. In addition, politicians should act to boost the labour supply because staff shortages are bound to worsen further as demographic change makes itself felt.

Headlines claiming that Germany is a millstone around the neck of the euro area[1] make for unpleasant reading. But the simple fact is that when the largest Member State's economy is weak, the average across the bloc will be depressed as a result. The euro area economy as a whole has gained some traction in the first two quarters of this year (recording quarter-on-quarter growth rates of 0.3% and 0.2%, respectively). In their latest projections, ECB staff are forecasting modest economic growth of 0.8% in full-year 2024, rising slightly to 1.3% next year.

The outlook is uncertain, particularly given what remains a tense geopolitical environment. Neither in Ukraine nor in the Middle East has the situation eased. The outcome of the presidential election in the United States is another source of economic uncertainty. Last week's TV debate gave us a taste of what is to come.Europe might end up losing out if, say, the United States adopts a more protectionist trade policy, takes government action to support the country as a business location, or turns its back on multilateral cooperation (on issues such as climate action, NATO and the WTO).

There's good news as well, though: the labour market in the euro area is as robust as ever, as unemployment hit an all-time low of 6.4% in July. Germany's economy hasn't recovered yet, so its labour market hasn't improved, but nor did it deteriorate significantly. Because firms in Germany have largely refrained from scaling back their workforces during the ongoing spell of economic weakness, they see little need overall for new hires. Even if they are certainly finding it difficult to fill vacancies in some areas.

An analysis by the ECB has found that labour hoarding–that is, keeping staff in reserve–is still above pre-pandemic levels in the euro area. Because profit margins were high at times, firms were able to hoard staff to a greater extent or for longer than usual when the situation or outlook deteriorated, the ECB noted.[2]

If profit margins now start to normalise, they will probably reduce the scope for firms to undertake labour hoarding. In addition, labour hoarding suggests that there will be fewer hires than usual as the economy recovers. Instead, productivity is more likely to rise. The new projections include an increase in euro area labour productivity of around 1% in both 2025 and 2026, following stagnation in the current year and a decline of just under 1% last year. Taken in isolation, this would dampen unit labour costs and thus inflation.

3 Inflation

This brings us to question number two concerning the outlook for prices. On this point, the focus is not only on the weak productivity growth observed so far, but also on the strong wage growth at the current juncture. For Germany, the latest wage deals have increased pay levels significantly. And relatively high wage settlements look set to be reached in the forthcoming pay negotiations as well. Understandably, the trade unions are looking to achieve lasting compensation for the real wage losses accumulated over the past three years.

Because inflation compensation bonuses will only be exempt from taxes and social contributions until the end of this year, the trade unions are now stepping up their demands for permanent wage increases. The still high willingness to strike and persistent widespread shortage of labour suggest that wage growth will remain comparatively strong. The longer-term outlook, too, indicates that labour scarcity in Germany will remain a key factor driving robust wage growth and thus high inflation in the domestic economy.

In the euro area, growth in negotiated wages slowed significantly in the second quarter. However, this was due in part to a one-off effect in Germany (owing to inflation compensation bonuses paid out in the previous year but absent this year). The persistent labour market tightness in the euro area means that a quick let-up in wage dynamics is unlikely.

With wage pressures easing only slowly, the disinflation process is proving to be slow and arduous. Right now, inflation is not yet where we on the ECB Governing Council want it to be. Headline euro area inflation stood at 2.2% in August, down from 2.6% one month earlier. That significant decline mainly came about due to energy prices. Whilst it is true that German inflation–as measured by the Harmonised Index of Consumer

Prices–has reached 2.0%, I'm afraid to say that, for the time being, that level is probably not yet here to stay. Services inflation in the euro area is still worryingly high, coming in at 4.1% at last count. Core inflation has eased only marginally, dropping to 2.8%.

According to the latest ECB staff projections, euro area price inflation will be back at the 2% mark at the end of 2025. The journey there remains uncertain and include a few bends. For instance, inflation rates are expected to edge somewhat higher again towards the end of this year due to energy prices being in decline in the fourth quarter of last year.

Overall, though, we have made huge advances towards safeguarding price stability. As the disinflation process plays out, inflation expectations have also receded the way we want them to, and the risk of higher inflation expectations has diminished in the view of markets and surveyed experts. This would suggest that inflation expectations are well anchored. It is now up to us on the ECB Governing Council to prove our staying power. If we achieve that, we will soon make it over the finishing line.

4 Monetary policy

The third question I asked at the beginning has basically been answered: the phase of steep tightening was followed by nine months of unchanged key interest rates, after which the ECB Governing Council subsequently loosened the reins somewhat in June and now again in September.

We don't know yet how things will unfold, but it is certain that key interest rates will not go back down as quickly and sharply as they went up! The intervals between the potential moves may vary depending on the incoming data, as monetary policy must remain tight enough for long enough to ensure that the inflation rate returns to the 2% target over the medium term. Assumptions to that effect about key interest rates also form the basis for the ECB's projections.

Ladies and gentlemen, public opinions on the best time for an interest rate move vary. This is due, not least, to the fact that the risks cannot be clearly quantified and that monetary policy time lags are impossible to measure with certainty. It is important for me to see inflation stable at the 2% target as soon as possible. To get there, we will not pre-commit to any path in our decisions going forward. Instead, we will continue to examine incoming data with an open mind. We are not flying on autopilot when it comes to interest rate policy.

4.1 Reducing the balance sheet

I will now turn to the three topics specific to monetary policy. The key interest rates are the central lever with which to adjust the monetary policy stance. In addition, gradual balance sheet reduction also influences the direction of monetary policy. This is because the length of the balance sheet is ultimately driven by previous accommodative non-standard measures.

Banks' repayment of loans under the longer-term refinancing operations has thus far been the primary contributory factor towards reducing the Eurosystem's total assets. Remaining outstanding funds borrowed under targeted longer-term refinancing

operations (TLTROs) are now only relatively small (around €76 billion). Next week will be the penultimate maturity date, and in December of this year the last repayments of funds borrowed under TLTROs will be made.

Moreover, the Eurosystem's large bond holdings are gradually declining, by an average of €25 to €30 billion per month (since July 2023), through the discontinuation of reinvestments under the APP, the largest such purchase programme. Since July of this year, reinvestments under the pandemic emergency purchase programme (PEPP) have been reduced by an average of €7.5 billion per month and will also be fully discontinued at the end of 2024.

The process of significantly shrinking current total assets of just under €6,500 billion is not done just yet. So far, the markets have taken the Eurosystem's balance sheet reduction (starting from a peak of over €8,800 billion) in their stride. I am confident about the future, too.

On the ECB Governing Council, I am one of those who has been advocating for reducing the Eurosystem's footprint in financial markets. This process will take time. It is closely linked to how monetary policy is implemented and passed through to the financial markets. That is why I now wish to briefly address, as the second of my three topics specific to monetary policy, the changes to the operational framework for implementing monetary policy adopted in mid-March.

4.2 Changes to the operational framework for implementing monetary policy

You might be thinking: what a dry, hard-to-digest topic, and right after lunch to boot! However, addressing these seemingly annoying details is worth the time and effort. This is because the new operational framework for implementing monetary policy will determine how central bank liquidity is provided to banks in the future and how short-term money market rates will evolve going forward.

With excess liquidity in the banking system declining, but still high for the time being, little will change at first: we will continue to regularly lend central bank liquidity to banks at the quantities demanded and a fixed interest rate, with a wide range of bonds and other claims being eligible collateral for these loans. The reserve ratio for determining banks' non-remunerated compulsory deposits with the Eurosystem remains unchanged at 1%.

On this very day, the gap between the main refinancing operations rate and the deposit facility rate narrowed from 50 to 15 basis points. This operational adjustment will incentivise bidding in the weekly tenders. Short-term money market rates are therefore likely to continue to evolve in the vicinity of the deposit facility rate, given limited fluctuations. In the process, we will observe the compatibility of our operational framework with market principles.[3]

The ECB Governing Council also agreed to introduce, at a later stage, new structural longer-term refinancing operations and a structural portfolio of securities. These transactions are intended to make a contribution to covering the banking sector's structural liquidity needs. But that is a way off yet. That's because, as already mentioned, banks' excess liquidity and Eurosystem bond holdings are still very sizeable.

We will now gain experience and gather insights. A review of the key parameters of the operational framework is scheduled for 2026. However, adjustments can be made earlier if necessary.

4.3 Monetary and fiscal policy interactions
My third topic specific to monetary policy, monetary and fiscal policy interactions, is a perennial theme. Generally, the combination of the two policy areas determines how accommodative or restrictive the overall effect on the economy is.

In some times of crisis, such as during the coronavirus pandemic, monetary and fiscal policy can work together in the pursuit of their respective objectives. In times of high inflation, however, there may be potential for conflict. At the very least, fiscal policy should not undermine a restrictive monetary policy in the fight against inflation, but rather support it as much as possible.

This year and next, the euro area fiscal stance is likely to have a roughly neutral effect, i. e. not generate any additional inflationary pressure. However, the expiry of crisis support measures is the reason why the deficit ratio is expected to decline. Seen from this perspective, fiscal policy is not restrictive.

The ECB projects that the euro area debt ratio will remain close to 90%. In some Member States, government debt is worryingly high, with no signs of a trend reversal happening any time soon. Monetary policy should ignore this. This is because the Member States will have to be able to deal with the interest rate level that is warranted from a monetary policy perspective. Governments ought to brace themselves for higher interest rate levels.

The new EU fiscal rules entered into force at the end of April. However, it is not yet clear what concrete requirements for fiscal consolidation will follow. In July, the existence of excessive deficits was established for seven countries, including the euro area countries France, Italy, Belgium, Slovakia and Malta. It will be crucial to implement the new rules in such a way that high debt ratios actually fall. This would require setting ambitious targets, and governments would then have to comply with them more ambitiously than in the past.

Setting priorities will remain the key fiscal policy challenge at any rate And this will not get any easier if additional expenditure, for example for climate action, defence or in view of demographic pressures, is moved higher on the priority list.

This is true even in Germany, where the debt ratio is no longer far from the 60% limit. In this case, it may indeed make sense to expand the fiscal scope somewhat by means of a moderate reform of the debt brake just as long as Germany complies with the European debt rules. The Bundesbank has put forward proposals to achieve that goal.

5 Concluding remarks

Ladies and gentlemen,

After three questions and three topics, I would like to end with a triad. Democracy, freedom and openness are core values on which our society, our daily coexistence, and

our prosperity are based. We are living in challenging times. This is exemplified by the elections in France and three eastern German federal states as well as, this coming November, in the United States. For the future, it remains to be hoped that we can maintain democracy, freedom and openness as a secure basis.

Thank you for your attention.

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[1] Konjunktur: Wirtschaft in Euro-Zone wächst–jedoch nicht in Deutschland (wiwo.de), Wirtschaft in Euro-Zone wächst trotz Bremsklotz Deutschland 0,2 Prozent (msn.com)

[2] European Central Bank, Higher profit margins have helped firms hoard labour, Economic Bulletin, Issue 4/2024, pp. 54-58.

[3] See Nagel, J., Reflections on the Eurosystem's new operational framework | Deutsche Bundesbank, speech at the Konstanz Seminar on Monetary Theory and Monetary Policy, 16 May 2024.