Philip R Lane: Moving from 3.75 to 3.50 - explaining the latest rate decision

Keynote speech by Mr Philip R Lane, Member of the Executive Board of the European Central Bank, at the European Investment Bank Chief Economists' Meeting, Luxembourg, 16 September 2024.

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Slides accompanying the speech

Introduction

My aim today is to cover two topics. First, I will briefly explain our decision last week to lower the deposit facility rate – the rate through which we steer the monetary policy stance – by 25 basis points. Second, I will outline some considerations that will be covered by the 2025 assessment of our monetary policy strategy.

The monetary policy decision

Based on our assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, our confidence in a timely return of inflation to target is supported by declining uncertainty around our projections, including their stability across projection rounds, and by inflation expectations across a range of indicators that remain aligned with a timely convergence to target.[1]

The incoming data on wages and profits have been in line with expectations. The baseline scenario of the latest ECB staff projections foresees a demand-led economic recovery that boosts labour productivity, allowing firms to absorb the expected growth in labour costs without denting their profitability too much. This should buffer the cost pressures stemming from higher wages, dampening price increases. Most measures of underlying inflation, including those with a high predictive content for future inflation, were stable at levels consistent with a return of inflation to target in a sufficiently timely manner. While domestic inflation is still kept elevated by pay rises, the projected slowdown in wage growth next year is expected to make a major contribution to the final phase of disinflation towards our target. Financing conditions for firms and households remain restrictive, as our past policy rate increases continue to work their way through the transmission chain. Credit growth remains sluggish amid weak demand.

Based on this assessment, it is now appropriate to take another step in moderating the degree of monetary policy restriction. The decision to lower the deposit facility rate (DFR) by 25 basis points is robust across a wide range of scenarios. At a still clearly-restrictive level of 3.5 per cent for the DFR, the realisation of upside shocks to inflation that would call into question the timely return of inflation to target could be addressed by a slower pace of rate reductions in the coming quarters compared with the baseline rate path that is embedded in the projections. At the same time, compared to holding at 3.75 per cent, a DFR level of 3.5 per cent offers greater protection against downside risks that could delay the recovery and lead to a material undershooting of our target further

out in our horizon, including the risks associated with an excessively-slow unwinding of the rate tightening cycle.

In the near term, headline inflation is expected to fluctuate over the next few months. In particular, headline inflation is expected to be low in September before rising again in the latter part of this year, partly because previous sharp declines in energy prices will drop out of the annual rates. Negotiated wage growth will remain high and volatile over the remainder of the year, given the significant role of one-off payments in some countries and the staggered nature of wage adjustments. The forward-looking wage trackers also signal that wage growth will be strong in the near term.

Further out in the projection horizon, staff continue to expect a rapid decline in inflation, from 2.6 per cent in the final quarter of this year to 2.0 per cent in the final quarter of 2025. The expected drop in core inflation (primarily services inflation) is even sharper, from 2.9 per cent in the final quarter of this year to 2.1 per cent in the final quarter of 2025. Indeed, the weaker economy and lower wage pressures that characterise the new projections mean the expected speed of disinflation in the course of 2025 has been upwardly revised. The expected significant deceleration in wage growth next year is in line with the information contained in the wage trackers and reflects the fading out of the "catch-up" dynamics that have driven wage growth in the last couple of years. The disinflation process in 2025 will also be supported by well-anchored forward-looking inflation expectations and weaker price-price and price-wage backward-looking dynamics, in view of the much lower inflation in 2024 compared to 2023.

Looking ahead, a gradual approach to dialling back restrictiveness will be appropriate if the incoming data are in line with the baseline projection. At the same time, we should retain optionality about the speed of adjustment. In one direction, if the incoming data indicate a sustained acceleration in the speed of disinflation or a material shortfall in the speed of economic recovery (with its associated implications for medium-term inflation), a faster pace of rate adjustment may be warranted; in the other direction, if the incoming data indicate slower-than-expected disinflation or a faster pace of economic recovery, then a slower pace of rate adjustment may be warranted. These considerations reinforce the value of a meeting-by-meeting and data-dependent approach that maintains two-way optionality and flexibility for future rate decisions.

The 2025 assessment of monetary policy strategy

An important element of the 2021 monetary policy strategy review was the commitment to assess periodically the appropriateness of the monetary policy strategy and it was flagged that the next assessment would take place in 2025. As indicated by President Lagarde at the July press conference, the preparatory work by the Eurosystem staff for this assessment has now started and the Governing Council expects to conclude this assessment in the second half of 2025.

The 2021 strategy review followed an eighteen year gap since the 2003 strategy review and was naturally a very thorough exercise. The 2021 review has served us well and important elements do not require any re-assessment. In particular, we will maintain the symmetric, medium-term oriented two per cent inflation target, which has been

essential in re-anchoring inflation expectations coming out of the low-inflation period and in keeping inflation expectations well anchored at target during the inflation surge period.

Our 2025 assessment will consist of two broad strands: economic developments since the pandemic; and the implications for monetary policy.

We will assess the cyclical and structural factors shaping the inflation and economic environment in the light of the recent inflation experience, analyse the likely evolution of those factors over the years ahead and examine the implications for the inflation challenges that may confront the ECB. As part of this analysis, we will also look at the possible enhancements of the existing analytical toolkit, including forecasting techniques.

We also assess the implications of the changed inflation environment for the monetary policy strategy. This will include reviewing the lessons learned from the low and high inflation periods and our experiences with the evolving roles of the instruments in the policy toolkit over the monetary policy cycle. We will furthermore examine the operationalisation of the medium-term orientation of the monetary policy strategy, with a focus on the ECB's reaction function to both upside and downside threats to the anchoring of inflation expectations to the target. This will includes the analysis of how risk and uncertainty should inform both policy decisions and policy communication.

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[1] A slide deck to accompany these remarks is available on the ECB website.