Christine Lagarde: International Monetary and Financial Committee statement

Statement by Ms Christine Lagarde, President of the European Central Bank, at the fiftieth meeting of the International Monetary and Financial Committee, IMF Annual Meetings, Washington DC, 25 October 2024.

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Introduction

Since our last meeting in April, the global growth outlook has remained broadly unchanged. While global growth is projected to expand at a moderate pace, risks to the outlook have shifted to the downside, reflecting rising economic policy uncertainty against a backdrop of heightened geopolitical tensions. Global headline inflation continues to recede amid falling energy prices, the normalisation of supply conditions and still tight monetary policy.

In October the Governing Council lowered the three key ECB interest rates by 25 basis points. The decision to lower the deposit facility rate – the rate through which it steers the monetary policy stance – reflects the Governing Council's updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. The incoming information on inflation shows that the disinflation process is well on track. Recent indicators of economic activity have surprised somewhat to the downside and financing conditions remain restrictive.

The Governing Council will keep policy rates sufficiently restrictive for as long as necessary to achieve its two per cent medium-term inflation target in a timely manner. The appropriate level and duration of restriction will continue to be determined by following a data-dependent and meeting-by-meeting approach. In particular, the Governing Council's interest rate decisions will be based on its assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. The Governing Council is not pre-committing to a particular interest rate path.

The Governing Council recently initiated an assessment of its monetary policy strategy, which will focus on the changed inflation environment and its implications for the monetary policy strategy, with conclusions expected in the second half of 2025.

Economic activity

After the broad stagnation in activity in 2023, euro area real GDP expanded moderately in the first half of this year, helped by the recovery in foreign demand and public spending. Private domestic demand remained weak, with households and firms still hesitant to consume and invest. Incoming data suggest economic activity may have softened again in the second half of the year amid rising geopolitical uncertainty.

Looking ahead, we expect growth to strengthen over time, as rising real incomes support household consumption and the gradually fading effects of restrictive monetary

policy should support consumption and investment. Exports should contribute to the recovery as global demand rises.

The labour market remains resilient, but indicators point towards cooling labour demand on the back of weaker economic activity. Employment continued to grow in the second quarter of 2024, albeit at a slower rate than in the first quarter of the year. In August the unemployment rate remained at 6.4%, its lowest level since the introduction of the euro. Labour productivity is expected to recover in the future as labour hoarding unwinds and profit margins moderate.

Fiscal and structural policies should be aimed at making the economy more productive, competitive and resilient. That would help to raise potential growth and reduce price pressures in the medium term. To this end, it is crucial to swiftly follow up, with concrete and ambitious structural policies, on Mario Draghi's proposals for enhancing European competitiveness and Enrico Letta's proposals for empowering the Single Market. Implementing the EU's revised economic governance framework fully, transparently and without delay will help governments bring down budget deficits and debt ratios on a sustained basis. Governments should now make a strong start in this direction in their medium-term plans for fiscal and structural policies.

Risks to growth remain tilted to the downside. Lower confidence could prevent consumption and investment from recovering as quickly as expected. This could be amplified by sources of geopolitical risk, such as Russia's unjustified war against Ukraine and the conflict in the Middle East, which could disrupt energy supplies and global trade. Lower demand for euro area exports due, for instance, to a weaker world economy or an escalation in trade tensions between major economies would further weigh on euro area growth. Growth could be lower if the lagged impact of our monetary policy tightening turns out stronger than expected. However, growth could also be higher if the world economy grows more strongly than expected or if easier financing conditions and declining inflation lead to a faster rebound in consumption and investment.

Inflation

Headline inflation fell to 1.7% in September 2024 due mainly to a sharp drop in energy inflation, following a broadly declining path since the last IMFC meeting. Core inflation – HICP inflation excluding energy and food – began to moderate in recent months after an overall sideways trend, reflecting mainly declining goods inflation. Services inflation edged down in September, but has been more persistent, hovering around 4%.

Most measures of underlying inflation have been gradually moderating in recent months. However, domestic inflation remains elevated, with strong price pressures coming from wages in particular. Wage growth has continued to be strong, but overall growth in labour costs has been moderating in recent quarters and profits have been buffering the impact of higher wages on inflation.

Looking ahead, we expect inflation to temporarily increase again in the fourth quarter of this year as the previous sharp falls in energy prices drop out of the annual rates. Thereafter, inflation should resume its decline, reaching our target next year and averaging 1.9% in 2026 according to the September staff projections.

Inflation could turn out higher than anticipated if wages or profits increase by more than expected. Upside risks to inflation also stem from the heightened geopolitical tensions, which could disrupt global trade and push energy prices and freight costs higher in the near term. Moreover, extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices. By contrast, inflation may surprise on the downside if low confidence and concerns about geopolitical events prevent consumption and investment from recovering as fast as expected, if monetary policy dampens demand more than expected, or if the economic environment in the rest of the world worsens unexpectedly.

Financial stability, euro area banking sector and non-bank financial intermediation

The financial stability of the euro area continues to be affected by geopolitical risks and uncertainties surrounding the macroeconomic outlook. The financial stability outlook remains fragile, with elevated vulnerabilities. Geopolitical risks from intra- and inter-country conflicts coupled with election uncertainties could trigger a sharp reversal of risk sentiment and weaken macro-financial conditions, leading to negative feedback loops between governments and both the non-financial and financial sectors. While the sharp corrections we saw in financial markets over the summer were short-lived, benign risk pricing underscores the potential for more disruptive developments. Additionally, although commercial real estate markets have shown signs of stabilising, the full scale of the correction may not yet have been reflected in valuations, which are slow to adjust.

Euro area banks have been a source of resilience thanks to their sizeable liquidity and capital buffers, and their profitability has been robust thanks to improved net interest margins. However, these profits will likely begin to moderate alongside declining rates. Asset quality is starting to weaken from a historically high level, particularly in commercial property lending. Bank valuations remain subdued and are vulnerable to geopolitical uncertainty, although recent political events have had a limited impact on the financial sector more broadly. From a macroprudential policy perspective and against a background of headwinds and uncertainty, it is crucial that the existing requirements for releasable capital buffers are maintained, or in some countries increased, and that adequate borrower-based measures are implemented as required. It is important that key jurisdictions are making progress in implementing Basel III. A full, faithful and timely implementation of Basel III is crucial, as strong regulation and supervision ensure that banks remain safe and sound.

Risks in the non-bank financial intermediation (NBFI) sector remain elevated, despite some rebalancing towards higher-quality assets. Asset price corrections and market volatility, as well as macroeconomic and geopolitical uncertainty, could trigger outflows from open-ended investment funds or margin calls for investment funds, insurance companies and pension funds. These dynamics would increase the likelihood of forced sales, which could negatively affect the markets in which non-bank financial intermediaries invest. Additionally, parts of the NBFI sector are highly leveraged, which could amplify liquidity shocks to the wider financial system. This underlines the need to strengthen the NBFI policy framework, including from a macroprudential perspective, in an internationally coordinated manner.

International cooperation

Geopolitical tensions are increasingly giving rise to economic and financial fragmentation and pose a significant risk to global prosperity, with trade flows already visibly decoupling along lines of geopolitical influence. So far, this decoupling has been limited to specific sectors, such as energy and key advanced technologies. ECB analysis suggests that trade fragmentation could result in global GDP losses ranging from nearly 6% in a scenario of higher trade barriers only being erected for strategic products, to 9% in a more severe scenario of full decoupling. Trade fragmentation could lead to renewed inflationary pressures globally, not only because of increased production input costs but also on account of reduced diversification opportunities. Overall, this would make it more challenging for central banks to ensure price stability. It is therefore crucial that legitimate concerns about security and supply chain resilience do not lead to a spiral of protectionism. Multilateral cooperation is more important than ever if we are to preserve the unparalleled achievements in global growth and poverty reduction of recent decades, and securing global peace is a precondition for economic prosperity.

With the IMF marking its 80th anniversary this year, its role and work remain absolutely critical in the current complex global environment. The Fund's multilateral and bilateral surveillance function remains as important as ever in protecting member countries from crises, and the upcoming Comprehensive Surveillance Review will help establish the most relevant priorities for years to come. We welcome the recent decisions to strengthen the IMF's lending toolkit as part of the Review of Charges and the Surcharges Policy and the Review of the Poverty Reduction and Growth Trust Facilities and Financing. We support the IMF's position at the centre of the global financial safety net, with a strong core mandate, and we highly value its unique role in bridge-building and facilitating global cooperation to tackle common challenges. We welcome the fact that Sub-Saharan Africa will shortly occupy the newly created seat on the IMF's Executive Board, which will significantly contribute to improving the overall balance of regional representation.

We continue to witness an increase in economic losses and financial risks stemming from extreme physical climate hazards, including record-breaking heatwaves in Asia, devastating floods and wildfires in the Americas and central and eastern Europe, and more frequent tropical storms in the Caribbean and South Asia. Adaptation measures to shield our lives and economies from the impact of climate change, alongside ambitious policies to put the climate transition on track, are more relevant than ever. We support international progress on transition planning, enabling corporations, financial institutions and governments to set up credible net-zero roadmaps in a systematic way. Furthermore, it is essential to further develop more systematic and comprehensive approaches to assess the impact of escalating nature-related economic and financial risks on price and financial stability, including integrated climate and nature risk analyses.