

## SPEECH

## Partly cloudy skies in the euro area, with a silver lining



'While macro indicators point to a soft landing, we do not foresee a recession in the euro area. Also, the financial sector is resilient and inflation is getting close to target.', said Klaas Knot at the G30 International Banking Seminar. He spoke about the outlook for growth and inflation in the euro area, as well as monetary policy.

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### Partly cloudy skies in the euro area, with a silver lining

Speech Klaas Knot at the G30 International Banking Seminar

Washington, 26 October 2024

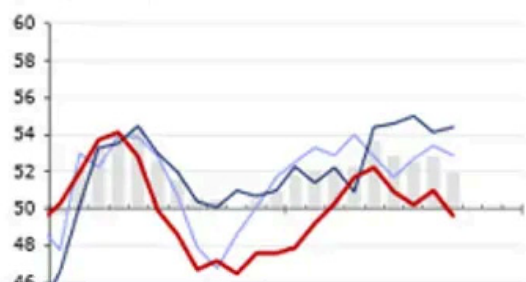
Good morning everyone,

It is my pleasure to present the euro area perspective in this panel session on the Global Economic Outlook. The latest PMI releases point to steady global growth. Weakness in manufacturing is compensated by strong growth in the service sector.

## Economic growth has been sluggish for two years

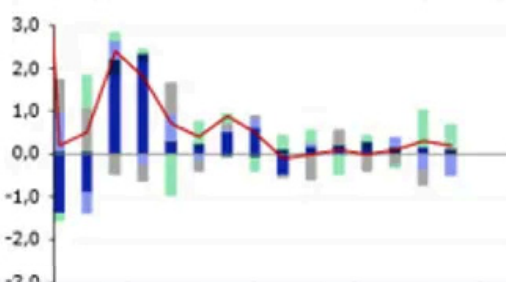
### EA economic outlook is less favourable compared to global economies...

Composite PMIs



### ... Driven by sluggish domestic demand (a.o. low investment and consumption)

GDP-growth and contributions euro area in Percent qo-q



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However, as you can see in the left hand chart, the economic situation in the euro area is less favorable than the global average. The current mood is a bit like October weather in Amsterdam. Not as bad as some people would have you believe, but definitely not great either.

Economic growth in the euro area has been sluggish for two years now. As shown in the right hand chart, especially domestic demand has been weak. Initially, this could be explained by falling real wages. Over the past two years, however, wages have largely been catching up with prices. The short-term outlook is pointing to slow growth while economic sentiment remains subdued and the household savings rate is still higher than before the pandemic. Looking further ahead though, we do expect the economy to strengthen. Rising real incomes will allow households to consume more and the gradually fading effects of restrictive monetary policy will support consumption and investment.

Zooming in on the various member states, confidence is not low everywhere. Economic sentiment is significantly above the long-term average in for instance Spain, Portugal and Greece. The mood is especially good in the service sector, benefiting from the reallocation of consumption from goods to services after the pandemic. This growth boost is particularly visible in tourism and hospitality. But also other sectors of the economy perform relatively well in these countries.

Other countries are lagging behind. This is mainly the case for Germany, where a combination of factors is weighing on the traditionally strong manufacturing sector. Energy-intensive manufacturing firms are still suffering from elevated energy prices.

Moreover, the sector is faced with weak external demand while domestic demand is not growing due to weak private consumption and falling business investment.

To me, the weak domestic growth in the euro area is slightly puzzling. Maybe the past high inflation or the political polarization and geopolitical tensions is weighing on consumers' moods. On the policy side, fiscal uncertainty may add to this picture and a significant fiscal consolidation in, for instance, France is necessary to bring public finances back on track and reduce this uncertainty. In line with the revised fiscal framework, the fiscal stance in the euro area is expected to tighten this year, and coming years, as energy and inflation support measures are gradually phased out. Debt levels, however, are expected to increase, particularly in high-debt countries.

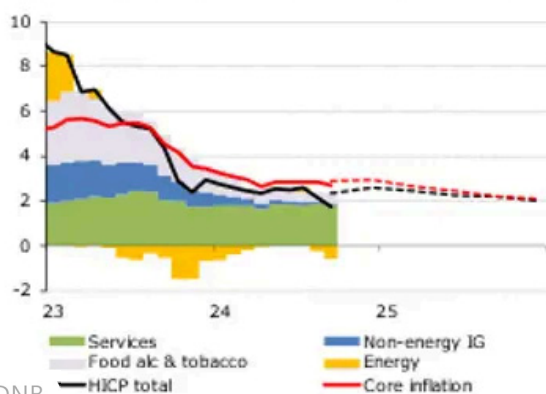
This said, I'm by nature an optimist. So let me get to the silver lining. While macro indicators point to a soft landing, we do not foresee a recession in the euro area. Also, the financial sector is resilient and inflation is getting close to target.

Let me focus on inflation.

## Disinflation proceeds, but services inflation still high

### Disinflation in the euro area is well on track...

HICP euro area, percent contributions by component

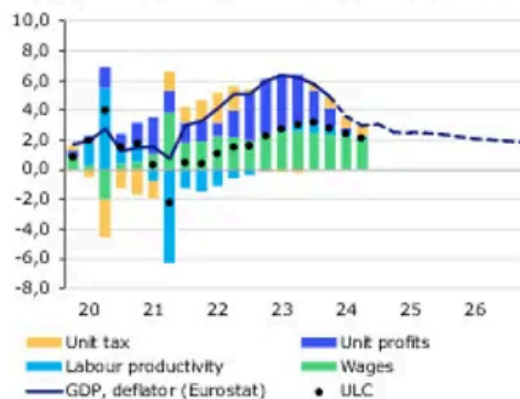


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### ... But wages keep domestic inflation elevated

GDP deflator EA, percent contributions by component



3

Headline inflation in the euro area has come down to around 2%. The latest reading was 1.7% for September, confirming our assessment that the disinflationary process is well on track. Underlying there are differences between components. On one end, energy prices have pushed down the latest inflation reading, contributing -0.6 percentage points to headline inflation in September. And on the other end, services inflation remains stubbornly close to 4%.

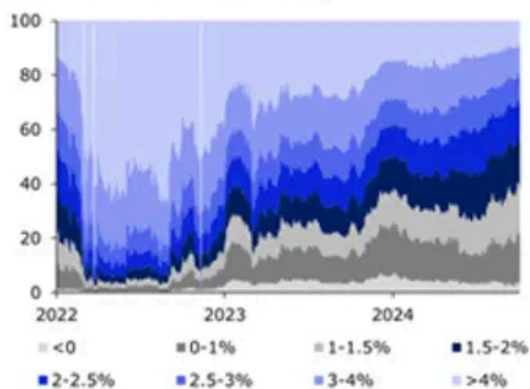
Part of this strong services inflation is driven by growth in nominal wages, which are still catching up with past inflation. We expect these second round effects to dampen further in the course of next year. The GDP-deflator, a measure of domestic inflationary pressures, has come down to 3.0% in the second quarter, from above 6% one year earlier. As you can

see on the right, while unit profits were the largest contributors in the high inflation quarters, increasing unit labor costs are now driving the GDP-deflator. And in absence of labor productivity growth, it is wages that determine most of domestic inflation.

On inflation, it is clear that the risks surrounding the outlook have become more balanced. In the short term, given the downward surprise of both headline and core inflation in Q3 of this year, we may see inflation dropping faster than expected. This is also supported by the further declining monthly dynamics of inflation and declining goods price pressures.

## Risks to inflation have become more balanced

**Market-based inflation measures more centered around 2% target...**



**... implying that markets view risks to inflation as balanced**

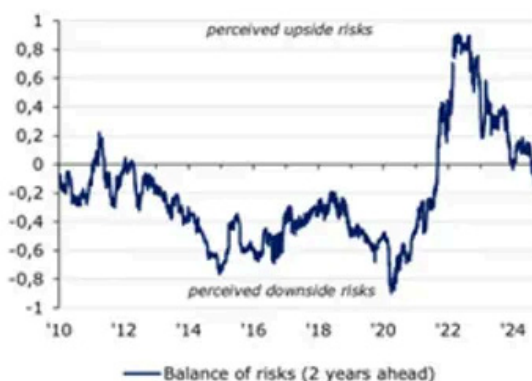


Figure 5 (LHS), 6 (RHS) show the option-implied inflation distribution for 2-years ahead. Figure 6 shows a balance of risks metric based on options-implied inflation probabilities. The balance of risk is defined as the difference between the probabilities assigned to inflation outcomes above vs below the 2% target level. Hence, the balance of risk indicator condenses the information content of the whole options-implied distribution into one metric and shows the market view on the directional risks to price stability.

These charts underline that also market participants hold a balanced view regarding the risks to inflation. As you can see in this option-implied distribution of inflation, the likelihood of inflation either below or above our target has become even-handed. This implies that for the coming two years market-based inflation expectations are much more centered around the ECB's 2% symmetric inflation target.

Coming from a prolonged period of setbacks and too high inflation, this is good news. Yet, at the same time, it is still too soon to declare victory, as in the medium term upward risks remain. We still need a significant easing of wages – which is only expected in the course of 2025 – and relatedly, a cooling off of services inflation to durably return to 2% over all. On top of that, uncertainty remains significant, in particular on the supply side of the economy as we are residing in an environment of heightened geopolitical risks. Hence more adverse supply shocks hitting the euro area economy can pose renewed upside deviations from our inflation target.

Based on this assessment, the Governing Council has taken another step in removing the top level of policy restriction at its October meeting. Incoming data since the September meeting have strengthened our confidence that inflation will return to target in a timely manner. Also, the data point to increasing risk of disappointing growth in the near and medium term. Given that policy rates are still some distance away from the range of

neutral rates, the decision to lower the deposit facility rate by 25 basis points is robust across a wide range of scenarios. Looking forward, in this environment with significant uncertainty about the supply side of the economy, it is important keep all options open.

Retaining full optionality would act as a hedge against the materialisation of risks in either direction to the growth and inflation outlook. On the one hand, policy restriction may be reduced quickly if incoming data indicate a sustained acceleration in the speed of disinflation *or* a material shortfall in the economic recovery with its associated implications for the medium term inflation outlook. On the other hand, policy restriction may be taken away more slowly should upside risks to inflation materialise or if incoming data sheds the opposite picture regarding growth and inflation. In any case, the meeting-by-meeting and data-dependent approach has served us well, as it helped to maintain the much-needed two-way optionality and flexibility for future rate decisions.

On that rather positive note, let me stop here and give the floor back to you, Mark.

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