Luis de Guindos: Monetary policy and financial stability in the euro area

Introductory remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at a meeting with business group Hotusa, Madrid, 28 October 2024.

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Inflation

Inflation in the euro area has come a long way. After peaking at more than 10% in October 2022 (in Spain, it peaked in July 2022), headline inflation stood at 1.7% in September this year. This was 0.5 percentage points lower than in August, largely reflecting a sharp drop in energy inflation. Core inflation has also fallen substantially from its peak, edging down from 2.8% in August to 2.7% in September.

Most measures of underlying inflation have declined or remained unchanged. Domestic inflation remains high, reflecting elevated services inflation as wage pressures remain strong, but it too is showing signs of moderation.

Inflation is expected to rise again later this year – partly due to base effects, as previous sharp falls in energy prices drop out of annual rates – before declining to our target of 2% in the course of next year. Inflation expectations of euro area firms and consumers have declined across all horizons. Most measures of longer-term inflation expectations stand at around 2%.

So, taken together, the incoming information shows that the disinflationary process is now well on track.

The outlook, however, is surrounded by substantial risks. The geopolitical situation, especially the conflict in the Middle East and Russia's war against Ukraine, poses a particular upside risk to inflation. Heightened geopolitical tensions could push energy prices and freight costs higher in the near term and disrupt global trade. Extreme weather events could drive up food prices. And inflation could also turn out higher than anticipated if wages and profits increase by more than expected. But we may also see downside surprises in inflation – for example as a result of a stronger-than-expected dampening impact of monetary policy on demand, an unexpected worsening of the global economic environment, or a slower recovery in consumption and investment due to concerns about geopolitical events.

Economic activity

Economic activity in the euro area has been weaker than expected, with persisting differences across sectors. The composite output Purchasing Managers' Index (PMI) fell into contractionary territory in September, its deterioration broad-based across countries and sub-indices. The manufacturing output PMI fell further while the services sector continued to expand, though at a slowing pace, pointing to an overall weaker near-term outlook for growth.

Despite rising incomes, household consumption remained weak and savings increased by more than expected. This was likely due to higher real returns on savings, efforts to recuperate past losses in real wealth and, more broadly, the lagged response of consumption to rising incomes.

The labour market remains resilient, with the unemployment rate at 6.4% in August, its lowest level since the introduction of the euro. However, surveys point to slowing employment growth and a further moderation in the demand for labour.

Economic activity is expected to strengthen as real incomes rise and the easing of financing conditions supports consumption and investment. With global demand increasing, exports are also expected to contribute to the recovery.

However, risks to the growth outlook remain elevated and tilted to the downside. In particular, lower confidence could prevent consumption and investment from recovering as fast as expected and geopolitical risks continue to pose a threat to the world economy by disrupting energy supplies and global trade. But euro area growth could be higher if the world economy grows more strongly than expected or if declining inflation and less restrictive monetary policy lead to a faster recovery in consumption and investment.

Financial stability

As concerns about inflation abate, weaker growth prospects are weighing on the outlook for financial stability in the euro area. At the same time, geopolitical risks and political uncertainty continue to raise the likelihood of tail events.

Let me mention three broad financial stability issues which stand out. First, while financial markets have shown resilience in recent periods of turmoil, they remain vulnerable to adverse dynamics as risk pricing appears too benign. Moreover, the non-bank financial sector – which is less transparent and subject to lighter regulation – could amplify any market correction, given concentrated exposures, liquidity and leverage vulnerabilities. Second, heightened political risks have highlighted closely interlinked vulnerabilities in sovereign, corporate, household, bank and non-bank sectors. Sovereign vulnerabilities are increasing, driven by heightened policy uncertainty and weak growth prospects. At the same time, interconnectedness between corporates, banks and non-banking intermediaries could create negative feedback loops if risks materialise in any of these sectors. Third, although conditions in commercial real estate markets have shown signs of stabilisation, there is a risk that the full scale of the correction is not yet reflected in valuations and that conditions could worsen again.

Monetary policy

The Governing Council of the ECB has responded forcefully to the largest euro area inflation surge on record. We raised our key policy rates by a total of 450 basis points between July 2022 and September 2023. We had kept them at those restrictive levels until June this year, with the key interest rates – in particular the deposit facility rate, through which we steer the monetary policy stance – contributing substantially to the ongoing disinflation process. Following the two 25 basis point cuts in June and September this year, we decided to lower the key ECB interest rates again at our

October meeting, based on our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

We remain determined to ensure that inflation returns to our 2% medium-term target in a timely manner. Our future decisions will ensure that our policy rates will stay sufficiently restrictive for as long as necessary. As we have made clear in our communication, the Governing Council is not pre-committing to a particular rate path. We will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction.