SPEECH

Securing stability in an insecure environment: navigating a bottleneck economy

Speech by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the University of Cyprus, Nicosia

Nicosia, 21 November 2024

When the President of the ECB, Christine Lagarde, spoke at the Central Bank of Cyprus in March 2022, she emphasised the importance of finding resilience in times of uncertainty.[1] And indeed, at that point in time the resilience of the European economy was being tested to the limit. We were just coming out of a global pandemic and adjusting to Russia's unjustified invasion of Ukraine, which had triggered an energy crisis in Europe. The combination of these two factors resulted in a surge in inflation.[2] The annual increase in the general price level of goods and services in the euro area peaked at 10.6% in October 2022, and Cyprus had already reached this peak in July. This was far above the ECB Governing Council's 2% target for inflation over the medium term, which we see as best maintaining our primary objective of price stability. To counter the increase in inflation, in July 2022 we began increasing our key interest rates at an unprecedented pace, and by September 2023 they had risen by 450 basis points in total, with the deposit facility rate – the rate through which we steer the monetary policy stance – reaching 4%.

Since then, the incoming information has shown that the disinflationary process is well on track. This has allowed us to steadily reduce our rates by 75 basis points since June this year, with the deposit facility rate now sitting at 3.25%. Throughout this adjustment to interest rates, which are still higher than they were before the pandemic, the European economy, including the financial system, has demonstrated its resilience, which is built on the reforms that have been implemented since the global financial crisis and the European debt crisis.

But despite this positive progress, I feel it is very important to warn of the dangers of complacency. Because the economy has by no means escaped the treacherous waters of recent years. If anything, we are venturing deeper into uncharted territory. In addition to the risks to the outlook for economic activity being tilted to the downside, structural trends are developing that will provide significant challenges to the global and European economies in the years to come. Geopolitical tensions are not expected to subside, with Russia's war in Ukraine still ongoing and the escalating conflict in the Middle East showing no sign of abating. We are seeing economic fragmentation along geopolitical fault lines, and protectionist tendencies are growing. And all the while, the climate and nature crises are worsening, with disasters becoming ever more frequent and severe.

Today I will outline how these trends are particularly notable for the bottlenecks that they may impose on the economy, while of course acknowledging that the word bottleneck fails to do justice to the human suffering and damage caused by geopolitical conflict, global heating and nature degradation. For the purposes of this speech, by bottlenecks I mean interruptions and damage to the productive capacity of the economy. I will argue that we need to future-proof our economy against geopolitical tensions, economic fragmentation and climate and nature hazards to ensure it is resilient in the face of more frequent bottlenecks. For monetary policy, this implies that we must remain laser-focused on our price stability objective, while maintaining flexibility to account for bottlenecks as they emerge.

From trends to day-to-day reality

As monetary policymakers we typically focus on our objective of maintaining price stability when we talk about the threats major trends pose to the economy. This may give the impression that the threats we see are quite far removed from people's day-to-day lives. However, nothing could be further from the truth. There are abundant examples of how these threats are already having very tangible effects on people's daily lives.

Just as an example, think about your morning cup of coffee at a local cafe before you start your day – with apologies to those of you who don't drink coffee. The queue has probably grown longer since the pandemic because of staff shortages – workers were let go during the pandemic and have not always been replaced in sufficient numbers. These staff shortages have also enabled the baristas who make your coffee to demand higher wages, which are probably then reflected in the price you pay. And this price has almost certainly further increased because the price of coffee beans has increased substantially compared with a year ago. This is largely due to adverse weather conditions linked to global warming, which are increasingly affecting coffee crop yields around the world. And in Europe in particular, the price may have increased still further because of disruptions to the supply of coffee beans. Shipping vessels are steering clear of the Red Sea to avoid militant attacks and are taking the longer route around South Africa instead.

Labour scarcity, global warming and geopolitical tensions, all pressed into the price of your morning espresso – or freddo espresso, as I understand is very popular in Cyprus.

Clearly, at the ECB it is not our statutory responsibility to maintain stable prices of individual products such as your morning coffee. But we are responsible for maintaining overall price stability in the euro area. This means that we are responsible for anchoring the change in the overall level of consumer prices over the medium term, and the price of coffee is a very small part of that. The broader trends that are affecting the price of your cup of coffee are also threats to our price stability objective. These threats will cause bottlenecks that will test the resilience of the economy even more rigorously than before. So we are paying very close attention to them as they represent risk factors for medium-term inflation in the euro area.

But while the reasons for labour scarcity being a bottleneck are fairly self-evident, the picture is more complicated when it comes to geopolitical tensions, economic fragmentation and the ongoing climate and nature crises. So I will now discuss these threats in more detail, while also being mindful that the associated bottlenecks are just one of the effects that we have to consider when assessing their monetary policy implications.

The consequences of a bottleneck economy

Let me start by discussing the bottlenecks that result from geopolitical tensions and economic fragmentation.

With the Kyrenia – a trading vessel dating back to the fourth century BC – featuring on its 10, 20 and 50 cent coins, Cyprus doesn't need reminding of the importance of international trade for economic welfare. However, in recent years we have seen globalisation reach a plateau and, notably, more frequent interruptions to global value chains in an increasingly fragmented geopolitical landscape. Protectionist measures are still looming on the horizon, so the risk of increased bottlenecks in global value chains also remains. Some geopolitical risks may escalate abruptly, requiring equally abrupt adjustments in the economy which would cause further production bottlenecks. We already experienced this during the energy crisis following Russia's invasion of Ukraine, when Europe quickly needed to reduce its dependence on Russian energy. China being a top provider of foreign critical inputs for industries in the EU – like the nickel used in car batteries and the silicon used in solar panels – might cause similar bottlenecks if the supply of those inputs suddenly dries up.[3]

Global heating and nature degradation are also eroding the productive capacity of the economy. Nature degradation depletes the services that ecosystems provide, such as food, drinking water and raw materials, as well as protection against natural hazards and carbon uptake and storage. In addition to this depletion of non-renewable resources, natural inputs to the economy that do regenerate are increasingly being degraded. Scientists have calculated that humanity is currently using natural resources 1.7 times faster than ecosystems can regenerate them – in other words, each year we are consuming resources equivalent to 1.7 planet Earths.[4]

And the impact of the climate and nature crises reaches far beyond the inputs that nature provides to the economy. For example, the average lifespan of the physical capital stock – including manufacturing plants, roads, ports, electricity grids, office buildings and people's homes – will shorten significantly due to increasing natural hazards. This implies that, without an increase in investment, the available capital stock will decline, negatively affecting the productive capacity of the economy.

In addition to climate and nature hazards reducing the stock of natural and physical capital, the economic yield of this capital is also adversely affected. To take just one example, crop yields have fallen because of more frequent extreme weather events. Estimates from ECB staff suggest that the heatwave in 2022 increased overall food price inflation by around 0.6 to 0.7 percentage points, with the impact lasting well into 2023.[5] At these magnitudes, this becomes a risk factor for overall price stability, especially because extreme weather events are becoming both more frequent and longer lasting. This is why, in our recent monetary policy communication, we explicitly acknowledge adverse weather conditions as risk factors for the inflation outlook.[6] Other sectors are similarly suffering from the impact of global warming and nature degradation. Think of the bottlenecks to trade and industrial production when inland shipping routes become unnavigable as rivers increasingly run dry. Companies may attempt to recoup the resulting losses by increasing their prices, but they may also simply see their financial resilience deteriorate.

Future-proofing the economy against bottlenecks

In the absence of mitigating factors, bottlenecks caused by geopolitical tensions, economic fragmentation and climate and nature hazards erode the productive capacity of the economy. The most straightforward and effective option to avoid these bottlenecks would be to reject protectionist tendencies and implement a timely and successful transition to a sustainable green economy. Earlier today, Claudia Buch, the Chair of the ECB's Supervisory Board, delivered a speech forcefully reiterating the call for this green transition while also emphasising its economic benefits.[7]

Unfortunately, we cannot take for granted that the best option will materialise. Central banks cannot influence the geopolitical tides. Despite the efforts of governments, climate and nature science tells us that climate and nature objectives will not be met in time, and hazards are already on the rise.[8] So, in addition to striving unrelentingly to accomplish this best option, we also need to identify ways of future-proofing the economy to increase its resilience in the face of bottlenecks that are likely to emerge. As President Lagarde made clear in a speech earlier this week, adaptation and anticipation will be crucial in this challenging environment.[9]

In fact, an adjustment to geopolitical risks is already taking place. While the euro area has been progressively diversifying import sources since the turn of the century – even though this means turning to a larger number of sourcing countries and increasing trade costs – our analysis finds that since 2016 this diversification increasingly has a geopolitical dimension.[10] And incoming data show that foreign direct investment made by companies to build new production capacity abroad, or extend existing capacity, is also showing signs of fragmentation along geopolitical lines.[11]

More investments are needed for upgrading, adapting and replenishing the existing physical capital stock to future-proof it against increasing climate and nature hazards. Increasing capital stock resilience may also require physically relocating parts of it to avoid proximity to areas that will be heavily exposed to hazards.

The adverse impact of evolving threats to the economy's productive capacity can also be reduced by countering labour scarcity and increasing productivity. In a recent speech, ECB Executive Board member Isabel Schnabel argued that there is scope for addressing labour scarcity by further increasing labour participation, allocating workers more efficiently, strengthening education and attracting foreign workers.[12] ECB Vice-President Luis de Guindos recently highlighted enhancement of the Single Market and advancement towards capital markets union in Europe as a means of bridging the productivity gap that has emerged between the euro area and the United States over the past 30 years.[13] And reports by Mario Draghi on European competitiveness[14] and Enrico Letta on the Single Market[15] provide a set of policy proposals that require serious consideration in this context. Technological advances – in particular, rapid developments in artificial intelligence[16] – also present an opportunity for Europe to increase productivity. At the same time, an increased reliance on technologies opens up new vulnerabilities in the form of cyber risks that are likely to be aggravated by geopolitical and climate and nature threats. Additionally, cyber incidents may very well create similar bottlenecks to those stemming from geopolitical tensions and climate and nature hazards, which only increases the importance of improving overall economic resilience.[17]

Implications for monetary policy

Let me turn to the implications of increased bottlenecks for the ECB and our monetary policy.

We are responsible for maintaining price stability. We have neither the competencies nor the instruments to stop bottlenecks emerging that affect the productive capacity of the economy. We also cannot avoid the adjustments that the economy will have to undergo in response to emerging bottlenecks. These typically take the form of relative price adjustments and sectoral adjustments in economic activity, which may translate into consequences for aggregate economic activity, unemployment and inflation. The ability of the economy to adapt – supported by fiscal policy whenever necessary – is in fact a crucial component of the economy's overall resilience.

Our task is to prevent situations where welcome adjustments to bottlenecks translate into very unwelcome risks to medium-term price stability – such situations can arise when adjustments go beyond relative price alterations and temporary deviations of inflation from our 2% target. When inflation expectations are firmly anchored at our target, workers and companies take this into account when negotiating wages and setting prices, which helps avoid spiralling wage and price dynamics aggravating the impact of shocks. So, the more frequent and more pronounced the adjustments facing the economy, the more important it becomes that the economy can rely on its price stability anchor.

At the same time, assessing the appropriate monetary policy response becomes more complicated. While we cannot avoid the occurrence of bottlenecks, we must be able to identify them and assess the implications for price stability. Besides accounting for the implications of geopolitical risks, fragmentation and climate and nature hazards for the productive capacity of the economy, we must also assess these effects in conjunction with changes to demand that are likely to occur at the same time. And, as bottlenecks may have an impact on the financial resilience of firms, there may also be financial transmission channels which must not be overlooked. If financial risks arising from bottlenecks were to impair the soundness of financial institutions – despite all our efforts as a banking supervisor to mitigate them – the effectiveness of our monetary policy could also be adversely affected. We cannot pre-empt exactly what the appropriate policy response to an emerging bottleneck would be. Therefore, the flexibility and data-dependency that we have applied in navigating the challenges of the past few years will remain crucial in the years to come.

Finally – all else being equal – monetary policy may have to respond more proactively to bottlenecks than has been considered appropriate in the past. Traditionally, central banks have often looked through temporary shocks affecting the productive capacity of the economy and not necessarily responded with policy adjustments.[18] Monetary policy works its way through the economy with long and variable lags. If a shock is short-lived and inflation expectations are firmly anchored, the inflation impact may have already faded by the time a monetary policy response has been transmitted to the economy. By not responding to such temporary shocks, central banks aim to avoid policy adversely affecting economic activity while inflation is still consistent with their medium-term target.

However, considering the magnitude, frequency and persistence of the bottlenecks that might emerge, their impact on inflation may also be more pronounced and long-lasting. This could increase the risks of inflation expectations becoming de-anchored and of second-round effects in the form of wage-price spirals, which would be inconsistent with our price stability objective. Therefore – again, all else being equal – the prevalence of geopolitical tensions, economic fragmentation and climate and nature hazards implies that there would be less scope for looking through deviations of inflation from our 2% target. In other words, in the future, monetary policy may have to respond more proactively to bottlenecks that affect the productive capacity of the economy, which heightens the importance of maintaining flexibility.

Conclusion

Let me conclude.

In the current environment of geopolitical tensions and economic fragmentation, and in view of the ongoing climate and nature crises, there is an increasing likelihood of bottlenecks emerging that will test the resilience of the economy. This not only complicates the pursuit of price stability, it also threatens the safety and soundness of banks – which is why it is also reflected in our priorities for European banking supervision.

More favourable winds would reduce bottlenecks and make the pursuit of our mandate easier. However, we are unconditionally committed to delivering on our mandate, and this is not changed by the way the wind blows. Sailor Pavlos Kontides, Cyprus' first Olympic medal winner, said in an interview just before winning silver at the Paris Olympics this summer: "If I make the right choices, I don't care if it's a light or a strong breeze." In our case, to make the right policy choices we must stay laser-focused on our objective of price stability, while maintaining flexibility to account for bottlenecks as they emerge.

My final message is addressed directly to the students, teachers and researchers gathered here today. The silver lining to the challenges that I have outlined is that your talents, knowledge and expertise are urgently needed. Roman philosopher – and follower of Zeno of Citium[19] – Seneca the Younger is known to have said that, while labour strengthens the body, difficulties strengthen the mind. Insecure times call for the strongest minds to secure stability and resilience.

Thank you for your attention.

1.

Lagarde, C. (2022), "Finding resilience in times of uncertainty", speech at an event organised by the Central Bank of Cyprus, Nicosia, 30 March.

2.

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3.

Essers, D. et al. (2024), "Critical inputs from China: how vulnerable are European firms to supply shortages?", *The ECB Blog*, ECB, 9 October.

4.

Global Footprint Network (2024), "Earth Overshoot Day 2024 approaching", *Blog*, 21 July.

5.

Kotz, M., Kuik, F., Lis, E. and Nickel, C. (2023), "The impact of global warming on inflation: averages, seasonality and extremes", *Working Paper Series*, No 2821, ECB, 23 May.

6.

For example, our most recent monetary policy statement acknowledges that extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices.

7.

Buch, C. (2024), "The transition towards a low-carbon economy: what supervision can contribute", speech at the ESM/CEBRA conference "The Role of Central Banks and International Financial Institutions in the Transition Towards a Low-Carbon Economy", Luxembourg, 21 November.

8.

Elderson, F. (2024), "'Know thyself' – avoiding policy mistakes in light of the prevailing climate science", speech at the Delphi Economic Forum IX, Delphi, 12 April.

9.

Lagarde, C. (2024),"The economic and human challenges of a transforming era", speech at "Les Essentiels des Bernardins", Paris, 18 November.

10.

Ilkova, I., Lebastard, L. and Serafini, R. (2024), "Geopolitics and trade in the euro area and the United States: a de-risking of import supplies?", *Economic Bulletin*, Issue 5, ECB.

11.

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12.

Schnabel, I. (2024), "Escaping stagnation: towards a stronger euro area", speech at a lecture in memory of Walter Eucken, Freiburg, 2 October.

13.

De Guindos, L. (2024), "Bridging the gap: reviving the euro area's productivity growth through innovation, investment and integration", speech at the Latvijas Banka and SUERF Economic Conference, Riga, 2 October.

14.

Draghi, M. (2024), *The future of European competitiveness*, European Commission, 9 September.

15.

Letta, E. (2024), *Much more than a market*, 10 April.

16.

Cipollone, P. (2024), "Artificial intelligence: a central bank's view", speech at the National Conference of Statistics, Rome, 4 July.

17.

For the importance of financial sector cyber resilience and a discussion of the outcome of a cyber resilience stress test conducted by ECB Banking Supervision in 2024, see Tuominen, A. (2024) "Enhancing banks' resilience against cyber threats – a key priority for the ECB", *The Supervision Blog*, ECB, 26 July. Improving cyber resilience is a key focus area of ECB Banking Supervision in 2024-25.

18.

Schnabel, I. (2022), "Looking through higher energy prices? Monetary policy and the green transition", remarks at a panel on "Climate and the Financial System" at the American Finance Association Virtual Annual Meeting, Frankfurt, 8 January.

19.

Zeno of Citium, who is known for having founded the Stoic school of philosophy in Athens around 300 BC, was born in Cyprus.

CONTACT