Monetary policy in times of uncertainty and structural challenges

Speech at the European Stability Mechanism

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1 Introduction

Ladies and gentlemen, it is a great pleasure to be here and address such a distinguished audience of financial market experts. As seasoned market observers, you are undoubtedly accustomed to the ups and downs of financial markets.

In the early autumn of 2023, financial markets were expecting that the Eurosystem would reduce its monetary policy rate by approximately 60 basis points throughout 2024. Just three months later, progress in central banks' efforts to tame inflation, together with a weakening real economy, led markets to believe that central banks would significantly accelerate their rate-cutting cycle, with a cumulative reduction of 160 basis points reckoned to be likely.

However, in the first half of 2024, inflation proved to be more persistent than anticipated. And the real economy, including the labour market, showed renewed signs of resilience. Consequently, expectations for rate cuts in the euro area for 2024 decreased steadily to approximately 65 basis points by June 2024.

Subsequently, the pendulum swung back again as we saw the inflation rate coming in several times lower than expected and the economy slowing down. Following the three 25-basis-point cuts already implemented in June, September and October, markets currently expect the overnight money market rate to stand approximately 100 basis points lower throughout 2024.

What accounts for these significant fluctuations in market expectations? The Eurosystem can closely steer the overnight money market rate by adjusting its monetary policy rates. Accordingly, the fluctuations in forward overnight money market rates ultimately reflect financial markets' expectations of how we see current and future economic developments and how we are going to respond. Or, to put it in central banker language, these fluctuations are inter alia interpretations of our reaction function.

The large swings observed over the past few months suggest high uncertainty regarding the outlook for the real economy and prices. In my speech, I aim to provide you with some guidance. More specifically, I will explore how the Eurosystem analytically addresses uncertainty and how this uncertainty impacts our monetary policy decisions. I will illustrate this with several scenarios recently analysed by Eurosystem staff.

I will conclude with a short outlook for our upcoming monetary policy meeting next week. Before delving into the scenarios, let me provide a brief overview of the current outlook for the real economy and prices in the euro area and Germany.

2 Current economic developments

In the September 2024 macroeconomic projections, ECB (European Central Bank) staff predicted that the euro area economy would grow by 0.8 percent in 2024, rising to 1.3 percent in 2025 and 1.5 percent in 2026. Furthermore, staff projected that the euro area inflation rate would gradually decline to an average of 1.9 percent by 2026. This anticipated decrease in the inflation rate was primarily due to reduced cost pressures, lower profit margins, and the delayed effects of monetary policy tightening.

Macroeconomic data received since September has been mixed. In the third quarter of 2024, economic output in the euro area increased more than expected. However, the underlying growth momentum remains subdued. Euro area inflation in September, October and November was – overall – weaker than expected, now standing at 2.3 percent. The core inflation rate, which excludes energy and food prices, remained unchanged in November at 2.7 percent.

Furthermore, wage growth picked up in the third quarter to 5.4 percent, driven by an exceptionally strong increase of negotiated wages in Germany amounting to 8.8 percent. The significant increase was driven by the high wage outcome in Germany's retail and wholesale trade sectors, which included, among other factors, substantial one-off inflation adjustment premiums. However, the latest negotiations in the metal and electronics sector show a more moderate trend. As temporary inflation compensation premiums expire by the end of 2024, the relative importance of permanent payments will increase significantly.

The German economy has recently been at the centre of attention due to its lacklustre growth. Germany's economic performance improved in the third quarter of 2024, with real GDP (gross domestic product) rising by a seasonally adjusted 0.1 percent compared to the previous quarter. While this exceeded earlier expectations, the GDP (gross domestic product) decline in the second quarter was revised up from 0.1 percent to 0.3 percent, indicating that overall economic performance remained weak during the summer half-year.

Currently, none of the major demand components offer much reason to expect a significant short-term recovery of the German economy.[1] Although private consumption benefited from steeply rising wages in the third quarter, the labour market is weakening, and high consumer uncertainty has likely dampened private consumption growth.

Exports and production in both industry and construction have continued to decline. High financing costs and significant economic policy uncertainty continue to weigh on investments, affecting demand for construction services and capital goods. Additionally, low capacity utilisation is further hindering investment in the industrial sector.

The competitive position of German industry has worsened, and growing foreign markets have not provided growth impulses as they did in the past. Industry is under significant pressure to adapt to changing structural conditions, both domestically and globally. Among these challenges are higher energy costs, the shift to carbon-neutral production methods, as well as increasing competition from emerging economies (such as China) and rising international tensions.[2] The German automotive sector is particularly affected by this structural transformation.

More generally, substantial bureaucratic burdens along with accelerating demographic change are negatively impacting the German economy. While many of these structural challenges might be particularly pronounced in Germany, they are also present in other European countries.

When we face the same challenges, we should consider dealing with them together: a common European approach will be key to overcoming many of these issues. The recently published reports by Enrico Letta and Mario Draghi offer valuable suggestions in this regard.[3] Delving deeply into these two reports could easily take up an entire speech, so I will focus on one aspect that I believe is most relevant to you.

What kind of public goods should we provide together in Europe and how should we finance them? There is a broad consensus that we can and should realise efficiency reserves. But as is so often the case, the devil is in the detail.

In general, joint provision is advisable if one of the following two criteria applies: First, that joint provision of public goods is more cost-effective. Second, that there is a risk of under-provision at the national level because benefits accrue across borders.

These criteria certainly apply to defence policy, which to date has largely been a national affair. As a European, I firmly believe that we should work more closely together in this area. However, well intentioned is not always well done. It is no child's play to create a reliable European defence policy. For example, we have to establish reliable and functioning decision-making structures.

Another area where there is certainly room for improvement is common European infrastructure, be it the energy or IT (information technology) infrastructure. Here, common European standards and policy coordination are crucial. For example, the countries of the EU (European Union) should reduce requirements and regulation that hinder cross-border cooperation.

While joint financing is not a precondition, the EU (European Union) budget could be used more to finance European public goods or to support the build-up of a European infrastructure. Currently, two thirds of the budget are used for agricultural subsidies and cohesion spending geared heavily towards redistribution.

Financing common spending through common debt is in my view not a near-term goal. There are economic as well as legal grounds for caution, as the German Constitutional Court has made clear.[4] Common EU (European Union) debt would thus require further integration with profound institutional reforms.

Stronger fiscal rules alone are not sufficient for shared debt responsibility. To ensure democratic decision-making structures, competencies would need to be transferred to the European level. But currently I do not see political majorities for such far-reaching institutional changes.

Taken together, the direction for Europe seems clear. However, there is uncertainty about how we will get there. And this brings me back to the beginning of my speech: the significant uncertainty that we currently face regarding future price developments.

3 Uncertainty in the Eurosystem's inflation projection

How does the Eurosystem address this uncertainty, and how does it affect our view on the inflation outlook? As many of you know, the macroeconomic projections are a key input to our monetary policy decision-making process and, as such, also an important communication tool of the Eurosystem.[5]

Every quarter, staff project the euro area inflation rate and other macroeconomic variables for the coming two to three years. The projections published in June and December are prepared by experts from national central banks (NCBs (national central banks)), in close coordination with experts from the ECB (European Central Bank). The projections published in March and September are instead prepared by ECB (European Central Bank) staff, with NCB (national central bank) experts providing the short-term inflation projections.

These projections rest upon certain technical – exogenous – assumptions. Accordingly, the projections can be viewed as conditional. Specifically, the staff projections build on market expectations with respect to our policy path. Thus, the projections do not necessarily reflect an interest rate path that the Governing Council deems most appropriate.

Market observers often focus on what we call the baseline projection. It re-presents the trajectory that Eurosystem staff consider most likely. However, the baseline is not the only scenario for future developments. The Eurosystem routinely performs various sensitivity and scenario analyses. And these sensitivity and scenario analyses also factor into our monetary policy decisions.

The Eurosystem summarises the results of these analyses in the "risk assessment" section of our monetary policy statement.[6] The more detailed results are published in our quarterly reports. But the sensitivity and scenario analyses are not only helpful for refining our monetary policy decisions. They can also help market observers to better understand our reaction function.

In the following, I would like to highlight three different sensitivity and scenario analyses that Eurosystem staff have conducted over recent quarters: First, the impact of alternative energy price paths. Second, the impact of alternative scenarios for consumer confidence. And third, the impact of alternative paths for euro area productivity developments.

3.1 Alternative energy paths

The first source of uncertainty concerns energy prices. The baseline inflation projection builds on the price paths contained in futures at a specific cut-off date for both oil and gas prices as exogenous variables.[7] Given the high uncertainty inherent in the future trajectory of oil and gas prices, alternative paths for these commodities may significantly influence economic projections.

Eurosystem staff address this uncertainty by exploring alternative downside and upside scenarios.[8] In technical terms, these scenarios are derived from the 25th and 75th percentiles of the option-implied estimated distribution of the probabilities that market participants attach to future oil and gas prices.

In the most recently published sensitivity analysis in September 2024, for oil prices, the alternative paths were symmetrically distributed around the baseline, indicating broadly balanced risks. However, for gas prices, the distribution suggested upside risks, probably reflecting adverse geopolitical factors such as escalating tensions in the Middle East and the war in Ukraine. For each scenario, Eurosystem staff computed a synthetic energy price index, a weighted average of the oil and gas price paths, and assessed the macroeconomic impacts using ECB (European Central Bank) and Eurosystem models.

The September results indicated generally stronger upside risks to inflation and more limited risks to GDP (gross domestic product) growth.[9] In the upside risk scenario, inflation could be a cumulative 1.5 percentage points higher until the end of 2026 than in the baseline. In contrast, the downside scenario foresaw inflation to be 1.1 percentage points lower. Taken together, temporary fluctuations in energy prices show a strong impact on euro area inflation. The main reason for this is that energy prices are highly flexible and have a strong pass-through.

3.2 Alternative scenarios for consumer confidence

Let me now turn to a scenario analysis for another important cyclical driver of the real economy. Following the Russian attack on Ukraine, consumer confidence in the euro area plummeted. It has remained subdued since, despite a recent uptick. Consequently, consumption and housing investment have been restrained, while savings have remained elevated.

In our September 2024 projections, Eurosystem staff delved into the potential risk that unexpected changes in consumer confidence pose to our baseline projections, my second source of uncertainty. I would like to highlight two alternative scenarios. [10]

The first scenario, assuming lower confidence, predicted an increase in the savings ratio and a decline in housing investment due to heightened geopolitical uncertainty and elevated financing costs. The second scenario, with higher confidence, envisioned a faster improvement in consumer confidence, leading to a lower savings ratio, higher spending, and increased housing investment.

The lower and higher confidence scenarios have noticeable effects on the growth rate of private consumption and real GDP (gross domestic product). Until 2026, the cumulative effect on consumption is 1.4 percentage points and on real GDP (gross domestic product) 0.9 percentage point, with a negative sign for the lower confidence scenario. Conversely, the cumulative impact on euro area inflation is rather negligible, amounting to plus or minus 0.1 percentage point. Taken together, while changes in consumer confidence seem to have a noticeable impact on the real economy, they hardly affect our baseline projection for the inflation rate – at least for September 2024.

3.3 Alternative paths for euro area productivity

Finally, allow me to consider a crucial driver of medium to long-term growth. Productivity growth in the euro area has been relatively weak for some time both in historical terms and in comparison to other countries, such as the United States. One reason for this development was that firms in the euro area retained or even created new jobs at a time when output growth was relatively weak. Furthermore, there are also strong indications that the underlying trend of productivity improvement has weakened significantly.

The latest baseline projections imply that productivity will gradually improve with a strengthening of GDP (gross domestic product) growth. Despite this improvement, productivity growth is expected to remain lower than over the past two decades. But a faster recovery of productivity cannot be ruled out either. It would require the widespread adaptation of new technologies such as artificial intelligence.

To assess the impact of alternative productivity paths, my third source of uncertainty, Eurosystem staff considered two scenarios in June:[11] In an optimistic scenario, staff assumed a faster unwinding of past cyclical drivers that supported employment, such as a reduction in labour hoarding and hiring incentives. This would result in weaker employment growth over the projection horizon, leading to higher labour productivity compared to the baseline.

In a pessimistic scenario, staff assumed structural factors negatively affecting capital and total factor productivity (TFP (total factor productivity)). One avenue would be that hysteresis effects from past low demand reduce the incentives to invest in the capital stock. Another channel would be that high energy prices, geopolitical tensions, and supply chain issues could also negatively influence trend TFP (total factor productivity).

In the optimistic scenario, the cumulative impact on the inflation rate up to the end of 2026 is very small, a negligible reduction of 0.02 percentage point. In the pessimistic scenario, inflation cumulatively increases by 0.25 to 0.3 percentage point. The impact on real GDP (gross domestic product) growth was negative in both scenarios, ranging from a cumulative reduction of 0.2 to 0.9 percentage point. Taken together, the baseline projection for the inflation rate is not very sensitive to these alternative scenarios for productivity.

3.4 Overall assessment

What are the main lessons you and market participants more generally can draw from these analyses? Let me mention three:

Firstly and obviously, energy prices have a strong immediate impact on our outlook for the inflation rate. Therefore, our December staff projection, too, will be taking a close look at energy prices in the baseline as well as in alternative scenarios.

Secondly, some factors that have a noticeable impact on real economic growth, such as changes in consumer confidence or productivity growth, need not significantly affect the outlook for the inflation rate.

Thirdly, it is important to recognise that all scenario analyses are determined by the specific risks prevalent at the time they are conducted. As we look ahead, we must consider the potential emergence of new risks that could significantly impact euro area inflation. Currently, one significant concern is the potential impact of the tariffs proposed by the incoming US (United States) administration. I imagine we are all aware of the frequent announcements on social media, featuring new numbers and new countries.

Accordingly, in these uncertain times, financial market participants are well advised not only to consider our baseline projections, but also to incorporate the Eurosystem's comprehensive scenario and sensitivity analyses.

4 Monetary policy outlook

Where does all this leave us regarding the decision to be made at the ECB (European Central Bank) Governing Council meeting next Thursday?

At the beginning of this week, markets had priced in an interest rate reduction of approximately 32 basis points. Given that the disinflation process is proceeding largely as currently projected, at this stage I would have no objections if we were to continue to reduce our policy rates.

But I reserve my final judgement until I have reviewed the new macroeconomic projections for December and made up my mind concerning the risks surrounding the baseline. In any case, I caution against lowering the degree of restriction too hastily. Interest rates should converge slowly and at a measured pace towards neutral territory.

I am well aware that the neutral territory is difficult to pin down, which adds another layer of uncertainty. This uncertainty is, in my view, another argument in favour of taking a cautious and gradual approach. As of now, I do not see a significant risk of inflation undershooting that would warrant the Eurosystem becoming expansionary in the near future.

Footnotes:

1. See Deutsche Bundesbank (2024), The German economy, Monthly Report, November 2024.
2. On the latter point, see Nagel (2024), Geoeconomic fragmentation: handling inflation pressures and volatility, increasing resilience, Speech at Tokyo University, 18 November 2024, Tokyo.
3. Letta, E. (2024), Much more than a market – speed, security, solidarity. Empowering the Single Market to deliver a sustainable future and prosperity for all EU (European Union) Citizens; Draghi, M. (2024), The future of European competitiveness – A competitiveness strategy for Europe.
4. See Federal Constitutional Court (2022), Judgment of the Second Senate of 31 October 2022, 2 BvR 900/22 –, paras 1-38, https://www.bverfg.de/e/rs20231031_2bvr090022en*[https://www.bverfg.de/e/rs20231031_2bvr090022en]*, in particular para 8.

5. See Nagel (2024), Dot plots for the Eurosystem?, Speech at Harvard University, 22 October 2024, Cambridge.
6. See, for example, https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2024/html/ecb.is241017~59ad385bab.en.html *[https://www.ecb.europa.eu/press/press_conference/monetary-policy-statement/2024/html/ecb.is241017~59ad385bab.en.html]*
7. Oil prices refer to Brent crude oil spot and futures prices. Gas prices refer to the Dutch TTF (Title Transfer Facility) gas spot and futures prices.
8. See ECB (European Central Bank) (2024b), Eurosystem staff macroeconomic projections for the euro area, September 2024, section 6, for details.
9. The macroeconomic impacts are reported as averages of a number of ECB (European Central Bank) and Eurosystem staff macroeconomic models.
10. See ECB (European Central Bank) (2024a), op. cit., box 2 for details. For the sake of brevity, the third scenario with temporarily lower confidence is not considered.
11. See ECB (European Central Bank) (2024a), Eurosystem staff macroeconomic projections for the euro area, June 2024, box 3 for details. The scenarios were evaluated using two different models. See the notes in Table B of ECB (European Central Bank) (2024a) op. cit. for details.