

SPEECH

The euro area outlook and monetary policy

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Introduction

The Governing Council last week decided to lower the deposit facility rate – the rate through which we steer the monetary policy stance – from 3.25 per cent to 3.0 per cent. This decision was justified by our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. In my remarks, I would like to discuss these three elements of our reaction function.^{[1][2]}

The inflation outlook

The December Eurosystem staff projections expect headline inflation to average 2.4 per cent in 2024, 2.1 per cent in 2025 and 1.9 per cent in 2026. It is then projected to increase to 2.1 per cent in 2027 as a result of the expanded EU Emissions Trading System. The projections continue to foresee a rapid decline in core inflation, from 2.9 per cent this year to 2.3 per cent in 2025 and 1.9 per cent in 2026 and 2027. Compared to the September 2024 macroeconomic projections exercise (MPE), the projections have been revised down by 0.1 percentage points in 2024 and 2025 for headline inflation, and in 2026 for core inflation.

The latest Survey of Monetary Analysts is broadly in line with the December projections for headline inflation. Market-based indicators of inflation compensation are also consistent with a timely return of inflation to target, while also showing a marked compression in inflation risk premia. This may suggest that markets have revised downwards the risk of future adverse supply shocks and revised upwards the risk of future adverse demand shocks.

The economic outlook plays a central role in determining the inflation outlook. The incoming information suggests a slowdown in the near term. Looking ahead, conditions are in place for growth to strengthen over the forecast horizon. According to the staff assessment, while structural factors have weighed on the euro area economy, especially the manufacturing sector, the weak productivity growth since 2022 has also included a significant cyclical component, largely driven by the past tightening of monetary policy and weak external demand. Domestic demand should therefore benefit from rising real wages, the gradual fading of the effects of restrictive monetary policy and the ongoing recovery in the global economy. Although fiscal policies are set to remain on a consolidation path overall, funds from the Next Generation EU programme will still support investment in the next two years.

On the external side, euro area export growth is expected to benefit from strengthening foreign demand. At the same time, trade uncertainty has increased materially and the effects of a potential increase in tariffs on the euro area economy will depend on the extent, timing and magnitude of tariff and non-tariff measures, as well as on the responses of the EU and other countries.

The labour market remains resilient. Employment grew by 0.2 per cent in the third quarter, again surprising to the upside, and the unemployment rate remained at its historical low of 6.3 per cent in October. However, labour demand continues to soften. The job vacancy rate declined to 2.5 per cent in the third quarter, 0.8 percentage points below its peak, and surveys also point to fewer jobs being created in the current quarter.

According to the December Eurosystem staff projections, real GDP growth is expected to average 0.7 per cent in 2024, 1.1 per cent in 2025, 1.4 per cent in 2026 and 1.3 per cent in 2027. Compared to the September projections, real GDP growth has been revised down by 0.1 percentage points in 2024 and 2025. The latest Survey of Monetary Analysts indicates a lower growth profile than the staff projections for 2025, 2026 and 2027.

The inflation outlook also encompasses the assessment of the risks surrounding the baseline path. The risks to economic growth remain tilted to the downside. The risk of greater friction in global trade could weigh on euro area growth by dampening exports and weakening the global economy. Lower confidence could prevent consumption and investment from recovering as fast as expected. This could be amplified by geopolitical risks, such as Russia's unjustified war against Ukraine and the tragic conflict in the Middle East, which could disrupt energy supplies and global trade. Growth could also be lower if the lagged effects of monetary policy tightening last longer than expected. It could be higher if easier financing conditions and falling inflation allow domestic consumption and investment to rebound faster, which would also make the euro area more resilient to global shocks.

Inflation could turn out higher if wages or profits increase by more than expected. Upside risks to inflation also stem from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more broadly could drive up food prices by more than expected. 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. Greater friction in global trade would make the euro area inflation outlook more uncertain.

Underlying inflation

The indicators of underlying inflation with the highest predictive power are developing in line with a sustained return of inflation to target; in particular, the Persistent and Common Component of Inflation (PCCI) measure remains at around 2.0 per cent. Domestic inflation, which closely tracks services inflation, again eased somewhat in October. But at 4.2 per cent, it remained high, reflecting strong wage pressures and the fact that some services prices have still been adjusting to the past inflation surge.

At the same time, the incoming information points to a moderation in services inflation dynamics, which should support an easing of domestic inflation. The three-month-on-three-month seasonally adjusted services inflation rate fell to 2.6 per cent in November from 3.4 per cent in October, indicating a further softening in momentum. Meanwhile, the sizeable gap between services inflation and its medium-term underlying trend – captured by the PCCI for services, which stands at 2.5 per cent – suggests there should be further downward adjustment in services inflation in the coming months.

The incoming wage data broadly confirm our previous assessment of elevated but easing wage pressures. The growth rate of compensation per employee moderated to 4.4 per cent in the third quarter from 4.7 per cent in the second quarter, 0.1 percentage points below the December projection. The growth rate of unit labour costs eased to 4.3 per cent from 5.2 per cent. Profit margins continue to buffer the impact of elevated labour costs on inflation: annual growth in unit profits remained negative in the third quarter. Forward-looking wage trackers continue to point to a material easing of wage growth in 2025.

The strength of monetary policy transmission

Market interest rates in the euro area have declined further since our October meeting, reflecting the perceived worsening of the economic outlook and the consequent repricing of policy rate expectations. Our past interest rate cuts – together with the anticipation of future cuts – are gradually making it less expensive for firms and households to borrow. The average interest rate on new loans to firms was 4.7 per cent in October, more than half a percentage point below its peak a year earlier. The cost of issuing market-based debt has fallen by more than a percentage point since its peak. The average rate on new mortgages has also come down, to 3.6 per cent in October, around half a percentage point below its peak in 2023.

But financing conditions remain restrictive. The cost of new credit for firms is elevated in historical comparison, particularly in real terms, and the cumulative tightening of credit standards since the beginning of the hiking cycle remains elevated. The average rate on the outstanding stock of mortgages is set to rise as loans granted at fixed rates reprice at higher levels. Bank lending to firms has only gradually picked up, from subdued levels, with the annual rate of increase rising to 1.2 per cent in October. The annual growth rate of debt securities issued by firms stood at 3.1 per cent in October, remaining within the narrow range observed over recent months. Mortgage lending continued to drift up gradually, to an annual growth rate of 0.8 per cent in October.

Conclusion

In summary, the incoming information and the latest staff projections indicate that the disinflation process remains well on track. While domestic inflation is still high, it should come down as services inflation dynamics moderate and labour cost pressures ease. Recent policy rate cuts are also gradually transmitting to funding costs, but financing conditions along the entire transmission chain, starting with the level of our policy rate and including the market interest rates that financial intermediaries charge on credit to households and firms, remain restrictive.

This assessment explains the decision to lower the deposit facility rate by 25 basis points. Looking to the future, in the current environment of elevated uncertainty, it is prudent to maintain agility on a

meeting-by-meeting basis and not pre-commit to any particular rate path. In terms of risk management, monetary easing can proceed more slowly compared to the interest rate path embedded in the December projections in the event of upside shocks to the inflation outlook and/or to economic momentum. Equally, in the event of downside shocks to the inflation outlook and/or to economic momentum, monetary easing can proceed more quickly. All else equal, the rate path will also be influenced by our ongoing assessment of underlying inflation dynamics and the strength of monetary policy transmission.

We are determined to ensure that inflation stabilises sustainably at our two per cent medium-term target. We will follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance. In particular, our interest rate decisions will be based on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. We are not pre-committing to a particular rate path.

Annexes

18 December 2024

[Slides](#)

1.

A [slide deck](#) to accompany these remarks is available on the ECB website.

2.

For further discussion of last week's monetary policy decision, see Lagarde, C. (2024), "Monetary policy in the euro area", speech at the Bank of Lithuania's Annual Economics Conference on "Pillars of Resilience Amid Global Geopolitical Shifts", on the occasion of the 10th anniversary of euro introduction, Vilnius, Lithuania, 16 December.

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