Luis de Guindos: The economic outlook and monetary policy in the euro area

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the 15th edition of Spain Investors Day, Madrid, 15 January 2025.

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It is a pleasure to speak here again this year.[1] In my remarks last year, I expanded on monetary policy in the face of high inflation risks. The outlook was then still being shaped by the easing of pandemic-related supply constraints and by the energy price shock. Inflation had fallen rapidly from its peak in autumn 2022, but we needed to keep monetary policy sufficiently restrictive to ensure a timely and sustainable return of inflation to our 2% target.

Today, the euro area is in a very different place. Having cut interest rates four times since last June, by a total of 100 basis points, we have made substantial progress in bringing inflation back to target. At the same time, the balance of macroeconomic risks has shifted from concerns about high inflation to concerns about low growth. The outlook is clouded by even higher uncertainty, driven by potential global trade frictions, macroeconomic fragmentation, geopolitical tensions and fiscal policy concerns in the euro area. As the new year starts, it is imperative to work towards resolving the various conflicts happening in the world.

Today I will outline how the Governing Council is taking this uncertainty into account in its assessment of the inflation and growth outlook, and how a sound financial system is vital in supporting monetary policy. I will then explain the rationale behind the monetary policy decisions that we took in December and how we will approach policy decisions over the coming months.

Inflation

The good news is that the disinflation process is well on track. Headline inflation came down quickly in 2023 from the double-digit figures we saw at the end of 2022, as the impact of energy and supply-side shocks faded. The decline in 2024 was more gradual but clearly in the right direction, with inflation averaging 2.4% over the year. The slight increase in inflation in December owing to energy-related base effects had been expected. Core inflation also declined over the past two years, falling from 5% in 2023 to 2.8% in 2024.

Most measures of underlying inflation continue to suggest that inflation will settle near our 2% medium-term target on a sustained basis. One of these measures, our Persistent and Common Component of Inflation, for example, which has the best predictive power for headline inflation over the one to two-year ahead horizon, has been around 2% for more than a year. Domestic inflation, which closely tracks services inflation, has edged down, but it remains high (at more than 4%) mostly because wages and prices in certain sectors are still adjusting to the past inflation with a delay. Wage growth has also been moderating.

The December Eurosystem staff projections expect inflation to average 2.1% in 2025 and to return sustainably to our target rather early in the projection horizon.

Economic activity

The outlook for the euro area economy, however, remains weak and subject to significant uncertainty. Output grew above expectations in the third quarter of 2024. This was mainly driven by an increase in consumption, which partly reflect one-off factors that boosted tourism over the summer, and by firms building up inventories. The latest information suggests that the economy is losing momentum. Surveys indicate that manufacturing is still contracting and growth in services is slowing, as still-high energy prices, regulatory costs and the lagged effects of previous monetary policy tightening continue to bite. Firms are holding back on investments, and exports remain weak, with some European industries struggling to remain competitive. The labour market remains resilient, with employment growing in the third quarter of 2024, again by more than expected, and the unemployment rate remaining at its historical low of 6.3% in October. Overall, the December projections see growth in 2024 at 0.7%.

Looking ahead, the conditions are in place for growth to strengthen over the projection horizon, although less than was forecast in previous rounds. As the catching up of wages continues and as inflation falls, rising real wages should lead to stronger household spending. More affordable credit should boost consumption and investment. Provided trade tensions do not escalate, exports should also support the recovery as global demand rises. Growth is projected to be just above 1% in 2025 and to move slightly up to modest levels in 2026 and 2027.

Nevertheless, 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. In particular, the outlook is characterised by high uncertainty around future trade policies in the United States, political and fiscal policy uncertainty in some large euro area countries as well as global geopolitical risks. In fact, over the past year the European Commission's uncertainty index has reached its highest level to date. Furthermore, with formal budget submissions from several euro area countries still pending, projecting the future fiscal policy stance is challenging.

This environment of very high uncertainty could dent confidence and dampen the recovery in consumption and investment. Such pessimism is visible, for instance, in consumer expectations. While real household income increased both in 2023 and 2024 according to national accounts, only little more than a third of respondents to our latest Consumer Expectations Survey see their real income as having increased or at least stayed the same. Whereas only about 10% of households indicate an increase in perceived real income, in reality more than half of the households surveyed experienced an increase in their real income, when inflation is netted out from their self-reported nominal income.[2]

Financial stability

In this volatile economic environment, we see elevated financial stability vulnerabilities.

High valuations and concentrated risks leave financial markets vulnerable to adverse dynamics, which could be exacerbated by non-banks. Non-bank financial intermediaries have remained resilient to recent bouts of market volatility, supporting market-based finance in the euro area. However, broader market shocks could trigger sudden investment fund outflows or margin calls on derivative exposures. Given relatively low liquid asset holdings and significant liquidity mismatches in some open-ended investment funds, cash shortages could result in forced asset sales amplifying the fall in asset prices. While generally limited, pockets of elevated financial and synthetic leverage in some entities, like hedge funds, may add to spillover risks.

Simultaneously, sovereign vulnerabilities are increasing. Despite recent reductions in debt-to-GDP ratios in some euro area countries, fiscal challenges persist in several others. They are exacerbated by heightened policy and geopolitical uncertainty and structural issues such as sluggish potential growth. We therefore need to keep monitoring risks to financial stability carefully, including those stemming from recent increases in sovereign yields in the United States, the United Kingdom and, though more moderate, in the euro area.

On a more positive note, euro area banks are strong. Their resilience has been underpinned by solid capital ratios, robust liquidity buffers and high bank profitability. The latter may have reached its peak, however, as net interest margins are already declining while credit losses are gradually rising.

In this uncertain macro-financial environment, preserving bank resilience remains crucial. Existing releasable macroprudential capital buffer requirements and adequate borrower-based measures should be maintained to ensure that banks can absorb any future shocks. At the same time, the policy framework for non-banks should be improved from a macroprudential perspective to strengthen the sector's resilience. Finally, to mitigate the current risks to sovereign debt sustainability, it is important to implement the EU's revised economic governance framework fully, transparently and without delay. Given the structural challenges related to low potential growth, the consolidation of public finances will need to be designed in a growth-friendly way.[3]

Conclusion

Let me conclude. In December we decided to further moderate the degree of monetary policy restriction, lowering the key ECB interest rates by 25 basis points. This decision was based on our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. We are also continuing the process of balance sheet normalisation. In December the last repayment of the targeted longer-term refinancing operations was completed and reinvestments were discontinued.

We are determined to ensure that inflation stabilises sustainably at our 2% medium-term target. Given the high level of uncertainty, we will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate monetary policy stance. The high level of uncertainty calls for prudence. In particular, severe global trade frictions could increase the fragmentation of the world economy, uncertainty about fiscal policy and its present challenges could weigh on borrowing costs, and renewed geopolitical tensions could affect energy prices. We are therefore not pre-committing to a particular rate path. If the incoming data confirm our baseline, the policy trajectory is clear, and we expect to continue to further reduce the restrictiveness of monetary policy.

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[1] I am grateful to Adriana Grasso, Max Lampe and Thomas McGregor for their contributions to this speech.

[2] Baumann, A., L. Caprari, G. Kocharkov and O. Kouvavas, (2025), "Are real incomes increasing or not? Pessimism and its impact on consumption", forthcoming in *Economic Bulletin*, Issue 1, ECB.

[3] See Draghi, M. (2024), *The future of European competitiveness*, September, and Letta, E. (2024), "*Much More Than a Market*", April.