Normalising monetary policy: way forward

1. The outlook for inflation and growth in the euro area

1.1 Inflation is falling, but it remains well above the 2% target

A Central Bank official considered that progress has been made towards the objective of reducing inflation to 2% in the medium term. In October 2022, Euro area annual headline inflation was 10.6%. In July and August 2023, it was 5.3%. For the first time, core inflation is coming down. However, some of this fall is due to the drop in energy prices. It is not easy to determine the degree to which it is related to the change in interest rates. The impact of higher rates is yet to be felt. Households and businesses have been using up savings accumulated during the pandemic, but these savings will eventually run out. Until now, the EU banking industry has shown resilient. It has accommodated the weakening growth and continued high inflation without an increase in non performing loans (NPLs), for example. At some point, this will change. There has been sluggish growth during this period of rising interest rates. There are some signs that a turning point has been reached, but it remains to be seen whether this is the peak of interest rates.

A Central Bank official observed that the EU economy is in a good position despite the high levels of uncertainty. It is not at all certain that the EU has reached the peak interest rates. The estimate of r star is slightly positive in real terms. As inflation falls, policy will become increasingly restrictive. The eurozone is projected to reach 2% inflation in 2025. For the first time, the realisation of core inflation has aligned with projections. If inflation falls at this pace, the current rate is likely to be the peak. If inflation falls more slowly than projected, it will be necessary to take further action via signalling through interest rates. It is unlikely that the rate will be increased in October. By December, there will be three further readings of inflation. If they align with the projection, immediate action will likely be unnecessary. If core inflation remains persistent, however, further rate hikes must be considered.

1.2 The economy has proved more resilient than feared

1.2.1 The labour market remains resilient despite the deceleration in the economy

A Central Bank official observed that the current situation also reflects the monetary policy decisions taken during the pandemic and Russia's invasion of Ukraine. These measures were unconventional and untested, and their consequences are not yet fully understood. Due to fiscal policy support, many EU economies have been very resilient. The situation in the labour market is also unconventional. In comparison with the same stage of the last business cycle, there is unusual resilience in the labour market. In any event, headline inflation has been decreasing. It is finally in line with expectations. The current level of restriction is helping to bring inflation down. The next decision on rates will need to remain data driven. The main concern is that higher wage growth could fuel inflation. Indeed, employees demanding compensation for the loss in purchasing power amid tight labour markets has resulted in high wage growth. When considering the next step to take, it will be important to remember that currently transmission is mostly working on the lending side of banks' balance sheets.

1.2.2 Balancing resilience in the labour market with inflation reduction

A Central Bank official suggested that the key question in 2024 will be whether the resilience in the labour market is consistent with inflation returning to 2%. If inflation stalls above the target, it will be necessary to take further action.

1.2.3 As input costs reduce, profit shares will come down and labour shares will increase

A Central Bank official noted that there has been extensive discussion across Europe about profit shares, which have increased substantially in the last year. This should not have been a surprise to anyone, however. When margins remain flat and input costs rise, profit shares rise. At the peak of inflation, profit shares are at their highest. As input costs have fallen while wage demands have picked up, we already profit shares going down, as expected. This will solve the political issue regarding profit shares.

2. The monetary policy stance of the European Central Bank (ECB)

2.1 Negative interest rates were a mistake, and the ECB's response to inflation came too late

A public representative commented that Christine Lagarde was entirely right to call inflation a 'monster'. If this monster is not faced now, it will return in a more dangerous form. While the increase in policy rate seems impressive, it is worth remembering that the starting point was -1%. It was probably a mistake for rates to be this low. Secondly, the ECB's response to inflation came too late. The Federal Reserve raised interest rates in March; the ECB started in July. Over the last few months, euro area core inflation has been 5.2%, 5.7%, 5.3%, 5.6% and 5.3%. The statistical relevance of the difference between these numbers is practically zero. Core inflation is stuck at 5%. A Central Bank official noted that this is

why the Governing Council takes account of momentum. Taking account of momentum, average three month core inflation was around 4% in September.

A Central Bank official disagreed with the suggestion that negative rates were a mistake. For a long period of time, inflation remained low while rates were around that level. Negative or nominally extremely low rates could not and should not have lasted forever, but there was a rationale for making these decisions.

A public representative agreed that it is easy to say with hindsight that things should have been done differently. However, the financial system is now extremely overleveraged as a direct consequence of that policy.

A Central Bank official stated that the negative externalities of negative rates are clear. In the future, central bankers will be much more cautious about using negative rates due to these unwanted consequences.

2.2 The ECB is committed to reducing inflation to 2%

A Central Bank official highlighted the importance of anchoring expectations. The 2% target is very clear, and the market understands the firm commitment to it. At a certain point, however, the focus on 2% can become an obsession. The anchoring of expectations is about creating stability in the real economy. It is about ensuring that companies are not obsessed with costs, price increases and margins. The objective of the 2% target is not to keep inflation at exactly 2.0%. It is to stabilise inflation around 2%. Monetary policy makers need to continue to demonstrate their determination to reach 2% and communicate the successes they have achieved so far. They will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

2.3 At current interest rates, the 2% target should be reached in the second half of 2025

A Central Bank official noted that the eurozone is on track to bring inflation to 2% towards the end of 2025. However, uncertainty is very high. It is by no means certain that the present policy rate is the peak. The Governing Council will keep an open mind about further action. The yield curve reflects the changing market perception about the duration of the higher interest rate period. The markets must understand that central bankers are resolute about the 2% target. At present, the policy is in a reasonable place. Indeed, there is no need to be extremely hawkish or extremely dovish. As the economy softens, the easing of profit margins should enable wage growth to be less inflationary. However, this is yet to be seen in the data. The policy rate should only be reduced when the inflation outlook is about to consistently (say, from year and a half into the forecast) undershoot the target. If the path is leading smoothly to 2% over the forecast horizon, there is no reason to cut rates. Cutting rates too early would also reduce future policy space and push inflation up.

The Chair suggested that the key word in the discussion was 'resolute'. The Governing Council has signalled its resolve to remain restrictive for as long as necessary.

2.4 The IMF's research suggests that the policy stance should have a tightening bias

An official explained that the IMF's baseline projection is that the ECB will achieve its inflation target in Q3 2025. The IMF's research on episodes of inflation has shown that 40% of central banks do not successfully bring inflation under control after five years. The remaining 60% take an average of three years to reduce inflation to target. The IMF's research also indicates that some of these negative outcomes were caused by countries prematurely declaring victory. The currently high levels of uncertainty make it difficult to determine what the right policy stance is. The inflation data will affect the inflation outlook. The IMF's research suggests that the policy stance should have a tightening bias. If there is a requirement to carry out a second tightening cycle after inflation expectations have been de anchored, it will be extremely costly for the economy.

The development of wages and profits will be a key factor in future policy decisions. Clearly, nominal wages need to recover. The projection of recovery in 2024 is based on a recovery in real incomes. Currently, the IMF projects that nominal wage growth could be 5% for 2023 and 3% for 2024. This projection assumes that input prices substantially align with the forecast, productivity growth is flat and profit shares decrease to pre 2019 levels. Profit shares need to be compressed to allow wage growth to take place to achieve the inflation target. However, the door should be left open to further policy action on interest rates. It is encouraging to hear that there seems to be a consensus on this. The future cannot be predicted perfectly. The only choice is to react to events, which always requires some preparation.

2.5 Markets are pricing in the inflation forecast, but there is still significant uncertainty

A Central Bank official commented that markets were pricing rate cuts too early - if central bank inflation forecast materialises, rates will be cut later than markets anticipate. This cut might need to happen faster than projected only if the economy softens dramatically, if transmission is faster and stronger than forecast, if the external environment worsens or if the pass through of the decline of commodity prices into retail prices happens faster than projected. Equally, further supply side shocks could be caused by geopolitical factors, the consequences of climate change on food prices or changes in firms' pricing behaviour.

3. The challenge of addressing excess liquidity in the euro area

A public representative stated that there is considerable excess liquidity in the market. More will have to be done to reduce the balance sheet. Eurofi's monetary scoreboard also suggests that excess liquidity is a significant issue. A Central Bank official emphasised that excess liquidity must be removed in a way that does not damage the financial system, and this will take time.

3.1 The implementation of QT must be gradual and cautious

3.1.1 Testing the market with asset purchase programme (APP) sales

A Central Bank official stated that the solution to excess liquidity is quantitative tightening (QT). The Chair highlighted the recent announcement about flexible reinvestment and fragmentation risk in relation to the pandemic emergency purchase programme (PEPP).

A Central Bank official agreed that testing the market with outright APP sales could be beneficial. The ECB is already in the process of shrinking its balance sheet. Targeted Long Term Refinancing Operations (TLTRO) redemptions have contributed significantly to the reduction in the balance sheet. After so many years of expansion, any reductions could have structural consequences for the economy, the financial market and the banking sector. When there is less attention on interest rates, there will be time to discuss whether the ECB should work more proactively in this regard.

3.1.2 The excess liquidity will need to be mopped up, but there is no urgency

The Chair noted that the EU is in uncharted territory. Negative rates, quantitative easing and excess liquidity are all unprecedented phenomena.

An official agreed that QE has impacted the operation and workings of the financial market. The transmission of monetary policy through interest rates is working, however, which means that central bankers will have the time to learn how to drain this excess liquidity properly.

3.1.3 QT must be implemented cautiously

A public representative remarked that an overly abrupt implementation of QT will result in financial instability. Caution is the price that must be paid for the actions of the past. This will be a task for regulatory authorities as well as central banks. The system has become excessively leveraged over the last 10 years. The shadow banking system is a major problem that is often discussed but rarely addressed.

3.1.4 The efforts to reverse QE have been successful

A Central Bank official noted that it is too early to commit to outright sales. It does not make sense to discuss sales while central banks are still using interest rate instruments to bring inflation to 2%. Everything that has been done to reverse quantitative easing has been successful. The TLTROs, early redemption and the reduction in reinvestment have all been successful. At some point, the market needs to work with less direction from the ECB.

A Central Bank official agreed that QT should proceed gradually. QT will take time to implement and will need to be sequenced correctly. Before cutting rates, central banks should have stopped reinvesting and perhaps moved into outright sales.

3.1.5 The reserve requirement can be a useful tool to sterilise liquidity

The Chair commented that raising reserve requirements could also help address excess liquidity. In July, there was a shift to unremunerated reserve requirements. It has been suggested that this might impact profit and loss (P&L) as well as liquidity.

A Central Bank official observed that all monetary policy instruments affect P&L. The reserve requirement has been around for 200 years. As a prudential tool, it has been superseded by measures such as the liquidity coverage ratio (LCR) or the net stable funding ratio (NSFR). Monetary policy makers reached the lower bound of interest rates and expanded their balance sheets, but they have not reduced them before raising rates. In this sense, the reserve requirement is a useful tool not to drain liquidity but to sterilise it. Increasing the reserve requirement sterilises part of the excess liquidity until it can be safely drained. This affects P&L because mandatory reserve requirements are unremunerated.

A Central Bank official considered reserve requirements to be a simple tool, rather than a crude one. Simplicity is often preferable to complication. For example, the question of reverse tiering creates an entirely new set of problems.

3.2 Excess profits should be used to increase resilience in the banking system

The Chair highlighted the fact that deposit rates have not risen in line with increases in the policy rate. There have been different responses to this across the eurozone. Lithuania has imposed a windfall tax on banks, for example. The excess liquidity in the system seems to be suppressing competition on deposits, which is one channel of transmission.

A Central Bank official agreed that the transmission of monetary policy has been strong in terms of its impact on bank lending growth. However, there is considerable variation between countries. Unfortunately, banks have not been keen to share their profits. Profitability in the banking sector is extremely high. Populist thinking about what to do with these excess profits can lead to short term politically motivated decisions that ultimately damage the economy. These excess profits also have negative implications for the transmission of monetary policy. In that regard, banks must use these profits wisely. In the past, the European banking sector has had low profitability and competitiveness issues. Banks should use their excess profits to improve their services, invest in digitalisation and strengthen the banking system against further shocks.

A Central Bank official stated that banks have been slow to increase deposit rates. This is not due to reserves; it is because their results are getting better. In fact, this is a political issue. It can be solved by taxing banks, but this could have significant macroeconomic effects. It could negatively impact the climate transition, for example. It will also be difficult to do QE in the future if the banks are aware they are going to be taxed if the process is loss making for member states.

A Central Bank official highlighted the importance of taking account of the pace at which transmission is felt in deposit rates. QE, negative interest rates and the low interest rate environment were the results of a crisis caused by serious deficiencies in the business models of many banks. Central banks should not over remunerate simply because interest rates are higher. In a competitive environment, there should be pressure to increase

deposit rates. Banks should want deposits because they want to do something with them that helps the real economy. This is why this is concerning. There has been a deceleration of credit, which will have important consequences for the real economy. In that sense, it will be important to closely monitor the loan to deposit ratios of banks.

A Central Bank official agreed that the banking industry must use the present situation wisely. The banking system needs resilience and efficiency. Weak banks are prone to failure, which weakens the system. Banks need to use the time and funding available to make the industry more resilient and drive economic growth. On the macroprudential side, these profits could also be used to strengthen countercyclical buffers, say introduce positive neutral CCyB. This moment of profitability should be used to make the system more efficient and resilient.

The Chair suggested that the PEPP flexible reinvestment and the Transmission Protection Instrument (TPI) could help protect against fragmentation risk, which Charles Goodhart had recently characterised as 'the dog that has not barked'. A Central Bank official noted that the EU banking industry is in a better position than it was in when 'the dog first barked' during the eurozone debt crisis. A Central Bank official emphasised that central bankers now have the right instruments to intervene if there is any unwarranted fragmentation.