BANCO DE ESPAÑA
Eurosistema

26.07.2022

Inflation and growth: economic policy challenges*

Encuentro Foros de Vanguardia

Pablo Hernández de Cos
Governor

* English translation from de original in Spanish

Good afternoon. It is a pleasure for me to participate in this event, organised by La Vanguardia. I would like to take this opportunity to explain the ECB's most recent monetary policy decisions, in particular those we adopted last Thursday. Let me first frame those decisions in the context of the current macroeconomic scenario and the inflationary episode. To conclude my address, I will also briefly describe the role that other economic policies can play in addressing the current challenges.

The macroeconomic context

The current context is one of extraordinary uncertainty. Economic activity in the euro area is slowing, weighed down by the war in Ukraine. The economy is being adversely affected by the impact on firms of rising energy and commodity costs and the effects of high inflation on households' purchasing power, along with the persistent supply-side constraints, supply chain disruptions and heightened uncertainty.

To illustrate this point, according to the flash figure published last week, in July the euro area composite output PMI was down by 2.6 points to 49.4, putting it in contractionary territory (below 50 points) for the first time since February 2021.[1] Overall, these factors are casting a considerable shadow over the outlook for the second half of 2022 and the longer term.

At the same time, economic activity continues to benefit from the reopening of the economy (which is underpinning spending on services, in particular in the tourism sector), a strong labour market, the support of the savings built up by households during the pandemic and fiscal policy support both at the national and European level thanks to the implementation of NGEU-funded projects.

Against this backdrop, the Eurosystem projections published in June envisaged real GDP growth of 2.8% in 2022 (albeit with 2 percentage points (pp) relating to carry-over from 2021) and 2.1% in both 2023 and 2024. These projections represented a further downward revision. For instance, compared with the December 2021 projections, the GDP growth forecasts for 2022 and 2023 were down by 1.4 pp and 0.8 pp, respectively. Meanwhile, last week saw the publication of the ECB Survey of Professional Forecasters (SPF) for the third quarter of 2022, conducted in early July. The results show a fresh downward revision of real GDP growth expectations from the second quarter, down to 2.8% for 2022 and to 1.5% for 2023 (down 0.8 pp on the previous survey), followed by 1.8% for 2024.

I should emphasise, however, that the Eurosystem projections are built on the assumptions that the sanctions against Russia will remain in place over the full projection horizon, that the intense phase of the war will continue until the end of the year with no further escalation, that disruptions to energy supplies will not lead to rationing in euro area countries, and that supply bottlenecks will gradually be resolved by the end of 2023.

[1] The reduction owed to the fall in both the services sector component (down 2.4 points to 50.6, a 15-month low) and the manufacturing PMI (down 3.2 points to 46.1, the second consecutive month in contraction).

However, a prolongation of the war in Ukraine remains a significant downside risk for growth, particularly if energy supplies from Russia are suspended and result in rationing for firms and households. Likewise, the war could also further dampen confidence and aggravate supply-side constraints, while energy and food prices could remain persistently higher than expected. A faster deceleration in global growth would also pose a risk to the euro area outlook.

Indeed, given the high uncertainty surrounding the outlook, the June projections are complemented by a downside scenario that reflects the possibility of a severe disruption to European energy supplies, leading to further increases in energy prices and production cuts. Under this scenario real GDP grows by only 1.3% in 2022, contracts by 1.7% in 2023 and, despite recovering in 2024 when it grows by 3%, remains significantly below the baseline level throughout the projection horizon.

The inflationary episode

Since mid-2021 we have witnessed a global inflationary episode that has proved more persistent than initially expected. This inflation has intensified in recent months as a result of the war in Ukraine, and has spread to numerous components of the consumption basket.

In June euro area inflation rose again, reaching 8.6%. This is the highest figure for the euro area overall since the launch of the euro and up from 1.9% just one year earlier.

The energy component remains the main factor behind this increase. However, food inflation also continued to rise, standing at 8.9% in June, partly reflecting the importance of Ukraine and Russia as agricultural goods producers.

The persistence of industrial supply chain bottlenecks and the recovery in demand, particularly in the services sector, are also contributing to the current high inflation rates.

Further, the inflationary pressures are spreading to a growing number of sectors, partly due to the indirect impact of the high energy costs across the economy. In consequence, most measures of underlying inflation have continued to rise. The increase in inflationary pressures also owes to the depreciation of the euro exchange rate.

For the more immediate future, the projections indicate that inflation will remain very high due to continued pressures from energy and food prices and pipeline pressures in the pricing chain, in addition to the effects of the economic reopening and the global supply shortages.

But looking further ahead, in the absence of new disruptions, energy costs should stabilise and supply bottlenecks should ease. This, together with the ongoing monetary policy normalisation, should support the return of inflation to our target.

In this setting, the performance of the labour market and inflation expectations are key. Unemployment in the euro area fell to an all-time low of 6.6% in May. Job vacancies across many sectors show robust demand for labour. Wage growth has continued to increase gradually over the last few months, but still remains contained overall. Most measures of long-term inflation expectations currently stand at around 2%, although recent above-target revisions to some indicators warrant continued monitoring.

The Eurosystem projections published in June showed that inflation would remain very high for most of 2022, averaging 6.8%, before declining gradually from 2023 to 3.5%. It would then converge towards the ECB's inflation target in the second half of 2024 (2.1%). The expected decline in 2023 and 2024 mainly reflects an anticipated moderation in energy and food commodity prices in the absence of additional shocks, as embedded in futures prices. In addition, the ongoing normalisation of monetary policy will contribute to the moderation in inflation, with the usual transmission lags.

HICP inflation, excluding energy and food, will remain very high until the end of 2022, but thereafter it is expected to decline as the upward pressures from the economic reopening subside and supply bottlenecks and energy input cost pressures ease.

The ongoing economic recovery, tightening labour markets and some effects from compensation for higher inflation on wages – which are expected to grow at rates well above historical averages – imply high underlying inflation until the end of the projection horizon, although the baseline assumes that longer-term inflation expectations will remain well anchored.

In any event, the risks to the inflation outlook remain on the upside and have intensified, particularly in the near term. In the medium term, these risks include a protracted worsening of production capacity in the economy, persistently high energy and food prices, inflation expectations being revised up above the target level and larger than anticipated wage increases. However, a decline in demand over the medium term would ease the inflationary pressures.

Under the downside scenario that I mentioned earlier, reflecting the possibility of a severe disruption to European energy supplies, inflation averages 8.0% in 2022 and 6.4% in 2023, before dropping below the baseline projection to 1.9% in 2024.

The ECB monetary policy response to the upturn in inflation

In December 2021, the ECB's Governing Council embarked on monetary policy normalisation, with the gradual withdrawal of the extraordinary monetary stimulus measures implemented during the pandemic, once these had succeeded in countering the adverse impact of the pandemic on the projected medium-term inflation path.

The measures taken by the ECB are part of the new strategy approved in 2021, which established a symmetric medium-term inflation target of 2%. This framework took shape in the form of forward guidance which makes the first interest rate rise subject to: (i) expected inflation standing at 2% over an 18-month horizon; (ii) it holding at 2% in the medium term; and (iii) the course of underlying inflation being compatible with inflation stabilising at 2% in the medium term. Net purchases under the asset purchase programme (APP) were also linked to these conditions, with the guidance stating that interest rates would only rise some time after the net purchases come to an end.

On that basis, first, in March we discontinued net purchases under our pandemic emergency purchase programme (PEPP) and we agreed to gradually reduce net purchases under our APP.

Second, in June we decided that as the three conditions established by our forward guidance for raising interest rates had been met, net purchases under the APP would end on 1 July, and we informed of our intention to raise policy rates by 25 basis points (bp) in July and again at our September meeting.

Third, at an ad hoc meeting held in June, we decided to activate the flexibility in reinvestment of redemptions coming due in the PEPP portfolio, as the first line of defence to counter the pandemic-related risks to the transmission mechanism being seen.

Fourth, at the latest meeting of the Governing Council held last Thursday, we decided to raise all three ECB policy rates by 50 bp, taking the deposit facility rate to 0%, thus moving out of negative territory for the first time since 2014. At the same time, we approved the new Transmission Protection Instrument (TPI), designed to safeguard the transmission of monetary policy.

That is, we felt that a larger increase than signalled at the previous meeting was required, for two reasons. First, the updated assessment of the risks to inflation, including the materialisation of certain upside risks in the short term. Second, we took into account the reinforced support for the effective transmission of monetary policy provided by the new TPI.

This 50 bp hike means an accelerated exit from negative interest rates, but does not imply a higher terminal rate in the hiking cycle. The pace at which we approach that level will be determined by the incoming data that we observe at our future meetings and how they affect our medium-term inflation target of 2%. In other words, our interest rate decisions will be made on a meeting-by-meeting basis.

Likewise, the Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past this first interest rate hike and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance. As concerns the PEPP, the Governing Council intends to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024. In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance.

As was to be expected, the monetary policy normalisation that began in December has translated into higher short and long-term interest rates in the euro area. Specifically, the 10-year OIS rate, which proxies the euro area risk-free interest rate, has risen by 143 bp since the beginning of the year, while the 12-month EURIBOR has increased by 170 bp. Over the same period, the risk premium on Spanish 10-year government bonds has increased by 44 bp.

The new Transmission Protection Instrument (TPI)

The TPI is necessary to support the effective transmission of monetary policy. While we continue normalising monetary policy, the TPI will ensure that it is transmitted smoothly across all euro area countries. The creation of this new instrument stems from the conviction that the singleness of our monetary policy is a precondition for the ECB to be able to deliver on its price stability mandate.

The TPI will be an addition to our toolkit and can be activated to counter any unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. By safeguarding the transmission mechanism, the TPI will allow the Governing Council to more effectively deliver on its price stability mandate.

Subject to fulfilling established criteria, the Eurosystem will be able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by economic fundamentals, to counter – to the extent necessary – risks to the monetary policy transmission mechanism.

The scale of TPI purchases will depend on the severity of the risks facing monetary policy transmission. Purchases are not restricted ex ante.

The main characteristics of the TPI are as follows:

Purchase parameters. Purchases will be focused on public sector securities with a remaining maturity of between one and ten years. Purchases of private sector securities could be considered, if appropriate.

Eligibility. The Governing Council will consider a cumulative list of criteria to assess whether the jurisdictions in which the Eurosystem may conduct purchases under the TPI pursue sound and sustainable fiscal and macroeconomic policies. In particular, the criteria include: (1) compliance with the EU fiscal framework; (2) the absence of severe macroeconomic imbalances; (3) having a sustainable public debt trajectory; and (4) compliance with the commitments contained in the recovery and resilience plans and with the country-specific recommendations in the fiscal sphere under the European Semester.

Activation. The activation decision will be based on a comprehensive assessment of market and monetary policy transmission indicators, an evaluation of the eligibility criteria and a judgement that the activation is proportionate. Purchases will be terminated either upon a durable improvement in transmission, or based on an assessment that persistent tensions are due to country-specific economic fundamentals.

Relation to the monetary policy stance. Should the TPI be activated, the Governing Council will address the implications of the TPI purchases for the scale of the aggregate Eurosystem monetary policy debt security portfolio and for the amount of excess liquidity. Purchases under the TPI would be conducted such that they cause no persistent impact on the overall Eurosystem balance sheet and, therefore, on the monetary policy stance.

In short, we are ready to adjust all our instruments to ensure that inflation stabilises around our 2% medium-term target. Our new TPI will ensure that our monetary policy is transmitted smoothly across the euro area, as we continue to adjust our stance in response to high inflation.

The role of other economic policies

I now wish to refer briefly to the possible role that other economic policies may play, both in Europe and in Spain.

First, against the current inflationary backdrop, profit margins and wages are key to avoiding a feedback loop that results in an inflationary spiral. This is precisely the overriding objective of the **incomes agreement** that we at the Banco de España have been advocating in recent months. It would consist of an agreement between firms and workers, under the social dialogue framework, to share the inevitable loss of national income that higher commodity import prices entail.

Fiscal policy should also play a key role, avoiding an across-the-board fiscal impulse and the use of automatic indexation clauses in expenditure items. Conversely, efforts should focus on supporting lower-income households, who bear the brunt of inflation, and the firms most vulnerable to this new shock. Moreover, any measures should be temporary, so as not to further increase the structural budget deficit. They should also be designed to avoid significant distortions to price signals.

However, offsetting the adverse effects of the current supply-side shock also calls for **ambitious policies to boost productivity growth and potential GDP**. In the framework of the NGEU programme, investment projects must be carefully selected in order to optimally complement, and act as a catalyst for, private investment.[2] But they must also be accompanied by structural reforms to support, for example, the reallocation of resources across firms and sectors.

Indeed, a recent Banco de España paper[3] shows that if projects with a high degree of complementarity between public and private investment are selected under the NGEU programme, and if structural reforms that reduce product and labour market rigidities are introduced, the potential growth rate of the Spanish economy could reach around 2% by the end of the decade compared with 1% in the absence of these effects.

At the same time, the **sustainability of national public finances must be ensured**; this is essential for the smooth functioning of the monetary union. With this in mind, the European

---

[2] In line with the findings of M. Alloza, D. Leiva León and A. Urtasun (2022), “The response of private investment to an increase in public investment”, Analytical Article, *Economic Bulletin* 2/2022, Banco de España.

[3] See P. Cuadrado, M. Izquierdo, J. M. Montero, E. Moral-Benito and J. Quintana (2022). “El crecimiento potencial de la economía española tras la pandemia”, *Documentos Ocasionales* Nº 2208, Banco de España (English version forthcoming).

Commission is reviewing the European fiscal rule framework. In my view the framework needs to be simplified, by establishing an expenditure growth rule and a debt-to-GDP ratio anchor, and countries' capacity to build up fiscal buffers in good times for use in crises needs to be reinforced.

In the case of Spain, shoring up the sustainability of public finances calls for a medium-term fiscal policy strategy. This should involve immediately setting out a multi-year fiscal consolidation plan for implementation once the economic impact of the pandemic and of the war in Ukraine has been overcome. The plan should have broad political consensus and be accompanied by an efficiency review of public spending and the tax system, including all tiers of general government. In addition to the medium and long-term benefits of such a strategy, defining the plan early on would generate greater certainty and trust in public policies, which is particularly important against the backdrop of the monetary policy normalisation I have described.

In any event, the course of the war in Ukraine and the subsequent sanctions and retaliatory measures have laid bare the EU's vulnerabilities and dependencies in key sectors, such as energy, as well as the disparities between Member States in their exposure to such tensions. A challenge of this magnitude underlines the importance of a joint response to common risks. **The response to the war in Ukraine must, once again, be more Europe**.

To address this common challenge, more emphasis has been placed on European **"strategic autonomy"**. This episode has shown that pan-European structural policies that foster the integration and interconnection of European markets – including energy markets – and strengthen the single market[4] will not only generate greater resilience to shocks, but also drive competitiveness.

In this respect, **joint funding arrangements** should be established to safeguard this common effort and avoid any excessive or highly unequal impact on national public finances. Common funding arrangements would allow European institutions to finance large-scale programmes based on shared quality standards and would provide for a uniform approach for assessing programme execution.

Headway must also be made **in the expansion of the public and private risk-sharing arrangements in the EU**.

First, the euro area needs a permanent macroeconomic stabilisation mechanism – with revenue-raising and borrowing capacity – to complement the single monetary policy.

Second, it is imperative that the banking union be completed with the establishment of a European deposit guarantee scheme. A common fund, with risk-pooling, would ease the sovereign-bank nexus that proved so damaging in the European sovereign debt crisis and would align financial responsibility with centralised decision-making in banking supervision

[4] Such as the important projects of common European interest, which include the development of batteries, microelectronics, hydrogen technologies and cloud services.

and resolution matters. It is also essential that the regulatory barriers that are hindering the emergence of a fully-fledged European banking market be lifted.

Third, headway must be made in the construction of the capital markets union, so as to boost the euro area's resilience to macro-financial shocks, better distribute the costs of asymmetric or idiosyncratic shocks, reduce the risks of financial fragmentation and provide an environment more conducive to private investment. At present, the relatively small size of equity markets and the considerable home bias of asset portfolios limit risk sharing in the euro area. Moreover, a deeper capital markets union could help channel high aggregate savings towards investment in infrastructure, energy and innovation, where private investment is crucial.[5]

Lastly, a key feature for a genuine, more integrated and deeper European capital market would be the existence of pan-European safe assets on a significant scale. A European safe asset would become a common benchmark for investors, allowing equity and bond prices across the euro area to reflect their fundamental risk more clearly. It would also facilitate the development and integration of the euro area's financial markets, while flight-to-quality movements would no longer imply cross-border flows to countries considered to be safer. And it would boost international investors' confidence in the European project, helping to strengthen the international role of the euro. All of which is especially relevant against a backdrop of geopolitical stress and asymmetric shocks.

Such resolute progress in completing the monetary union would structurally reduce the risks of financial fragmentation and ensure the smooth transmission of monetary policy, which in turn would support our monetary policy action.

[5] For instance, public and supranational investment (NGEU funds) will only be able to meet a small proportion of the investment required in the energy transition, estimated by the European Commission as more than €400 billion per year over the next decade.