Tina Žumer: Time for interest rate normalisation

Keynote speech by Ms Tina Žumer, Deputy Governor of Bank of the Slovenia, at the Government Borrowers Forum 2022, Llubljana, 1 June 2022.

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Dear ladies and gentlemen, dear speakers and organisers of this event, dear guests, good morning.

It is with great pleasure that I am addressing you today – especially as I can do it in person. Over the last two years, **face-to-face interaction has gained my appreciation.**

With all the uncertainties surrounding the economy and high volatility in financial markets in recent months, the **time is particularly appropriate for engaging with treasurers, investors, bankers and other financial experts.** It will be interesting to hear your views on various challenging issues - such as the geopolitical and energy crises, climate change and global health risks – and your expectations regarding macroeconomic and financial developments.

As we are continuing with the normalisation of our monetary policy and approaching the first rise in the ECB interest rates since 2011, **I will devote an important part of my speech today to policy making**, in particular to monetary policy decisions and monetary-fiscal interaction. As these depend on economic and financial developments and outlook, let me start by outlining the recent economic situation.

After the greatest global health shock in our lives, triggering a sudden and deep recession, **most euro area economies recovered faster than expected**. In the first quarter of this year, the output in the euro area exceeded the pre-pandemic level by 0.5%, while it was more than 7% higher in Slovenia.

A rapid and comprehensive policy response – including monetary and fiscal policies – combined with the progress in vaccination, have been instrumental in the speedy recovery. Together we prevented the free fall of the economy and helped to preserve financial stability and protect productive potential. As our interest rates were near the effective lower bound, the Eurosystem resorted to unconventional monetary policy measures in response to the pandemic, launching tailor-made instruments to leave no country behind. For example, we launched a new asset purchase programme – the pandemic emergency purchase programme (PEPP) – and a new series of targeted longer-term refinancing operations (TLTRO III).

Strong economic rebound after the reopening of the economies lead to global shortages of different goods and, in turn, **the pick-up of inflation**, as COVID-related supply disruptions continued. An increase in inflation was not unexpected, considering the low reference base in 2020, but turned out to be more significant, broader and more persistent. For Slovenia, the broadening of inflationary pressures is well illustrated by the fact that the share of items in the HICP basket with **more than 5%** price growth increased from around 20% in the autumn of last year to over 60% in April.

However, even before the Russian invasion of Ukraine there were signs that it will take longer for inflation to moderate than projected last year. **The war and anti-Russia sanctions on top of new waves of COVID infections** exacerbated global supply constraints. This caused the euro area and global inflation to surge further, and accelerated the process of winding down of the historic monetary stimulus globally.

In turn, the **worry arose whether all these developments could tip our economies into a recession**, as shown – for example – by the rising number of Google searches for the word "recession". The topic was also high on the agenda at the recent gathering in Davos. Within the Eurosystem, we are in the process of preparing new macroeconomic projections, which we will publish next week.[1] As already revealed publicly, the **recession is not part of the baseline scenario** that is the most likely to materialise.

While there are some clouds gathering over the economy, we do not currently see a storm. Despite the increased cost of living and the devastating war at the door of Europe, the economic activity in the euro area expanded further in the first quarter. The incoming high frequency and first hard data also bode quite well for the second quarter. In particular, the number of people employed in the euro area is at a record high, and the unemployment rate hit new low in May. The Eurozone Purchasing Manager Index (PMI) declined somewhat in May but still signals growth. Consumer confidence, which deteriorated sharply after the Russian invasion, broadly stabilised in May, while at the same time households have accumulated considerable savings during the pandemic. However, beyond the second quarter, the uncertainty is greater and there are considerable economic risks due to the war and geopolitical tensions.

In sum, we are currently in an unusual and challenging situation. According to many economic indicators - such as employment, labour shortages, capacity utilisation in manufacturing, elevated inflation and over-valuation of housing markets - we are **high in the business cycle**. At the same time, **our monetary policy is still exceptionally accommodative** after coping with the lengthy period of deflationary pressures and the pandemic shock. Let me now turn to inflation, the key variable of our monetary policy.

A series of supply-side disruptions and a rapid recovery in global demand have pushed inflation significantly above our medium-term target of 2%, after almost a decade of too-low inflation. This might not necessarily be an undesirable development, if the reasons behind the pick-up in inflation were about to fade soon, bringing inflation swiftly to its target.

However, **inflation expectations have adjusted and shifted upwards**, with financial market and consumer survey indicators pointing to inflation between 2% and 3% in the medium and longer-term.[2]

Moreover, expected inflation is becoming an important element in **price setting in euro area firms**, as shown by the ECB survey.[3] High inflation – coupled with labour market tightness - has also triggered **calls for higher wage rises.** The ECB's experimental wage tracker so far points to a moderate increase in wage growth in this year and the next, below the projected inflation in the euro area. However, the longer the high inflation rates persist, the likelier it is that they will be transmitted to higher wage growth and potentially lead to a wage-price spiral.

In the medium term, therefore it seems possible that inflation will settle at higher levels than we have observed in the recent years, even after the existing supply shocks fade. We could face **a switch to a higher inflation regime**, as some of the drivers of past deflationary pressures have lost steam, such as global trade liberalisation and the integration of low-wage Chinese workers to the global economy. At the same time, **some structural inflationary factors are gaining momentum,** namely the green transition, strengthening of the EU's strategic autonomy and the reorganisation of global supply chains with possible nearshoring. There will still be some deflationary forces at play, such as rapid digital transformation, other innovation and elevated debt levels, but there is a question as to whether these could overcome the inflationary forces.

Let me now turn to monetary policy.

Given the high inflation in the euro area, reaching 8.1% annually in May and ranging from 5.4% in Malta to 20.1% in Estonia, together with strengthening inflation expectations, **we need to make further steps towards normalisation of our monetary policy**. After we ended net asset purchases under the special pandemic programme in March this year, we are now winding down also other asset purchases. Soon, preferably by July, net asset purchases should be fully completed. This would allow for the first ECB rate hike since 2011.

The next policy steps will depend on incoming data and prospects for approaching our 2% inflation target in the medium term. Given the uncertain economic outlook, it is important to move on gradually. By being able to flexibly reinvest maturing bonds from the pandemic portfolio, we will continue to work against increased fragmentation in the bond markets.

While is a priority for the Eurosystem to navigate the challenges of elevated inflation, monetary policy interacts with fiscal and other policies. Fiscal and monetary policy consider each other's actions when designing policy measures. Acting within their own mandates, the two policies can be mutually reinforcing. Stabilisation of the economy after the pandemic shock is a great example of this!

However, in times of high inflation and slowing economic growth - that put low-income households in a particularly difficult position - **mutual policy support is a greater challenge**. In order not to hinder the moderation of inflation, fiscal support should be targeted at the most vulnerable households and businesses. Excessive and too general mitigation of the burden of rising living costs would further stimulate aggregate demand and, in turn, the growth of prices. Governments should also carefully consider potential increases in minimum wages and the wages of civil servants. It is important not to fuel the risk of second round-effects from the currently high inflation and rising inflation expectations being transmitted to higher wage and price pressures in the euro area.

Due to high inflation and the expected normalisation of our monetary policy, **borrowing in the financial markets has become more costly for sovereigns, banks and corporates**. Similarly, the bank lending rates for households and corporates have also started to rise, though at a slower pace.

Despite considerable increases in the yields of sovereign bonds, the costs of borrowing by the euro area governments are **still manageable**. Average yields that governments pay on their outstanding debt remain low in historical terms. Moreover, with high inflation and further economic growth, government revenues have also increased. However, given the elevated public debt levels of several countries and the slowdown in economic growth, **further tightening of government borrowing conditions will put pressures on fiscal policies**. At the same time, governments are facing rising costs related to population ageing, and the need to strengthen the resilience of health systems and ramp-up public investments in support of the green transition.

Let me conclude this part with **being more general**. Fiscal policy should support price and broader macroeconomic stability. The suspension of EU fiscal rules should not be a reason to delay the return of fiscal policy to a sustainable path. Regardless of the rules, financial markets are starting to respond more to the perceived fiscal health of individual countries than in the last two years.

This brings me to my last point.

The actions of governments and central banks can also be **mutually reinforcing and complementary in tackling structural challenges, such as climate change**. The primary role in this regard lies with governments, as they have the power and democratic legitimacy to adopt legislation that compel industries and individuals to act sustainably. Nevertheless, there are also areas where central banks can and should contribute.

Climate change is **affecting our economies and thus price and financial stability, which lie at the heart of central banks' mandates**. This urges us to take climate-related considerations into account in the conduct of monetary and macroprudential policies and in the supervision of banks.

In July last year, the Eurosystem central banks concretised our commitments and adopted a **roadmap on climate-related actions**. Regarding monetary policy, we agreed to include climate-related factors in macroeconomic modelling and monetary policy operations, more specifically the collateral framework and corporate asset purchases. Related to banking supervision, our activities are focused on the disclosure and assessment of climate risks. This year, together with the banks, we are performing the **first climate stress tests,** the results of which will be available soon.

Regarding our investments that are not related to the implementation of monetary policy, Banka Slovenije is **increasing the share of green and other sustainable bonds**. We also abstain from investing in firms in the tobacco and arms industries, and firms causing major environmental harm. In the future, we plan to further enhance our socially responsible investment framework by setting targets that are even more ambitious. **Next year we will start measuring and reporting carbon footprints**, and other indicators of socially responsible and sustainable investing.

There are several challenges along the road, such as availability and quality of climate-related data. However, we strive for green, which is also the **colour of our logo**.

To conclude. We are facing a number of challenges, among which price stabilisation and financial stability are the priorities for the Eurosystem. However, challenges can also be opportunities. And by acting together, as we have done over the last two years, we will manage and take advantage of them.

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[1] On 9 June 2022.

[2] Five-year forward ILS rate currently stands at 2.3% and three-year-ahead inflation expectations from the ECB Consumer Expectations Survey shifted from 2.0% to 2.9% in March. 5 Year 5 Year Forward Inflation Expectation | MacroTrends

[3] The globalisation of inflation (europa.eu)