Boštjan Vasle: Controlling inflationary pressures in a demanding geopolitical and financial environment

Speech by Mr Boštjan Vasle, Governor of Bank of the Slovenia, at the Banking Conference "Slovenia one year after the outbreak of global energy crisis and development priorities", organised by the Bank Association of Slovenia, Ljubljana, 2 June 2023.

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Dear Ladies and Gentlemen,

Let me begin with something encouraging: after two major shocks in recent years – the pandemic and the outbreak of the Russian military aggression – this year began in a slightly less uncertain environment.

Economic growth did slow significantly, but most euro area countries, Slovenia included, avoided any decline in GDP. Amid continuing support from economic policy measures, the euro area and the Slovenian economy within it both proved themselves to be resilient. The favourable developments are being reflected on the labour market, which is enjoying record performance, in both high employment and low unemployment.

High inflation remains the key macroeconomic imbalance, and controlling it is a priority of economic policy.

Recent months have seen headline inflation in the euro area slow significantly to 6.1%, thanks to a slowdown in energy prices, but core inflation remains stubbornly high. It is running at above 5% in the euro area overall, and above 7% in Slovenia. There has also been a shift in the main drivers of inflation. After an initial period when global factors were dominant – we can all remember the disruptions to supply chains and the energy shortages – in recent months inflation has increasingly been driven by domestic factors:

- high demand, particularly for services,
- a favourable economic picture, particularly on the labour market, which is driving up wage growth,
- past increases in production costs, which in all likelihood have not yet fully passed through into retail prices, and
- a relatively strong fiscal impulse.

The current inflation, and the factors driving it, demand a coordinated response from economic policies. If we begin with monetary policy, over the last year the stance has moved from providing ample liquidity, which was vital in the wake of the aforementioned shocks, to the most extensive set of interest rate hikes seen since the introduction of the euro. The key interest rates have been raised by 3.75 percentage points since last July. However we have not yet reached the ultimate interest rate level to return inflation sufficiently quickly to our target of around 2%.

In light of current inflation developments, the inflation forecasts for this year and the coming years, the unrealised pass-through of prices along production chains and, in particular, the elevated wage pressures, I expect further rises in interest rates before the summer break, with similar steps to those taken at the last monetary policy meeting. Any subsequent steps over the remainder of the year will depend on developments in inflation, core inflation in particular, on other economic policy responses, and on the speed and strength of the transmission mechanism.

According to past experience, monetary policy measures tend to show their full effects between 18 and 24 months later.

In my judgment the transmission of monetary policy measures is working in line with expectations, as we are already seeing a slowdown in lending activity, which will curtail aggregate demand. The sole visible exception is interest rates on deposits, where banks have been much slower in passing through the effects of the measures than on the lending side, which is particularly true of Slovenia, which is far off the euro area average.

In addition to raising interest rates, we have also changed the stance with regard to our other instruments:

- by withdrawing from longer-term refinancing operations (the TLTRO programme), and
- by ending net asset purchases (the APP).

Having ended additional asset purchases in the Eurosystem in the first half of last year, we began reducing our securities holdings in March of this year.

The pace of disinflation process and the monetary policy measures needed will also depend on the response from other economic policies. Before I go into details, I should once again recall that the monetary policy stance is tailored to the euro area as a whole, and that our measures are formulated with regard to average inflation.

Deviations in the inflation rate, whether as a result of national specifics or of different economic policies under the remit of individual countries, can thus not be addressed by monetary policy. It is therefore of key importance, in the short term, what the stance is in fiscal policy, wage policy, and the margin policies pursued by firms.

Over the longer term the differences in inflation will reflect the structural attributes of individual economies, namely competitiveness, productivity, openness and the functioning of markets, which can of course be influenced by policies that fall under the remit of individual governments.

As I come to a close, I should touch further on the impact on the banking system from the current macroeconomic situation and the monetary policy stance. In the early part of the period of high inflation and fast-rising interest rates, these were having a beneficial impact on the banking system in Slovenia and elsewhere in Europe. This is thanks in part to the resilience of businesses and individuals, who in the wake of good performance and robust income are showing no signs of financial weakness, and in part to the rise in interest income at banks as a result of the aforementioned asymmetry in the setting of interest rates. The key parameters in the performance of the Slovenian banking system thus remain stable, and are not deviating significantly from the euro area average.

To maintain this over the medium term, it is vital that we remain alert to the fact that the current situation is sharply increasing the risks for certain participants on the financial markets.

Looking solely at the latest developments in the United States, we can reach two important conclusions:

- high importance of good risk management and high standards of internal controls at individual banks were abandoned by the banks that collapsed recently,
- vital need for high quality supervision of the financial system, and the banking system within it, from both a microprudential and macroprudential perspective, so that we are able to promptly identify deviations from the principles of sound business, and take supervisory measures.

Allow me to close with this broader challenge: in recent years extensive support from economic policy has been the key to successfully withstanding shocks of a type that that our generation had never witnessed before. But this economic policy response was only made possible by the interaction of one-off developments at the global level (the period of low inflation, which opened up space for such an unconventional approach in monetary and fiscal policy). Right now, when we are facing the challenge of restoring price stability and the normal, i.e. more market-oriented, functioning of our economies, an approach of this kind is no longer feasible. It remains vital, however, that exceptional policy support remains available for instances of exceptional shocks.

But the real key is for all market participants to strengthen their own resilience, and thus to be ready for any adverse scenarios that might be realised in the future.