Olli Rehn: Dialling back monetary restraint

Speech by Mr Olli Rehn, Governor of the Bank of Finland, at the Citi Macro Forum, Washington DC, 18 April 2024.

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Slides accompanying the speech

Ladies and Gentlemen, Dear Friends,

Let me start by thanking the organisers for the invitation to share some thoughts with you here at the Citi Macro Forum today. In my introductory remarks, I will discuss the euro area economic and policy outlook following our ECB Governing Council monetary policy meeting last week.

As you know, we at the Governing Council started discussing the dialling back of our restrictive monetary policy stance in March, and we continued that discussion in our meeting last week.

Slide 2. Economic activity in the euro area, 2007-2026

What makes this discussion particularly interesting is the fact that this time we are considering easing our monetary policy stance simultaneously with a projected start of recovery in domestic demand and a record low unemployment rate. Growth is projected to pick up in the course of the second half of this year and to strengthen in the 2025-2026.

This interesting policy situation reflects the unconventional path that has led us to this point over the past one and a half decades.

Slide 3. Three periods of inflation in the euro era, 1999-2024

Let me illustrate this trajectory with a graph that neatly divides the last quarter century of the euro era into three periods of inflation: approx. 2% in 1999-2009; 1.2% in 2009-21; and 6.6 % since 2021.

It is worth remembering that only three years ago, in 2021, we had had 13 years of too low inflation behind us, although we had resorted to a negative policy rate for seven years, and to significant asset purchases and credit operations as well, which took our balance sheet from 2 trillion to almost 9 trillion euros. This stubbornly low inflation, together with a structurally low natural rate of interest and very limited remaining policy space, led us to launch the review of our monetary policy strategy in January 2020. It was concluded in July 2021.

Slide 4. The ECB strategy review and symmetric inflation target

The key outcome of the strategy review was that we decided to change our inflation target to a symmetric one, meaning that both negative and positive deviations from the 2% target are regarded as equally undesirable. Prior to the review, our price stability definition ('below but close to 2%') was perceived as asymmetric, effectively setting a 2% ceiling for inflation. This asymmetry very likely contributed to lowering inflation expectations and thereby inflation itself. The new symmetric inflation target is expected to influence long-term inflation expectations and to anchor them more solidly to the 2% inflation target.

When we published our new symmetric inflation target in July 2021, the operating environment for monetary policy was changing dramatically.

Slide 5. Inflation is converging towards the ECB's 2% target

The supply shocks, caused first by the pandemic and then by Russia's unjustified and brutal war in Ukraine, pushed the euro area inflation rate above 2.5% for the first time in nine years by the fall of 2021, and then all the way up to 10.6% in October 2022.

Thanks to the normalisation of energy prices and the determined but very consistent monetary tightening, euro area HICP inflation is now at 2.4%. It is expected to decline further, reaching our inflation target next year.

When I addressed this forum a year and a half ago, in October 2022, the uncertainty related to energy supply in Europe was extreme. Rationing of energy supplies was widely discussed. So were the various risk scenarios, some containing severe stagflationary tendencies. At the time, energy was the key driver of euro area inflation, while moderate wage inflation was acting as an anchor.

Subsequently, Europe reacted decisively and cut the energy crisis short. Today, wages have replaced energy as the main inflation driver – but wage growth is now moderating and inflation declining.

Due to the energy price assumptions, our inflation forecasts overestimated actual inflation in the fourth quarter last year. For this year, our assumptions and inflation forecasts have been more accurate, although in March we did revise down our inflation forecast for this year to 2.3%. In September last year, our 2024 inflation forecast was at 3.2%, so we have in fact been approaching our target faster than we had expected at the time we raised the policy rate to the current level.

However, disinflation is more than just a story of the reversal in energy price movements. Monetary policy has played an important role in dampening demand since the rate hiking cycle started in July 2022. Monetary restraint is continuing to reduce inflation and impact the real economy strongly, affecting the growth outlook, particularly for this year. In March, we also revised down our growth forecast for this year to 0.6%.

Slide 6. Wage growth is moderating in the euro area

The euro area unemployment rate has remained at a record low and employment has increased, even though growth has been at a standstill since the end of 2022. This said, there are indications that labour demand is now adjusting downwards. Recent euro area wage growth has been developing broadly in line with our expectations, slowing from 5% to 4%. Importantly, a key driver of wage growth has been past inflation surprises rather than higher inflation expectations.

Slide 7. Inflation expectations remain well anchored to the target

Inflation expectations have in fact been well anchored at around our 2% target, as can be seen from this slide.

Referring to the ongoing weak demand conditions in the euro area, and in the spirit of the multilateral IMF and World Bank spring meetings this week, I would like to draw your attention to the developments in the euro area current account. In the March projections, the forecast for the current account surplus was revised significantly upwards, from 1% to 3.2% of GDP for the current year and similarly for the two following years.

As we know, the current account can be defined as the difference between investment and savings. This definition provides a useful viewpoint when assessing the effects of recent monetary policy tightening and its strong transmission. An increase in the current account surplus may reflect a lower level of investment or higher level of savings – or both, which seems to be the case in the euro area currently.

An important factor contributing to a higher euro area current account is the low level of business and housing investment, which are expected to be very weak this year. This is reflected in the weak credit demand due to higher interest rates and also somewhat tighter credit supply. As bank profitability is not expected to remain as strong as before and credit risks are increasing somewhat, the supply factors may start to play a bigger role in credit extension, while credit demand is expected to start recovering.

If weaker investments are contributing to a stronger current account, so too are higher savings. The savings rate increased to 14.6%, which is clearly above the pre-pandemic 13%.

Of course, tighter monetary policy and higher interest rates play a major role in explaining the higher savings rate. However, uncertainty and low confidence also incentivise higher savings. The continuation of the Russian war has probably had more complex and wide-ranging effects on confidence and savings than we can currently estimate.

The ECB, major forecasters like the IMF, central bank watchers and the current pricing in the financial markets all seem to agree that the euro area inflation rate will return to our 2% target in a sustained manner in the course of next year. Since prolonged high inflation could put the well-anchored inflation expectations at risk, any further delay in achieving the target cannot, of course, be accepted.

Slide 8. The ECB decisions in April

The key message from our policy meeting last week was that although the key ECB interest rates are at levels that are making a substantial contribution to the ongoing disinflation process, we no longer see the need to maintain them at the current levels for a long duration.

It is also worth noting that with the extent of disinflation already seen, real short-term rates are now higher than we expected them to be when the policy rate was raised to the current level last September.

With declining inflation and delayed economic growth, we are continuously assessing how restrictive our policy stance is and should be. Without prejudging our primary objective of price stability we need to avoid a stance that unduly delays the closing of the negative output gap.

The risks to the growth outlook remain tilted to the downside. Russia's unjustified war against Ukraine and the intensified conflict in the Middle East are major sources of geopolitical risk, feeding uncertainty and potentially increasing energy prices again. Clearly, geopolitics is the risk factor that could derail the improving outlook for the euro area economy.

As headline inflation and underlying inflation have continued to slow down and inflation expectations have remained well anchored, we can start dialling back monetary restraint as summer approaches. Provided that we are confident that inflation will continue converging to our 2% target in a sustained way, the time will be ripe in June to start easing the monetary policy stance and to cut rates. This obviously assumes that there will be no further setbacks in the geopolitical situation and thus in energy prices.

We in the ECB Governing Council will continue to follow a data-dependent and meeting-by-meeting approach when determining the pertinent policy stance. We will set our rates based on our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission. And we are not pre-committing to any rate path.

Thank you very much for your attention, and I look forward to your questions.