Luis de Guindos: Monetary policy and financial stability in the euro area

Introductory remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at a Euro 50 Group meeting, London, 29 April 2024.

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Inflation

As regards inflation in the euro area, we have come a long way, but there is still work to be done. Nevertheless, we are heading in the right direction. After peaking at more than 10% in October 2022, headline inflation fell to 2.4% in March this year. Core inflation has also come down substantially from its peak 12 months ago of almost 6%. In March 2024 it stood below 3% for the first time in two years. In addition, most measures of underlying inflation declined further in February, confirming the picture of gradually diminishing price pressures. The impact of previous adverse supply shocks continues to fade and tight monetary policy is weighing on demand.

Mirroring the disconnect between manufacturing and services activity, goods and services inflation have diverged. Goods inflation dropped to 1.1% in March after almost reaching 7% in early 2023. Services inflation has also eased substantially from its peak level of close to 6% in July 2023. However, its decline has stalled since the second half of last year and it has remained at 4% for the last five months of available data.

Although inflation dynamics are broadly heading in the right direction, our work is not yet done. We expect inflation to fluctuate around current levels in the coming months. In particular, the swings in energy prices during 2023 and the associated base effects in calculating annual comparisons mechanically imply a bumpy path in the monthly readings for inflation rates over the remainder of 2024. In addition, the withdrawal of various temporary fiscal support measures will affect prices in an uneven manner.

Looking through these shorter-term fluctuations, a key factor we need to monitor is whether underlying inflation continues to ease. This applies in particular to our measure of domestic price pressures, which reflects the interplay between wages, productivity growth and profit margins. Wage growth based on national accounts data is showing signs of easing, potentially at a faster pace than we previously expected. But high employment growth, coupled with subdued output growth, continues to weigh on labour productivity. We have not seen improvements in productivity per employee or per hour worked. As a result, unit labour costs are still increasing. Looking ahead, we expect productivity to recover as activity strengthens. Turning to profits, restrictive monetary policy is reducing firms' pricing power and weighing on unit profits, which is slowing the pass-through of wages to prices. In fact, unit profit growth fell to 2.5% in the last quarter of 2023, down from a peak of more than 9% in the last quarter of 2022.

While we expect inflation to return to our 2% target next year, the outlook is surrounded by substantial risks. The geopolitical situation, especially in the Middle East, poses a particular upside risk to inflation. While growing tensions in the region initially triggered only moderate movements in oil prices, recent developments remind us that monitoring such risks and their impact on commodity prices remains highly relevant for our inflation outlook. Should tensions in the region escalate further, major trading disruptions and impediments to oil supplies could push up energy prices and freight costs in the near term, disrupting global trade. Inflation could also turn out higher than anticipated if wages increase more than expected or if profit margins prove to be more resilient. By contrast, a stronger-than-expected dampening impact of monetary policy on demand or an unexpected worsening of the economic environment in the rest of the world may result in downside surprises in inflation.

Economic activity

Growth is expected to resume at a moderate pace. The latest economic indicators suggest that activity is gradually recovering after a period of stagnation. But there are notable differences across sectors. Production in manufacturing continues to put a drag on activity. In the first two months of 2024 industrial production was still 1.5% below the average level in the final quarter of 2023.

By contrast, services activity offers a silver lining, as it is likely to have picked up again since the turn of the year. Services production rose by 1.5% in January, which is the highest reading since May 2023. Survey information confirms the diverging paths between manufacturing and services. The manufacturing output Purchasing Managers' Index (PMI) has remained well in contractionary territory for some time while the PMI for services has been improving since October last year, returning to expansionary territory in the first quarter of 2024.

Although we will have to wait and see to what extent the encouraging signs of a pick-up in the services sector will be reflected in the hard data for the first quarter of the year, they do lend support to the assessment we provided in our March projections. ECB staff currently see economic activity remaining subdued in the near term before gradually recovering over the course of the year.

Consumer spending should strengthen as real disposable income continues to recover. Employment continued to grow in the final quarter of 2023, driven mainly by an increase in the labour force. In February the unemployment rate remained at 6.5%, its lowest level since the introduction of the euro. Barring further shocks, exports are also expected to recover amid improving global demand and a gradual rebalancing of consumption from services back to goods.

However, risks to our growth outlook remain elevated and tilted to the downside. In particular, geopolitical risks pose a threat to the world economy. If these risks were to materialise, specifically in the light of tensions in the Middle East, major trading routes could be blocked and global supply-side bottlenecks could worsen. A further slowdown in global trade would ultimately also weigh on euro area growth.

Financial stability

Weaker growth could pose challenges to the overall positive outlook for financial stability in the euro area, while rising geopolitical risks and policy uncertainty could raise the likelihood of tail events. We assess the outlook as fragile. While risk pricing in financial markets has generally been characterised by low volatility, market sentiment remains vulnerable to sudden shifts in response to negative surprises. Structurally low liquidity buffers combined with high leverage in segments of the non-bank financial sector could further amplify any market correction.

Real estate markets have remained in focus. While residential real estate markets have seen an orderly cooling, commercial real estate markets have faced more challenges – as tighter financing costs, a move towards hybrid working practices, e-commerce and environmental, social and governance requirements are likely to continue to put pressure notably on the office and retail segments. Mild signs of asset quality deterioration are becoming visible in commercial real estate (CRE) lending. That said, banks' exposures are broadly contained. The same cannot be said for parts of the non-bank financial sector, which are less transparent and subject to lighter regulation.

But all in all, the euro area financial system has remained strong, supported by declining inflation. Firms and households have shown resilience in the face of rising debt servicing costs resulting from higher interest rates. Banks have maintained sound liquidity and capital buffers, while non-performing loan ratios remain close to historically low levels.

Monetary policy

The ECB Governing Council has responded forcefully to the largest inflation surge on record in the euro area. We raised our key policy rates by a cumulative 450 basis points between July 2022 and September 2023 and have kept them at the current restrictive levels since then. At our recent April monetary policy meeting, we considered that the current level of key ECB interest rates is contributing substantially to the ongoing disinflation process. We remain determined to ensure that inflation returns to our 2% medium-term target in a timely manner. Our future decisions will ensure that our policy rates will stay sufficiently restrictive for as long as necessary. If our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase our confidence that inflation is converging to our target in a sustained manner, we will dial back the level of monetary policy restriction. In any event, we will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and we are not pre-committing to a particular rate path.

Thank you for your attention.