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The normalisation of the ECB's monetary policy

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Since mid-2021, inflation has maintained a clear upward trend. This has intensified in recent months, mainly as a consequence of the war in Ukraine. Euro area inflation reached 7.5% in April 2022, the highest figure ever since the creation of the euro area. While most of this increase has been attributable to the upsurge in energy prices and, to a lesser extent, food prices, underlying inflation, which reflects more stable prices, has also risen considerably, to stand at 3.5%.

The consensus of macroeconomic projections expects inflation to remain high in the coming months, to slow gradually thereafter, assuming there are no new inflationary shocks, towards levels compatible with the 2% inflation target of the European Central Bank (ECB). Medium and long-term inflation expectation indicators drawing on financial markets and surveys of experts also point to inflation around 2%.

Nevertheless, the upside risks to these projections have risen. Inflationary pressures have intensified in recent months, increasing the likelihood of more pronounced indirect and second-round effects. Indirect effects occur when increases in energy costs end up passing through to the prices of other goods and services. Second-round effects arise when, in an attempt to avoid the erosion of purchasing power, incomes are revised in line with inflation, generating further inflationary pressures. Although such effects have not yet materialised significantly, there are signs that medium-term inflation expectations are being revised up above the target level, and they must be closely monitored. Conversely, the negative impact, of uncertain intensity, that the war in Ukraine is having on economic growth could curb inflationary pressures in the medium term.

Against this backdrop, the ECB has embarked on a process of monetary policy normalisation, from the starting point of an extraordinarily accommodative monetary policy stance. Before the onset of the pandemic, the ECB maintained highly accommodative financial conditions through the asset purchase programme (APP) and negative interest rates. The aim was to drive inflation, which had remained persistently below 2%, to levels closer to our policy aim. During the pandemic, in an endeavour to combat the risk of financial fragmentation and deflationary trends, the ECB rolled out, among other measures, the pandemic emergency purchase programme (PEPP). This programme has proved essential to maintain highly favourable financial conditions during the crisis and to minimise the impact of the crisis on households, businesses and the public sector across the euro area.

The actions taken by the ECB should be seen in the context of the new strategy that we approved last year, which established a symmetric medium-term inflation target of 2%. Symmetry signifies that we are committed to fighting both upside and downside deviations of inflation from target. The medium-term orientation means that our decisions are conditioned by the inflation projected over a two or three-year horizon.

This framework was operationalised, in the context of the conditions that we were facing, in a formulation for rate forward guidance which makes the first possible interest rate rise subject to three conditions: 1) that expected inflation stands at 2% “well ahead of the end of our projection horizon”, approximately over an 18-month horizon; 2) that it remains at 2% in the medium term; and 3) that developments in underlying inflation are compatible with an inflation rate stabilising at 2% in the medium term. The net asset purchases under the APP are also linked to these conditions, since interest rates will be raised only “some time after” the end of the purchases.

Given this strategy, a progressive withdrawal of the extraordinary current monetary stimulus is now warranted: inflation expectations for the intermediate horizons and the medium term stand at around 2%, underlying inflation is well above 2% and there are upside risks to the projections. One benchmark that could inform the normalisation process is the level of the natural rate of interest, defined as the rate that maintains inflation stable at its target level. According to the estimates available, which are subject to much uncertainty, the natural interest rate is low in the euro area, hovering around or slightly above 1%. This would suggest that, until these levels are reached, the monetary policy stance will continue to be expansionary.

Accordingly, in March we discontinued net purchases under the PEPP and announced that those under the APP will conclude in the third quarter. In my opinion, given that the inflation outlook is consistent with fulfilling our forward guidance conditions, purchases under the APP should conclude early in the third quarter so that the first interest rate rise can be made soon after. Further rate rises could be made over the following quarters until reaching, for example, levels in line with the natural rate of interest, assuming the medium-term inflation outlook remains around our target.

Interest rate increases should be gradual. The aim is to seek to avoid abrupt movements, which could be particularly harmful in the current highly uncertain setting. To enable us to adopt this gradual approach, it is essential that inflation expectations remain anchored and that no indirect or second-round effects arise on a scale that could jeopardise such anchoring.

We do not have pre-established guidelines for the normalisation. Our decisions will be data dependent, as the current uncertainty affects such important aspects for future inflation as the course of the war in Ukraine, the horizon over which global transport and production bottlenecks will fade away, the likelihood of second-round effects, globalisation dynamics and energy and climate change policies.

We will act with total flexibility and adopt the measures needed to fulfil our mandate and contribute to safeguarding financial stability. Flexibility is particularly important, to prevent

that, along the way toward a more normal interest rate setting, threats may arise to the smooth transmission of monetary policy throughout the euro area. The pandemic has shown that, under stressed conditions, flexibility in asset purchases effectively helps to counter these threats, and, within our mandate, it will remain a cornerstone of our monetary policy.