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Euro area economy: situation, outlook and monetary policy challenges*

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* English translation from the original in Spanish.

Good evening, ladies and gentlemen.

I should like to begin my address by thanking the Governing Board of Spain Investors Day for their kind invitation to speak at the 13th edition of this annual international forum which, with each passing year, further cements its reputation as an excellent event for fostering international investment in Spain.

Holding this event in January gives us a good opportunity to take stock of the past year and to consider the outlook for the year ahead. On this occasion, as member of the Governing Council of the European Central Bank (ECB), I would like to give a brief account of where we are with the process of monetary policy tightening. We began this process in late 2021 with the aim of dealing with the episode of high inflation that went on to mark 2022 and has become a key determinant of economic and financial activity. To put it into context, let me first review the situation and outlook of the euro area.

Euro area: situation and outlook

The last year was shaped by the withdrawal of the pandemic-related restrictions and, to an extraordinary and dramatic degree, by Russia's invasion of Ukraine. Lifting the pandemic restrictions provided a major economic boost in the first part of 2022. But the effects of reopening the economy have waned, and the recessionary forces have increased on account of the war in Ukraine, owing in particular to its impact on the international commodity markets, specifically the energy markets.

Indeed, given our geographical proximity to the warzone and our dependence on energy and other commodity imports, **the euro area economy has been one of the hardest hit by the war**. For instance, **the deterioration of real terms of trade – attributable to import prices outpacing export prices – led to an annual income loss for the euro area of around 2 percentage points (pp) of (nominal) GDP up to 2022 Q3**.

Overall, 2022 was characterised by an economic and geopolitical setting of unprecedented uncertainty, with strong and persistent inflationary pressures worldwide prompting a tightening of most central banks' monetary policies and, therefore, of financing conditions.

In this setting, **international organisations and private institutions alike have successively revised downwards their economic growth forecasts for the euro area**. By way of example, compared with its GDP growth forecasts for 2022-2024 published in December 2021, the Eurosystem's latest projections, published in December 2022, point to cumulative growth being around 3 pp lower in that period, primarily in 2022 and 2023.

That said, the European economy appears to be more resilient than was expected a few months ago, with growth potentially standing around 3.4% in 2022.[1] This resilience is **particularly evident in the job market**, with unemployment reaching record-low levels (6.5% in November). Thus, despite the aforementioned downward revision to GDP growth for 2022-2024, the Eurosystem made very limited revisions to its employment forecasts last year.

[1] In December 2021 the Eurosystem forecast euro area real GDP growth of 4.2% for 2022. In the case of employment, growth of 2.1% in 2022 is now expected, compared with the 1.3% forecast in December 2021.

One notable recent development has been the **significant correction of the extraordinary spike in gas prices observed in the summer**. This correction owed to a combination of lower demand, higher-than-expected gas storage levels (against a backdrop of mild temperatures in the autumn and so far this winter) and the measures taken by different national and European authorities.

Looking ahead, in the very near term, **the latest Eurosystem projections expect economic activity to worsen in 2022 Q4 and 2023 Q1**, following the slowdown in growth already observed (to 0.3% quarter-on-quarter) in Q3. According to these projections, **however, if there were a recession in the euro area, it would be relatively short-lived and shallow**, a view that seems to have been confirmed by the latest data published.

Assuming the energy market rebalances, uncertainty decreases and household real income improves owing to the slowdown in inflation, **activity is expected to improve in the second half of the year**.

Overall, in the latest Eurosystem projections, euro area GDP growth is expected to stand at 0.5% in 2023 (reflecting a worse outlook for both domestic and external demand),[2] before rising to close to 2% in 2024 and 2025 (above potential growth). This would allow for a gradual improvement in the output gap from its current negative values.

The surge in **inflation** has been **heavily influenced by higher energy and food prices**, which have added to the effect of other supply-side factors related in particular to supply chain disruptions. Nevertheless, **demand-side factors, linked above all to the post-pandemic re-opening of the economy, have also played a role, as has the depreciation of the euro**.

The supply and depreciation shocks also appear to have passed through more swiftly than in previous episodes. This has exacerbated inflationary pressures, prompting very sharp increases in a large number of expenditure items, despite the gradual easing of the supply bottlenecks. Overall, **it is estimated that close to 75% of the increase in inflation in 2022 was caused by the direct and indirect effects of higher energy and food prices**.

According to the latest data available, having exceeded 10% in October and November, inflation eased to 9.2% in December, reflecting the slowdown observed in energy prices. Nevertheless, **underlying inflation stood at an all-time high of 5.2%**, 0.2 pp up on the November figure.

In the projections, **the expected path of euro area inflation has been successively revised upwards**. Specifically, after average inflation of 8.4% in 2022, the December 2022 Eurosystem projections forecast a much higher rate for 2023 (6.3%) than expected in September (5.5%) or June (3.5%). **Inflation is then expected to fall gradually** to an average of 3.4% in 2024 (compared with the September forecast of 2.3%) and of 2.3% in 2025, above the ECB's medium-term inflation target of 2%.

[2] Lower than the 0.9% expected in September and the 2.9% projected one year ago.

The upward revision to inflation for 2023 and 2024 reflects the inflation data of recent months, which show, as I mentioned earlier, a stronger and more persistent inflationary process than expected.

The projected inflation path **is also heavily influenced by the fiscal measures** adopted by the authorities to compensate households for high energy prices and inflation, which are set to dampen inflation over 2023 but will raise it once they are withdrawn, potentially making the inflationary episode more persistent.

In this respect, allow me to stress, as I have done on a number of occasions, that the fiscal support measures to shield the economy from the impact of high energy prices should be temporary, targeted on the most vulnerable and tailored to preserving incentives to consume less energy. If the support were more generalised (rather than targeted), it could exacerbate inflationary pressures, which would necessitate a stronger monetary policy response. **At the present juncture, consistency between fiscal and monetary policy is essential.**

Moreover, in line with the European Union's economic governance framework, **fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt**. In this respect, supply-side policies to enhance the euro area's supply capacity, especially in the energy sector, can help reduce price pressures in the medium term. Specifically, governments should swiftly implement their investment and structural reform plans under the Next Generation EU (NGEU) programme. And targeted support for the most vulnerable should be compatible with the start of a fiscal consolidation process in countries with a high debt level and/or structural deficit.

Moreover, in line with the EU's economic governance framework, fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, can help reduce price pressures in the medium term. To that end, governments should swiftly implement their investment and structural reform plans under the Next Generation EU programme. And targeted support for the most vulnerable should be compatible with the start of a fiscal consolidation process in highly indebted countries or those with a high structural deficit.

The projections also reflect the expectation that **future wage growth may be somewhat sharper than anticipated a few months ago**, in a context in which real wages have declined significantly. Wage growth in the euro area as a whole is gaining pace, underpinned by strong labour markets and the effect of inflation on wage demands, both of which are expected to continue. As I have stressed on other occasions, the income lost as a result of higher energy prices and the resulting deterioration of real terms of trade ought to be distributed equitably between wages and profit margins, to avoid the risks of an inflationary spiral. In any event, most measures of long-term inflation expectations continue to stand at around 2%, meaning that such expectations remain anchored, although the latest above-target revisions to some indicators warrant continued monitoring.

Lastly, allow me to stress that **the level of uncertainty we currently face remains extremely high**. Needless to say, this makes it hard to forecast how activity and inflation will develop. In the near term, the balance of risks is titled to the downside for forecast

growth and to the upside for inflation, although the risks are more balanced towards the end of the projection horizon.

The economic repercussions of the war in Ukraine (particularly should any energy market shocks materialise) represent the main source of risk. On the external side, there is also considerable uncertainty regarding the buoyancy of global economic activity in the near term, in a context in which monetary policy tightening is the norm at almost all central banks. The performance of the Chinese economy after the country abandoned its zero-COVID policy is an additional source of uncertainty. On the domestic side, the main focal points of risk arise with respect to the future path of the household saving rate, following the rise seen during the pandemic, and the impact of the projects under the NGEU programme. Moreover, inflationary pressures pose a genuine risk for the economic outlook.

Meanwhile, the inflation projections assume that a sizeable (albeit incomplete) part of the cumulative increase in production costs has already been passed through to final sales prices. Over the medium term, risks stem primarily from domestic factors such as a persistent rise in inflation expectations above our target or higher-than-anticipated wage rises. By contrast, a decline in energy costs or a further weakening of demand would lower price pressures.

The role of monetary policy

Against this economic background, soundly managed economic policy is crucial if inflation is to return to the target underpinning the ECB's price stability mandate: an annual inflation rate of 2% over the medium term.

In December, based on the substantial upward revision to our inflation outlook I referred to earlier, we agreed to raise the key interest rates by 50 basis points (bp), taking the deposit facility rate to 2%. This represented an overall increase of 250 bp since the interest rate normalisation process began in July last year, the fastest in the history of the euro. That month saw the first increase, of 50 bp, in the three key rates, which took the deposit facility rate to 0%, thereby abandoning negative interest rate territory for the first time since 2014.[3] In September and October, in view of the unexpected and extraordinary rise in inflation and the expectation that it would remain above target for a prolonged period of time, we agreed on two consecutive 75 bp increases, the biggest hikes in the euro's history.

Looking ahead, the Governing Council **expects to continue raising interest rates at a steady pace at its next meetings, to sufficiently restrictive levels to ensure that inflation returns to the 2% medium-term target**. Keeping interest rates at restrictive levels will reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift in inflation expectations.

The need to continue raising interest rates at coming meetings can be explained, as I have elsewhere, using the concept of "target-compatible terminal rate", meaning the level that interest rates would have to reach if medium-term inflation is to fall to our 2% target. As things stand, as I noted earlier, inflation remains above the medium-term target in the ECB's

[3] At that same meeting, we approved the Transmission Protection Instrument, a key tool for ensuring the effective transmission of monetary policy across all euro area jurisdictions.

latest projections (2.3% in 2025), even though they were based on market expectations for the future path of interest rates that were higher[4] than those in the previous projections. Taking these projections as valid, this would suggest that interest rates would need to rise more than the markets expected when they were prepared in order for inflation to return to its medium-term target. In this regard, since the last ECB Governing Council meeting the maximum interest rate level expected by the market has increased by roughly 30 bp, to around 3.4%, although such market rates incorporate a positive term premium. Accordingly, the genuine market expectations for the maximum deposit facility rate would be somewhat lower.

In any event, it is essential to continue emphasising how important it is to consider the extraordinary uncertainty we currently face. This uncertainty concerns geopolitical developments, the economic environment and how the supply and demand-side factors shaping it will evolve. There is also uncertainty about the persistence of such factors, and even the impact our measures have on the economy in this context. All of which leads us to stress, as we have been doing in recent months, that **our future interest rate decisions will continue to be data-dependent** and follow a meeting-by-meeting approach.

As regards the asset purchase programme (APP), following the decision to discontinue net purchases on 1 July, at our December meeting we announced that, **from early March 2023, the Eurosystem will no longer reinvest all of the principal payments from maturing securities under the APP**, thereby reducing the size of its portfolio. All of this on the understanding that the key ECB interest rates are our primary tool for setting the monetary policy stance. **The decline will amount to €15 billion per month on average until the end of Q2.** This figure represents around half of the principal payments from APP securities maturing during this period. At our February meeting, we will announce the detailed parameters for reducing our APP holdings, **which will in any event be at a measured and predictable pace**. **The pace at which the portfolio is to be reduced after Q2 will be determined over time**. At any rate, we will regularly reassess the pace of the APP portfolio reduction so as not only to ensure it remains consistent with the monetary policy stance, but also to preserve market functioning and maintain firm control over short-term money market conditions.

With regard to our pandemic emergency purchase programme (PEPP), we brought an end to net purchases in March 2022, and we intend to reinvest the principal payments from maturing securities until at least the end of 2024.

Moreover, in keeping with the broader monetary policy normalisation process, in October we decided to adjust the interest rates applicable to the third series of targeted longer-term refinancing operations (TLTRO III) and to offer banks additional voluntary early repayment dates, thereby reinforcing the transmission of our policy interest rate increases to bank lending conditions.

Last but not least, at the December meeting we also undertook to review, by the end of 2023, our operational framework for steering short-term interest rates, which will also

[4] Specifically, the December projections were based on short-term interest rates of 0.4% in 2022, 2.9% in 2023 and 2.7% in 2024 (2.5% in 2025). Likewise, at that time the average nominal yield on euro area 10-year sovereign bonds was 1.8% for 2022, rising gradually to 2.7% in 2024 and 2025. It should be borne in mind that market expectations for interest rates include not only expectations for ECB policy rate increases at any given time, but also a risk premium component.

provide information regarding the endpoint of the Eurosystem's balance sheet normalisation process.

I hope that with this account I have been able to convey the ECB Governing Council's commitment to preventing high inflation from taking root and to meeting our inflation target. As I always say, the more confident our fellow euro area citizens are of a timely return of inflation to 2%, the smoother the adjustment process will be.