Meeting 26th January 2023

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I. Introduction.

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I will devote most of my 20 minutes to talk about interest rates, which I think is, again, the dominant issue in the monetary policy domain, with balance sheet policy now very much in the background. I will then move to the closely related issue of inflation. We can cover in the question time other issues you may be interested in, including QT, Italy and TPI, activity and employment.

II. Interest rate

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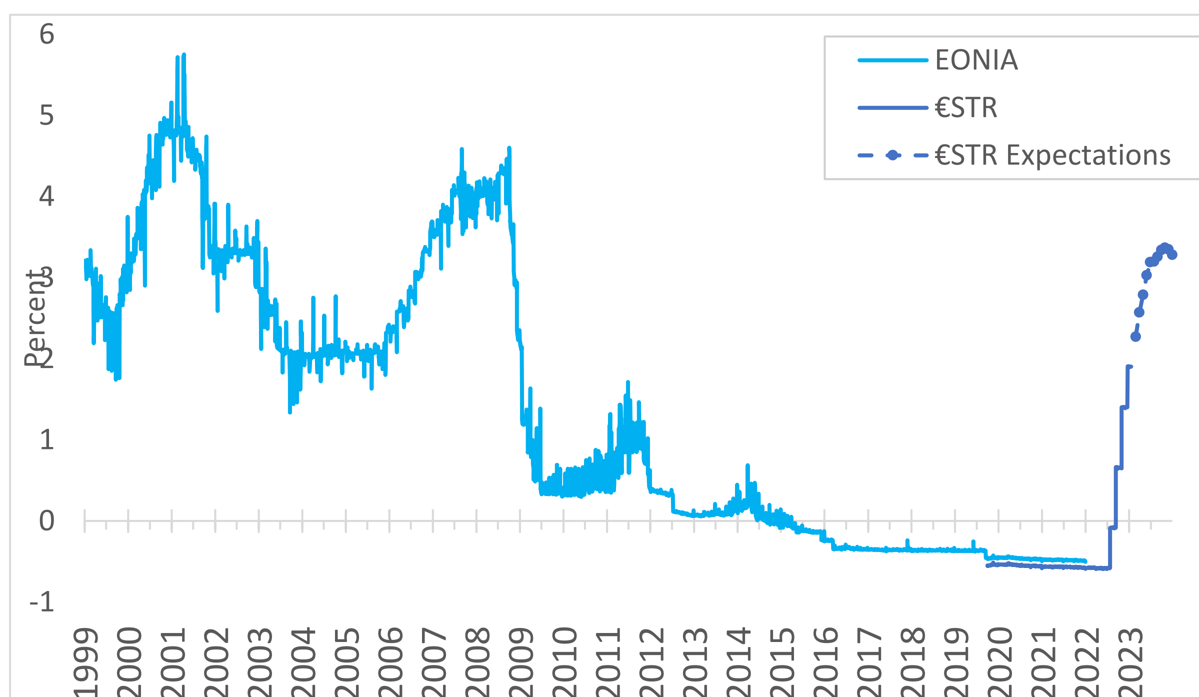
The historical behaviour of Eonia and the current expectation path for €STR over the next year is reported in Figure 1.

Fig. 1 Eonia and €STR



The chart indicates that the ECB has not yet fully convinced market participants that it has the intention to continue with decisive tightening. Indeed at 3.4%, the peak rate would not leave much room for more interest rate hikes after the implementation of the quasi announced two next 50 b.p. points increases. This is the case even if 3.4% is an increase with respect to the projections in the Survey of Market Analysts (SMA) in December 2022, where a peak of 2.87 % was expected for the overnight rate (€STR) in April 2023. Furthermore, the ECB was further expected in the SMA to cut rates soon after the peak.

The ECB seems to have convinced, instead, the OECD, which forecasts rates close to 4.0% in the autumn of next year, as it can be seen in figure 2.

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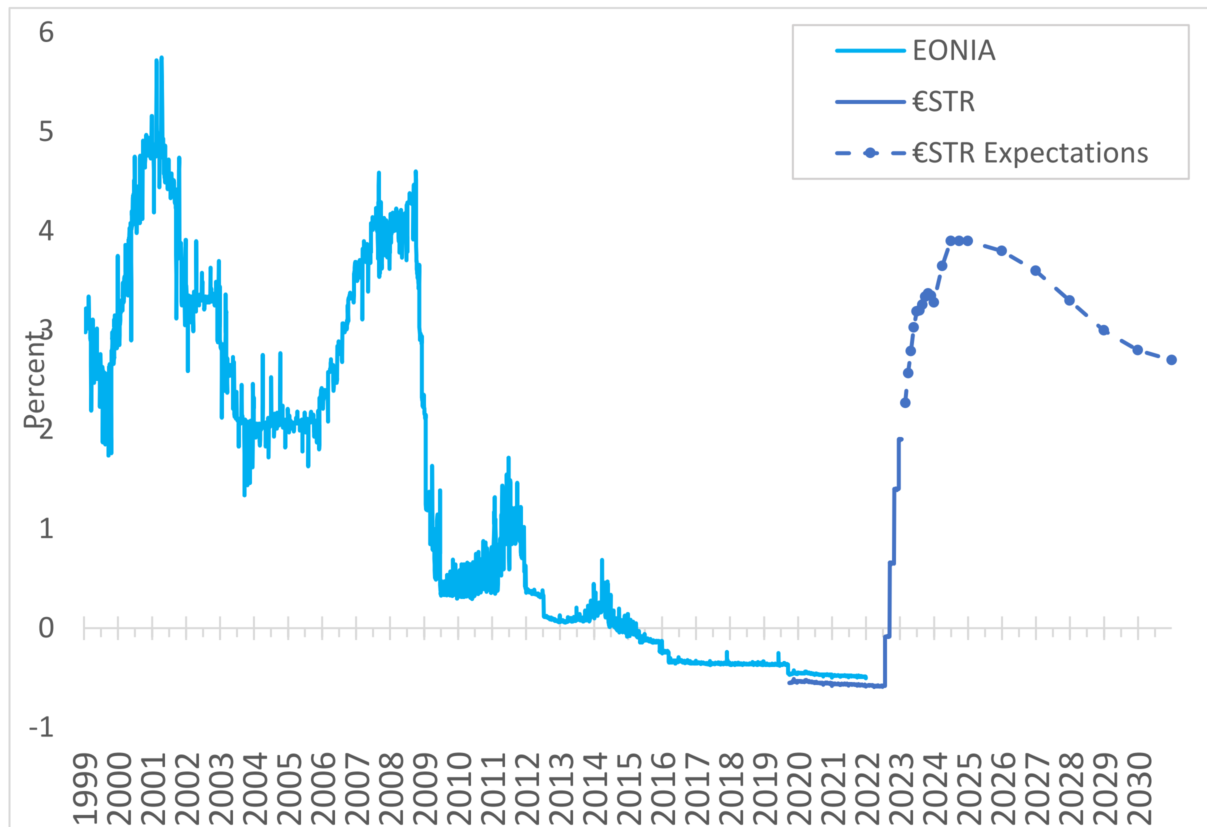
Figure 2. Eonia-€str and OECD money market forecasts



The OECD thus foresees a doubling of the O/N rate from around 2 now to nearly 4 in the second half of 2024.

Before dwelling further on the issue of the possible developments of interest rates, let me mention, as a kind of anecdote, an unexpected reflex of the tug of war between the ECB and the market, leading to a statement that I have read in the latest Monetary Policy Account. Ms. Schnabel said in her initial statement in the GC meeting that recently there had been: "lower inflation, increase in risk appetite, lower nominal and real yields, credit spreads, easing of global financial conditions, tighter credit spreads and buoyant equity markets". This would be normally regarded as good news, but, in her view and probably in the view of the GC overall, these were bad news, as they worked against the intention of the ECB to withdraw monetary policy accommodation. I think one could add another piece of information to those listed by Schnabel: better news about economic activity in the €-area. And these could be considered good both intrinsically and for the tightening intentions of the ECB.

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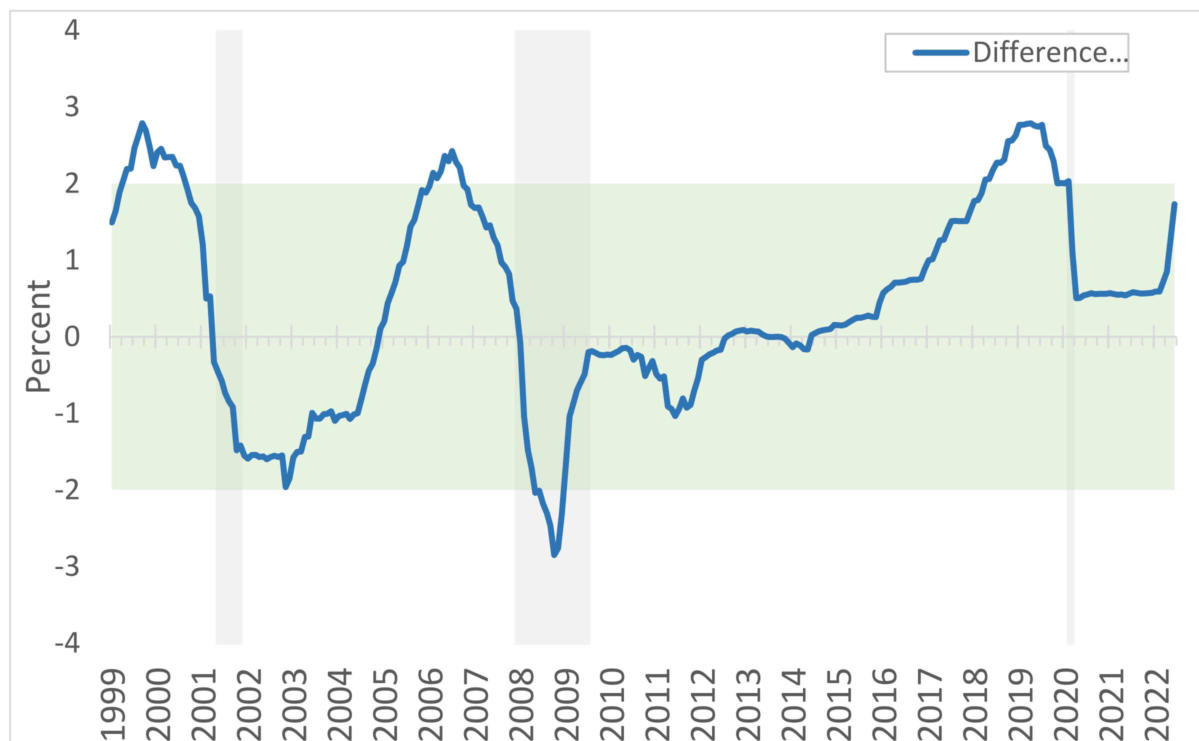
The expectation of rates not far from 4 percent is consistent with the historical pattern whereby it is very unusual for the ECB rate to differ more than 2%, up or down (see green area in figure 3), from the Fed rate, which would have been the case if the ECB would have stopped raising rates at or below 3%.

Figure 3. Eonia and Federal Funds rate



US: Federal Funds Effective rate. €-area: Eonia-€str.

(Slide 6)

In a recent Tweet I disputed the view that the ECB President was univocally hawkish in her latest press conference. I started noting an apparent contradiction in her presentation: on one hand, forward guidance is considered no longer appropriate, on the other hand, she practically announced that, at least, the following two rate changes would be 50 b.p. increases. My interpretation is that this apparent contradiction is instead a subtle way to keep two avenues open for future action. If inflation, and in particular core inflation, will come down more than currently expected, the “no forward guidance message” will be privileged, and a less stringent path could be chosen. If that will not, instead, be the case the path of multiple 50 bp increases will be the one actual chosen. And the prevailing message is that the latter rather than the former is the most likely development.

Consistently with the desired ambiguity that I see in ECB’s communication, there is considerable uncertainty around interest rate developments, as Ms. Schnabel noted at the last Governing Council meeting: *“Market conditions remained challenging as uncertainty about monetary policy and volatility in market interest rates continued to be high,… ».*

This means that not only the path over the next months of interest rates is uncertain, but also that the rate at which the ECB could see its monetary policy correction concluded, call it equilibrium interest rate if you wish, is uncertain.

I will look at the inflation situation and its possible future developments in a moment. But I find useful, when thinking about the equilibrium interest rate, to look at a table like the following one, drawn from the latest ECB projections and reporting forecasts of different institutions.

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Table 1. Macroeconomic projections of different institutions.

		Real GDP growth				HICP inflation			
	Date of release	2022	2023	2024	2025	2022	2023	2024	2025
Eurosystem staff projections	December 2022	3.4	0.5	1.9	1.8	8.4	6.3	3.4	2.3
Consensus Economics	December 2022	3.2	-0.1	1.3	1.6	8.5	6.3	2.2	1.9
OECD	November 2022	3.3	0.5	1.4	-	8.3	6.8	3.4	-
European Commission	November 2022	3.2	0.3	1.5	-	8.5	6.1	2.6	-
Survey of Professional Forecasters	October 2022	3.0	0.1	1.6	-	8.3	5.8	2.4	-
IMF	October 2022	3.1	0.5	1.8	1.9	8.3	5.7	2.7	2.2

There is one simple message from this table: forecasters see the €-area economy moving towards and eventually settling again, in 2025 after the repeated shocks of the last 3 years, into a broad 2-2 pattern: 2 per cent real growth and 2 percent inflation. Given these forecasts, it is a reasonable assumption that the nominal interest rate would also settle around a "normal" level of 4 per cent: 2 per cent real and 2 percent for inflation compensation.

The peak rate could even be a little higher, if more tightening is needed to squeeze inflation from the European economy. My main message about interest rates is that, from today's perspective, there is an attraction towards 4.0%.

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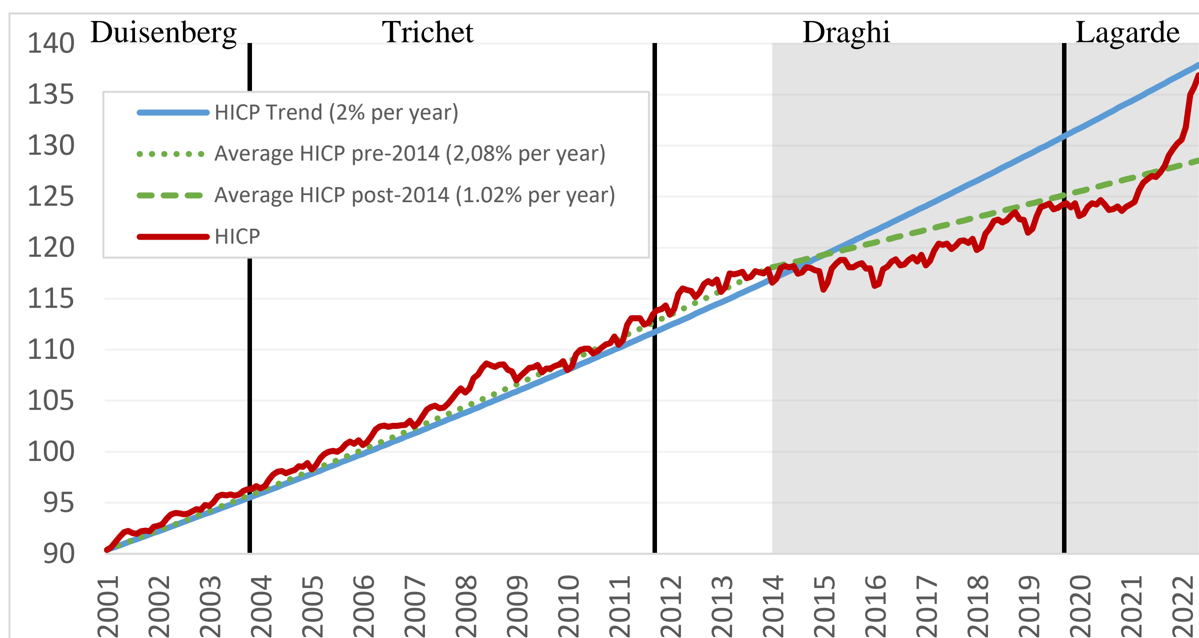
III. Inflation

As I mentioned, any view about interest rate must include a view about inflation, not only because inflation is the first mover of a price stability oriented central bank, but also because the two are tightly linked in the structure of the economy. Let me try and present a different perspective on inflation by looking at the price level instead of its percentage change.

Figure 4. Consumer price level in the euro area under four ECB presidents.



You can distinguish in the figure three different periods:

1. A first period between the launch of the € and 2014, basically corresponding to the tenure of the two first ECB Presidents, Duisenberg and Trichet, in which the price level was very close to the trend corresponding to a 2% constant increase,
2. A second period between 2014 and 2021, when HICP distanced itself from the 2% trend, as inflation was too low, corresponding to much of the tenure of Draghi,
3. The burst of inflation since the end of 2021, under the leadership of Lagarde.

Of course, one should not conclude about the success of the different presidents just looking at this chart, since the conditions under which they led the Bank were very different. In particular, the shocks to the economy, and in particular to inflation, were much larger in the most recent period. Still, it is illustrative of some fundamental developments taking place during the life of the euro.

Rather than looking at median inflation expectations, I think it is more illustrative to look at the variance of inflation expectations, in particular as derived from the ECB's Survey of Professional Forecasters, as in the figure below.

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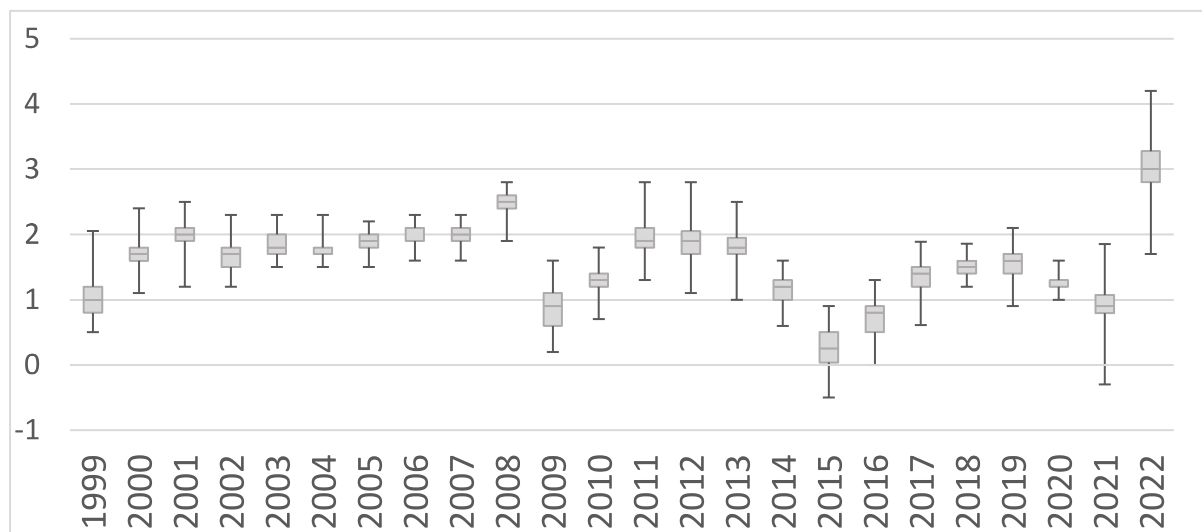
Figure 5. Forecast variance from the Survey of Professional Forecasters.



Own calculations on data from ECB Statistical Data Warehouse. Note: Each grey box represents the first quartile up to the third quartile, with a black line inside representing the median. The minimum and maximum are shown by black lines outside each box, connected to the box by dotted lines Inflation is defined as Harmonised ICP (annual averages of quarterly forecasts).

In the figure we see that inflation forecasts have not only been very high recently, but also that forecasters have expressed very diverging views, as shown by the size of the boxes and the distance between maximum and minimum forecasts, exceeding past observations. In a recent post on Bruegel, which presented this same figure, Monika Grzegorczyk and I recently documented how macroeconomic uncertainty has been in recent times the most intense in the life of the euro.

Of course, this inflation uncertainty is directly connected to the uncertainty about interest rates going forward and justifies, in my view, the subtly ambiguous message from the ECB about interest rates. It also justifies, in my view, the insistence in the determination to regain price stability. The ECB sees inflation uncertainty and realizes that its action, current and expected, can push it into one or the other direction. In a way, monetary policy effectiveness is higher when inflation prospects are uncertain than when they are solidly into either the increase, decrease or stability direction. Financial, labour and good market don't know exactly where inflation is going and they are more eager to get signals from the central bank.

No talk about inflation can avoid talking about wages. Here my message is very simple: it is inevitable that wages will accelerate in 2023, given what happened to inflation in 2022. What is important is what wages will do subsequently. ECB projections are not reassuring in this respect as wages are projected to grow still at 3.0% in 2025, which means, with projected labour productivity growth of 1.3 per cent, unit labour costs increasing at 2.6 %, not quite consistent with the 2.0% inflation target.

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Overall, my sense about inflation is that fully recovering the 2.0 objective will be hard and the ECB is right in warning that this could mean monetary policy remaining tight for quite some time. This is consistent with my conclusion that interest rates will have to reach 4% and may be a little further to fully regain price stability.

Over the years the exchange rate has lost importance, in the assessment of the ECB, as inflation factor. Indeed, the ECB has moved in its assessment of inflation from the "small country" assumption, which was prevailing practically for all countries joining the €area in 1999, to a large country assumption, long prevailing in the US, where domestic factors, and wages in particular, are more important than international ones in explaining inflation. Still the exchange rate is not irrelevant. This structural consideration is reinforced looking at exchange rate developments.

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Figure 6. Euro-dollar exchange rate.

Figure 6 shows that, with the recent appreciation, the euro has started moving away from the quite exceptional weakness against the dollar, which had briefly brought it below parity. But the relationship towards the dollar is not the most important part of the story. The following charts shows that more than talking of euro weakness, one should talk, notwithstanding the recent correction, of dollar strength. Indeed, the dollar is at around the highest rate of the last 15 years, while the euro is wandering on a plateau prevailing since 2005.

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Figure 7. Dollar effective exchange rate.

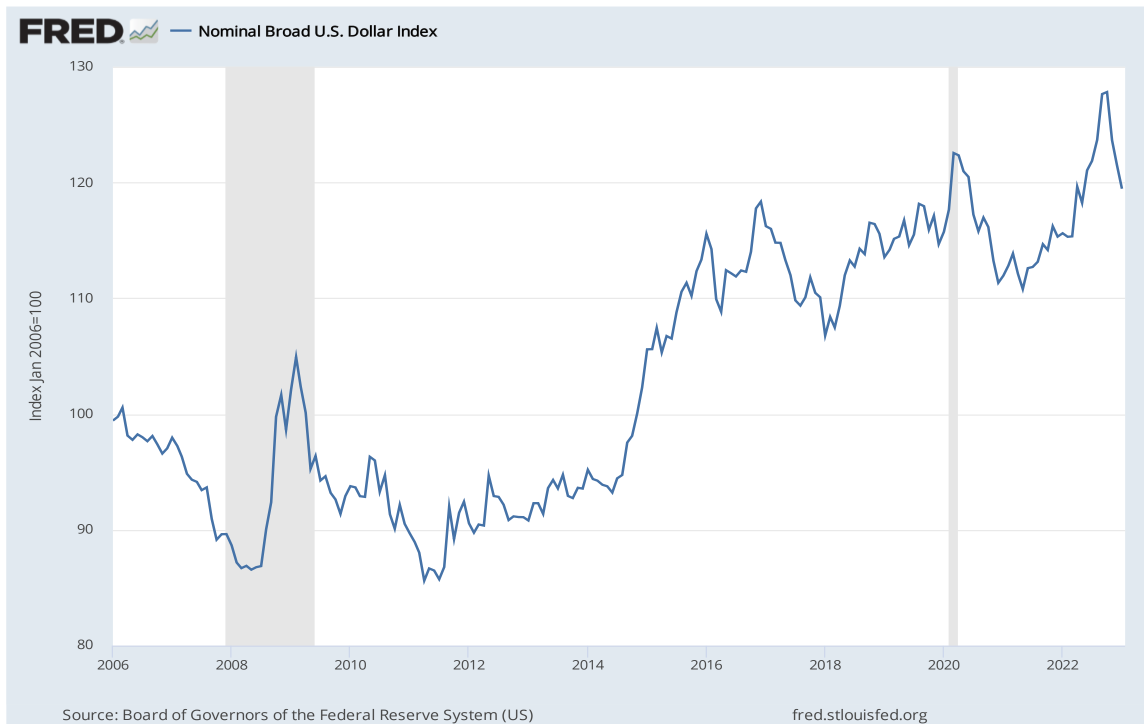

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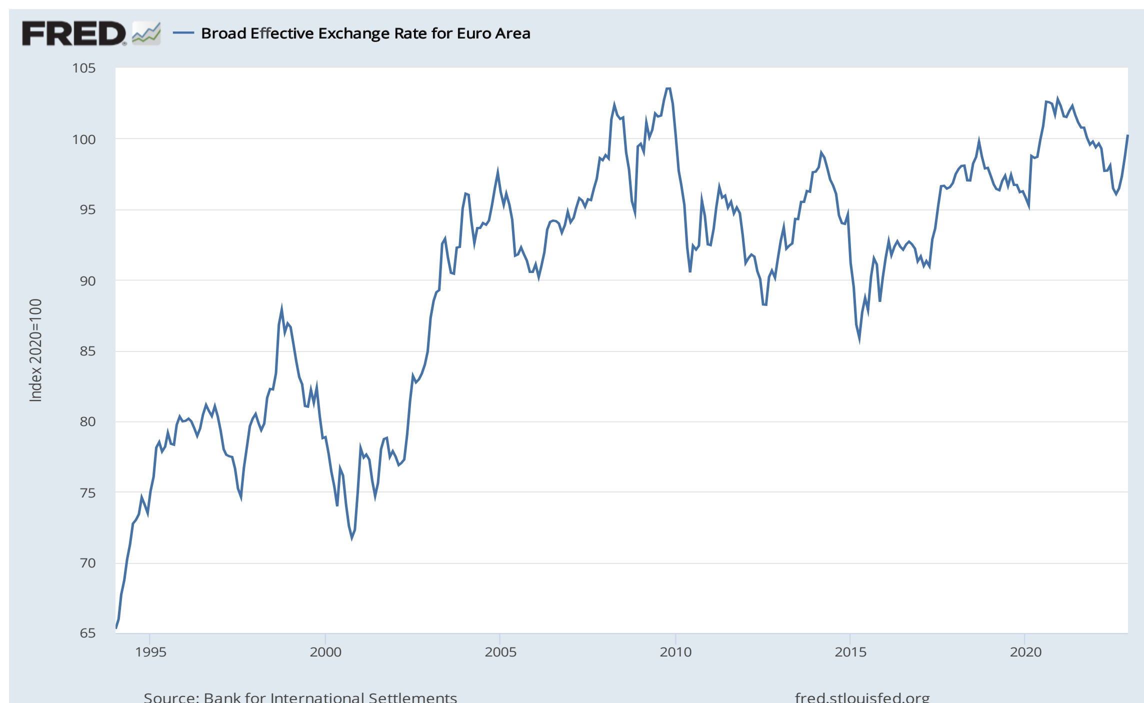
Figure 8. Euro effective exchange rate.



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In conclusion, I see the difficulty of regaining price stability and the need for the ECB to further tighten monetary policy significantly, while admitting that there is a lot of uncertainty and that any expectation can be held only with weak confidence.

I just echo here some strong words in the ECB Monetary Account: *Against this background it was remarked that the inflation projections were surrounded by an unusual degree of uncertainty, particularly over the medium term. The confidence bands surrounding the inflation projections were vast and grew over the projection horizon. The precision of the inflation projections two to three years ahead was assessed as extremely low."*

(Slide 15)

Fig. 9. Bond yields of selected area countries.