Philip R Lane: A middle path for European Central Bank monetary policy

Speech by Mr Philip R Lane, Member of the Executive Board of the European Central Bank, at the Peterson Institute for International Economics (PIIE), Washington DC, 5 February 2025.

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Accompanying slides to the speech

It is a pleasure to be here at the Peterson Institute for International Economics (PIIE): your impressive research on a wide range of topics is extremely valuable for policymakers.[1]

At last week's monetary policy meeting, the ECB's Governing Council decided to lower the deposit facility rate – the rate through which we steer the monetary policy stance – by 25 basis points from 3.0 per cent to 2.75 per cent. In cumulative terms, the deposit facility rate has declined by 125 basis points since last June. The decision reflected our updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

In what follows, I will explain in more detail the basis for this decision. I will review inflation developments, economic developments, our risk assessment, and financial and monetary conditions. Finally, I explain why pursuing a middle path for monetary policy is best suited to the current environment.

Inflation developments

The disinflation process remains well on track. Inflation has continued to develop broadly in line with the staff projections and is set to return to our two per cent medium-term target in the course of this year. Most measures of underlying inflation suggest that inflation will settle at around our target on a sustained basis. The Persistent and Common Component of Inflation (PCCI), which has the best predictive power among underlying inflation indicators for future headline inflation, continued to hover around two per cent in the December data, indicating that headline inflation is set to stabilise around our target.

Domestic inflation, at 4.2 per cent, stayed well above all the other indicators in December mostly because wages and prices in certain sectors are still adjusting to the past inflation surge with a substantial delay. However, the PCCI for services, which should act as an underlying attractor for services inflation and domestic inflation, fell to 2.3 per cent.

The anticipation of a downward shift in services inflation in the coming months also relates to the expected deceleration in wage growth in the course of 2025. Wages have been adjusting to the past inflation surges with a substantial delay, but the ECB wage tracker and the latest surveys point to a significant moderation in wage pressures this year. According to the latest results of the Survey on the Access to Finance of

Enterprises (SAFE), firms expect wages to grow by 3.3 per cent on average over the next twelve months, down from 4.5 per cent this time last year. Similarly, the latest Corporate Telephone Survey indicates that wage growth should decelerate from 4.3 per cent in 2024 to 3.6 per cent in 2025 and 2.7 per cent in 2026. This assessment is shared broadly among forecasters. Consensus Economics, for example, foresees a decline in wage growth by about one percentage point between 2024 and 2025.

Most measures of longer-term inflation expectations continue to stand at around two per cent, despite an uptick at shorter horizons that may reflect the recent rise in energy prices. While the inflation expectations of firms have stabilised at three per cent across horizons, according to the SAFE, larger firms that are aware of the ECB's inflation target show convergence towards two per cent. Consumer inflation expectations have edged up recently, especially for the near term, which can at least be partly explained by their higher sensitivity to the recent uptick in realised inflation. Inflation expectations of professionals – as captured by the latest vintages of the Survey of Professional Forecasters and Survey of Monetary Analysts – as well as market-based measures of inflation compensation have ticked up for the near term but, over longer horizons, remain stable at levels consistent with our medium-term target of two per cent.

Economic developments

On a fourth-quarter-to-fourth-quarter basis, the 2024 growth rate came in at 0.9 per cent, constituting a material improvement in momentum relative to the 2023 growth rate of 0.1 per cent. While 2024 saw a modest recovery in consumption, investment remained weak and exporters continued to suffer competitiveness challenges. In terms of the quarterly profile, growth stagnated in the final quarter following a comparatively robust third quarter.

The incoming survey indicators suggest that the euro area economy is set to remain subdued in the near term. While unemployment remained low at 6.3 per cent in December, there has been some softening in labour demand, as reflected in lower vacancies and lower employment growth.

At the same time, our baseline assessment is that the conditions for a recovery remain in place. Higher incomes, lower interest rates and stronger household balance sheets should allow a faster pick-up in consumption. More affordable credit should also boost housing and business investment over time. Exports should also support the recovery as global demand rises, although this is highly conditional on developments in international trade policies.

Financial and monetary conditions

Global and euro area bond yields have increased significantly since our last meeting. Amongst other factors, the spillover impact of the rise in US and global longer-term rates has contributed to the steepening of the euro area yield curve.

Our past interest rate cuts are gradually making it less expensive for firms and households to borrow. The cost of borrowing for firms has declined by 92 basis points and mortgage rates have declined by 62 basis points since their peaks in autumn 2023. However, the interest rates on existing corporate and household loan books remain high, especially in real terms, with pre-2022 debt still re-pricing at higher rates as fixation periods expire.

In overall terms, financing conditions remain tight. While credit is expanding, lending to firms and households remains subdued relative to historical norms. Growth in bank lending to firms rose to 1.5 per cent in December. In part, the pick-up in December reflects firms substituting market-based long-term financing for bank-based borrowing amidst tightening market conditions and increasing upcoming redemptions of long-term corporate bonds. Overall external debt financing of firms increased by 1.9 per cent in December, but remained well below the historical average of 4.9 per cent.[2] Loans to households continued to rise gradually, driven by mortgages, but remained muted overall, with an annual growth rate of 1.1 per cent in December, notably below the long-term average of 4.2 per cent.

According to the latest bank lending survey, the demand for loans by firms increased slightly in the fourth quarter. At the same time, credit standards for loans to firms have tightened again, after having broadly stabilised over the previous four quarters. The renewed tightening of credit standards for firms was driven by the fact that banks see higher risks to the economic outlook and have lower tolerance for taking on credit risk. This finding is consistent with the results from the SAFE, in which firms reported a small decline in the availability of bank loans and more demanding non-rate lending conditions. In terms of households, the demand for mortgages increased strongly, mostly on the back of more attractive interest rates and better prospects for the property market. Credit standards for housing loans remained unchanged overall.

Risk assessment

Risks to economic growth remain tilted to the downside. In addition to trade policy uncertainty, lower confidence could prevent consumption and investment from recovering as fast as expected. This could be amplified by geopolitical risks, such as Russia's unjustified war against Ukraine and the tragic conflict in the Middle East, which could disrupt energy supplies and further weigh on global trade. Growth could also be lower if the lagged effects of monetary policy tightening last longer than expected. In the other direction, growth could be higher if easier financing conditions and falling inflation allow domestic consumption and investment to rebound faster.

We take a two-sided approach to assessing inflation risk. Inflation could turn out higher if wages or profits increase by more than expected. Upside risks to inflation also stem from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices by more than expected. By contrast, inflation may surprise on the downside if low confidence and concerns about geopolitical events prevent consumption and investment from recovering as fast as expected, if monetary policy dampens demand by more than expected, or if the economic environment in the rest of the world worsens unexpectedly. Greater friction in global trade would make the euro area inflation outlook more uncertain.

A middle path for monetary policy

Taken together, the incoming data since our previous meeting meant that it was clear that we should take a further step in monetary easing by lowering the deposit facility rate to 2.75 per cent. By excessively dampening demand, the alternative of holding the deposit facility rate at the level of 3.0 per cent would not have been consistent with the set of rate paths that would best ensure that inflation stabilises sustainably at our two per cent medium-term target. At the same time, the new level for the deposit facility rate at 2.75 per cent preserves considerable optionality in responding to shocks. In particular, the rate path can adjust as appropriate in the event of material upside or downside shocks to the inflation outlook and/or to economic momentum.

While our baseline is that inflation should decline from 2.5 per cent in January to around our target in the coming months, it is still important to take into account that this deceleration might take longer than expected and that new upside risks to inflation could emerge, including due to external developments. These considerations explain why we have taken a step-by-step approach to rate cutting since last June.

At the same time, an excessive abundance of caution in monetary easing could threaten the recovery in domestic demand that is needed to support the pricing environment compatible with our medium-term two per cent target. Under this too-cautious path, a below-target inflation dynamic could take hold, which would then require a more sizeable policy response to ensure inflation returns to our symmetric two per cent medium-term target.

Balancing these considerations suggest a middle path is appropriate, which neither over-weighs upside risk nor over-weighs downside risk. That is, a robust monetary policy approach should balance the risks of moving too slowly against the risks of moving too quickly. Accordingly, it is prudent to maintain agility in adjusting the stance as appropriate on a data-dependent and meeting-by-meeting basis and to not pre-commit to any particular rate path.

In closing, let me comment on two much-discussed concepts: restrictiveness and neutrality.

When inflation is materially above target and requires a monetary response to ensure that it returns to target in a timely manner and that inflation expectations remain anchored, the monetary stance must be clearly restrictive. As inflation returns close to target, policymakers need to shift their focus to adjusting monetary policy in line with the incoming economic and financial data and the evolving risk assessment to deliver the two per cent target over the medium term. In other words, policymakers should deliver the monetary stance that is appropriate to the situation.

In exiting a restrictive phase, much energy could be diverted towards creating a summary "restrictiveness" index. Any such index would have to incorporate at least nine factors: (i) the still-important rolling off of super-cheap debt that was taken out in the "low for long" era that is now being re-financed at higher rates; (ii) in the other direction, the transmission of the easing since the peak of the hiking cycle; (iii) the impact of the anticipation of future rate cuts on current financing conditions; (iv) the evolving contribution of quasi-exogenous influences on financing conditions (such as global upward pressure on term premia); (v) the dynamics of bond and equity risk premia; (vi) the evolution of credit standards in bank lending; (vii) the different timelines for market-based and bank-based transmission; (viii) the responsiveness of consumption and investment to shifting monetary conditions; and (ix) the responsiveness of price setting to shifting monetary conditions.

All of these factors enter our calibration of monetary policy (our assessment of the strength of monetary policy transmission has been highlighted as central to our reaction function) and cannot be summarised by a single indicator such as comparing the prevailing policy rate to a highly-uncertain estimate of the so-called neutral rate.[3]

In terms of policy making, uncertainty about the level of the neutral rate and, more generally, about the strength of monetary transmission inescapably sits alongside uncertainty about the inflation outlook and uncertainty about the economic outlook.

This is why our 2021 monetary policy strategy statement highlights that our decisions are based on an integrated assessment of all relevant factors. Over the last two years, we have emphasised in particular the importance of underlying inflation and the strength of monetary transmission as particularly relevant in complementing our analysis of the inflation outlook. More generally, it is essential that all relevant risks are incorporated in monetary policy decisions.

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[1] A slide deck to accompany these remarks is available on the ECB website.

[2] The starting date for the historical/long-term averages is January 1999.

[3] The neutral rate is an important concept in understanding the likely long-run average interest rate but it is not a good guide to near-term policy decisions. A team of ECB economists will release an updated assessment of the neutral rate for the euro area on Friday.