Monetary policy of the ECB

Berlin, 16 November 2022

Claus Tigges – President of the Regional Office in Berlin and Brandenburg of Deutsche Bundesbank

Content

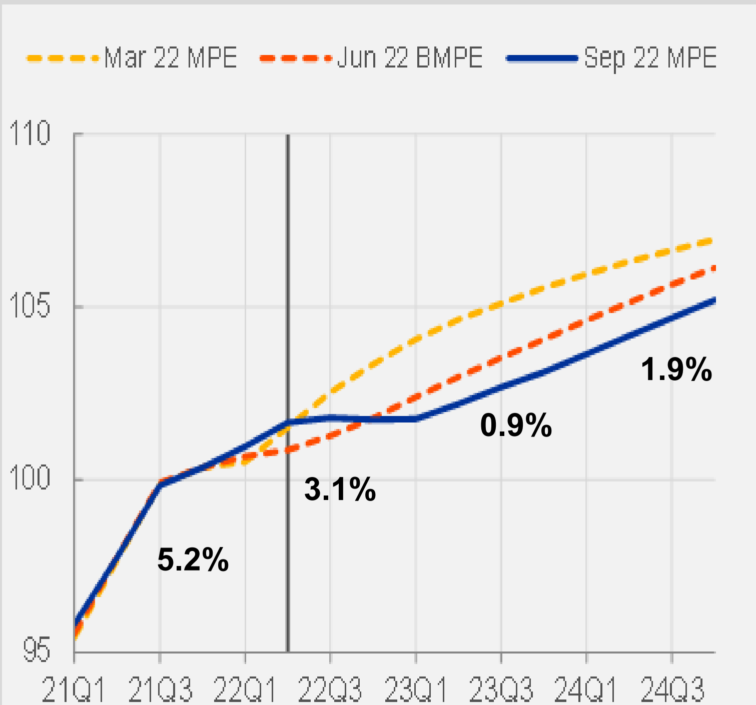
Economic Conditions

Euro area - Growth prospects have steadily deteriorated

Real GDP

Seasonally and calendar adjusted

2019Q4=100



Sept. MPE Report p. 8, ECB

- Recovery from the pandemic-induced recession is being hampered by supply chain disruption and uncertainty related to the war in Ukraine.

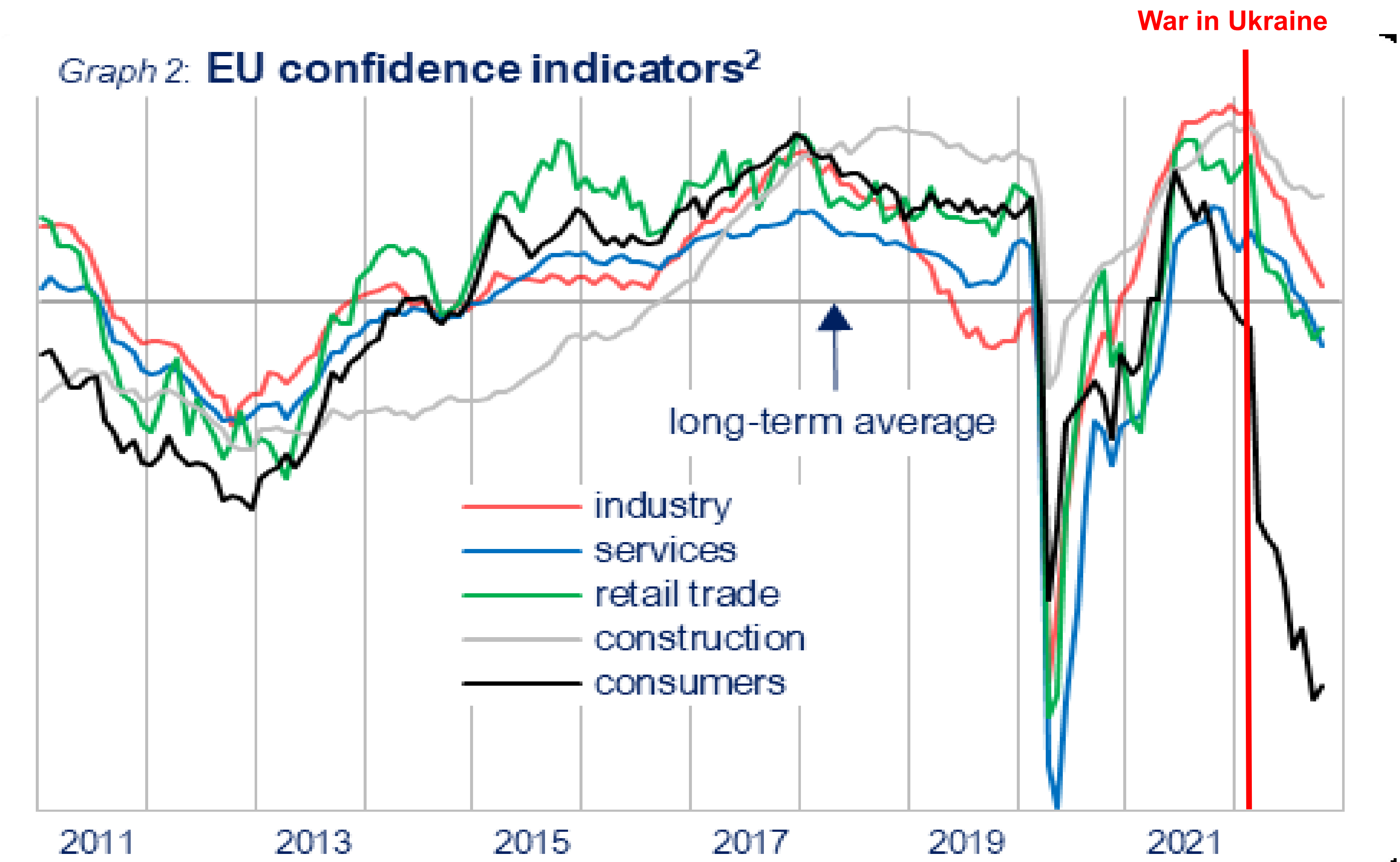
- The resurgence of inflation and the tightening of monetary policy will further slow economic growth.

  - Risk of a recession.

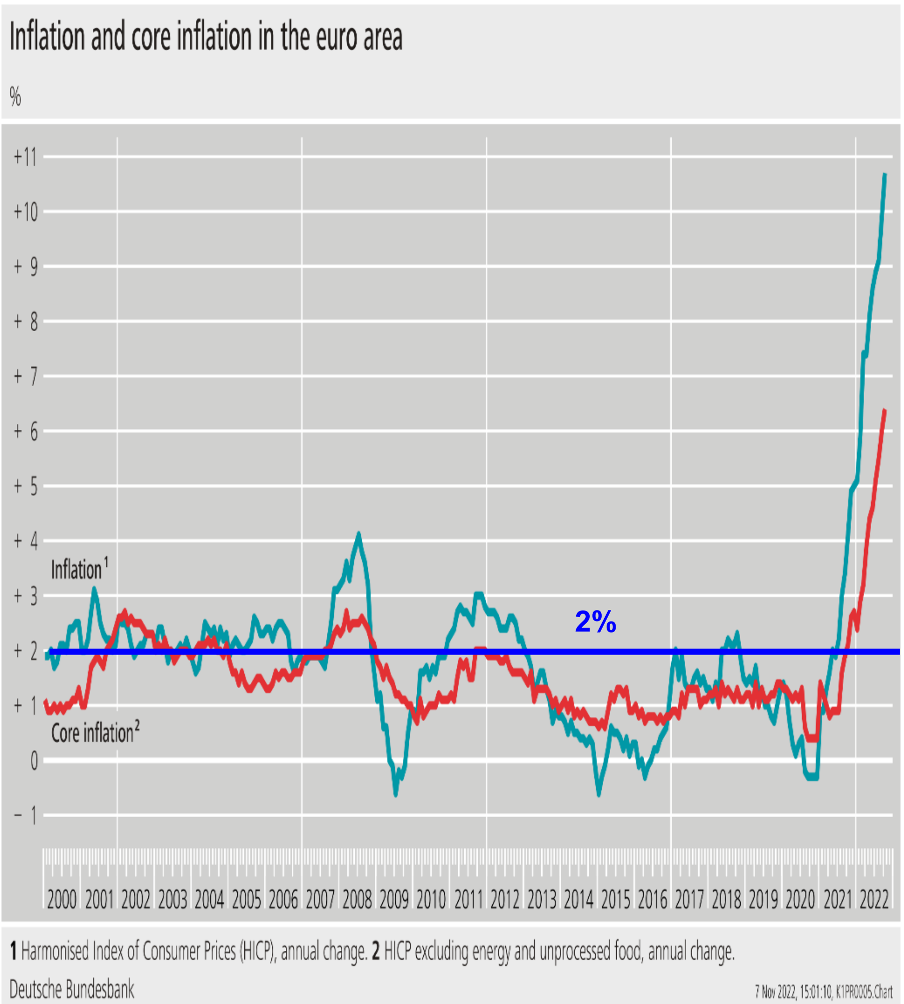
- Fiscal support on the national, but also the European level.

  - Risk of a conflict with the monetary policy stance?

Euro area - The business climate has clouded. Consumer climate and thus also retail trade and service sector continuously weakening



Euro area: Inflation significantly overshoots ECB inflation target, price increase affects almost all goods and services

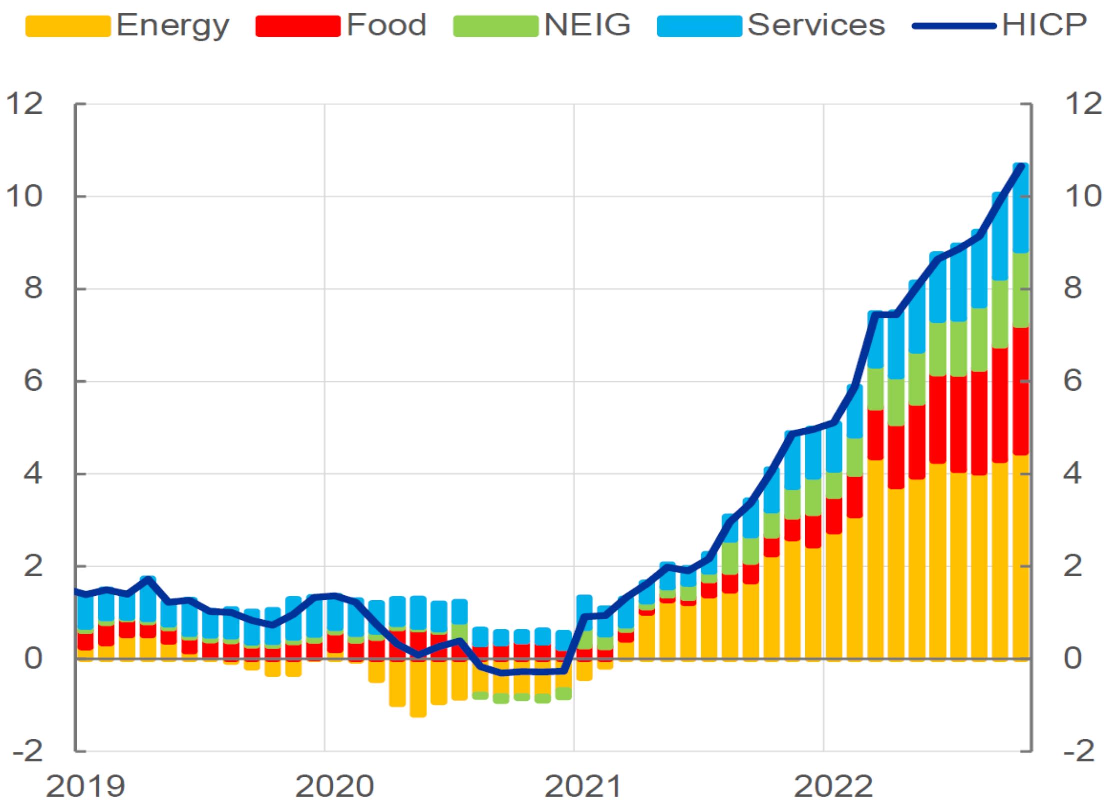


- **HICP** increase 10,7% (October 2022), **core rate** (excluding energy, unprocessed food) at 6.4%.
- **Initial Causes** of higher inflation:
  - Rise in **energy and commodity prices**, in the wake of growth revival (demand) and war in Ukraine (supply).
  - **Shortage** of Russian respectively Ukrainian agricultural products (as well as fertilizers).
  - Delayed unloading of containers in China (zero-covid strategy) and Europe cause **freight rates** to rise and supply chains to break.

Euro area: Energy and food price increases account for 2/3 of total price acceleration

Contributions of components of euro area headline HICP inflation

(annual percentage changes and percentage points contributions)

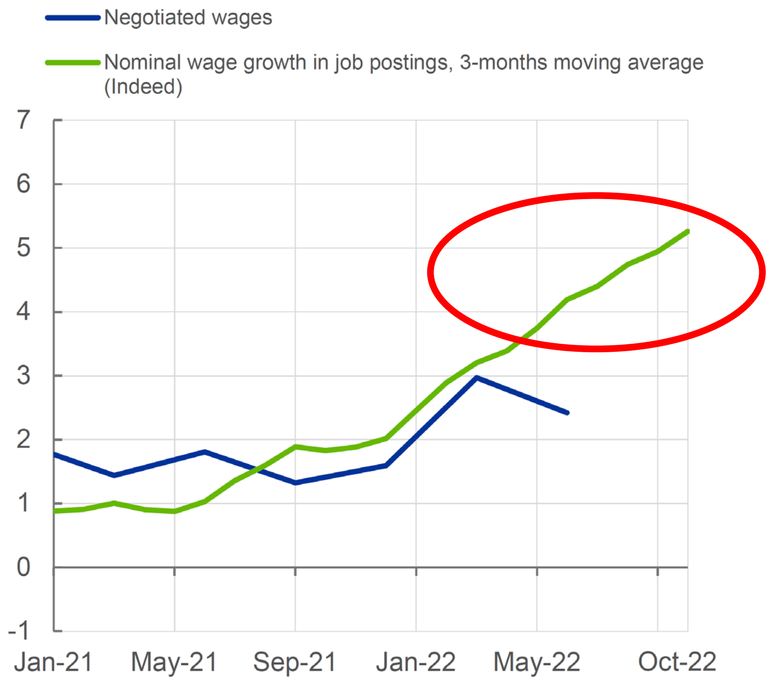


Sources: Eurostat and ECB calculations.
Notes: NEIG stands for “non-energy industrial goods”. The latest observation is for October 2022.

Second round effects - Wage growth still moderate, but falling real wages likely to push up wage demands

Negotiated wage growth and nominal wage growth in job ads

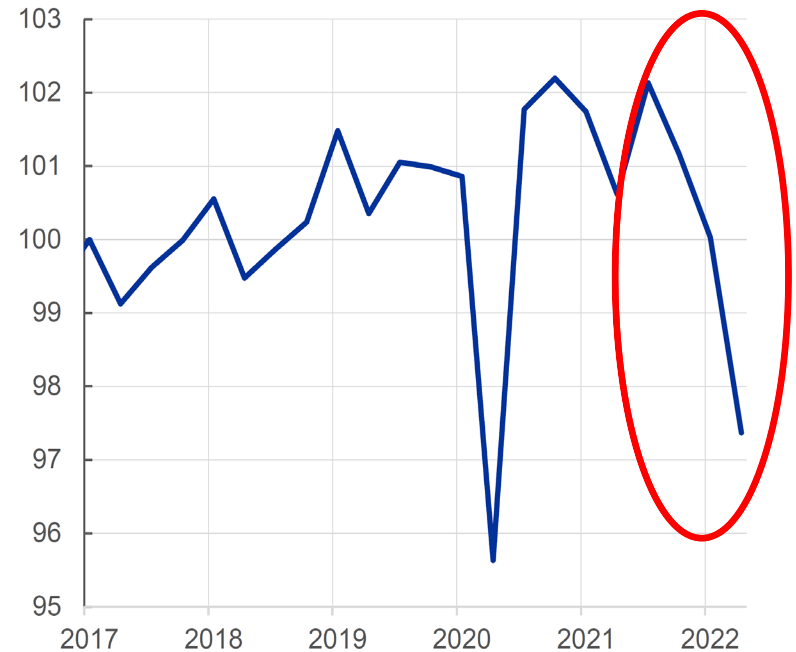
(annual percentage changes)



Sources: Adrjan, Pawel & Reamonn Lydon (2022), Wage Growth in Europe: Evidence From Job Ads – Central Bank of Ireland - Economic letter - Vol 2022, No. 7 (November) and ECB.
Latest observation: 2022 Q2 for negotiated wages and October 2022 for Indeed data.

Real compensation per employee

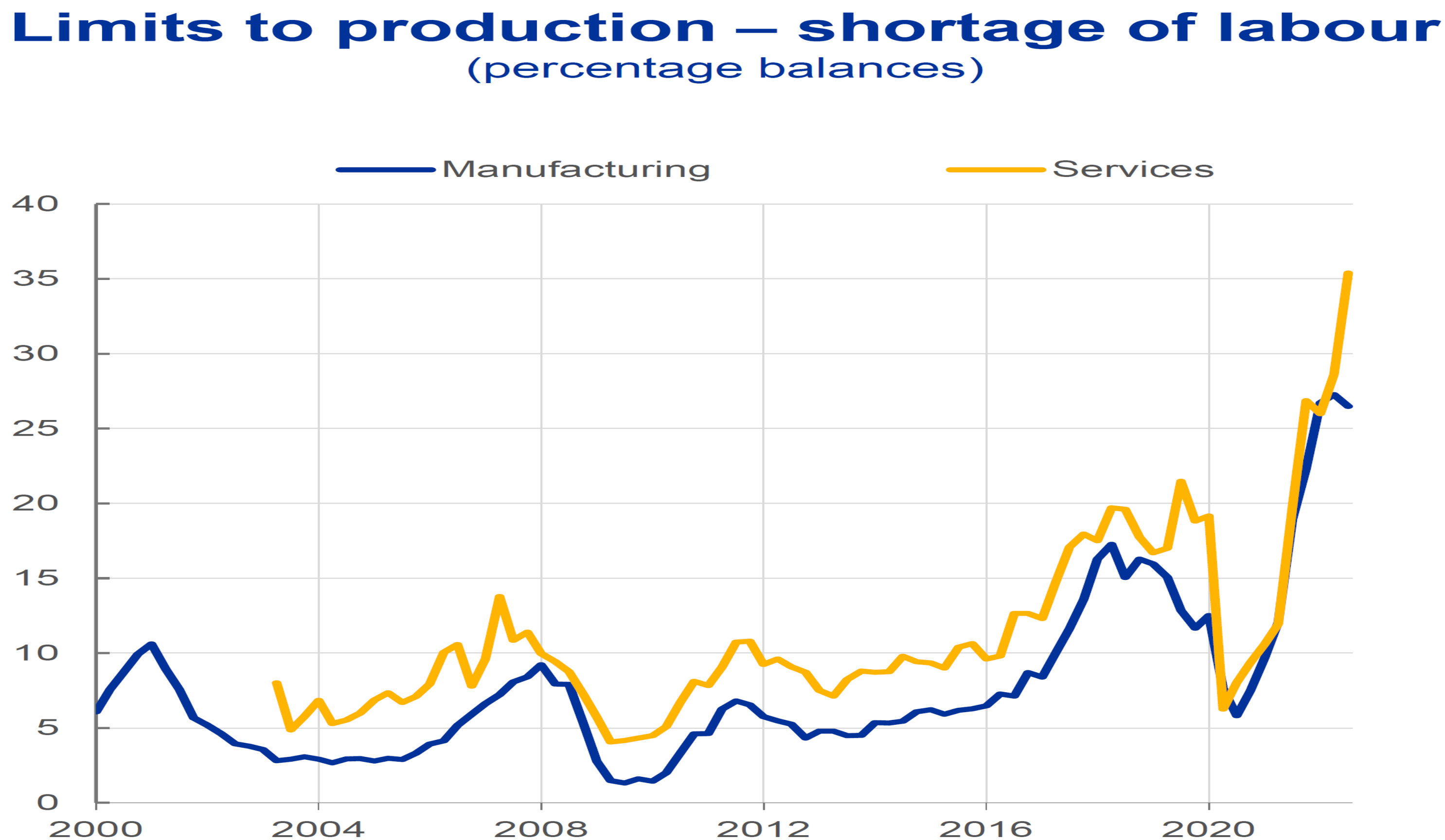
(index: 2017Q1 = 100)



Source: Eurostat and ECB calculations.
Notes: Compensation per employee is deflated using the HICP.
Latest observation: 2022Q2.

Besides real wages, scarcity of (skilled) labor intensifies wage pressure in the Euro area

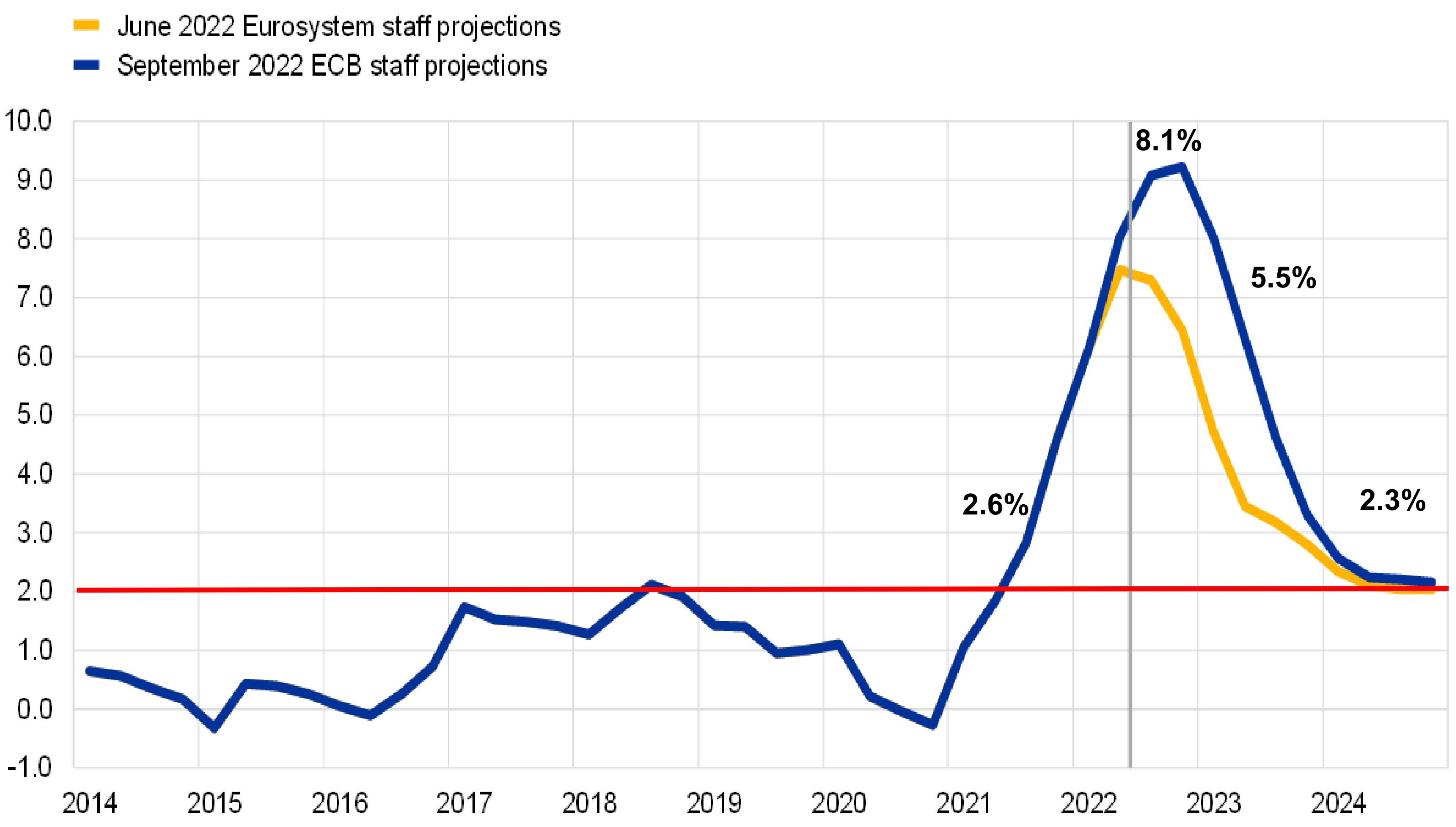
Germany (industry) ●



Source: European Commission.
Notes: Survey in industry and the services sector: percentage of firms who indicate labour shortages as limits on production and business.
Latest observation: 2022 Q3 (August 2022).

Euro area - Inflation threatens to remain above target until well into 2024. Underestimation of pass-through of higher costs

Update of inflation projection for the Euro area
HICP change yoy in %, monthly data



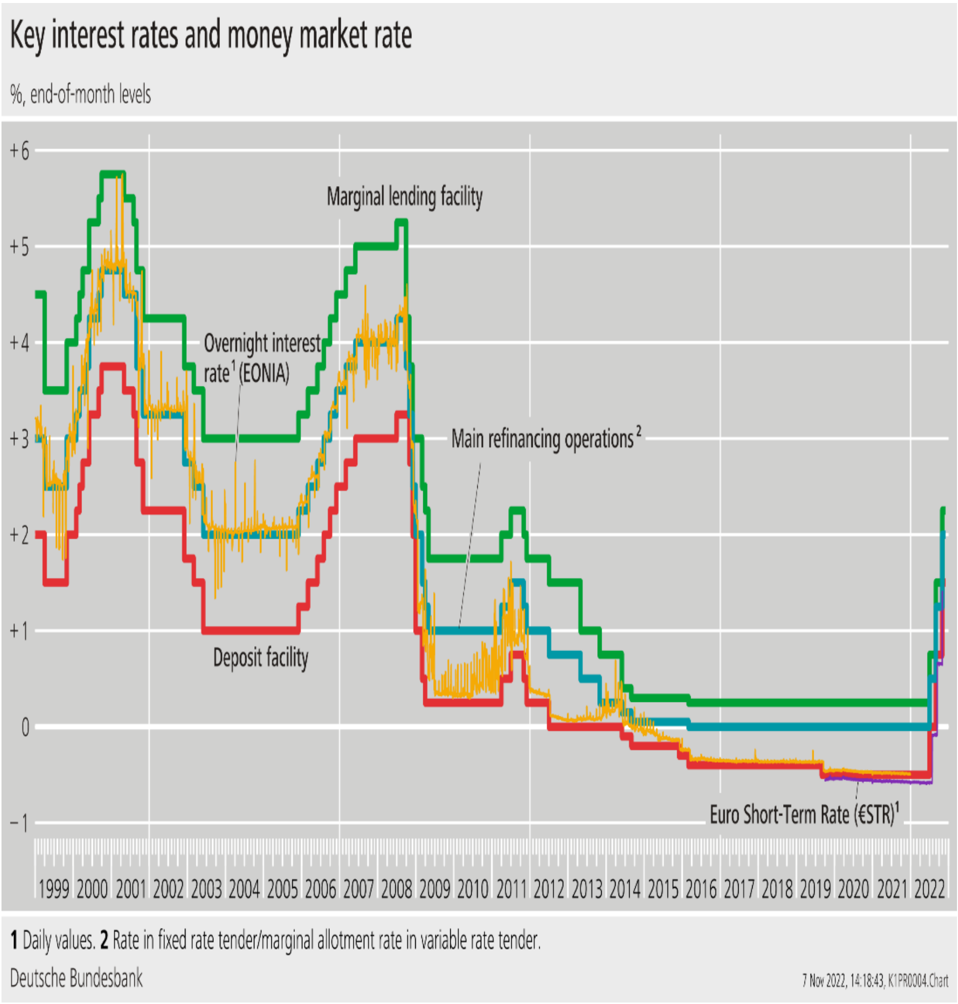
Euro - The devaluation of the euro increases inflationary risks

- The widening of the interest rate differential against the US dollar (+ Ukraine war) had pushed the euro below parity .
- With the latest signs of easing inflationary pressure in the US and expectations of a less aggressive Fed policy, the euro has regained strength.

Content

Monetary Policy Outlook

Interest rate policy – Status Quo



- **Refinancing rate** positive again (since March 2016). As of October 27, 2022: **+2.0%.**
- No interest burden on banks due to "penalty interest," as the **deposit rate** (on central bank balances held by banks) is no longer in negative territory. Since October 27, 2022: **+1.5%.**
- The **deposit rate remains the relevant policy rate**, as excess liquidity drives the money market rate close to the deposit rate.
- Banks continue to receive any desired amount of liquidity (**full allotment policy** "as long as necessary").

Monetary Policy Outlook – Purchase programs

- The Eurosystem has ended all net asset purchases since July 2022.

- Unlike the Fed, the Eurosystem has decided **not reduce its balance sheet** through active sales **until the end of 2024**.

- **But**: Is this decision still appropriate in view of increased inflation risks? Discussion has already started with the **Bundesbank favoring a balance sheet contraction**.

  - Raising interest rates at the short end and keeping them low at the long end seems to be confusing and does not go together.

Monetary Policy Outlook – Interest rate policy

- Three rate hikes so far. Main refinancing rate at 2.0% and deposit rate at 1.5%.
  - Further rate hikes announced.
  - The **deposit rate is still below the neutral rate**, so the economy will continue to be stimulated.
  - **Bundesbank:** Strong signal and determined action needed to avoid a de-anchoring of inflation expectations.

Inflation expectations

- **Forward guidance suspended** due to high uncertainty about future inflation trend. Future interest rate increases are **data-driven**.
  - The ECB is following a **meeting-by-meeting approach**.

Continue

Inflation expectations anchored so far near the 2% inflation target

back

Monetary Policy Outlook - TPI

- **Problem**: Rate hike initially accompanied by increasing yield differentials, especially between long-term Italian/Greek and German bonds.

Yield-Spreads

- **First line of defense**: Reinvestment of maturing bonds from the PEPP program is done in a "flexible manner."

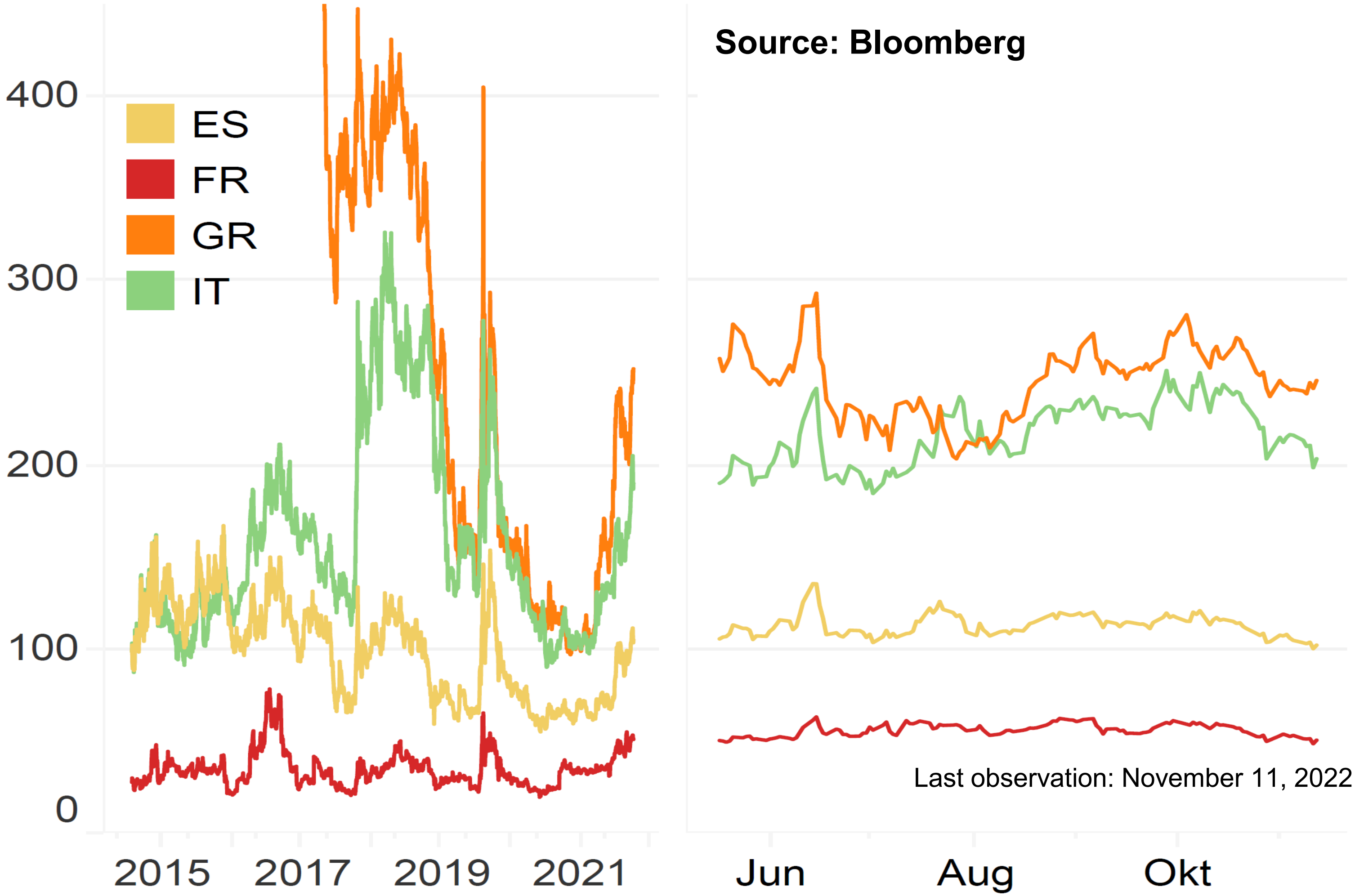
  - Proceeds from maturing German, Dutch and French bonds are invested in Italian, Spanish, Portuguese and Greek bonds.

- **Second line of defense**: Establishment of a Transmission Protection Instrument (TPI).

Continue

Asset purchase programs – Widening of yields

Spreads to German Bunds (10years) in BP



back

Monetary policy outlook

- A **"transmission protection instrument" (TPI)** is established to counteract yield spreads caused by “unjustified and disorderly” market dynamics.

- **Aim:** Similar impact of monetary policy, that is similar (but not identical) financing conditions for the government and the real economy in all euro area countries.

- **Design**: Purchases of government bonds. Volume of purchases **initially not limited**.

- **Preconditions (proportionality assessment)**:

  - Compliance with **fiscal rules** (lack of bite) and sound as well as sustainable **macroeconomic policies** (arbitrary).

Monetary policy outlook

- **Bundesbank view on the TPI:**

- Transmission Protection Instrument (TPI) increases **risk of fiscal dominance**.

  - Central bank policy may determine the sustainability of government debt!

  - **But:** the ECB's mandate is price stability and does not include ensuring favorable financial conditions for governments.

- **Consequence**: TPI should only be activated in cases of extreme market distortions.

Thank You