EDITORIAL

ECB's rapidly tightened monetary policy is being transmitted forcefully to the economy

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The global economy's recovery from the consequences of the pandemic and of Russia's war in Ukraine has continued to be slow and uneven. Growth in the global economy is also expected to continue at a slower rate than seen in recent decades. The reasons for this are both cyclical and structural.

High inflation is a global phenomenon, and the pursuit of tighter monetary policy to bring it under control has restricted demand worldwide. Decisions by central banks to raise interest rates have been essential for preventing the threat of wage-price spirals and for strengthening purchasing power. The protracted high inflation has particularly affected those households that have to use much of their income on everyday basic necessities.

The demand-boosting effect of fiscal policy has also grown smaller, because the need for financial support has eased and the rise in debt levels and interest rates has added to loan servicing costs. In an environment of high inflation, it is important that monetary policy and fiscal policy do not have conflicting impacts on demand, as this would require central banks to implement even stronger measures. Inflation is slowing worldwide, but this is happening only at a leisurely pace. In the euro area and in many countries around the world, forecasts show that the central bank's price stability objective will not be achieved until 2025.

While GDP growth in the United States has been stronger than was projected, due to consumer spending, growth in China's economy has been surprisingly weak for reasons that include the still continuing crisis in the country's real estate market. Geopolitical fragmentation has gathered strength, creating friction in world trade, amplifying fluctuations in raw material prices and slowing the green transition. Extreme weather events have become more common and have multiplied human suffering and economic burdens.

The threats to financial stability in the spring this year eventually dissipated quickly, owing to the prompt actions of the US and Swiss authorities. Disruptions of this kind were avoided in the euro area, thanks to the resilience of the financial and banking systems, maintained by the robust capital and liquidity buffers of banks. Nevertheless, a rapid rise in interest rates can cause sudden disruptions in the financial system. Central banks are ready to intervene in such events through targeted actions without jeopardising the restrictive monetary policy stance or the slowing of inflation towards its target.

With inflationary pressures in the euro area proving to be stronger and more persistent than projected, the Governing Council of the ECB has raised its key interest rates by a total of 4.50 percentage points since July 2022. The ECB's principal policy rate – the deposit facility rate paid to banks – stood at 4.00% after the September increase of 0.25 percentage points. Although the ECB's principal policy rate has been higher than this before,[1] the current series of interest rate rises made in ten successive monetary policy meetings has been exceptionally rapid and forceful.

Euro area inflation is slowing but is still expected to remain too high for too long. The latest ECB staff projections show that by 2025, inflation in the euro area will have remained above the ECB's 2% medium-term target for more than four years. Through its interest rate decisions, the ECB Governing Council has sought to return inflation to its target in a determined manner and in accordance with its mandate.

Based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target. In any event, future decisions will ensure that the key ECB interest rates are set at sufficiently

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1. The main refinancing operations rate paid by banks on their central bank loans, which was the ECB's principal key interest rate at the time, was higher than the current 4% during the periods 9 June 2000 – 18 September 2001 and 9 July 2008 – 15 October 2008. At its highest, the ECB's principal policy rate has been 4.75%, during the period 6 October 2000 – 11 May 2001.

restrictive levels for as long as necessary.

The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. Interest rate decisions will be based particularly on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.

The September ECB staff projections for the euro area economy see inflation slowing to 5.6% this year, 3.2% in 2024 and 2.1% in 2025. Core inflation, which excludes food and energy, has proved to be stubborn, even though many of the indicators of its future path have begun to ease. Forecasts of core inflation show 5.1% for 2023, slowing to 2.9% in 2024 and then 2.2% in 2025.

The ECB Governing Council's interest rate increases continue to be transmitted forcefully to the euro area economy, and financing conditions have tightened further. With domestic demand softening and the demand for exports losing momentum, growth in the euro area economy came to a standstill in the first six months of this year and is expected to remain sluggish in the months ahead. ECB staff now expect the euro area economy to grow by 0.7% this year, 1.0% in 2024 and 1.5% in 2025. Growth in employment is slowing but is expected to continue. Unemployment is projected to grow only slightly from its unprecedented low of 6.4%.

These estimates anticipate a 'soft landing' for the euro area economy. As longer term inflation expectations have stayed anchored in line with the ECB's target, wage growth is projected to remain moderate. The slowdown in inflation is nevertheless pushing up real wages, and this is expected to boost private consumption – important for growth – next year in particular. It should be noted, however, that there are significant downside and upside risks to the outlook for the economy and inflation.

When monetary policy is tightened in a determined manner to bring down high inflation, it also weakens GDP growth temporarily. It is therefore important that central banks openly explain the reasoning behind their decisions and the objectives of these decisions. The primary objective of the ECB is to maintain price stability, which means an inflation rate of 2% over the medium term. To ensure price stability and the credibility of monetary policy, it is important that achievement of this inflation target is not unduly delayed, and that inflation expectations do not become de-anchored.

The ECB's monetary policy is conducted for the entire euro area, with the objective of euro area price stability. This is in Finland's interests as well. The impacts of the ECB's monetary policy are transmitted differently and at varying speeds within the euro area, depending on factors such as how variable the lending rates are in the different countries. If inflation and GDP growth in a euro area country differ from the euro area average, the single monetary policy may, in the short term, be looser or tighter for that country than the euro area average.

Finland's GDP growth and inflation will slow this year and in 2024 by more than the euro area average, largely as a result of factors other than monetary policy tightening. Finland's industrial structure is more heavily weighted towards manufacturing and construction than the average, and these sectors are sensitive to movements in interest rates. The same applies to Germany, whose GDP growth is similarly projected to remain below the euro area average in both 2023 and 2024. A further factor underlying Finland's weak GDP growth in the short term is that residential mortgages in Finland are mostly variable rate loans. This means that higher interest rates feed through quickly not only via new mortgages but also to the entire loan stock. The increase in loan servicing costs reduces the amount of households' disposable income available for other consumption, dampening domestic demand.

It is nevertheless worth remembering that the current rapid and substantial rise in interest rates was preceded by a long period of accommodative monetary policy, when the mortgage rate in Finland was lower than in the rest of the euro area. Despite the rapid increase in the key ECB interest rates, the average interest rate on new housing loans in Finland is currently around the euro area average. The rapid transmission of monetary policy in Finland also means that the adjustment of lending rates in line with the rise in key ECB interest rates will be completed more quickly than the average for the euro area as a whole.

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Tuomas Välimäki

Member of the Board of the Bank of Finland and Member of the Governing Council of the European Central Bank

Tags

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