

Monetary policy in the euro area*

di Christine Lagarde

It is an honour to be here today to mark 10 years of Lithuania in the euro.

“*Laisvė, Vienybė, Gerovė*” – freedom, unity and well-being. These are core national values in Lithuania – and accordingly, they are engraved in the edge-lettering on Lithuania’s €2 coin.

Freedom, because of the liberation from Soviet occupation. Unity, because of the need for national solidarity. And well-being, expressing hope for economic and social prosperity.

These three words capture the spirit of the Lithuanian people. And I believe that being part of the euro has strengthened each of them.

The country is now an equal partner in setting monetary policy by one of the world’s most important central banks in the third largest economy, the euro area. That gives Lithuania *freedom* in charting its own macroeconomic destiny that smaller economies cannot typically claim, who often have to import the monetary policy of their larger neighbours.

Lithuania now also issues the world’s second most important reserve and invoicing currency. That provides *unity* in the face of a more volatile world, as foreign shocks do not penetrate the domestic economy as much, owing to domestic currency invoicing.

Lithuania is especially resilient on this front, invoicing 78% of its exports to non-member countries in euros last year, the fourth highest share across the EU.

And being part of the euro has increased the *well-being* of the Lithuanian people. When Lithuania joined the euro area in 2015, GDP per capita in purchasing power standard terms was around 70% of the euro area average. By 2023, it exceeded 83%.

But more recently, the country has dealt with very high inflation, peaking at 22.5% in September 2022 – more than double the peak seen in the euro area as a whole.

This high-inflation episode has led to a pronounced monetary policy cycle, with the ECB raising rates by 450 basis points, holding them steady for 9 months, and then

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cutting rates by 100 basis points since June as we entered the “dialling back” phase of our policy.

However, even in this “dialling back” phase, until recently we retained a restrictive bias in our future policy orientation. At our last meeting, we dropped that bias.

Today, I would like to explain what motivated this change and what it implies for the future.

In a nutshell, we have seen the environment change in three important ways that increase our confidence that inflation is returning to our target. These changes concern the *path of inflation*, the *shocks driving inflation* and the *risks to inflation*.

The path of inflation

The first important change relates to the *path of inflation*.

In the earlier part of our monetary policy cycle, the path of inflation was characterised by high uncertainty. We consistently saw the return of inflation to target in our projections being pushed back. At the same time, the incoming inflation data were surprising on the upside, casting further doubt on the accuracy of those projections.

ECB staff models using machine learning^[1] indicate that in 2022 and 2023 uncertainty around inflation forecasts was around four to five times higher than in the long-term average.

This uncertainty about the inflation path had implications for the policy horizon – that is, the period within which we want to see inflation converging to our target.

Normally, the medium-term policy horizon is flexible and can be extended depending on the nature, size and persistence of the shocks. But if there is a risk of inflation expectations becoming de-anchored, the horizon must be shortened to the nearest possible date that monetary policy can take effect to prevent that risk materialising – which given normal transmission lags is around two years.

With inflation rising and its return to target continually being pushed back, at a certain point we considered that the risk of de-anchoring had become too high. So, in September 2022 we introduced the notion that the return of inflation to our target had to be “timely”. Our aim was to fix the policy horizon and thereby build confidence among the public that there would be no more delays.

Now, after a lengthy period of restrictive policy, our confidence that we are seeing a “timely” return to target has increased.

Since September last year, we have had six consecutive forecast rounds showing inflation returning to target in the course of 2025. And this arrival date has stayed constant even as we have drawn closer to it.

The uncertainty around these projections has decreased significantly. Our machine learning models now put the uncertainty bands at close to pre-pandemic levels.

The incoming data have, over time, validated the path laid out in the forecasts. Since early 2023, the accuracy of staff projections has returned to the levels seen pre-COVID, especially for headline inflation. While errors for core inflation have taken longer to normalise, this year they have also returned to historical standards.

And this confidence is confirmed in inflation expectations. Among households, median expectations for inflation three years ahead are close to 2%, and market-based indicators of longer-term inflation expectations have also fallen in recent months.

The shocks driving inflation

The second change in the environment relates to the *shocks driving inflation*.

The major challenge for monetary policy during this cycle is that we have faced a sequence of very large shocks which – given staggered wage- and price-setting in the euro area – have transmitted through the economy in persistent and hard-to-forecast ways.

So, even as our confidence in our projections increased, we had to be careful in making our policy stance less restrictive too quickly. We needed a policy framework that would allow us to better understand this complex inflation process. That is why we built our reaction function around our well-known three criteria: the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission.

Focusing on the dynamics of underlying inflation allowed us to extract more robustly the trend in inflation based on the data we could see in front of us, complementing the information provided by our forecasts.

And for a given inflation path, assessing the strength of monetary transmission allowed us to judge whether our tightening impulse was being passed on through the transmission chain and was thus effective in steering inflation back towards 2%.

This forward-looking framework has provided a way of broadening our information set to capture the pace at which a very large past shock – 10.6% inflation at its peak

– was running its course, and how our monetary policy stance was transmitting through the economy and affecting medium-term inflation.

For some time, the signals from underlying inflation were still flagging the risk that inflation might not decline as quickly as indicated in our forecasts. But recently this risk has declined and there is now greater alignment between our forecasts and underlying inflation.

The width of the range of measures of underlying inflation that we monitor has narrowed towards its historical average, with most indicators hovering between 2% and 2.8%, which we take as an indicator of receding uncertainty on future inflation dynamics. The Persistent and Common Component of Inflation (PCCI), which has the best predictive power for future inflation, has remained at around 2% since the end of last year.

There is one measure that is still above this range, which is domestic inflation, capturing items with a low import content. But this is a year-on-year measure that is made up 97% of services items, and so it is still registering repricing events that took place earlier this year that are keeping services inflation around 4%.

However, if we look at the PCCI for services, which strips out base effects, the measure currently stands at 2.5%. Inflation momentum for services has also dropped steeply recently. These data suggest that there is scope for a downward adjustment in services inflation, and thereby domestic inflation, in the coming months.

Confirming this picture, wage growth – which is the main cost factor driving services – is on a downward trajectory and continues to be buffered by negative growth in unit profits, buffering the pass-through of rising wages to prices.

The ECB wage tracker – which captures wage agreements in seven euro area countries representing around 85% of total wages in the euro area – sees wage growth slowing from 4.8% this year to around 3% in 2025, the level we generally consider to be consistent with our target.

The risks to inflation

The third change in the environment relates to the *risks to inflation*.

The fact that past shocks were expected to travel slowly along the pricing chain meant that, in recent years, the risks to inflation were mostly to the upside. And despite the progress we have seen in underlying inflation, these risks have not disappeared entirely.

The composition of inflation remains unbalanced, with the recent slowdown being driven mostly by energy inflation, which is particularly volatile, and industrial goods. The adjustment process for slower-moving services inflation is still unfinished. So, we will have to remain watchful until the downward adjustment in services inflation that we expect is confirmed by the data.

However, as past shocks fade, the risks to the inflation outlook have changed. And crucially, these risks are now related more to potential future shocks than to the transmission of past ones.

The main downside risks relate to the weaker-than-expected growth outlook and the increased uncertainty surrounding growth triggered by geopolitical events.

For some time now, we have been seeing small sequential downward revisions to the growth outlook which have cumulatively amounted to a quite significant downgrade over time. For example, if we go back to our June 2023 projections, we expected average growth of 1.5% in 2024. Now, we expect 0.7%.

One driver of this delayed recovery has been sluggish export growth, driven by the competitive challenges facing euro area companies. But the most important driver of our growth forecast misses has been the domestic economy. In fact, around half of the misses since end-2021 relate to investment and a quarter relate to consumption.

The behaviour of investment can be attributed to a combination of factors, including the stronger-than-expected impact of higher interest rates, higher energy prices and structural deterrents. The inertia in consumption has been striking given that the conditions for a recovery are in place. Employment is historically high and real incomes are rising. But households continue to save an unusually high share of their income and take a cautious approach to spending.

One reason for this caution is that many households have a perception of their real income growth that is well below measured data. Just 37% of households in our consumer survey believe that their real income has risen or stayed the same, even though 50% of all households have experienced actual increases. And these households have significantly lower consumption growth than those with correct perceptions.

This pessimism about real incomes is largely driven by past inflation, and so in principle it should dissipate as the high-inflation episode moves further into the rearview mirror.^[2] But increasing geopolitical uncertainty could create new dents in household sentiment.

In particular, if the United States – our largest export market – takes a protectionist turn, growth in the euro area is likely to take a hit. Our exporters also specialise in capital goods that other countries use for export production, which makes them particularly sensitive to shifts in confidence about world trade.

The main upside risks we see in the future also relate to external shocks. A rise in geopolitical tensions could push energy prices and freight costs higher in the near term, while extreme weather events could drive up food prices. The net effect of trade fragmentation and tariffs on inflation remains uncertain, as it involves assumptions that are impossible to anticipate with precision. These include potential retaliatory actions as well as exchange rate and commodity price movements.

Implications for monetary policy

So what does this changing environment mean for our monetary policy? There are three main implications.

The first concerns our current *policy stance* and its *future orientation*.

The current policy stance is restrictive. But if the incoming data continue to confirm our baseline, the direction of travel is clear and we expect to lower interest rates further.

In terms of the future orientation, we previously said that “we will keep policy rates sufficiently restrictive for as long as necessary”. This bias was necessary in an environment of high realised inflation and high uncertainty about future inflation. But it no longer reflects the evolving macroeconomic landscape, our outlook for inflation or the balance of risks around it.

With the disinflation process well on track, and downside risks to growth, this bias in our communication is no longer warranted. These considerations are reflected in the monetary policy statement adopted by the Governing Council last week. We no longer aim for “sufficiently restrictive” policy, but rather intend to deliver an “appropriate” policy stance.

The second implication for monetary policy concerns our *reaction function*.

The high-inflation period has proven the value of the three criteria we have been using to take decisions, which is why the Governing Council confirmed this policy framework at last week’s meeting. And these criteria will be invaluable in the period ahead, even as the risks to inflation move from past shocks to future ones.

In an uncertain environment, we will need to continue complementing our baseline outlook with a rich distribution of possible risks derived from current data. But our framework is flexible, in the sense that we can change the weight we put on the different legs of our reaction function depending on the nature of the shocks we are facing.

For example, if we face large geopolitical shocks that significantly increase uncertainty about the inflation projections, we will need to draw on other sources of data to make the risk assessment surrounding our baseline outlook more robust.

At the same time, the purpose of monitoring underlying inflation is to help us differentiate noise in the inflation data from underlying trends. So, if underlying trends are not affected, it will help increase confidence in the baseline projection.

And assessing monetary transmission will continue to be important, as geopolitical uncertainty may affect monetary transmission by altering the risk appetite of investors, borrowers and financial intermediaries.

The third implication concerns the *policy horizon*.

Even though we are not there yet, we are close to achieving our target. So, we are no longer in a situation where we need to fix the policy horizon at the shortest possible transmission lag. We can return to a situation where the policy horizon can adjust depending on the nature, size and persistence of the shocks as needed.

This change explains why we have removed the notion of “timeliness” from our monetary policy statement, focusing instead on achieving “sustainable” inflation convergence. And it puts us in the best position to react to future shocks.

Conclusion

Let me conclude.

The Lithuanian poem “The Seasons” (*Metai*), written by Kristijonas Donelaitis, charts the cyclical nature of the rural life of Lithuanians.

The ECB is also moving through its monetary policy cycle, and we are now at a stage where the darkest days of winter look to be behind us, and we can start to look forward instead.

We certainly hope that the days ahead will be better. But winds are blowing in different directions and there is much uncertainty before us.

So, our monetary policy will be prepared for all scenarios to come.

[This speech was updated on 16 December 2024 at 11:25 CET to correct the ECB's June 2023 average growth projections for 2024.]

1. Lenza, M., Moutachaker, I. and Paredes, J. (2023), “Density forecasts of inflation: a quantile regression forest approach”, Working Paper Series, No 2830, ECB.
2. The ECB's consumer expectations survey shows that perceptions of past inflation have declined by more than 5 percentage points from their peak of 8.4% in September 2023.