

# Back to the future: forward-looking considerations on monetary policy normalization\*

di Fabio Panetta\*\*

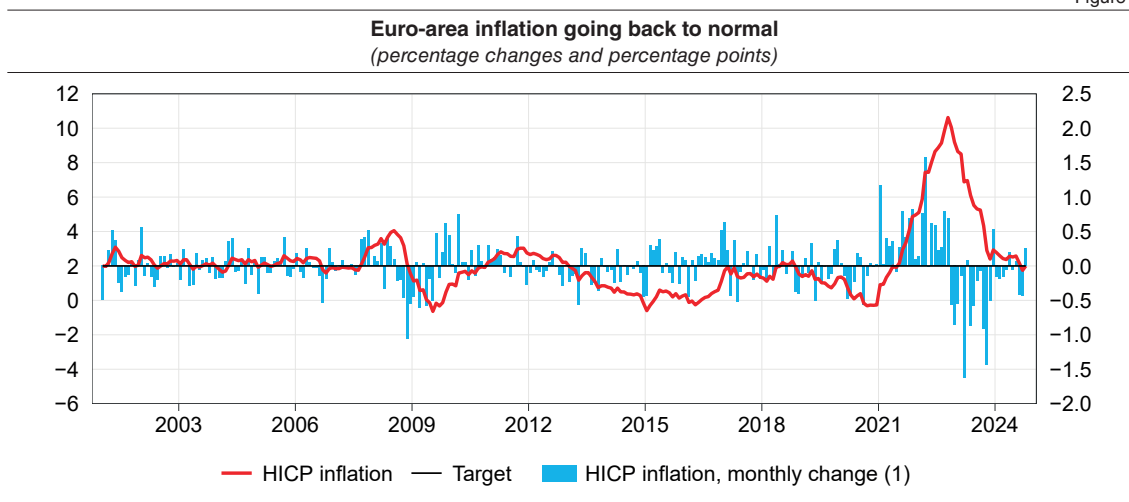
Good morning everyone.

Let me first of all thank the Rector of Università Bocconi, Professor Francesco Billari, for inviting me here today. It is a pleasure to visit this prestigious and renowned institution. And it is always a privilege to discuss economics with young people who are studying this discipline today, but will shape its course tomorrow.

This meeting takes place at an interesting time for monetary policy.

The exceptional shocks of 2022-23 are gradually fading into the background, and inflation in the euro area is not only lower, but also less volatile than it has been for a long time (Figure 1). As a result, inflation forecast errors have also normalized (Figure 2). The euro area has completed a long, historic journey through *terrae incognitae* that began immediately after the COVID pandemic.

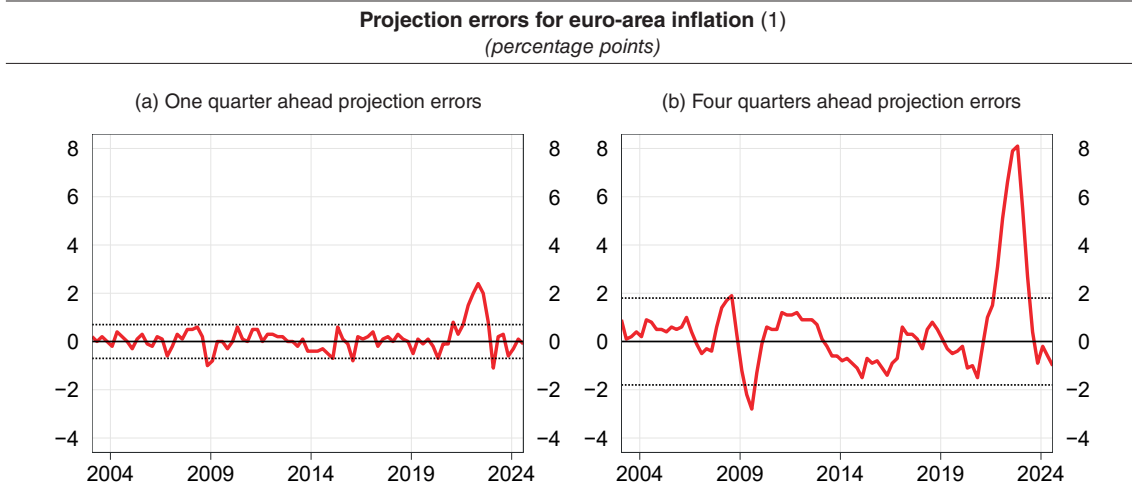
Figure 1



Source: ECB and Eurostat.  
(1) Right-hand scale.

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\*\* I wish to thank Piergiorgio Alessandri and Alessandro Secchi for their valuable insights and contributions.



Source: elaborations on ECB data.

(1) Based on ECB/Eurosystem projections for headline inflation. Dotted lines denote an interval around zero of plus/minus two standard deviations of projection errors realized in 2003-2020.

This return to charted territory is clearly good news. But the current economic landscape presents its own challenges. At the global level, geopolitical tensions are high, and political developments in a number of countries are difficult to predict. In the euro area, the economy is stagnating and interest rates are still in restrictive territory. How should the ECB proceed?

Today I will argue that this 'new' phase has three main implications for the conduct of monetary policy.

First, with inflation close to target and domestic demand stagnant, restrictive monetary conditions are no longer necessary. In the current phase we should focus more on the sluggishness of the real economy: without a sustained recovery, inflation risks being pushed well below target, opening up a scenario that would be difficult for monetary policy to counteract and should therefore be avoided. In short, we need to normalize our monetary policy stance and move to neutral – or even expansionary territory, if necessary.

Second, we can now return to a more traditional, genuinely forward-looking approach to monetary policy, in line with our medium-term orientation. Removing monetary restrictions when aggregate demand is faltering is a simple example of how this principle translates into practice; but the principle is far more general. The exceptional circumstances of the past two years have forced central banks to give less weight to forecasts and to live day by day (or 'meeting by meeting'). Now that the situation on the inflation front is normalizing, the ECB should also normalize the way it calibrates its monetary policy stance, by returning to tradition and refocusing on its medium-term reaction function. In short, we should go 'back to the future'.

Third, and in line with the points I have just made, our communication should provide more guidance on the expected evolution of our policy than has been the case in the

recent past. This will help firms and households to form their views on the future path of policy rates, thereby supporting demand and the recovery of the real economy.

In the rest of my speech I will explore these issues starting with an analysis of what has changed and why it matters.

## 1. A fragile global macroeconomic outlook

Inflation has been falling steadily in the main advanced economies in 2024;<sup>1</sup> the disinflation process has been rapid and generally less painful than in past experiences. For economic activity the picture is more complex. A clear divide has emerged between the two main global players, the US and China.

In the US inflation is falling, albeit unevenly, amid robust consumption and income growth. This prompted the Federal Reserve to cut interest rates by 75 basis points between September and November. The forthcoming change in the US administration adds uncertainty to the inflation outlook: changes in fiscal and trade policy are likely to have a significant impact on the economy, with implications for monetary policy.

In China, by contrast, subdued demand and a protracted real estate crisis have depressed inflation and weakened economic activity, leading to extraordinary monetary and fiscal interventions. These measures have supported financial markets, but their effectiveness in boosting growth and restoring price stability remains uncertain.

At the global level, activity in the goods and services sectors continues to diverge. These two sectors took different paths in the aftermath of the pandemic, and the gap is still pronounced: manufacturing performed poorly throughout the year, while services generally performed better.<sup>2</sup> After a robust expansion in the first half of the year, trade slowed in the third quarter, partly due to the slowdown in China.

Looking ahead, the IMF forecasts that global growth will remain roughly constant at 3.2 per cent for the next two years, with a significant gap between the US and the euro area. The IMF's medium-term forecast of 3.1 per cent remains close to its historical minimum.

## 2. The euro area: a shaky recovery with falling inflation

Inflation in the euro area is in line with or ahead of the global trend. The disinflation process has been faster and smoother than some had anticipated: medium-term inflation expectations remained anchored, generalized second-round effects through wages did not materialize, and concerns about the 'last mile' problem – the idea that

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<sup>1</sup> With the exception of Japan, where it remained roughly constant near the 2 per cent target.

<sup>2</sup> This sectoral divergence also affects inflation rates, which are globally much higher for services than for goods. More on this below.

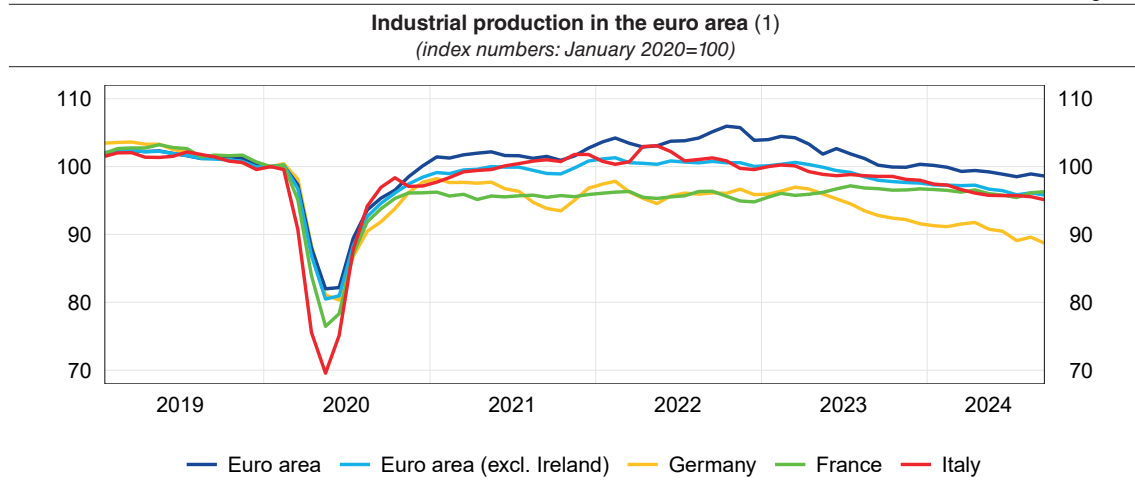
the final phase of the disinflation might for some reason be the most difficult – proved groundless.

This rapid normalization was largely due to the unwinding of the supply shocks that had caused prices to accelerate in the first place. The ECB’s action and its credibility contributed to the process.

Headline inflation fell below the 2 per cent target in September. It then returned exactly to target in October, reflecting a temporary increase largely due to base effects.<sup>3</sup> Some ups and downs are to be expected in the coming months, again due to base effects, but the baseline is one in which inflation continues to fall in early 2025 and remains on target thereafter.

Economic activity remains weak. The 0.4 per cent growth rate recorded in the third quarter of 2024 provided some respite after two years of stagnation, but we should not read too much into this figure: the region remains on course for annual growth of at most 1 per cent in 2024. The malaise of European manufacturing is confirmed by the fact that industrial production has been falling for two years and is now below pre-pandemic levels (Figure 3).

Figure 3



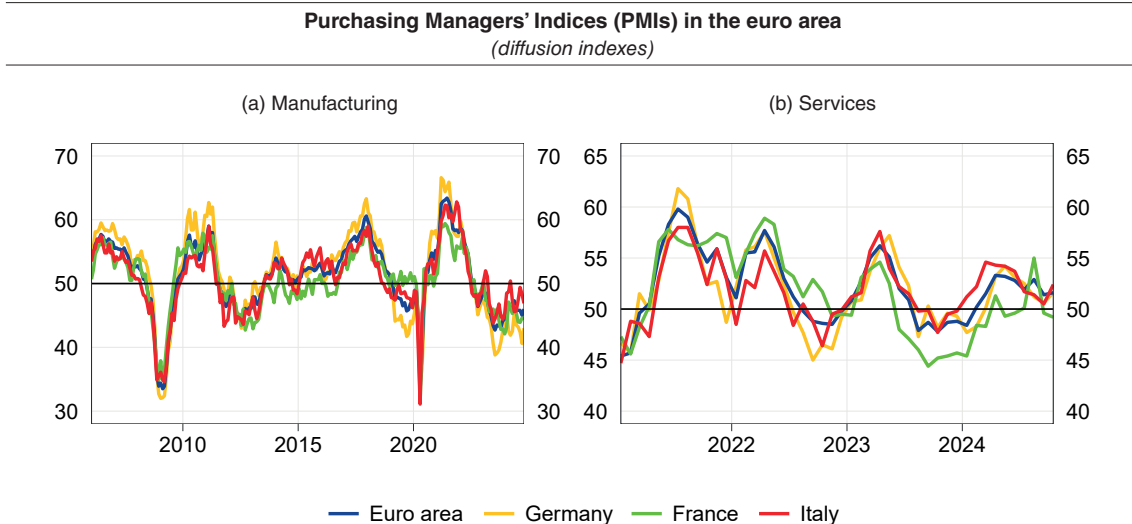
Source: elaborations on Eurostat data.  
(1) Three-month moving average.

Leading indicators suggest that the turning point for Europe’s beleaguered manufacturing sector is not in sight. In Germany, PMIs are around the levels seen in the spring of 2020 or in 2009, neither of which are particularly reassuring benchmarks (Figure 4.a).<sup>4</sup> The euro area services sector is in better shape, but it benefited from one-off events such as the Olympic Games in the summer and may now be slowing down (Figure 4.b).

<sup>3</sup> The base effect is the temporary effect on the measurement of inflation resulting from unusual price developments in the initial (base) period for which inflation is calculated. These mechanical changes are statistical phenomena due to past events and do not reflect current economic trends.

<sup>4</sup> The problems are widespread. The German economy is a good barometer for the area as a whole; given its size, it also has a powerful indirect influence on its neighbours.

Figure 4



Source: Standard & Poor's Global.

The unemployment rate remains at its historical minimum of 6.3 per cent (Figure 5.a). However, the job vacancy rate, a leading indicator of future employment dynamics, has been on a downward trend for more than two years and is currently not far from pre-pandemic levels (Figure 5.b).

Figure 5



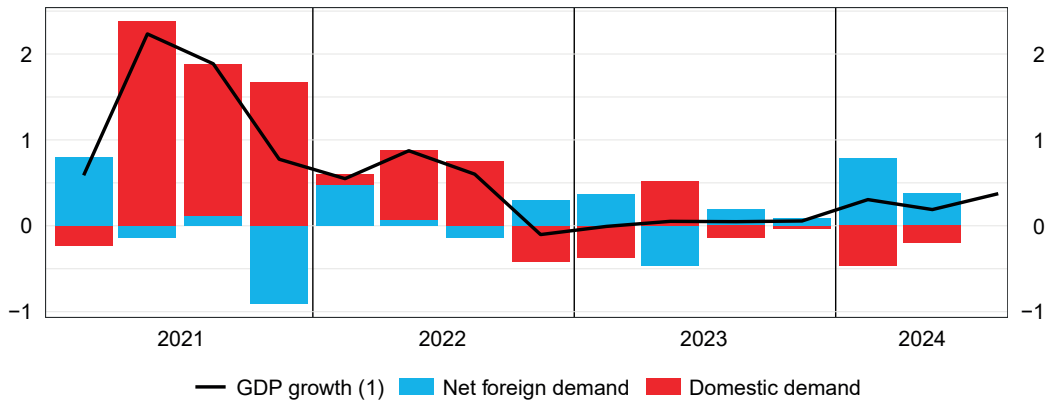
Source: Eurostat.

In any case, it is especially the demand side of the economy that gives less cause for optimism. Private domestic demand contracted in the first half of this year, leaving growth entirely dependent on foreign demand (Figure 6).

The extent to which exports will continue to support GDP in 2025 is unclear at best. The possibility that the US administration will introduce new tariffs is not reassuring in this respect. Without a boost from exports, the euro area will need a strong rebound in domestic demand to grow.

Figure 6

**Euro-area GDP growth rate and contributions of domestic and foreign demand**  
(percentage changes and percentage points)



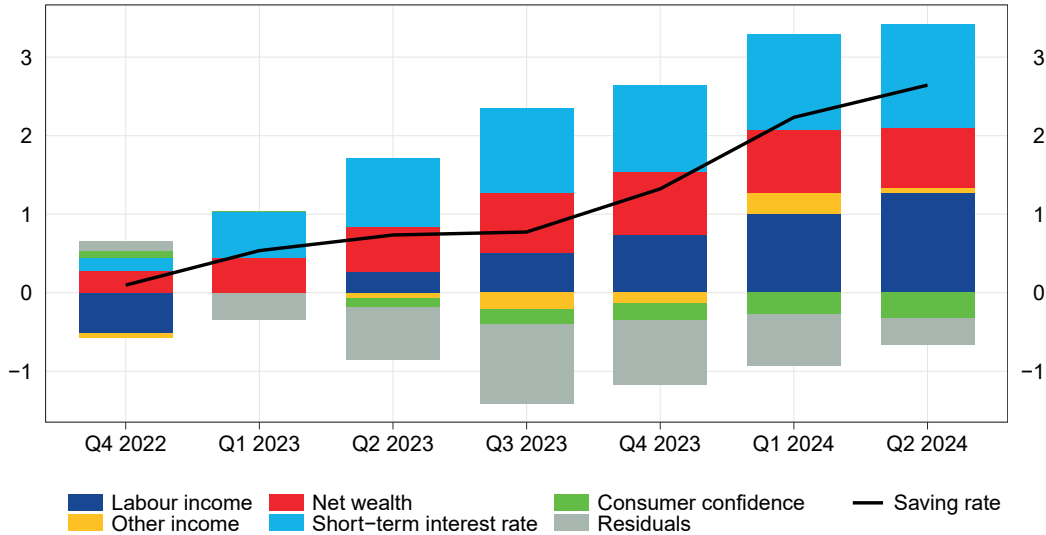
Source: elaborations on Eurostat data.  
(1) Quarterly percentage changes.

The question is, how likely is this rebound?

Consumption has been a recurrent disappointment so far. The recovery embedded in past Eurosystem projections has repeatedly failed to materialize: households have proved reluctant to spend, partly because of high real interest rates (Figure 7).<sup>5</sup>

Figure 7

**Model-based decomposition of the change in the saving rate (1)**  
(percentage points)



Source: P. Lane, 'Inflation and monetary policy in the euro area', Seminar at Columbia University, 22 October 2024 (updated estimates).  
(1) Decomposition based on an error-correction model for private consumption, including real household labour and other income, real net wealth, real interest rate and household confidence. Real interest rates are computed as the difference between the nominal three-month EURIBOR and households' inflation expectations one-year ahead.

Investment also remains weak. This is partly due to uncertain growth prospects. However, tight financing conditions are also increasing the cost of capital for companies. In addition to dampening demand in the short term, a persistently high cost of capital (relative to

<sup>5</sup> Preliminary data suggest a possible strengthening of consumption in the third quarter, but its precise extent and resilience remain to be seen.

labour and intermediate goods) prevents the adjustment in the capital-to-labour ratio that would be necessary to raise productivity.<sup>6</sup>

Last but not least, restrictive fiscal policies are likely to compress demand in 2025.<sup>7</sup>

This interpretation of the data points to downside risks to growth, and hence inflation.

As always, there are alternative interpretations of the possible course of events, some of which are associated with an emphasis on upside risks. In the absence of major shocks, two factors could keep inflation persistently above target: service prices and labour costs. The ECB should certainly remain vigilant on these fronts.

But how likely are services and wages to be a primary concern going forward?

Services inflation remains high, at 3.9 per cent in October. However, services prices are notoriously sluggish: for a large proportion of the services in the consumption basket,<sup>8</sup> prices adjust to past inflation with a lag. Since inflation is now much lower, it will not lead to further large increases in services prices. Moreover, services inflation has historically always been higher than goods inflation. This means that the ECB does not need services inflation to reach 2 per cent to meet its target.<sup>9</sup>

As regards wages, after the robust catch-up in 2023 and 2024, which was inevitable given the previous rise in inflation, their dynamics are now normalizing. Wage growth is evolving in line with Eurosystem projections. Moreover, business surveys suggest that wage pressures will ease going forward, in line with the projections. If history is any guide, the recent decline in the vacancy-to-unemployment ratio also points to a less tight labour market, and hence to a moderation in compensation per hour in the near future (Figure 8). Indeed, against the backdrop of subdued economic growth, it is unlikely that we will see a new acceleration in wages next year.

Private sector inflation expectations are broadly consistent with the predominance of downward risks to inflation. For example, inflation-linked swaps suggest that inflation will fall below 2 per cent in early 2025 and will remain around that level for the rest

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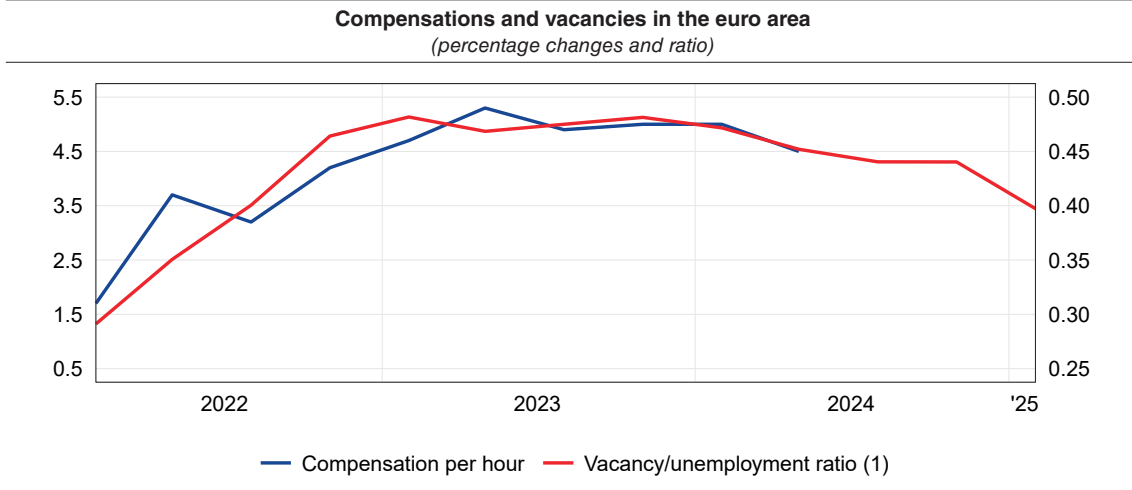
<sup>6</sup> F. Panetta, 'Monetary policy in a shifting landscape', dinner speech at the Inaugural Conference of the Research Network on 'Challenges for Monetary Policy Transmission in a Changing World' (ChaMP), Frankfurt, 25 April 2024. See also P. Cipollone, 'Some like it hotter: the conditions for a cyclical recovery in euro area productivity', contribution to the Centre for European Reform's annual economics conference on 'A European path to higher economic growth', Ditchley Park, 15 November 2024.

<sup>7</sup> These may be driven by fiscal rules (such as the debt brake in Germany) and/or efforts to rein in high deficits (e.g. in Italy and France).

<sup>8</sup> Sluggish items (or 'latecomers'), such as insurance policies or health services, account for around 40 per cent of the total services basket and 20 per cent of the total HICP basket. Last September, they contributed 1.7 percentage points to an overall services inflation of 3.9 per cent.

<sup>9</sup> F. Panetta, 'Monetary policy after a perfect storm: *festina lente*', speech delivered at the Bank of Finland International Monetary Policy Conference on 'Monetary Policy in Low and High Inflation Environment', Helsinki, 26 June 2024.

Figure 8

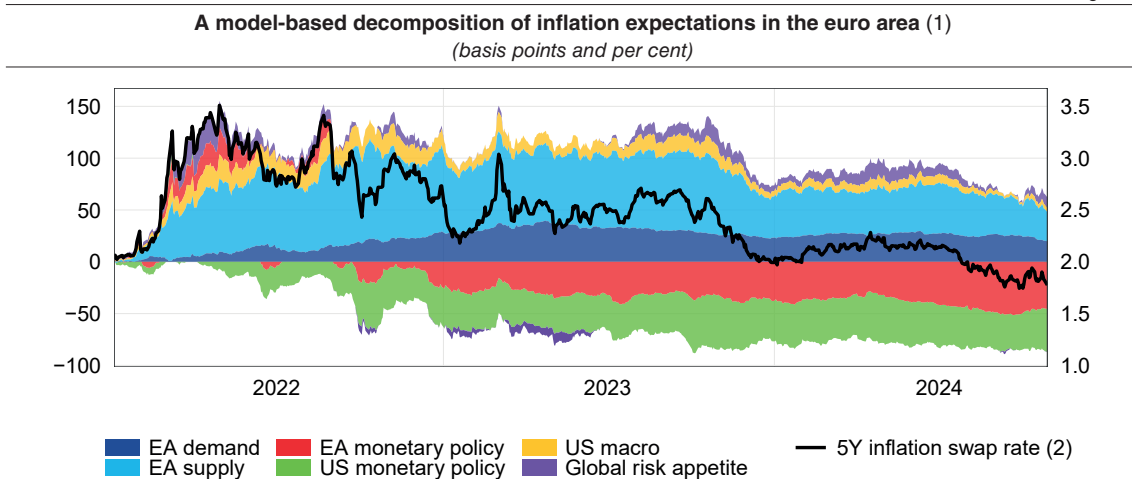


Source: Eurostat.

(1) Right-hand scale. The vacancy-to-unemployment ratio is shifted three quarters ahead.

of the year;<sup>10</sup> beyond one year, they signal risks of undershooting our target. In recent months, restrictive monetary policy has played a key role in pushing these expectations below 2 per cent (Figure 9).<sup>11</sup>

Figure 9



Source: elaborations based on C. Höyneck and L. Rossi, 'The drivers of market-based inflation expectations in the euro area and in the US', *Economic Letters*, 232, 2023, also published in Banca d'Italia, *Questioni di Economia e Finanza* (Occasional Papers), 779, 2023.

(1) Changes relative to 3 January 2022. – (2) Right-hand scale.

The policies implemented by the new US administration may of course have an impact on the inflation outlook, but we know too little today to speculate on the likely impact. There could be inflationary pressures from a generalized increase in tariffs and a depreciation

<sup>10</sup> Around 60 per cent of the analysts surveyed by the ECB (SMA) see inflation risks in 2025 as 'balanced', but 35 per cent now believe that they are tilted downwards. Consumers' inflation expectations are declining too. According to the ECB-CES data for September 2024, one-year ahead inflation expectations declined to 2.4 per cent (from 2.7 per cent), and three-year ahead expectations fell to 2.1 per cent (from 2.3 per cent).

<sup>11</sup> It is worth noting that market-based inflation expectations did not move much after the US elections. This reflects the widespread view that the policies adopted by the new administration could, if anything, affect the growth prospects of the euro area (for instance through a reduction in exports) rather than its inflation outlook.

of the euro. But these could be offset by the recessionary effects of a decline in trade flows, higher economic uncertainty and lower commodity prices due to lower global activity. In this case, the overall impact on euro area inflation could even be negative.

### 3. Implications for monetary policy

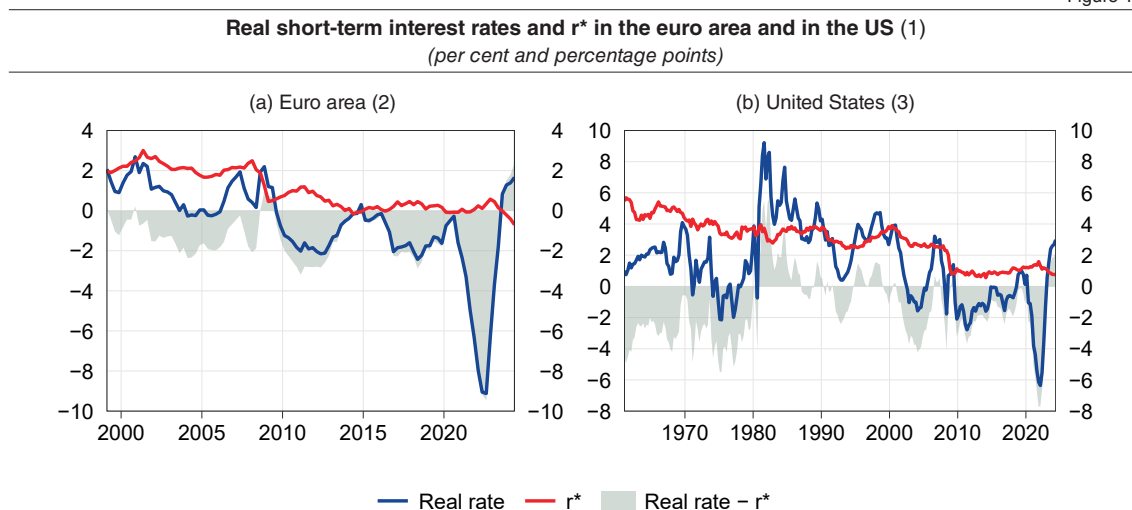
How should monetary policy respond to the economic environment I have just described?

First and foremost, the overarching objective should be a timely normalization of the monetary policy stance. As outlined above, weak domestic demand continues to weigh on economic activity, while the outlook for external demand is far from encouraging. In a scenario where demand remains subdued, inflation could fall well below 2 per cent. Tackling this situation with a restrictive monetary stance would be a mistake, as it would exacerbate the undershooting of the inflation target. Instead, the ECB should face this situation with a neutral stance. This way it could pause rate cuts if the undershooting is likely to be temporary – or cut rates further if the undershooting appears likely to persist.

When discussing this issue, one is often confronted with the objection that the so called  $r^*$  (or 'r-star', namely the threshold that determines whether the stance is restrictive, neutral or expansionary) is an elusive concept: nobody knows exactly what its value is. The objection is factually correct, but I do not think it is relevant at this stage.

We are probably a long way from the neutral rate.<sup>12</sup> Moreover, we may need to cut policy rates to below  $r^*$  if the cycle deteriorates. There is nothing exotic about this possibility: lowering policy rates below the neutral level at the trough of the cycle is a standard policy prescription, which both the ECB and the Fed have adhered to in the past (Figure 10). The question is not whether the ECB can, but whether it must.

Figure 10



Source: elaborations on data from the Board of Governors of the Federal Reserve System, the ECB, Eurostat, the Federal Reserve Bank of New York and the US Bureau of Economic Analysis.

(1) The natural rate ( $r^*$ ) is estimated according to the Holston, Laubach and Williams methodology. – (2) EONIA and Euro short-term rate (€STR) deflated by one quarter ahead annual inflation. – (3) Effective federal funds rate deflated by one quarter ahead annual inflation.

<sup>12</sup> Most estimates place it near zero, and in any case below 0.5 per cent. See C. Brand, N. Lisack and F. Mazelis, 'Estimates of the natural interest rate for the euro area: an update', European Central Bank, Economic Bulletin, 1, 2024, pp. 66-69.

Answering this question requires a constant and careful examination of the evolution of the macroeconomic outlook.

Second, policy decisions should once again be guided by a truly forward-looking view of economic developments and inflation. The prescription to normalize the monetary stance is, in fact, a corollary to this principle. So far, the strong reliance on actual outcomes has been justified by the exceptional shocks and the associated high uncertainty observed in the period 2020-23. Now, the supply shocks of recent years have been absorbed, inflation volatility and forecasting errors have declined and macroeconomic relationships have become more stable. In this context, inflation projections based on a genuine economic analysis of the fundamental drivers of inflation are more relevant than price indicators, such as “underlying inflation” estimates. All indicators have a place in a central bank’s toolkit, but their relative relevance naturally changes over time.<sup>13</sup>

Finally, communication matters. After three rate cuts, with inflation around the target and economic activity stagnant, the tightening bias in our official description of the monetary stance is no longer necessary.<sup>14</sup> Furthermore, the emphasis on ‘meeting-by-meeting, data-dependent’ decisions does not fit well with the renewed focus on a forward-looking approach. It would continue to place the ECB at the far end of the spectrum ranging from ‘no guidance’ to ‘full commitment’.

There is an obvious trade-off between the two: ‘no guidance’ leaves a central bank free rein, but creates uncertainty about the path of policy rates; ‘full commitment’ is more effective in anchoring expectations, but can create undesirable constraints and reputational costs. We deliberately chose to maximise our freedom in the eye of the storm, choosing the first option – but the situation has changed, and it is now time for the ECB to give more explicit indications of its intentions.

Some are extremely cautious. I understand that position, but I am also aware that ‘no guidance’ carries its own risks, as it can make interest rates highly sensitive to economic news. For example, interest rate expectations took a nosedive in October: a handful of new numbers was enough for markets to price a much higher chance of a rate cut (Figure 11). The Fed had a similar problem in August, when weak job reports led to market volatility and an abrupt downward revision in interest rate expectations. These reactions may indicate that – despite their best efforts – central banks are seen as ‘data point dependent’ rather than ‘data dependent’. Clearly, this incorrect perception needs to be addressed. A more explicit element of guidance would achieve this.

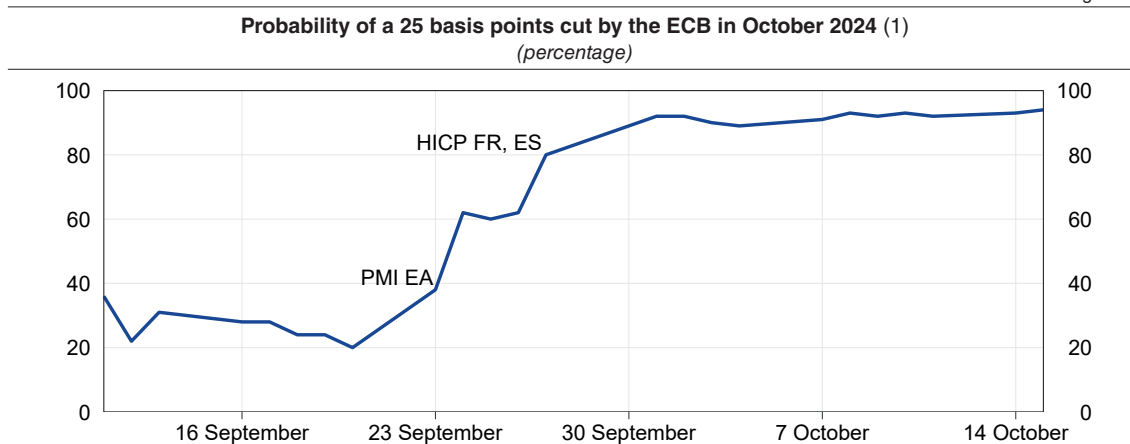
A ‘directional guidance’ would help to stimulate consumption and investment, thereby reducing the likelihood of a weak-demand scenario. It would help households and firms to take more informed longer-term decisions. After all, the purchase of durable or capital goods

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<sup>13</sup> The very characteristics that made ‘underlying inflation’ so valuable during the volatile 2022-23 period, including its smoothness and stability, make it less informative today. See also P. Lane, ‘Underlying inflation’, lecture delivered at Trinity College, Dublin, 6 March 2023.

<sup>14</sup> The last press releases emphasized that “The Governing Council [...] will keep policy rates *sufficiently restrictive for as long as necessary*” to achieve price stability.

Figure 11



Source: elaborations on LSEG data.  
(1) Market-based probability.

is a form of commitment. If the central bank is not prepared to abandon the 'no-guidance' approach, it becomes more difficult for households and firms to make commitments.

#### 4. Conclusions

After a long journey in *terrae incognitae*, the euro area economy has returned to more normal conditions.

The supply shocks of recent years have been absorbed, inflation volatility has declined and inflation is close to target. Macroeconomic relationships have become more stable and the real economy is likely to come (back) to the fore as a key driver of inflation dynamics.

In this context, the ECB can afford to normalize its monetary policy. It should do so by bringing its policy rates to a neutral level, in line with the economic and inflation outlook, so as to avoid the risk of undershooting the target; by returning to a more traditional, genuinely forward looking approach to monetary policy, in line with its medium-term orientation; and by adapting its communication in order to provide the necessary guidance to consumers and investors.

This requires taking a brave step: we should brace ourselves and go 'back to the future'.

Thank you for your attention.