MNI Connect: finally light at the end of the tunnel?

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Main takeaways

1. Inflation on track to 2%, economic growth remains weak, uncertainty is high, risk of further disruptions.

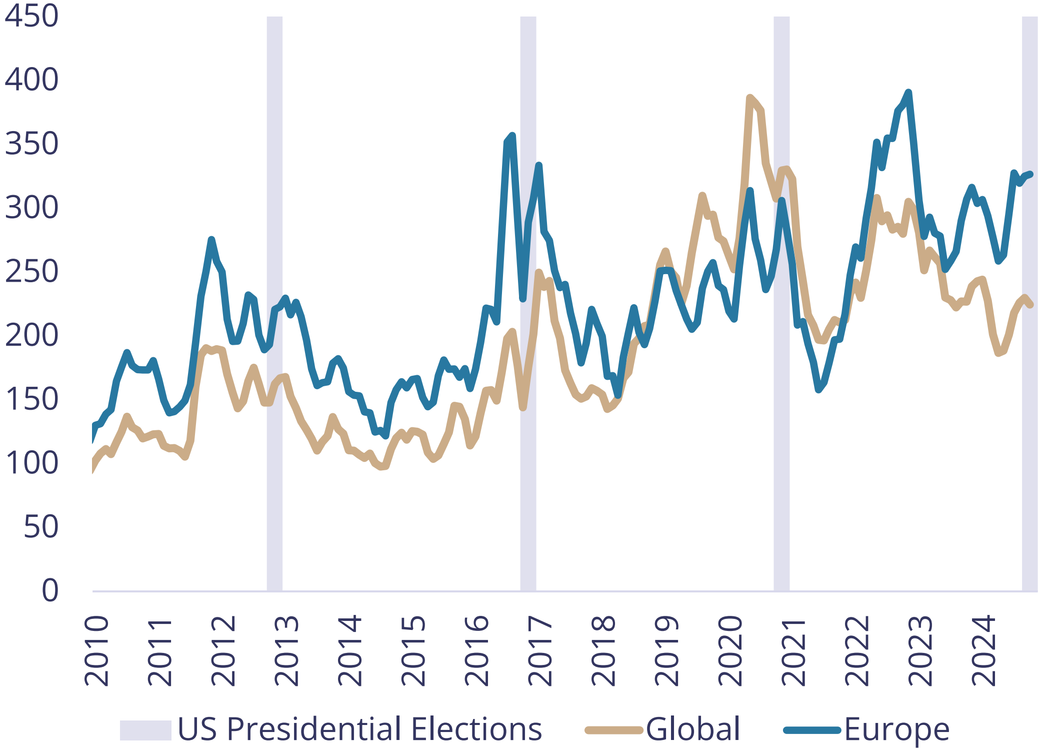
2. Key downside risks to growth: exports and private consumption. Risks of a more rapid labour market adjustment are non-trivial. Lack of structural breakthrough.

3. However, there are some reasons for optimism: bank lending is picking up, and inflation on the trend that is consistent with projections.

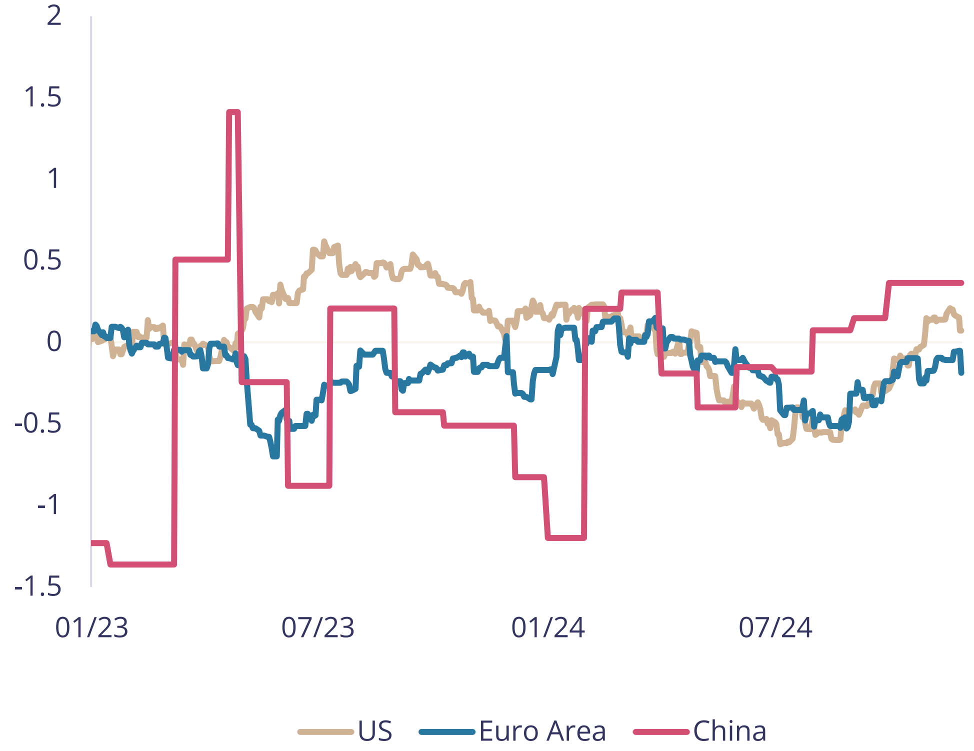
4. **Monetary policy:**
   1) Data dependent and gradual approach remains appropriate.
   2) At the same time, if downside risks were to materialize, data dependency allows to act in faster to avoid settling into "bad" equilibria.
   3) Monetary policy should not be the only game in town: low productivity growth requires action on the structural reform side.

Uncertainty remains elevated

Economic Policy Uncertainty and US Presidential Elections (index; 3m-MA)



Bloomberg Economic Surprise Index (points)



Sources: Bloomberg; Economic Policy Uncertainty Project (Davis, S., 2016. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review)

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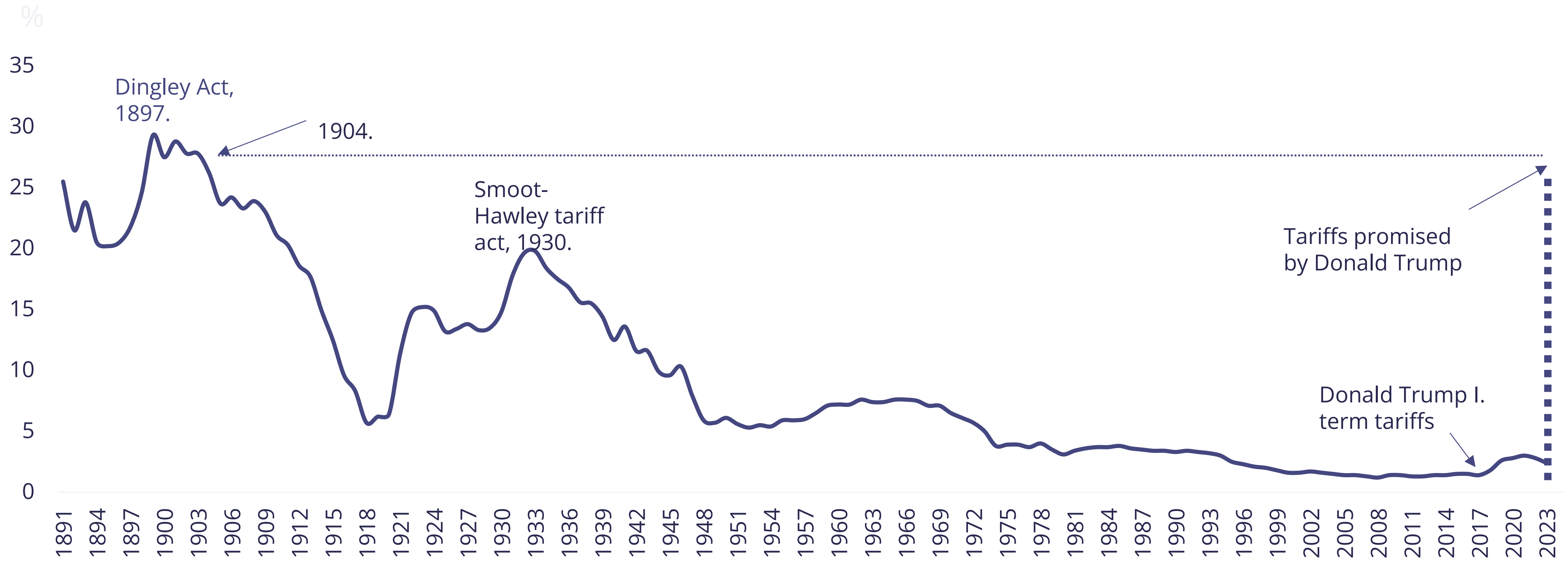
Trade wars: what if, how and when?

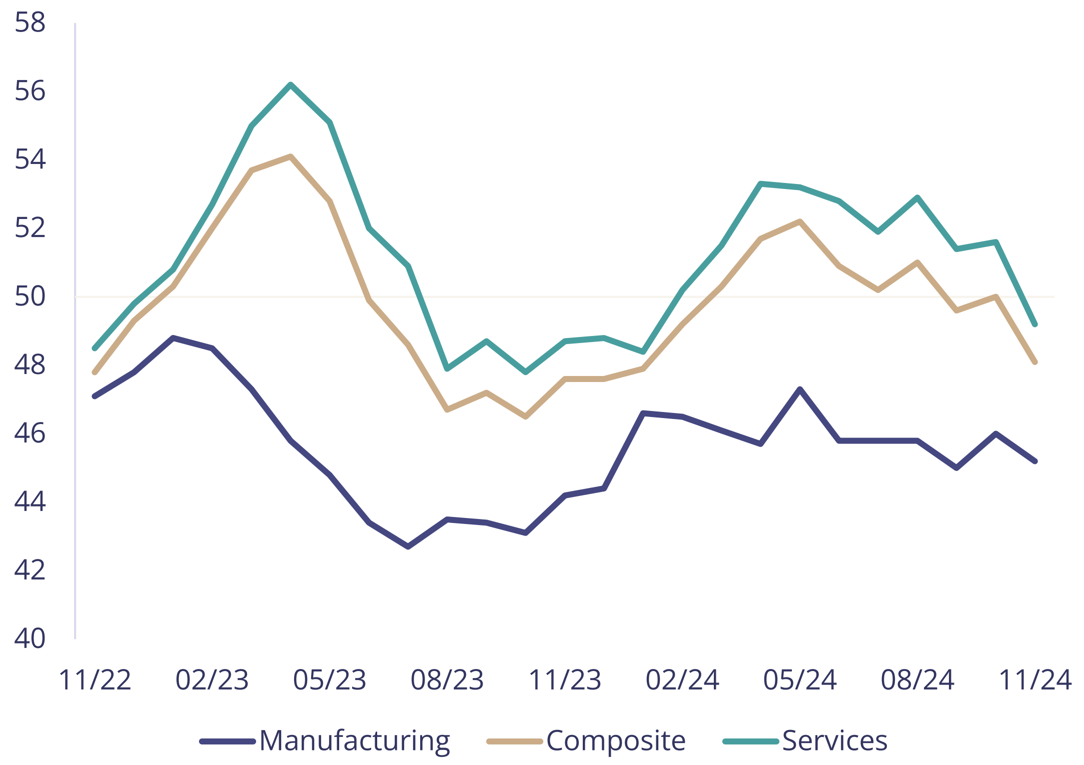
US average import tariff (tariff revenues to total imports), %



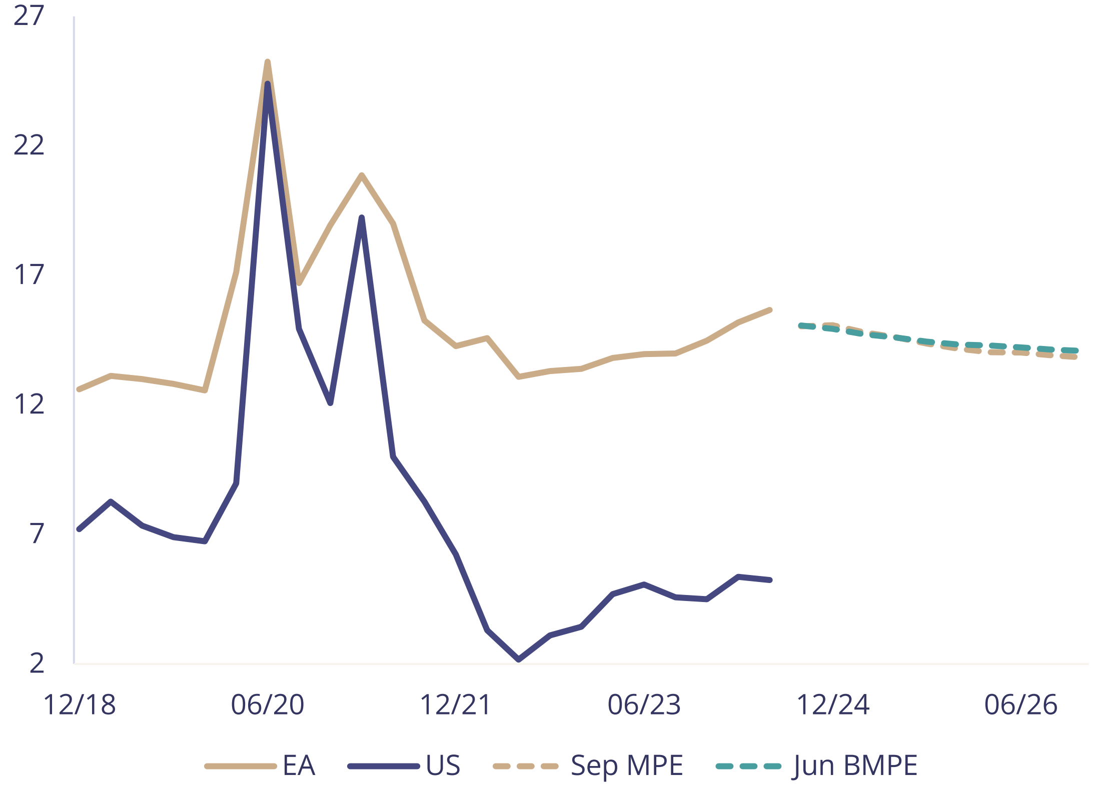
Source: U.S. Commerce Department, Charles Schwab.

Uncertainty is a drag on household consumption

EA PMI* (balance of answers)



Households' savings rate (% of disposable income)



Source: ECB, Eurostat

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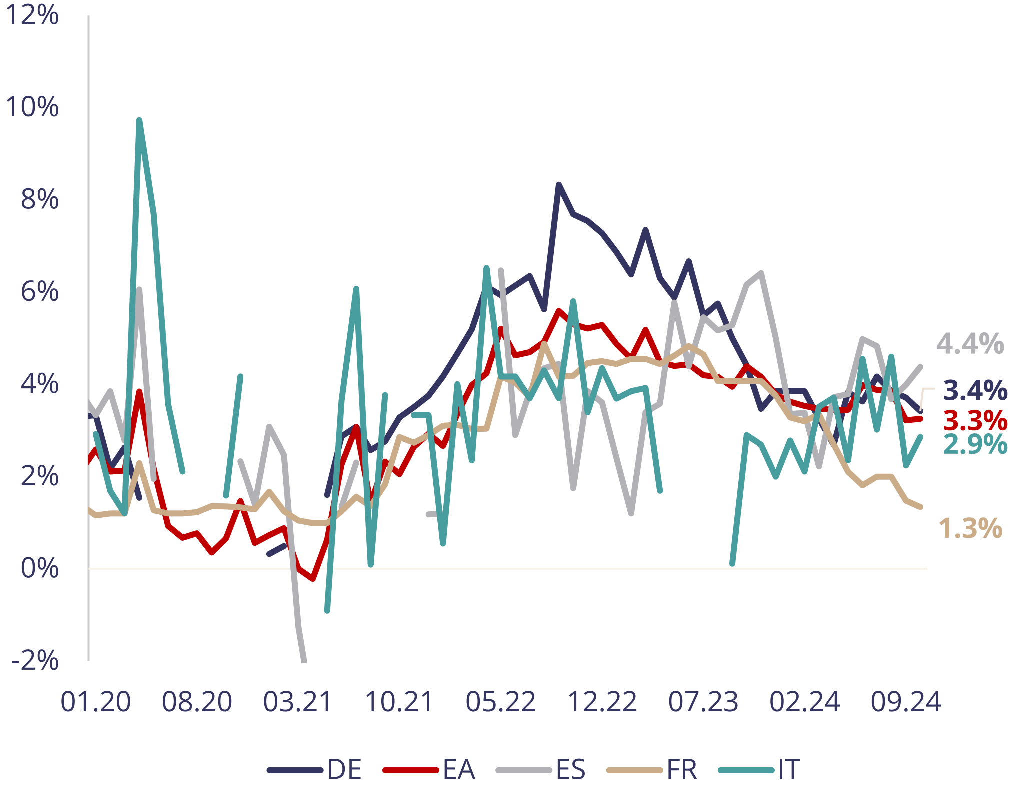
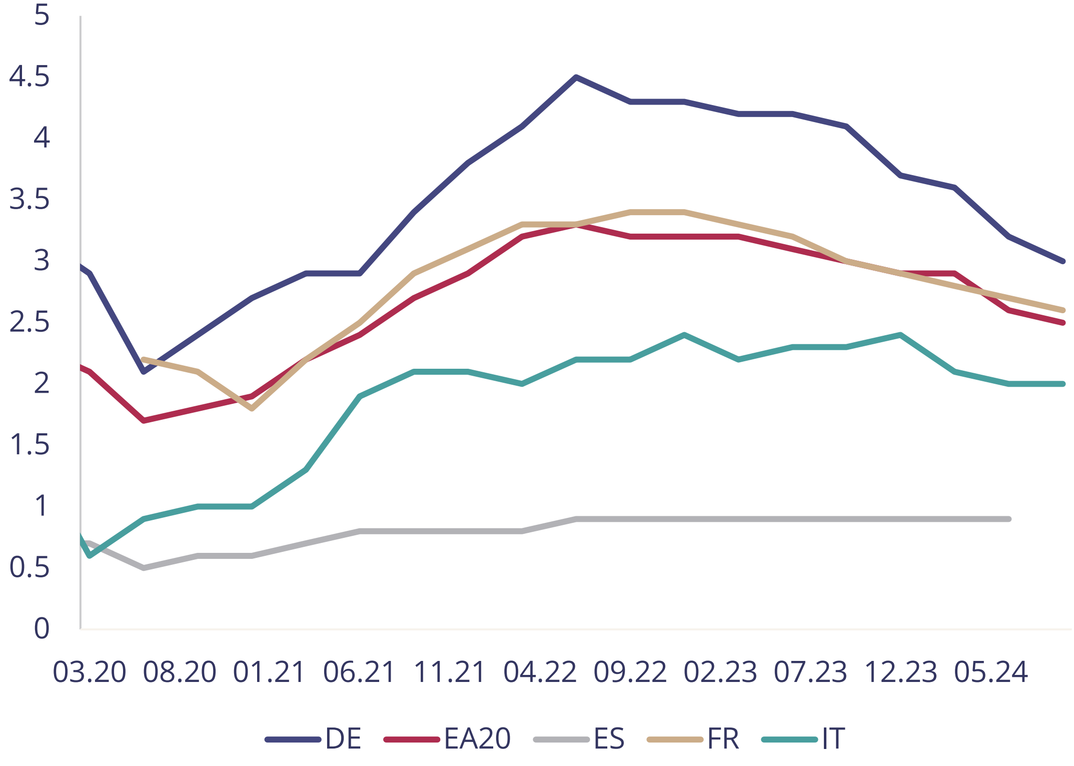
Cooling labour vacancy rates, yet still above long-term averages

Indeed Wage Tracker (y/y, %)



Job vacancies (nsa, %)



Source: Indeed, Eurostat

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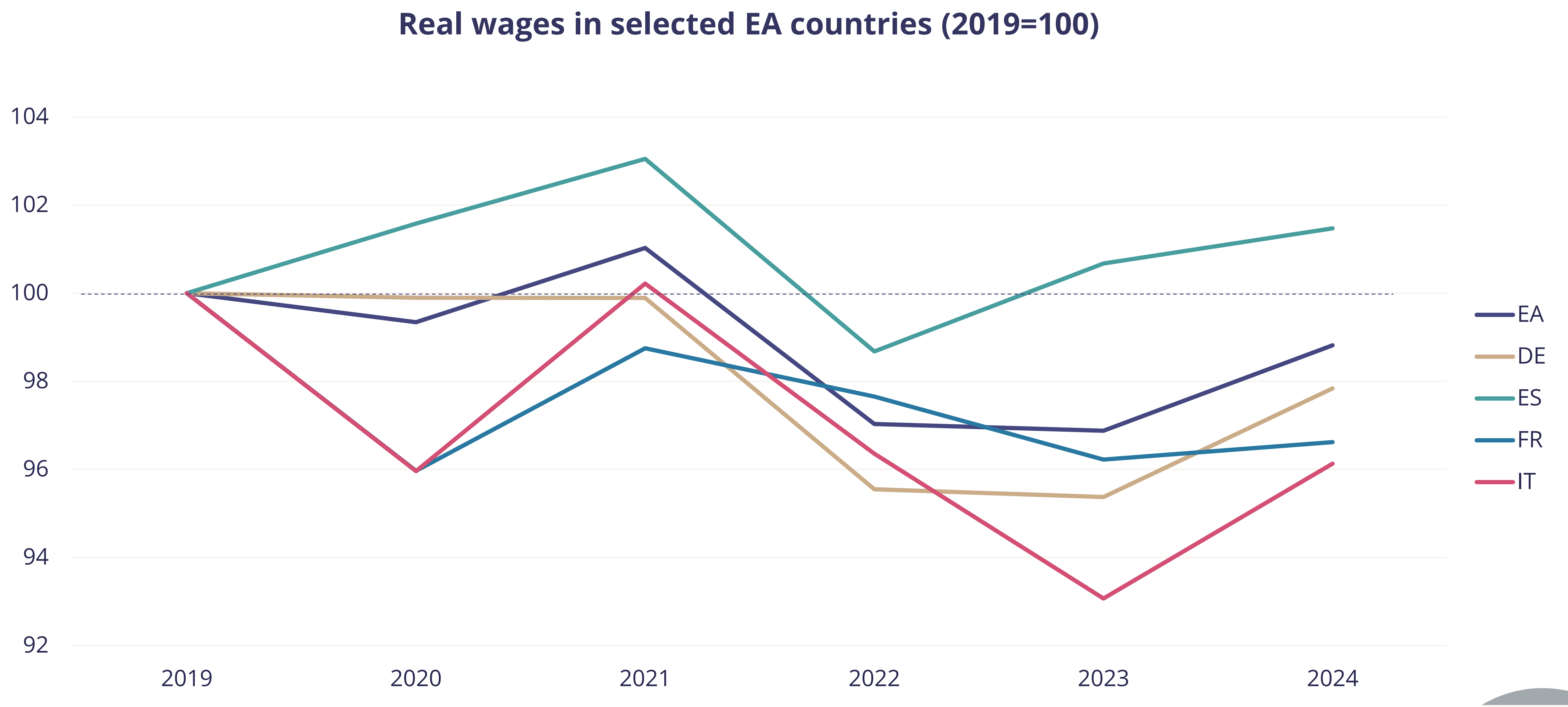
Real wage gap still negative



Source: ECB, Eurostat

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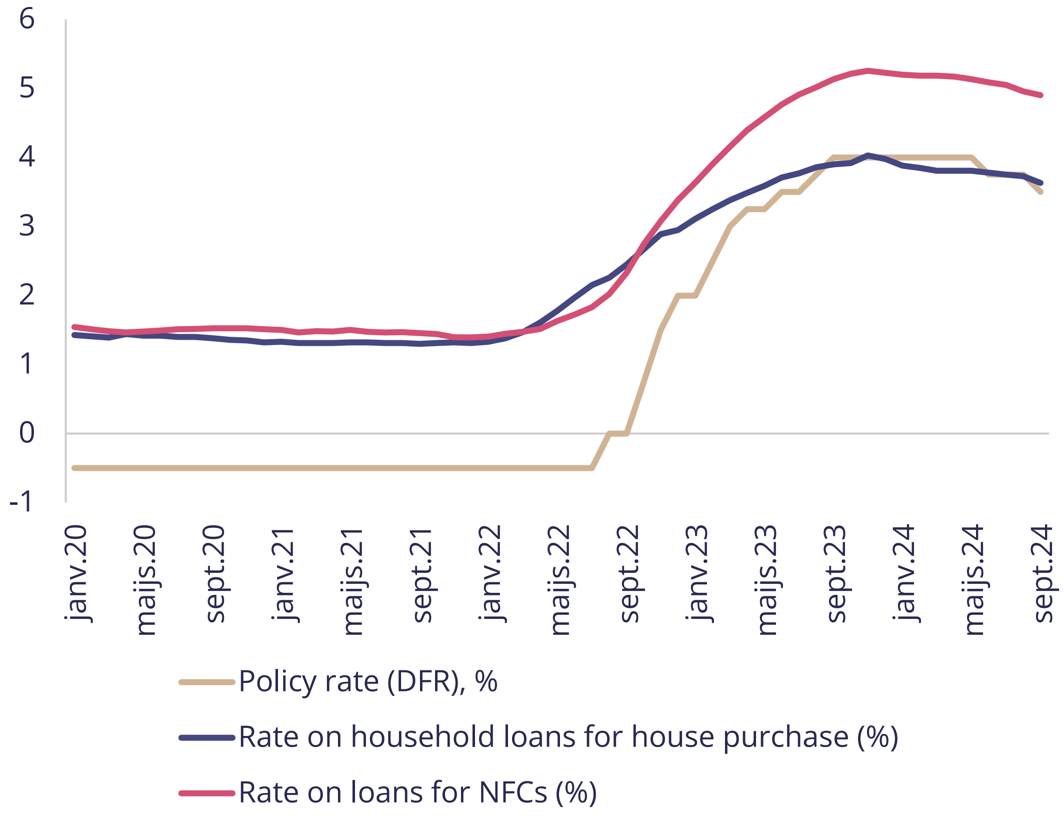
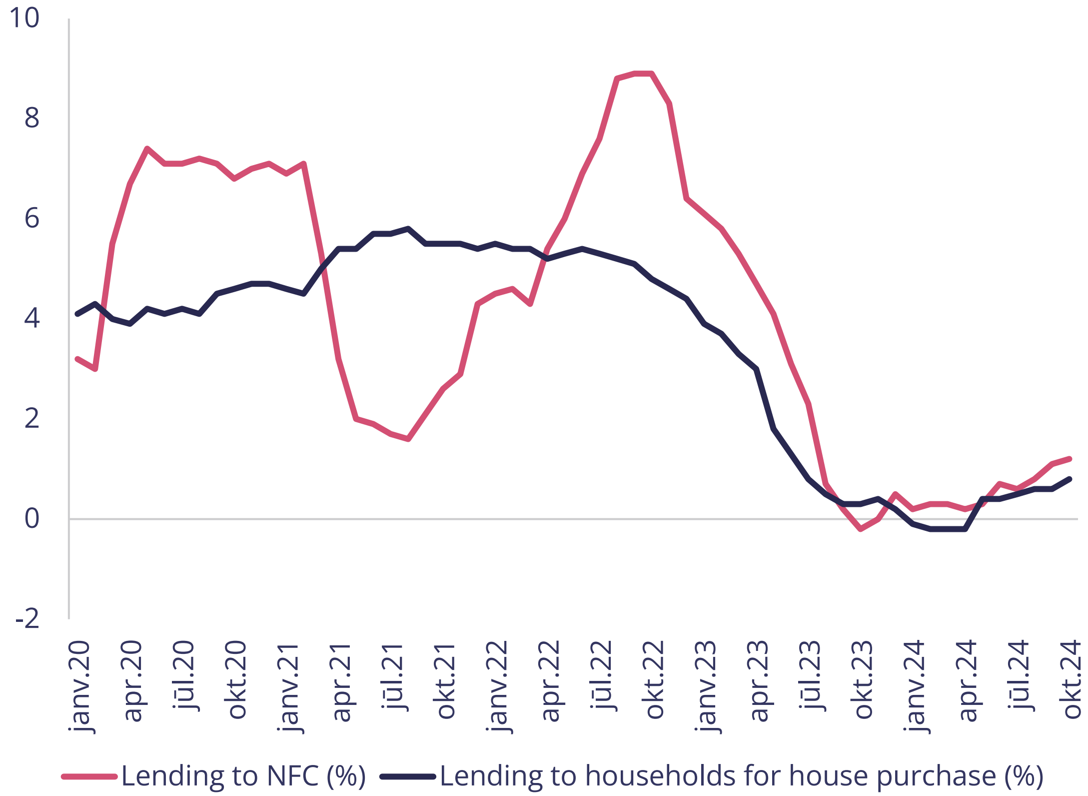
Rate cuts work through the banking system, providing a support to the economy

Interest rate on loans (%)



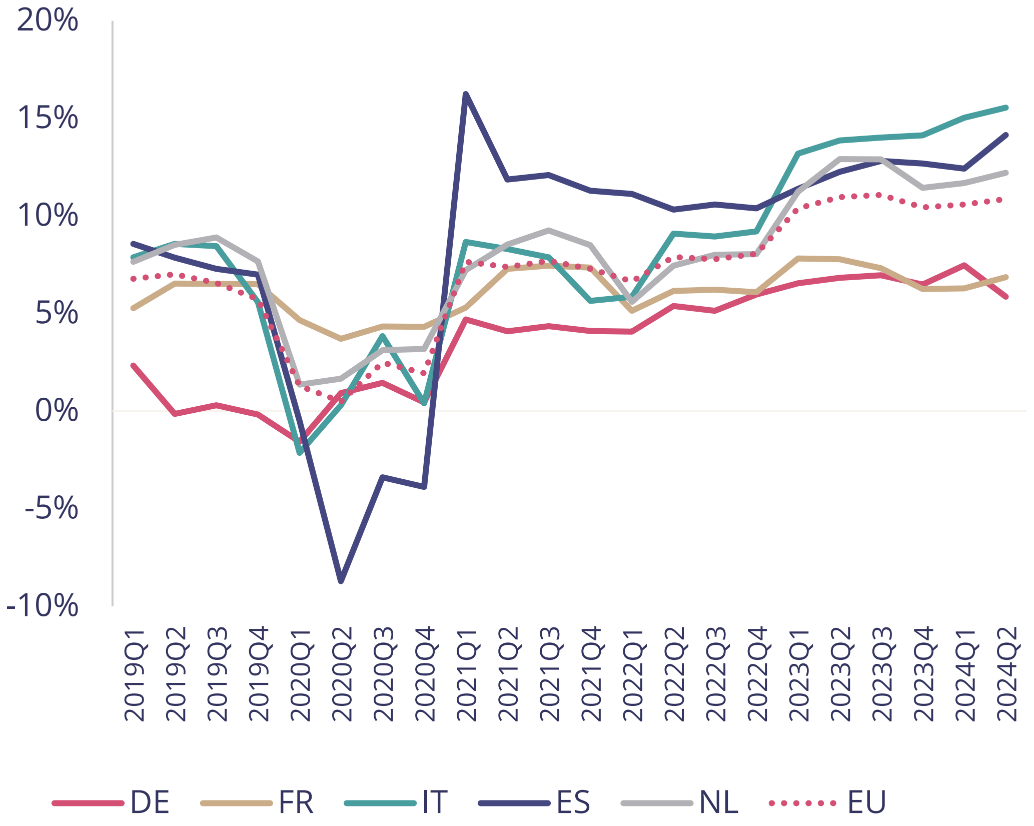
Annual growth rates of loans (%)



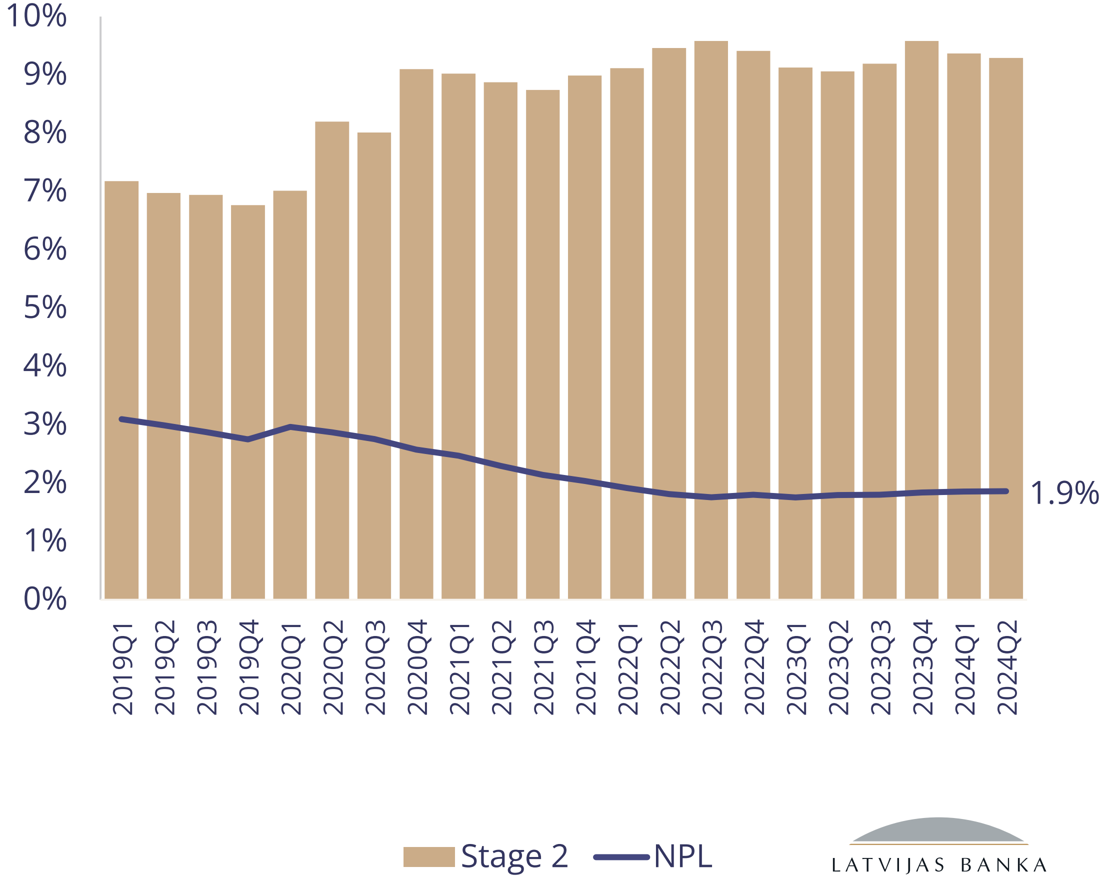
Source: ECB

Strong profits and good loan portfolio quality to boost credit supply in the near term

Bank ROE in selcted EA countries (%)



NPL and Stage 2 loans for EA banks (% of total loans)



Source: EBA

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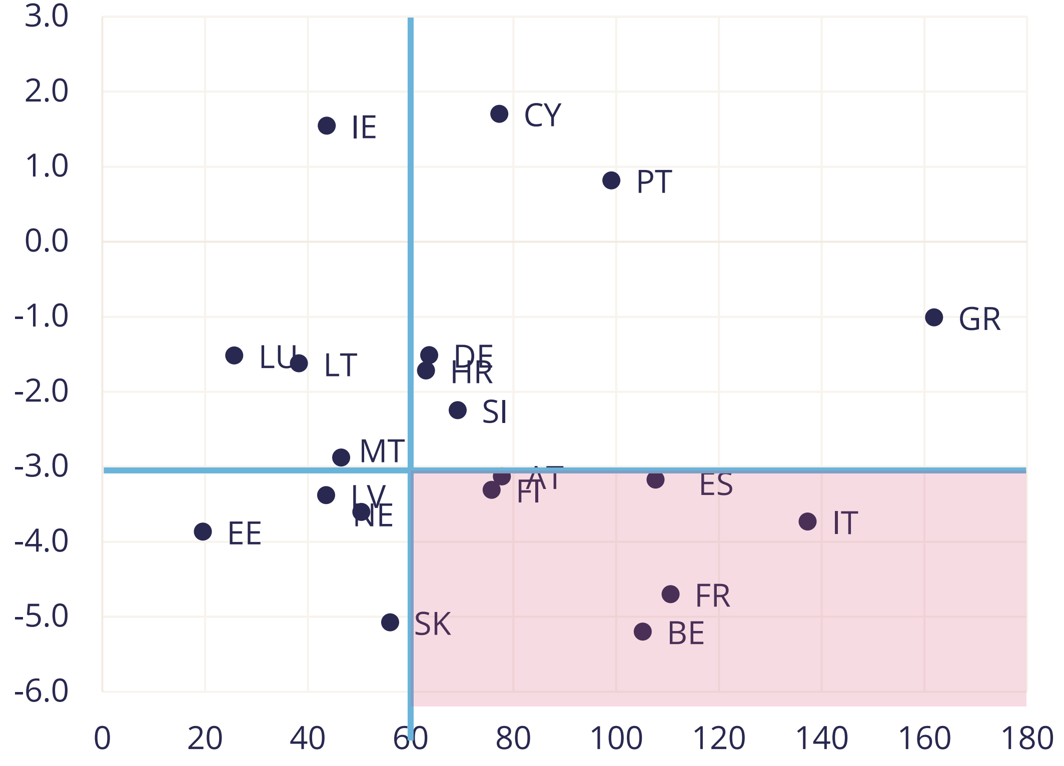
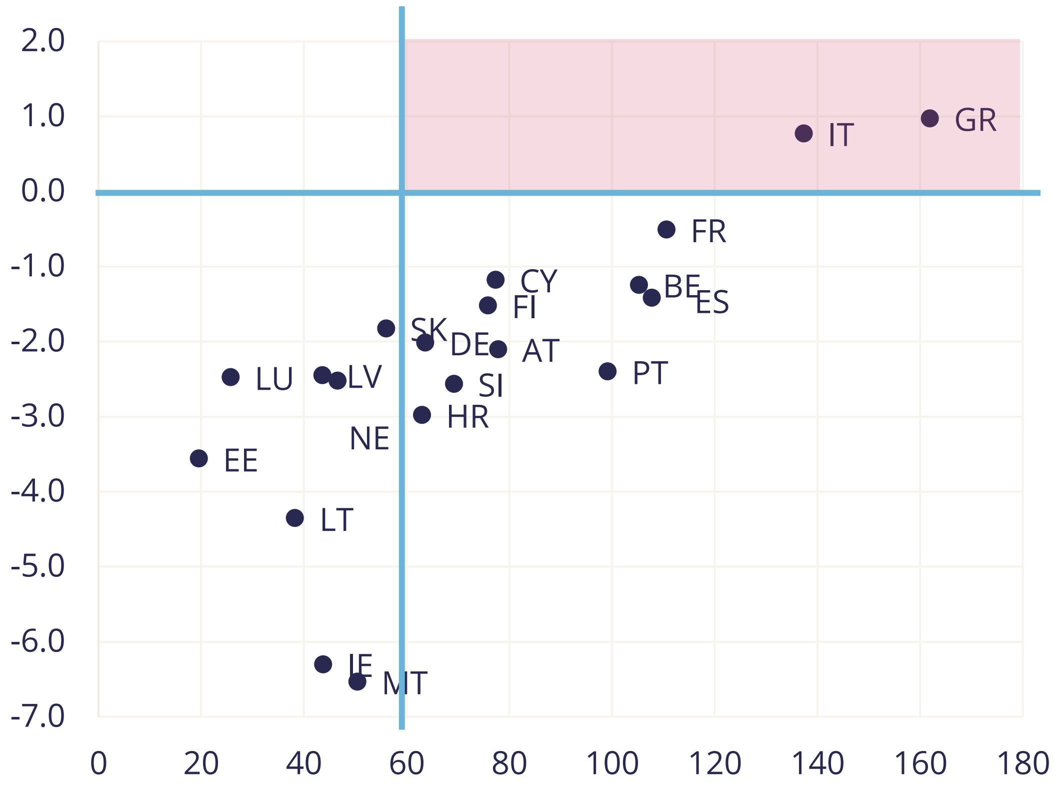
Fiscal policy: more deficit and/or debt is not the rigth answer

EA countries: government debt in 2023 (X-axis) vs projected deficits 2024-2026 (Y-axis)



EA countries: government debt in 2023 (X-axis) vs i-g ratio in 2024 (Y-axis)



Source, EC: Eurostat, ECB

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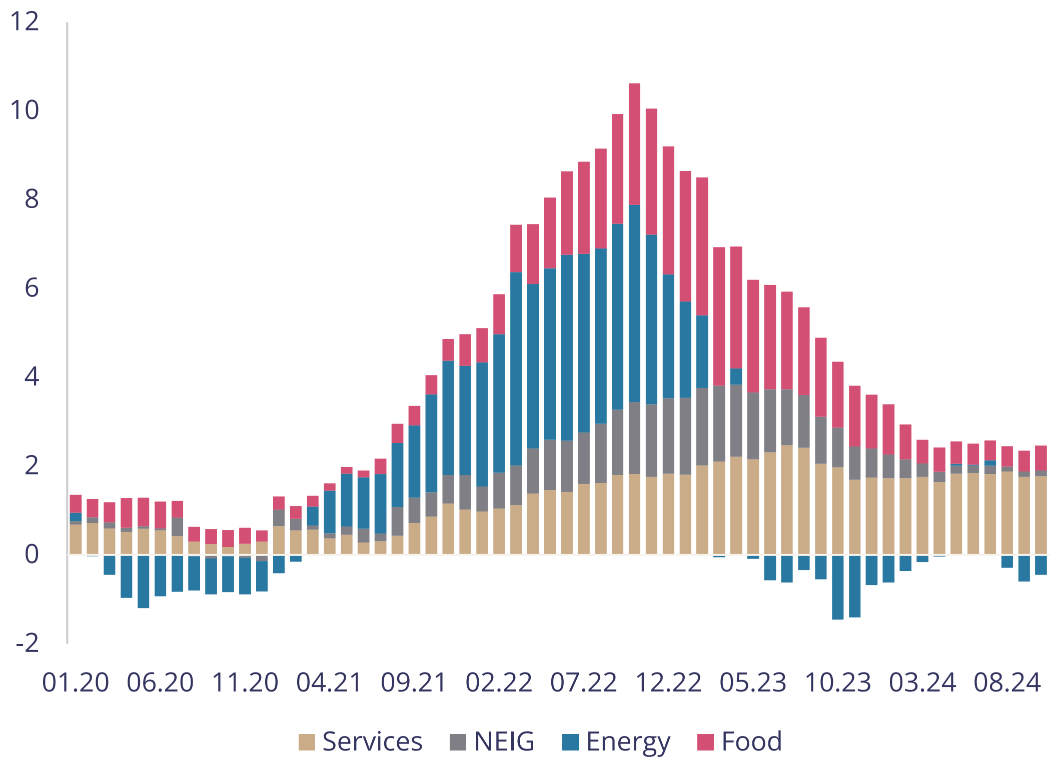
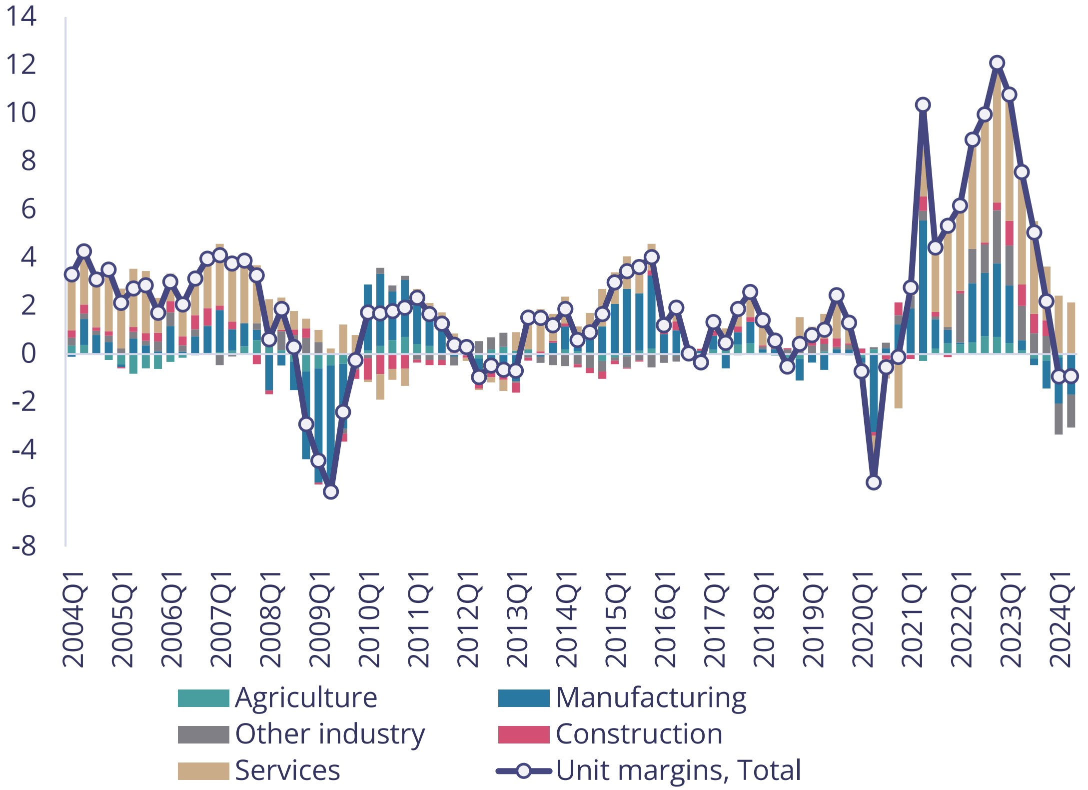
Inflation on track to 2%, but with various speeds of adjustment (goods vs services)

Contributions to EA HICP, y/y, %



EA unit profit margins (contributions of sectors, % and ppts)



Source: Eurostat

Monetary policy has been efficient, in large part because inflation expectations have been kept in check

Sacrifice ratio of monetary policy in the EA (pp)

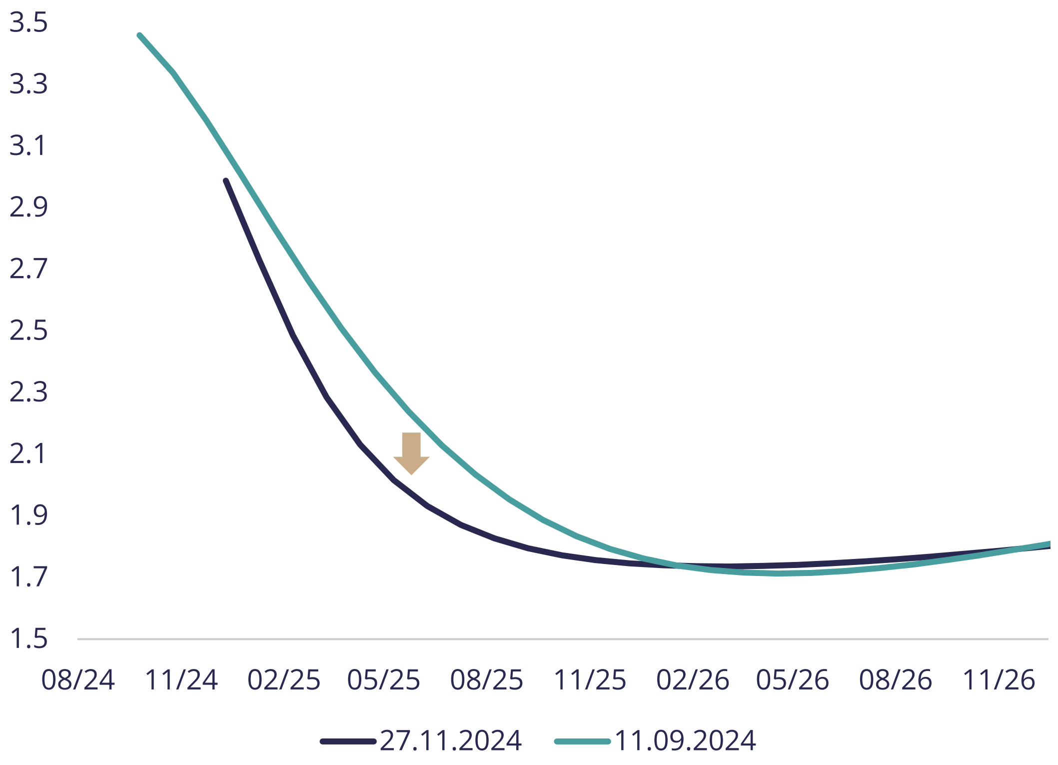
Notes: Sacrifice ratio has been calculated by dividing peak response of real GDP to a conventional monetary policy shock by peak impact on inflation, inferred from impulse response functions obtained via structural vector autoregression with time-varying parameters and stochastic volatility.

SPF 5Y-ahead and swap implied inflation expectations in EA (%)

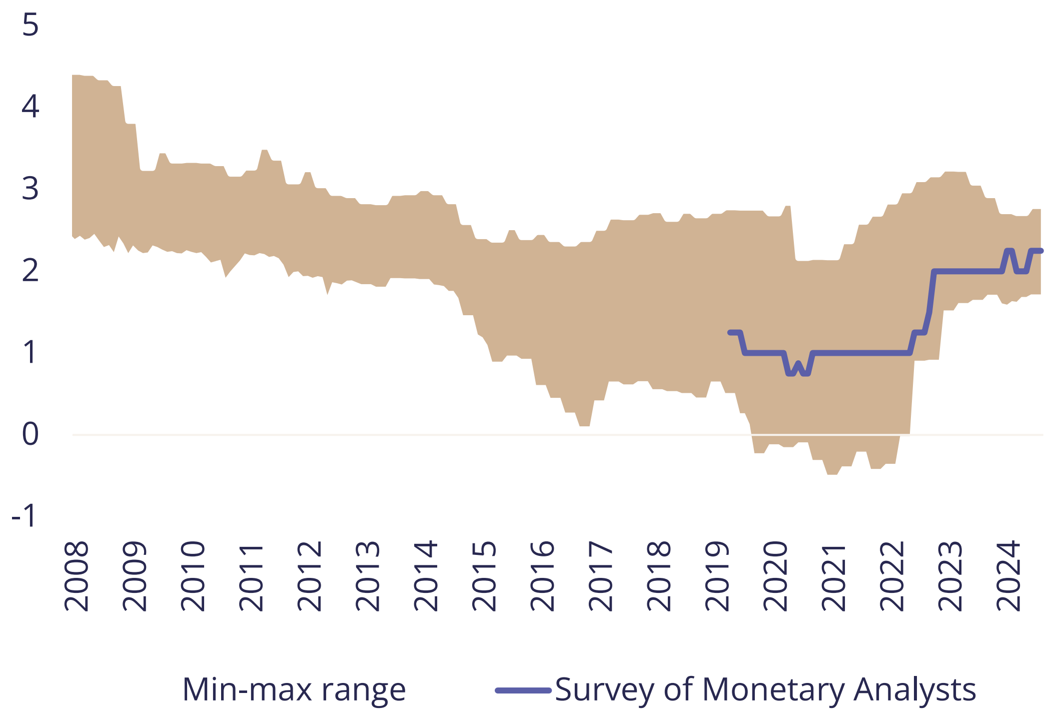
Source: BoL, Bloomberg

Market pricing implies going below r* – a sign of inflation undershoot?

Ester OIS implied forward rates (%)



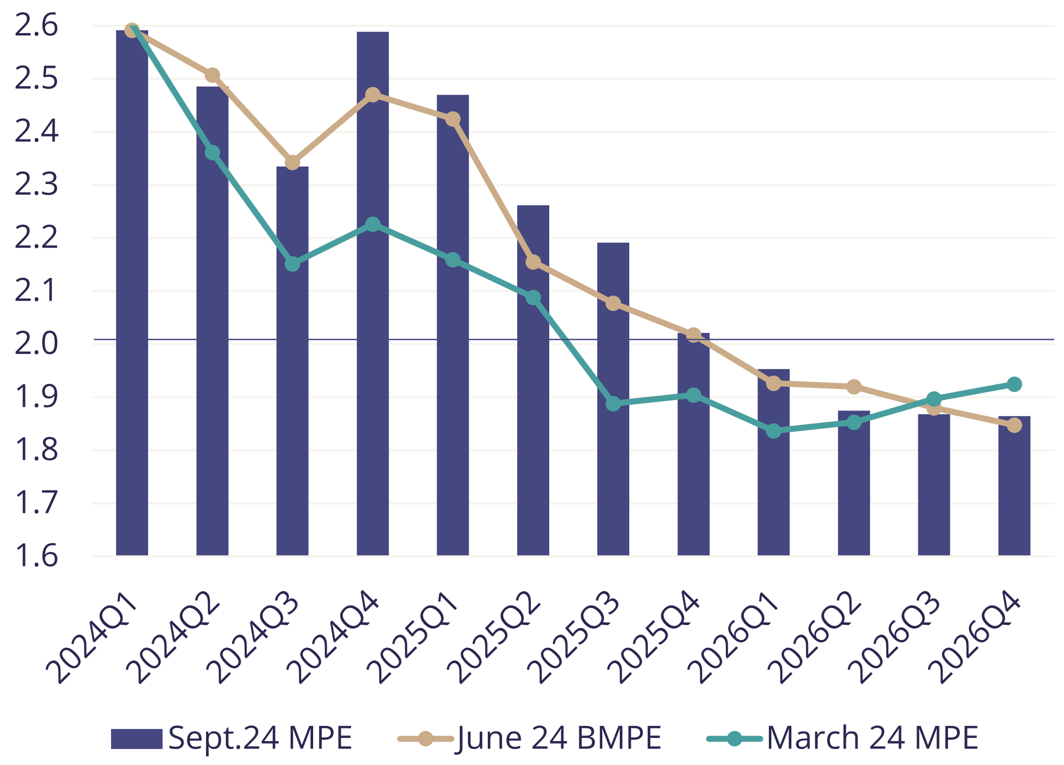
Estimates of real natural rates of interest in the euro area (%)



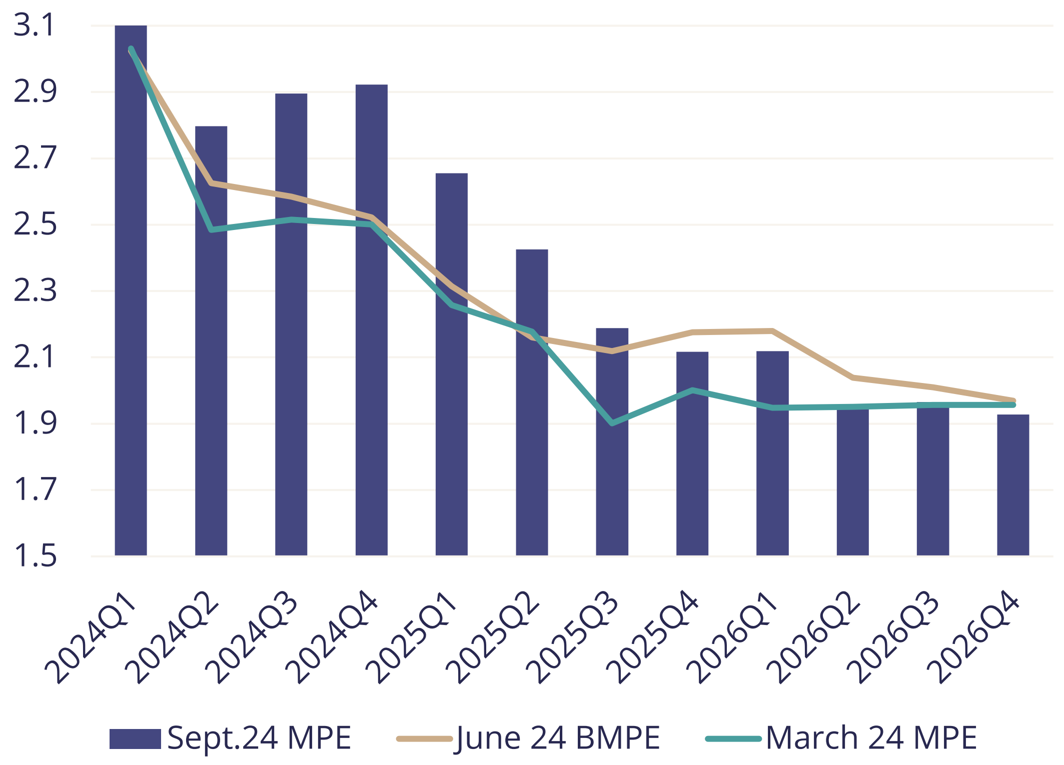
Source: LSEG, Latvijas Banka staff calculations, Bloomberg, ECB

Our projections so far do not suggest serious inflation undershoot risks; but close monitoring is duly warranted

Projections of HICP changes (%)



Projections of changes in core inflation (%)



Source: ECB

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The easing cycle will continue, but the pace and depth of it will continue to be determined by the incoming data and GovC judgement

Why ECB could adopt a steeper path of interest rate cuts:

- If global trade disruptions lead to a significant weakening in EA growth outlook that is accompanied by deflationary pressures on prices;
- If the persisting uncertainty leads to an excessive accumulation of savings and/or significant drop in investments, thus intensifying risks of recession;
- If the current labour markets tightness (sharply) goes into reverse;
- If significant undershoot risks to our medium term inflation objective emerge.

Why ECB could be on a more gradual easing path:

- If persistent labour shortages lead to strong wage growth and rising unit labour costs;
- If profit margins stay elevated and do not absorb the rising ULC to the extent that is currently envisaged;
- If fiscal policy is overly expansionary (beyond what is justified by the current economic cycle), thus contributing to inflationary pressures;
- If significant additional investment needs (green transition, digitalization etc.) lead to estimates of a persistently higher r* for the euro area.

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Thank you!