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European Central Bank

Statement by Christine Lagarde, President of the ECB, at the forty-ninth meeting of the International Monetary and Financial Committee

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Introduction

Since our last meeting in October, the global growth outlook has improved somewhat, reflecting revised growth prospects across both advanced and emerging market economies. The disinflationary process has continued amid falling energy prices, the normalisation of supply conditions and tight monetary policy. While the global economy has weathered the tightening of monetary policy well, growth prospects remain subpar by historical standards. Risks to the global outlook are broadly balanced for both economic activity and inflation, though rising geopolitical tensions pose an upside risk to inflation and a downside risk to growth.

The Governing Council in April kept the three key ECB interest rates unchanged at their September 2023 levels. It considers that these policy interest rates are at levels that are making a substantial contribution to the ongoing disinflation process. The Governing Council's future decisions will ensure that its policy rates will stay sufficiently restrictive for as long as necessary. It will continue to follow a data-dependent and meeting-by-meeting approach to determining its interest rate decisions, based on the same three criteria that guided its decisions during the earlier tightening phase and the current holding phase: the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. If the Governing Council's updated assessment of these criteria were to further increase its confidence that inflation is converging to its 2% medium-term target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction. At the same time, the Governing Council is not pre-committing to a particular rate path.

In March the Governing Council concluded the review of the operational framework for implementing monetary policy, which will help us steer short-term market rates in line with our policy stance as the Eurosystem balance sheet normalises. The new framework clarifies how the ECB will implement monetary policy in the future.

This year we also celebrated the 25th anniversary of the euro. This is an important reminder that there is strength in unity as we look ahead to future challenges.

Economic activity

Over the past year, economic activity in the euro area has broadly stagnated, as slower global demand and the impact of tighter financing conditions have weighed on growth. Real GDP was flat in the final quarter of 2023 and incoming data suggest that activity remained weak in the first quarter of 2024. Surveys point to a gradual recovery over the course of this year, as falling inflation and higher wages support real incomes and consumer spending. The dampening effect of past interest rate rises should fade over time and demand for euro area exports is expected to pick up, which should increasingly support investment.

The labour market remains resilient overall, but indicators point towards a cooling down of labour demand on the back of weaker economic activity. Employment continued to grow in the final quarter of 2023, mainly driven by an increasing labour force, and in February the unemployment rate remained at 6.5%, its lowest level since the introduction of the euro. Labour productivity is expected to recover in the future as labour hoarding unwinds and profit margins moderate.

Governments should continue to roll back energy-related support measures so that disinflation can proceed sustainably. Implementing the EU's revised economic governance framework fully and without delay will help governments bring down budget deficits and debt ratios on a sustained basis. National fiscal and structural policies should be aimed at making the economy more productive and competitive, which would help to reduce price pressures in the medium term.

Risks to the growth outlook remain tilted to the downside. Weaker global demand would weigh on growth. Geopolitical risks – stemming from Russia's unjustified war against Ukraine and the tragic conflict in the Middle East – could lower confidence and lead to global trade disruptions. The dampening impact from earlier monetary policy action could still turn out stronger than expected. On the upside, a faster-than-expected decrease in inflation could support higher spending as real incomes rise, while stronger-than-expected global growth could also support a faster recovery.

Inflation

The disinflation process in the euro area has continued, broadening across all main components of inflation. In March 2024, headline inflation stood at 2.4%. The ongoing decline reflects the fading impact of large past supply shocks, lower energy commodity prices and tight monetary policy weighing on demand. Core inflation has remained somewhat more elevated, at 2.9% in March, due to the relatively larger role of domestic factors such as labour costs. The degree of further disinflation depends on the interplay of labour costs and profit margins. Wage growth has been high amid tight labour markets, but it started moderating in the second half of 2023. Together with negative productivity growth, high wage growth kept unit labour cost growth elevated, though profit margins are absorbing part of their impact on inflation. The disinflation process is expected to continue, especially once a recovery in productivity growth starts reinforcing downward pressure on labour cost growth. Inflation is expected to decline to 2.3% in 2024 and reach 2.0% around mid-2025.

Risks to the inflation outlook are two-sided. Upside risks include heightened geopolitical tensions, as well as higher wage growth and more resilient profit margins than anticipated. Downside risks include monetary policy dampening demand more than expected, and an unexpected deterioration in the economic environment in the rest of the world.

Financial stability, euro area banking sector and non-bank financial intermediation

The euro area financial system has remained strong, aided by declining inflation. Non-financial corporations and households have shown resilience and are poised to gain from a forthcoming easing of financing conditions. The outlook remains fragile, however, marked by elevated vulnerabilities stemming from weakening growth prospects, still tight financial conditions and the materialisation of geopolitical risks. As higher financing costs, a move towards hybrid working practices as well as environmental, social and governance requirements are likely to continue posing cyclical and structural challenges, we are closely monitoring developments in euro area real estate markets.

Euro area banking sector profitability reached its highest level since the global financial crisis but is likely to have peaked, as net interest margins started to decline in the last quarter of 2023. Banks are maintaining sizeable liquidity and capital buffers despite considerable reductions in central bank funding and substantial shareholder payouts. Specifically, significant banks reported an average liquidity coverage ratio of around 164% and an aggregate Common Equity Tier 1 ratio of 15.7% at the end of 2023. Non-performing loan ratios remain close to historically low levels,

although mild signs of deterioration are visible in loans to small and medium-sized enterprises and to the commercial real estate sector. Banks' exposures to commercial real estate are contained, at around 5% of their total assets. The euro area banking sector has proven resilient to tensions in other parts of the world so far, and confidence in it has been supported by strong rules and supervision. Looking ahead, it is crucial that all jurisdictions finalise their implementation of Basel III.

Risks in the non-bank financial intermediation (NBFI) sector remain elevated, despite some portfolio rebalancing towards higher-quality assets. The sector is vulnerable to asset price corrections, macroeconomic uncertainty and market volatility. These factors could contribute to rising outflows from open-ended investment funds, which can exhibit significant mismatches between asset liquidity and redemption terms, or to potential margin calls for investment funds, insurance companies and pension funds. Additionally, parts of the NBFI sector also display significant financial and synthetic leverage, which can propagate liquidity shocks to the wider financial system and amplify stress. Recent market episodes − including the turmoil in March 2020, commodity market tension in 2022 and UK government bond market stress in September 2022 − underline the need for international coordination to strengthen the NBFI policy framework, also from a macroprudential perspective.

International cooperation

We welcome the IMF's continued support for Ukraine, in particular its recent approval of the third review of the Extended Fund Facility arrangement, marked by Ukraine's strong performance under very challenging conditions. Timely disbursement of external support by all donors will be critical for the future of Ukraine's programme. We also welcome the conclusion of the 16th General Review of Quotas in December 2023, which strengthens the quota-based nature of the IMF at the centre of the global financial safety net. The priority now is to implement the Review by mid-November 2024. We look forward to the upcoming evaluation by the Fund's Independent Evaluation Office on the evolving application of the IMF's mandate. Focusing on the IMF's mandate and its cooperation with the World Bank will be important, also in their implementation of the Resilience and Stability Trust.

Geopolitical tensions are increasingly giving rise to economic and financial fragmentation and pose a significant risk to global prosperity. A world divided along geopolitical lines would be more prone to adverse supply shocks and reduced trade, possibly leading to higher inflation and lower welfare. We also see a greater deployment of trade-restrictive measures targeted at sectors considered strategically important for technological progress and the green transition. However, legitimate concerns about security and supply chain resilience should not lead to a spiral of protectionism. If we are to preserve the unparalleled achievements in global growth and poverty reduction made in the past decades, multilateral cooperation is more important than ever.

The COP28 Global Stocktake has clearly shown that the world is far off track to meet the goals of the Paris climate agreement, while our lives and economies are already being affected by the greater impact of natural disasters. Stronger international cooperation is essential for scaling up transition and resilience finance and shielding those who are hardest hit. Progress is needed on pricing carbon, putting the right regulatory framework in place and defining key elements of credible transition plans, both at sectoral and national levels. All stakeholders need to contribute within their mandate. The ECB has stepped up its efforts and recently published its new climate and nature plan 2024-2025. We will focus on three areas over the next two years: navigating the green

transition, addressing the physical impact of climate change, and understanding the risk that nature loss poses to our economies and the financial system.