Peterson Institute for International Economics

The euro area in 2025

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[00:05:04.19] - David Wilcox

Good morning, everyone. May I encourage I encourage you all to take your seats. My name is David Wilcox. I'm a senior fellow here at the Peterson Institute and director of US economic research at Bloomberg Economics. It's my privilege to host this morning's conversation. I'm as devastated as all of you to have been advertised a fireside chat and there's no fire. So I thought I'd better get that out of the way.

[00:05:32.20]

Right at the top.

[00:05:33.14]

It's a pleasure to welcome all of you to today's discussion at the Peterson Institute for International Economics. At Peterson, we're committed to fostering forward-looking conversations on the most pressing economic issues. And today's topic, the future of the euro area, certainly fits that description. It's an honor to introduce today's distinguished guest, Philip Lane. A leading voice in global economics. Philip became chief economist and, and member of the executive board of the ECB in 2019. Prior to his role at the ECB, he served as governor of the Central Bank of Ireland. Additionally, he's currently on leave from his position as the Watley Professor of Political Economy at Trinity College Dublin. Today, Philip will share his perspective on the outlook for the euro area in 2025. We're fortunate to have him here, and I know this discussion will be both substantive and thought-provoking. With that, please join me in welcoming Philip Lane. Philip, the podium is yours.

[00:06:46.09] - Philip R. Lane

So I'd like to thank the Peterson Institute for hosting this event. Thank you for the invitation. And, uh, you know, like, like every other policymaker, uh, we really value the work done by the Peterson Institute on so many topics. It's really a global public good. So what I want to do is, I, I

think this morning is really, uh, in two parts. So I have these opening remarks, and, and then, uh, even without a fireside, we can have a chat. And then of course I'm sure some interaction from the floor. And then within these opening remarks, it's really, I think, two sections. One section is really to try and summarize and explain the decision we made last week, and then the second section is really some comments, if you like, about our kind of approach to monetary policymaking at the moment, which, which I think is maybe worth briefly discussing. So let me start off with, with the inflation outlook and what we said last week. And we said before, and I think has been, by the way, confirmed by the January inflation number that came out on Monday, is that the disinflation process remains well on track.

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What do I mean by this? It means that The December projections, you know, are holding up. The— in fact, Q4 came in a bit below our December projection. And what we see in the latest numbers is, yes, there's been a noticeable increase in energy inflation. But we've also seen, if you like, welcome indications of the deceleration in services inflation that we want to see. So it is the case in December— we don't have the granular January data yet, but in December, you know, domestic inflation, which if you like, is mostly the domestic component of services inflation on an annual basis, still stood at 4.2%. And this is clearly where the concern is. Tell us why you think that's going to decelerate? Well, I think one basic reason is when you do a kind of filtering exercise, for example, our kind of dynamic factor model we call the PCCI, and for services inflation, that's running at 2.3%. And again, we don't need services inflation to be at 2% for overall inflation to be at 2%, given that we expect services inflation typically to run hotter than goods inflation, for example. So, so that's a kind of a data kind of a point.

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But then there's an economic point, which is there is a close connection between wage inflation and domestic and services inflation. And then when we start to look at the wage data, and again we had new data for the January meeting, every indicator since suggest a substantial deceleration over the course of this year. So, for example, this is indicated by our wage tracker. The latest version of the ECB wage tracker came out this morning. Now, let me just say, because of course this morning there's been some commentary on it, the wage tracker reflects the wage contracts that have been concluded. This— these numbers will move around as more wage settlements have different countries get concluded. But with that caveat, we do think it points to deceleration. And then for the January meeting, we had a number of surveys. So when we asked a pretty large sample of firms through, through the SAFE sample, they said they expected wage growth this year to be around 3.3%. A year ago, they were indicating 4.5%. So that's a significant deceleration this year. Our quaintly titled Corporate Telephone Survey, which

focuses on large firms and which I don't think is over the telephone anymore, again, it's very consistent.

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It's coming down to about 4.6% last year to again 3.3% in '25 and 2.9% in '26. And then other commentators, for example, Consensus Economics, also sees this scale of decline this year. So the mechanism, again to repeat, or one of the mechanisms is a significant deceleration this year, and that in turn, that will allow less cost pressure on the services sector. Let me turn now to the economic outlook and last week on Thursday when we were finishing our meeting, the Q4 GDP number came, came through. And maybe I think the way to think about what's happening in Europe is that 2024 on a Q4, Q4 basis, comparing the end of '24 to the end of '23, the euro area economy grew by 0.9%. That's a lot stronger than the 0.1% 1 in '23. So our basic, uh, narrative is that there's going to be a recovery from the, uh, depth of the energy shock, uh, held up directionally last year. What is true is the scale, of course, is, is less than we would have liked. So I'm not disputing that the kind of magnitude of recovery— there is a shortfall there. And when we look at the near-term data to survey data and so on.

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You know, I think the near-term does look weak, but we do think, you know, in the end, it's some pretty strong recovery baselines here. So last year, household real income grew quite a bit. Consumption did pick up in the second half of the year. But there's still, I think, a distance to months to go for, for consumption to normalize. As we've been cutting interest rates, we are seeing the early stages of a recovery in, in the housing market, but it's more at an early stage. And by the way, I'm not putting up slides today, but on the ECB website there is a set of slides, so you can look at, for example, a bit more detail about housing investment in, in the slide deck when you get a chance. So, so there is essentially a sense of this year consumption recovering, but then between this year and into '26, a recovery in investment, in housing investment and business investment. So we do have essentially the European economy growing above normal levels this year and next. And this is an important baseline to think about. And we do expect exports to recover more strongly, of course, conditional on the state of the world's trade policies.

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And then when I turn to financial conditions, maybe it's important to highlight there has been some changes since the autumn. So we have seen a rise in the longer end of the yield curve. Which of course is partly a spillover from conditions here in America and also more globally. And that element is clearly a tightening factor. And I would say the other tightening factor is from

the Bank Lending Survey, where after a year where there was not— where conditions were pretty stable, there was a renewed signal of tightening of credit conditions. Conditions where firms are saying, well, we think the outlook and the risk environment is becoming more adverse, which again, in the context of fairly weak end-of-year data, is maybe understandable. So we, we are right now in this situation where there's some pushback in financing conditions from those elements, but we also have in our bank-based system, you know, a gradual easing in the works. So again, the latest interest rate data came out, I think yesterday, and compared to the peak in late '23 for firms, the lending rate has come down by 92 basis points. For households, the mortgage rate has come down by 62.

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So this is by now a significant pass-through from the easing of the policy rate into these bank lending rates, which is relevant. So are we seeing a pickup in credit, which is a basic transmission mechanism? And there is— it looks like there is a pickup. The December lending data came in stronger than that for a while. But let me emphasize, this again, I think, is early days. So on an annual basis, bank lending to firms in December grew at 1.5% at nominal. Now, in the context of having been very weak, that is a recovery. But compared to historical averages, it's still pretty subdued. So I think you can look at that as, okay, it's starting. You can also look at it as it's still early stages in a kind of easing of credit activity. So let me, having run through very briefly inflation, the economic outlook, the financial conditions, let me say that we also last week we reconfirmed our risk assessment. So what I say there is for the economy compared to, I think, a reasonable baseline we think there remains downside risk. And of course, among the other factors which we kind of list, trade policy uncertainty is, of course, one of those key issues.

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On inflation, we— our approach is not really to emphasize on net, is the risk more to the upside or to the downside? What we emphasize is we take a two-sided approach. We try and run through upside scenarios, we run through downside scenarios, and then again, in relation to, to trade, what we think from, from having looked at this, which is that essentially our call is the effect is uncertain. So rather than saying we know for sure it's an upside risk or we know for sure it's a downside risk, it's very model specific. Very assumption-specific what happens to inflation. Okay, so let me just turn to a little bit of a discussion of our monetary policy approach. And so, and this is reflected, I think, in the title of the talk, which is, you know, maybe at one level it's going to sound obvious, But another level, actually, at least to me, it's not obvious. So we can maybe in the discussion there see if anyone else thinks it's just basically obvious, which is essentially that monetary policy should pick a middle path. So what do I mean by that? Is that

essentially there is still upside risk to the inflation outlook because remember, we are coming— We are coming down from a high inflation rate.

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We want to glide to 2%. And it's important to go through scenarios where, okay, what happens if that stalls out? And it could stall out if the wage deceleration I signaled doesn't happen. It could stall out if the level of activity in the economy picks up more strongly and we don't get that. Moderation in the labor market. And it could pick up if there's new shocks. So I emphasize the new wave of energy shocks that are happening. But you can generalize that upside risk situation. So you might say, well, this upside risk, inflation still above target, would that not mean that you should change your policy to be a bit higher just in case. But I think for the euro area, it's important also to take into account downside risk. So an excessive abundance of caution in March could threaten the recovery in domestic demand that is needed to support the pricing environment needed to deliver 2% inflation. I would say this is, you know, common to other European central banks. For example, the Riksbank and some others, which is basically— it's not a given that inflation settles at 2%. And we have to take into account that downside risk.

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And so what does that give you? It suggests a middle path is appropriate, which you neither overweight upside risk nor overweight downside risk. And that robust policy approach balances the risks of moving too slowly against moving too quickly. And in calibrating that middle path, agility is important to make sure you don't pre-commit, to make sure you are data dependent, and use the meeting-by-meeting flexibility to recalibrate as needed. Okay, so maybe we can talk again. Is that just obvious, or is there something not obvious what I just said. But then let me in closing talk about two concepts which are also discussed over here— restrictiveness and neutrality. So when inflation is materially above target, which it has been for the last 2 years, and requires a monetary policy response to make sure it returns to target in a timely manner and that inflation expectations remain anchored. Then we— the monetary stance must be clearly restrictive. There must be a coherence between monetary policy and the inflation profile that you see. However, as inflation returns close to target, policymakers need to shift their focus to adjusting monetary policy in line with the incoming economic and financial data.

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And the evolving risk assessment. So in other words, for me, and this is what we said in our December meeting, the guidance on monetary policy is we will be appropriate, i.e., whatever monetary stance is needed to sustainably deliver 2%. So in the transition, in making the

transition from being restrictive, clearly restrictive, to this phase of kind of searching for the appropriate monetary policy stance, it's tempting. And the question does get asked, you know, are you still restrictive? So let me say that for me, if you try to create a yes/no answer to that and to create a kind of summary restrictiveness index, which you could say, well, yes or no, then I think it needs to have 9 factors. At least 9, so I stopped at 9. So one is in the context of your area, there's a lot of super cheap debt that was taken out in the low-for-long era that is now— the fixation periods are expiring, and that debt is being repriced at a higher rate. So there's a tightening going on, and in the charts in my slide deck, you can see the average cost of debt is not falling. Because those loans are still there.

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And just think about people with a mortgage or a firm with a long-term loan. Second, we have eased since last June by now 125 basis points, but we know that it takes time for that to transmit, to transmit via the banks, to transmit in other ways. So you have to think about, okay, how much of the tightening is still kicking in, how much of the easing is kicking in in the other direction. A third factor is clearly long rates take into account the anticipation of future rate cuts. So when you look at financing conditions today, they are dependent on the market view of future cuts. So when you say is today's rate restrictive or not, you have to make a call about, okay, what what is the future rate path that's embedded in that question. Number 4, you have taken into account the contribution of basically quasi-exogenous factors, such as the global upward pressure on the long end that I just mentioned. Number 5, you do have to take into account the evolution of risk premia, whether that's corporate bond risk premia, sovereign risk premia, equity be risk premia. You have to take into account, as I mentioned, the evolution of credit standards in bank lending.

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That's very important in the European system. You have to take into account that we have some segments which are market-based, some segments which are bank-based, and these have different speeds of transmission. Then you also take into account the real economy. So are we seeing consumption and investment respond to lower rates? And then finally, are we seeing price setting respond to the evolving situation? Because in the end, this was what I tried to— how I tried to answer the question in Jackson Hole is the measure of monetary policy is, is this bringing you towards 2% inflation or not? And that's the ultimate test of restrictiveness. Is it a path that's consistent with that? So given that, you might imagine that there's no single indicator that's going to tell you whether you are restrictive or not. And in particular, comparing the current policy rate to some version of the neutral rate is not going to be— it's not bad over a 20-year average. If you're trying to work out the next few policy meetings, it's not going to be all that

helpful. And I would say I'll pre-advertise on Friday this week, the ECB staff will provide a new set of estimates of the neutral rate.

[00:25:39.08]

But I'm pretty sure the one— the attitude I've just expressed here, which is it has its role, but it's not a sufficient statistic for the next monetary policy meeting, is important. So given all of that, I mean, what we're going to do and what we always would do is we will look jointly at the evolution of the economic data, the inflation data, and the transmission data. We have flagged this for the last 2 years. The strength of monetary transmission is not a known number. It's evolving over time, and that's why we need to study it. And our 2021 strategy review said our decision would be based on an integrated assessment of all factors. So that is not particularly helpful to you if you're trying to come up, find, you know, a single dimension to, to index our policy. But I think that that's— I think the important to have that kind of approach to policymaking. And then finally, last couple of years, the risks have been dominated by how sure are you inflation's going to smoothly fall from 10.6% at the peak to 2%. And that's why we've emphasized indicators like underlying inflation. And then second is, how sure are you that hiking from -50 to +400 and then starting to reverse— how sure are you that that rate path is the best rate path?

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And again, what we emphasize there is we will be recalibrating every meeting depending on what we observe about the strength of monetary policy transmission. So with that, let me I'll stop there, and I guess we'll continue in the other format.

[00:27:45.26] - David Wilcox

Thank you, Philip. You'll notice that there are no elephants in the Siegfried Bergsten conference room, and the reason there are no elephants in this room is because we imposed a 200% tariff on elephants. However, for those of us in Washington, the elephant in the room is tariffs at the moment, and especially for those of us at the Peterson Institute. So I'm wondering if you could elaborate a bit on how you and your colleagues at the ECB see the possible effects of US tariffs on the European economy and the possible effects of retaliation if the EU undertakes to do such on the European European economy?

[00:28:42.19] - Philip R. Lane

Yeah, so, um, obviously, uh, we've been looking at this for, for quite a while, uh, and the overall bottom line is, as I indicated, we do think it's a downside risk to economic activity, uh, and we do

think that, um, uh, the range of, of outcomes for inflation is— it means that We should be uncertain about the net effect. That's partly a timeline issue is if you say, well, what's the impact effect versus what is the effect, you know, one year down the road, it's going to differ. So some of the issues I think is, of course, I think it'd be excessively narrow to build a scenario where that is the question. You say, what happens if there's, uh, US, uh, tariffs on the European Union? Because of course, uh, we, we trade with the world. Uh, in, in the slide deck behind this talk, I have a set of slides about trade, and it's very important to recognize in our import mix, uh, China and the rest of Asia are far more important than the US in our trade mix on the import side. So when, when we would have to think through a scenario, you have to think through about, okay, what's the global context here?

[00:30:15.24]

Is it essentially many bilateral tariff policies, many and possibly differentiated forms of retaliation. So this is why, of course, the reason why that matters is some of the big factors in any monetary policy assessment is going to be what happens to global commodity prices. So whether global commodities are part of what's being tariffed or export restricted, depending on the point of view, uh, the scale of the disruption to economic activity and therefore to the demand for global commodities, I think is an important margin. Uh, it's— I think a very big issue is what's happening to US inflation. And what's happening to US inflation, of course, is not just the trade policy but every other policy that's been implemented. On net, is it the case that there's going to be more inflation pressure in the US? which, you know, in any model is going to mean you pick a different rate path for the Fed. I think a different rate path for the Fed, uh, I think in terms of the different exchange rate scenarios. So, so some of that is basically, okay, tell me what exactly you're talking about. Then maybe what's interesting for the international economists here is also how the firms are reacting.

[00:31:42.11]

Essentially, it's a pass-through question. How the firms are— are they essentially deciding that any cost increase, at least initially, will they absorb that in lower profits to wait and see, see what happens? Or if you believe that there's a permanent tariff increase, do you have a more rapid pass-through than normal? So, uh, you know, I've covered a, a small amount of dimensions there. But maybe again, it might not be the most interesting headline, but what brings you back to is, you know, compared to having the kind of a calm multilateral trading equilibrium, having— introducing trade frictions is going to be bad for output under most scenarios. The effect on inflation, near-term, medium-term, long term will depend on the bilateral policy, the global implications, and then also— and this is maybe, I think, coming to some of what I said earlier on— is the impact on, if you like, investor confidence and consumer confidence in Europe.

Because this is— if you kind of create a lot of uncertainty about the basic assumptions about how the economy works. If you get a kind of hit to domestic demand, that clearly is something that would matter quite a bit for monetary policy.

[00:33:14.27] - David Wilcox

I should say, by the way, I will take the privilege of the moderator to ask a few questions, but in about 5 or 6 minutes, I'll open the floor, so please formulate your own questions for Philip. You spoke a little bit about the inflation outlook in Europe. There's an interesting divergence. I— my sense is there's an interesting divergence among inflation analysts regarding the situation in Europe compared to the situation in the United States. At the moment in the U.S., the emphasis seems to be on getting the job done, getting back to— getting inflation lingering above 2% for longer than desired. And I've been struck that there seems to be a bit of an undercurrent of thinking with regard to Europe that maybe there is more of a risk of undershooting the 2% objective. I'd be curious to hear your thoughts about how serious you see that risk and how aggressively, in your view, the ECB should respond if that were to emerge as more of a reality.

[00:34:35.17] - Philip R. Lane

So of course, you know, you've articulated the difference in one way. Another way to articulate the difference difference, which is not strictly about inflation, is a very much stronger growth rate in the American economy, uh, whereas Europe— and it's not just Europe, I mean many countries have quite moderate recovery from the pandemic. So of course, uh, the, the kind of— if we had the growth rate of America, then I'm sure the conversation would be more American in its nature. So what I gave you in talking was basically a baseline where we do actually have a, a reasonable recovery this year and next. But I've also flagged the downside risk to that baseline. So one issue is basically the amount of momentum in the economy. And what you've seen in some parts of Europe now, on top of that, is if you see, if you like, structural challenges for example, to the car industry. You've seen some very now, uh, moderate wage deals in some— by some unions who are shifting focus from compensating for inflation to basically preserving jobs. And that kind of dynamic, uh, if you like, uh, was there before the pandemic, and, and it led to, to, if you like, uh, a situation where you can create an equilibrium where wages are quite moderate, not too much pressure on firms to raise prices, demand quite limited, and therefore not a hot economy to raise prices.

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So I think it is important to recognize that that is— it's not our baseline. Our baseline— and by the way, it's not just our us. And so the market view is there's an opportunity here now indeed to

achieve 2% inflation on a sustainable basis. But that's contingent on making sure the monetary policy delivers that. So this is basically why I said we want the middle path. There is still some upside risk. It's not a zero upside risk. But with that downside risk, risk also. Essentially, this is why, if you like, the middle path, I think, is the appropriate framing for your area's policy. Whereas over here, I'm not hearing too much discussion right now of inflation collapsing below the target. Whereas, you know, I think it's a— again, it's not just us. If you read the Riksbank monetary policy reports, there's a similar concern.

[00:37:26.21] - David Wilcox

Let's stay with this general topic for just one more moment. Some voices, as I hear them, seem to be arguing for— if a downside move in inflation does emerge, some voices seem to be arguing for— I think the expression is keeping your powder dry. On the theory that inflation running a little below target isn't all that damaging to households or businesses or economic performance. Others take a view that I associate with my former Federal Reserve Board colleagues, Reif Schneider and Williams, that you should be especially aggressive in that moment in order to pack in as much monetary accommodation before you hit the zero lower bound. Where do you fall on that debate between keeping your powder dry and Raiff Schneider-Williams' aggressiveness?

[00:38:30.03] - Philip R. Lane

So let me differentiate. So my first point is both to the upside and to the downside. It is we take a medium-term perspective. And, uh, you can always have in any given interval, uh, most obviously from energy, like a really big either surge or really big drop in energy prices. So if basically you see something where, okay, uh, given that, uh, you're gonna see headline inflation fall below 2% for, for a bit or rise above 2% for a bit. If that is assessed as essentially something that's not really going to change the medium-term trend, then I would tend to say, okay, it's below 2. We're not going to have a hair trigger because of some non-sustainable— and this is why it's an important phrase we have in the statement. We want on a sustainable basis inflation to be at 2. If it moves away from 2 for kind of non-sustainable or whatever, or the phrase you want to use for—

[00:39:36.21] - David Wilcox

You're avoiding the word transitory.

[00:39:38.20] - Philip R. Lane

So the— of course, I think we have a symmetric 2% target. The medium-term focus means we're not going to sweat it, you know, a small deviation if it's not seen as threatening the medium-term sustainable trend. But let me just go back to our strategy statement from '21. Which is basically where we say we will be forceful in responding to threats to that target. I think that's two-sided, by the way. I don't disagree how he wrote the 21 strategy statements focused on downside risk, but look at what we did and every other central bank did. Once there's a threat, a material threat to the 2% anchor, you do need to be forceful for different reasons. From above and from below. But for the reasons you say, waiting until you hit the lower bound would be costly. And this is why the speech today, I did say an abundance of monetary caution would, would be a problem. So again, that's our strategy. We have symmetric target, it's 2% point. That's very important because, I mean, of course We don't want— I think it'd be very confusing for anyone if we said we have some kind of range, because when people see a range, they're going to try and say, okay, is it the upper edge, the lower edge of the range?

[00:41:06.07]

Is there a real trigger point? And having two but medium term gives you that flexibility to look through the temporary factors and still be crystal clear And this is why it's helpful, by the way. Now, I mean, inflation is 2.5%. Uh, we are clear 2.5% is not acceptable. I think that really helps price setters, weight setters, the financial markets to know, have the clarity that the target is 2.0%. Everyone understands you're not going to hit it continuously, but I think it's very important to have that point estimate. And we did say in, uh, that we're not going to revisit that. So we are doing a reassessment this year of the strategy. That's not in it. 2.0 is the target.

[00:41:54.29] - David Wilcox

Why don't we open it at this point to questions from the floor? There's a mic stand. And Jessica, I believe, will you have a strolling mic? Joe, would you— oh, two ground rules, please. Identify yourself, including your name and affiliation. And please actually state a question, not a sermon.

[00:42:21.11] - Audience

Thank you, David. Joe Gagnon, Peterson Institute. Philip, so I just have a genuine question that I haven't been following the euro area closely, but before the pandemic, there were these divergences within the euro area. Italy and Spain had had years of higher inflation and they were sort of uncompetitive, and so then they were going into the pandemic, they had lower than average inflation, they were kind of depressed, and then Germany had higher than average inflation and it was booming. And then in the pandemic, I noticed that different countries had

very different inflation experiences. The Baltics had super high inflation. Where do those divergences stand now?

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How—

[00:43:05.29]

are there notable divergences of competitiveness and, and weakness or strength in demand, and where, where do they lie? I imagine it might be totally different than it was before the pandemic. I'm just curious.

[00:43:25.02] - Philip R. Lane

So I think it's always important to take this dual perspective onto your area. Just like the US has many regions, and you can think about the, uh, the Californian economy versus the DC economy, Uh, uh, we have that even more so. But maybe I should say, by the way, uh, and we essentially do our analysis both ways. We treat it as a single macroeconomy. We look at euro area numbers, and you can run macro models just saying, okay, the euro area is an aggregate economy. That works well, but it's also important to think about, okay, on a country-by-country basis. What's happening. And because we have all the national central banks in the euro system, we also do that kind of aggregation country by country. So this was a classic topic always about, you know, are the real exchange rate movements within the euro area stabilizing or destabilizing? Essentially what I would say is that what happened, the pandemic, did not really connect to any outstanding imbalances. What happened in the pandemic is, uh, how is your energy produced? Uh, because of course France with a lot of nuclear energy had a very different experience. How is your energy priced to consumers?

[00:44:49.02]

In some countries it's long-term contracts, so the utilities, uh, took a lot of volatility. In other countries, the consumer price is very close to the wholesale price. Then also with the war, there was a differential. It's unusual in the sense of— I mean, there were differentials, but let's say they were tiny compared to what happened. You had this shock which had this differentiated impact. Then there are second-round effects. Regardless of why inflation was higher in the Baltics, of course, the workers there have had pretty big nominal wage increases. Catch up, but that does leave a legacy in terms of the cumulative wage differentials that have built up. So there are a number of regions which do now have a real exchange rate challenge. And then, as you indicated, we have seen this interesting development, which is the— if you like, a lot of the

global factors are hitting Germany harder than they're hitting Spain in particular. And so we are seeing some reallocation within the euro area, which is, you might imagine, makes sense in line with the macro fundamentals. So I'd encourage anyone who's got a spare energy in their research activity is, you know, understanding This ongoing, uh, differentiation across the national economies is, uh, interesting.

[00:46:25.08]

It's a challenge. But what I would say, if you like, it's important to keep in mind the area that we have this divergence. So right now Spain is growing very strongly, employment's growing very strongly, and that's a counterbalance to the weaker performance in Germany in particular. So if you just extrapolate from Germany to the whole euro area, you're going to be, I think, misled to some extent.

[00:46:55.18] - David Wilcox

Yes, sir. Uh,

[00:46:58.29] - Audience

I— Stan Walker, American Enterprise Institute.

[00:47:01.29]

Um, earlier you presented a, a 9-factor test to determine how restrictive policy is.

[00:47:07.16]

Could you give us the result of the test?

[00:47:12.17] - Philip R. Lane

Well, let me try to, uh, boil it down a little bit, which is you can do different thought experiments. One thought experiment is last week, so going into the meeting, the policy rate was at 300. One thought experiment would be if we left it at 300 forever, do we think inflation would converge to 2%. So one definition of calling 300 too restrictive was basically that, that you do need to move down from that level. But let's imagine you said, well, if I left that subnumber forever, you still have to take into account the lags. And maybe again, for the audience here, what's very important lurking in the background of the European financial system is a really big steady-state recess. Before the inflation took off, there's a very high conviction that low for long would remain

forever, or as good as forever. So even in December '21, when inflation had already picked up, the market curve suggested the market did not believe the policy rate would go positive, go above zero nominal through 2027. The long-term— so if you think about the valuation of assets, how the housing market works, What we have now is there's not much weight on that.

[00:49:01.02]

There's a lot of weight saying after we have kind of normalized, the policy rate will settle down somewhere plus or minus something around 2. And that— so in other words, it's a 250 basis points increase in the kind of a normal, so-called normal interest rate compared to before the pandemic. That's a big steady-state dynamic. And then you have to overlay that with the cyclical issue, okay? In order to get inflation down from 2.5 to 2, what do we still need to do? So, I mean, there's a debate here. I think the debate here is simpler. We have the debate adding in that kind of steady-state long-term adjustment, which is pretty big. It's in the neighborhood of 250 basis points compared to what people believed before the inflation took off. And that's a really interesting kind of topic. I mean, we were clearly trying to accommodate before the pandemic. That was not a steady state interest rate, but people felt maybe like Japan for a long time. It's basically an indefinite state, an indefinite state of inflation being too low and having to have very low nominal rates. So another way of saying that is if you look at the charts which are on the website, the average interest rate out there now is not coming down because those old loans have been repriced higher.

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The marginal loans, if you come out fresh and want to take a new loan, yes, that's coming down, but we have to think about the full, uh, uh, universe of credit, and this is why I really try hard not to boil it down to a single number. The staff, in their forecasting exercise, we've many different models feeding into the forecast, and maybe what's important is compared to before the financial crisis, there's a lot of weight on, if you like, these different financial factors feeding into the forecast. And this is why it's not so easy, uh, to kind of replicate it from the outside, because you might be tempted to use a super simple equation model. But it's very important that this financial factor is taken into account.

[00:51:28.27] - David Wilcox

Integrity and standing by our word is an important, uh, value here at the Peterson Institute. We've— we advertised a conclusion at 9:40. 45, we've reached that moment. So with that, thank you very much.

[00:51:41.22] - Philip R. Lane

Thank you, David.

[00:51:42.16] - David Wilcox

It's a real privilege to have you join us this morning, and we hope for your success and that of your colleague policymakers.