The Economic Environment Faced by the ECB's Monetary Policy

ECB Watchers Conference

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The Big Picture

Where are we coming from?

Where are we now?

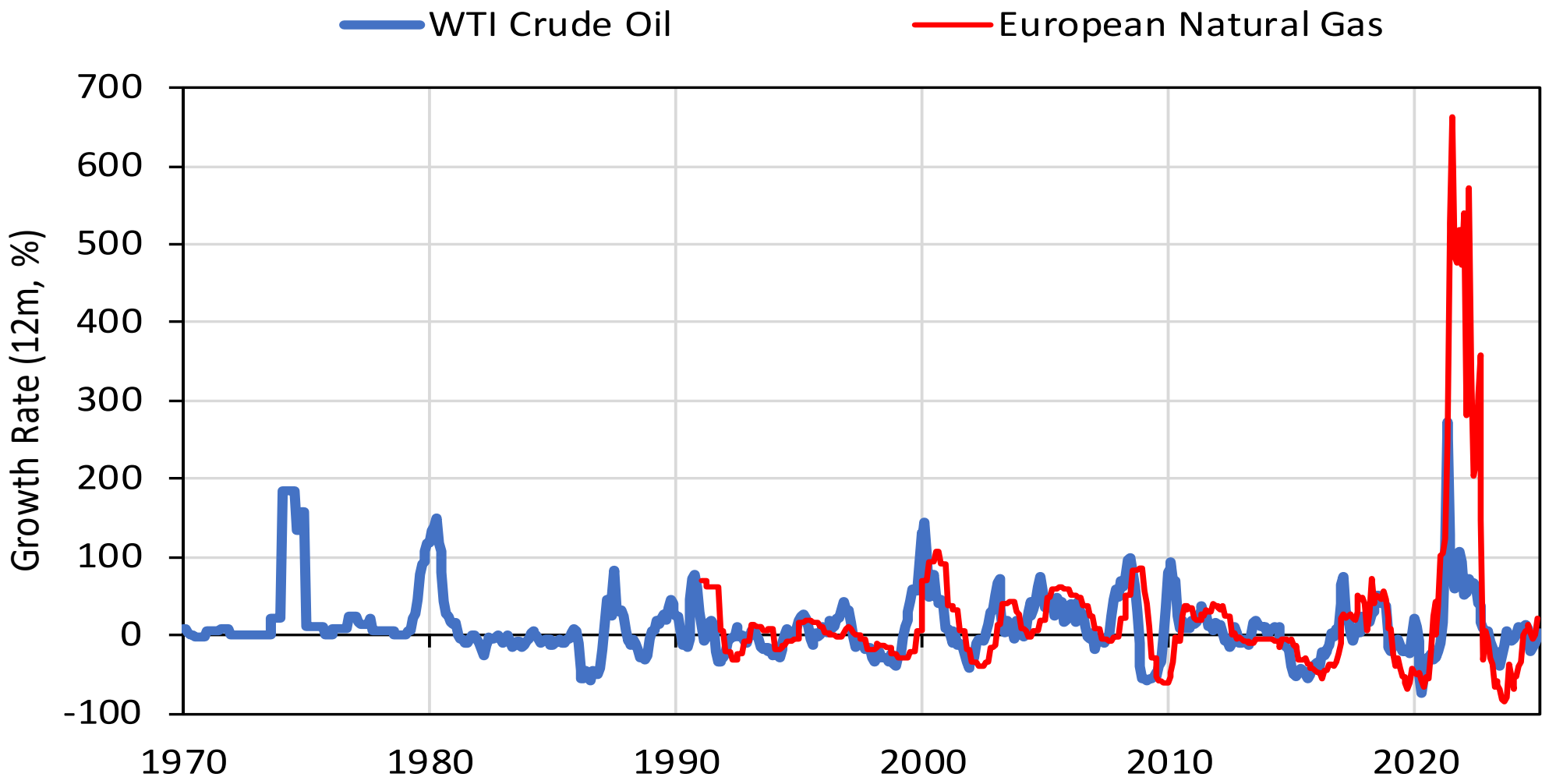
Where might we be heading to?

1. Where are we coming from?

Pandemic

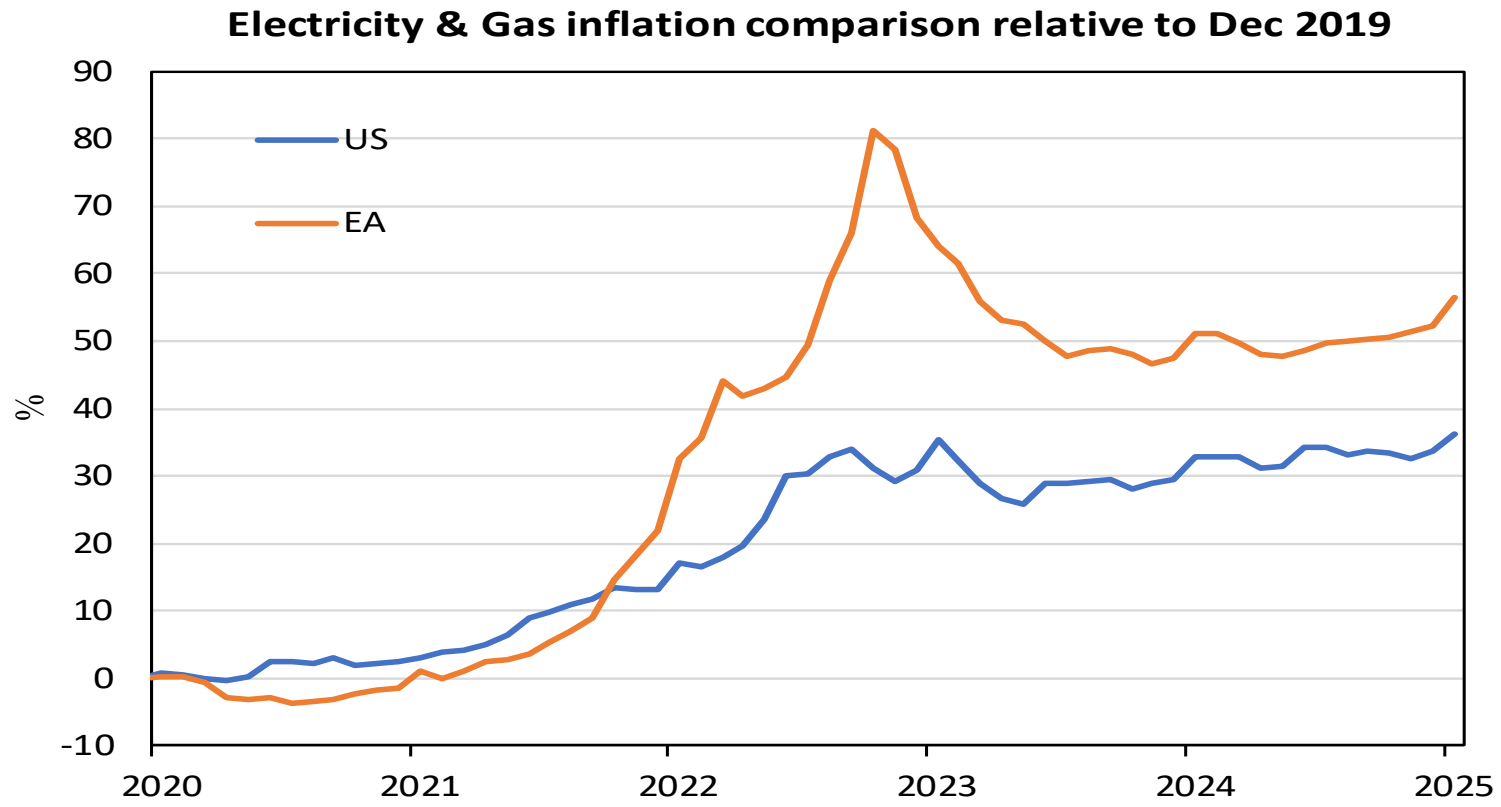
Invasion of Ukraine

Global Energy Prices: Oil and Gas



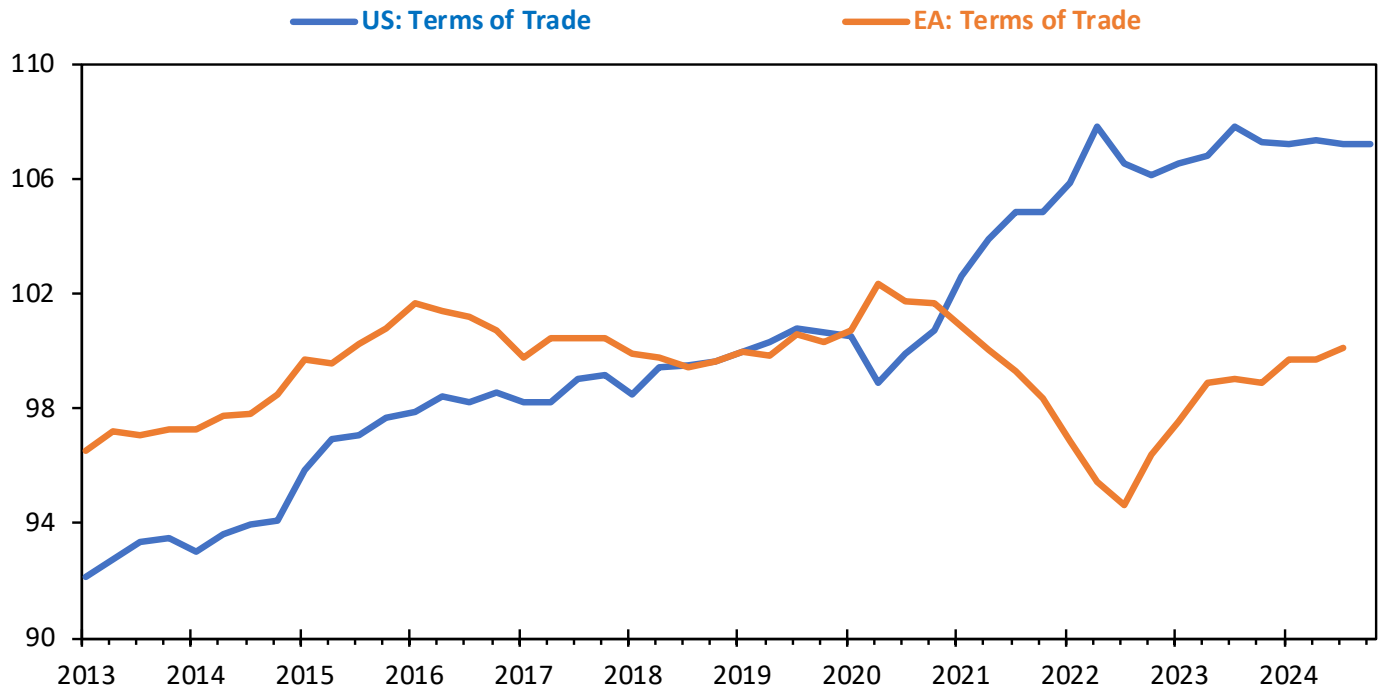
Source: Federal Reserve Bank of St. Louis/US EIA, Federal Reserve Bank of St. Louis/IMF

Retail energy prices: EA and US



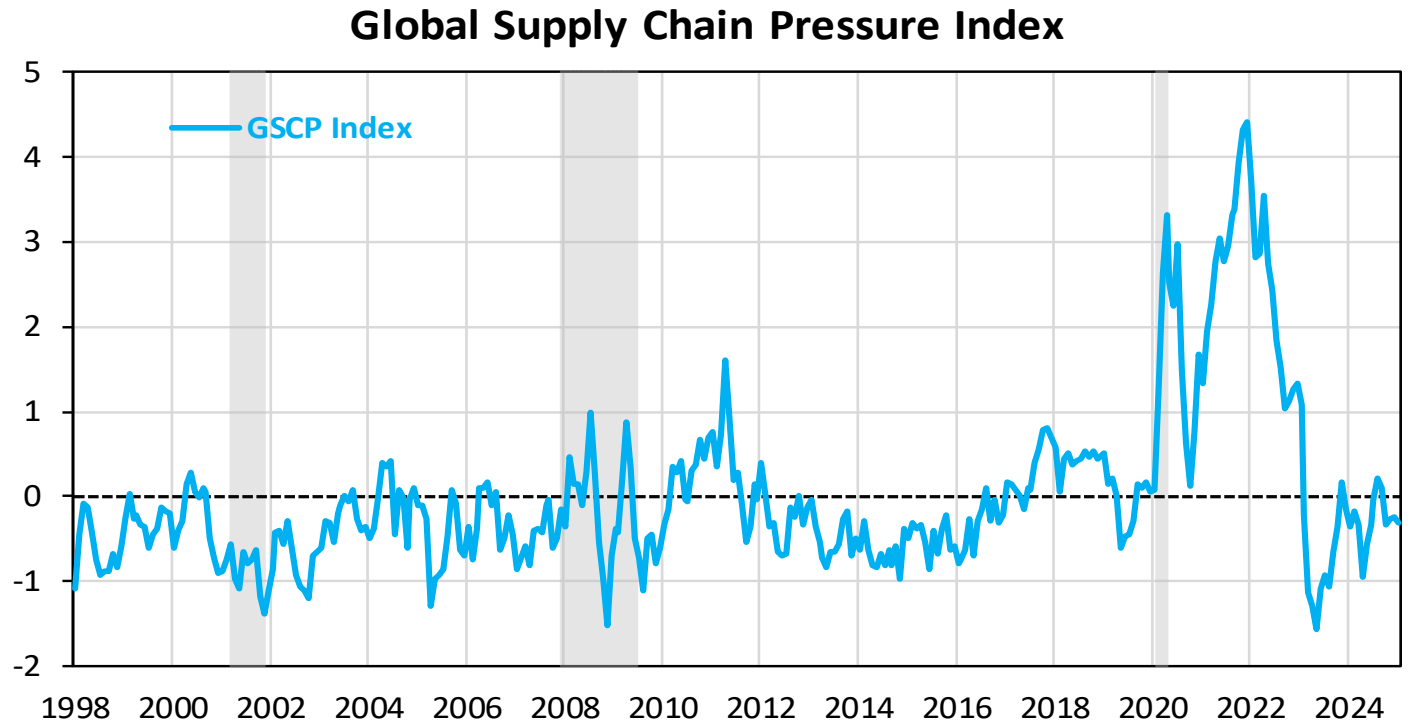
Source: US – BLS, EA – Eurostat

Negative Terms of Trade Shock for the EA
Positive Terms of Trade Shock for the US



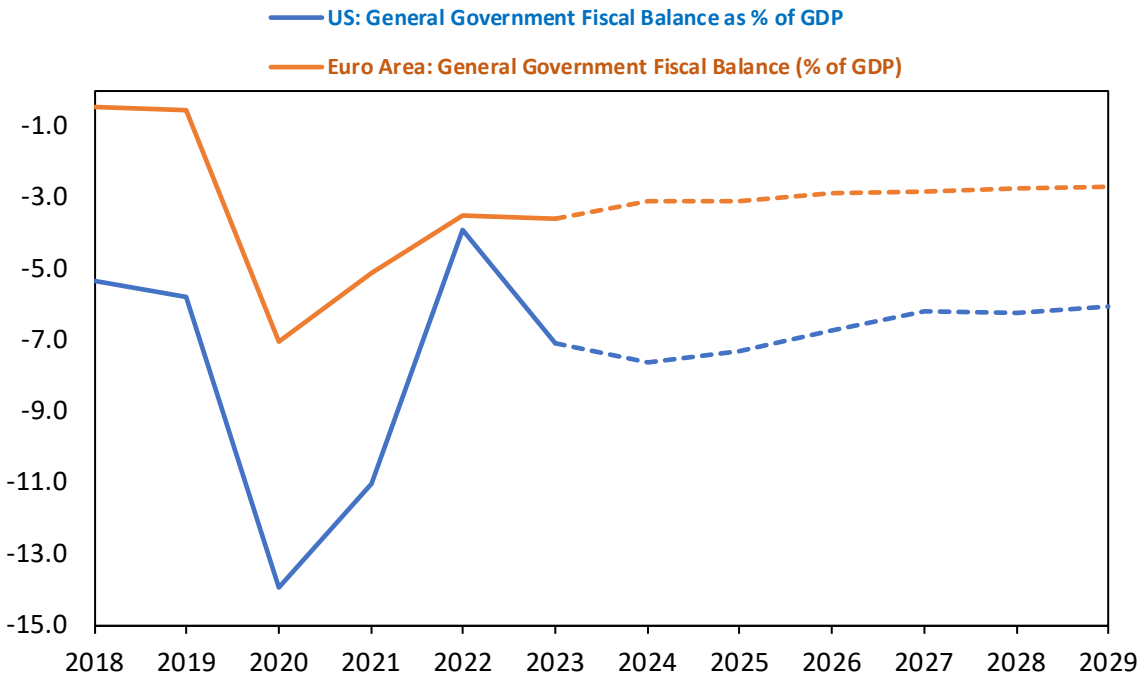
Source: BEA, LSEG Workspace/Datastream

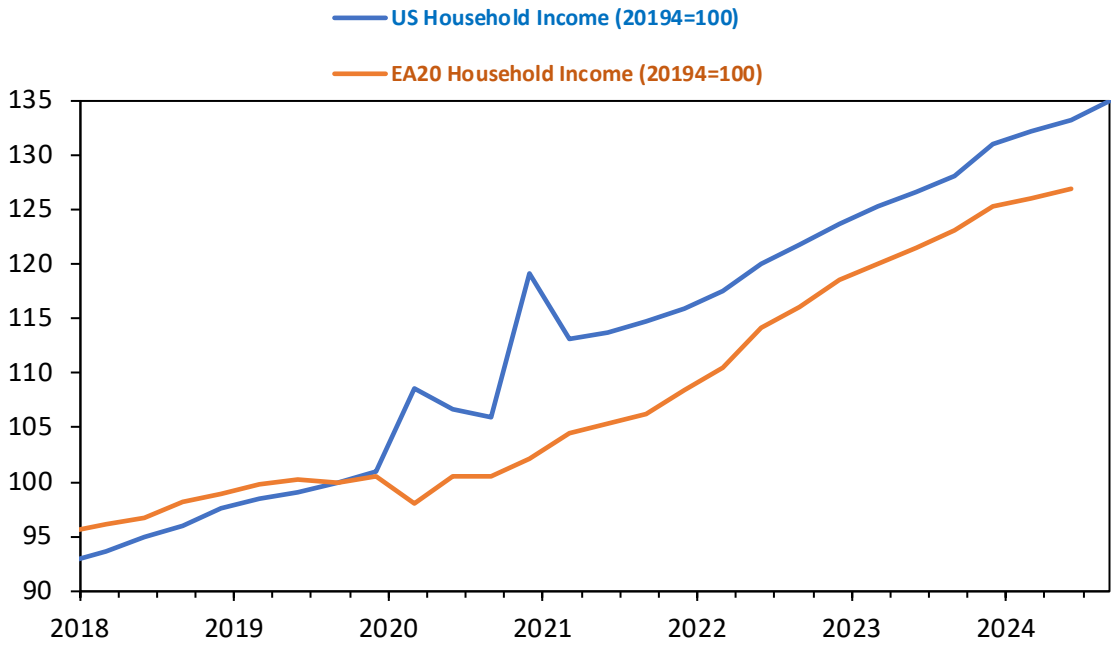
Pandemic: also a global shock but…



Source: Federal Reserve Bank of New York

Different fiscal stimulus in EA and US





Source: US – LSEG Workspace/BEA, FRED; EA – LSEG Workspace/IMF, ECB

Challenges for central banks

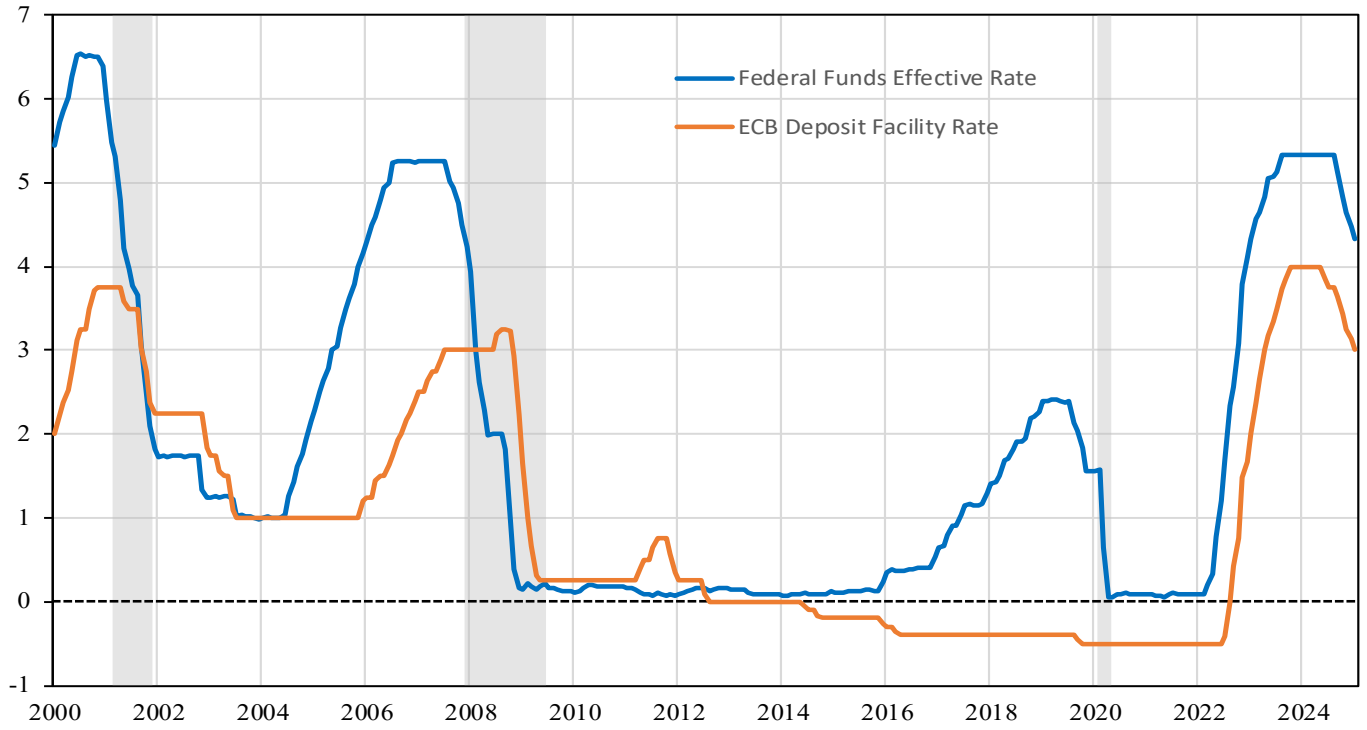
EA and US faced effectively different shocks and fiscal responses

EA: large negative terms of trade shock, less demand stimulus

Trade off was much more difficult for ECB

Monetary policy is an aggregate demand tool

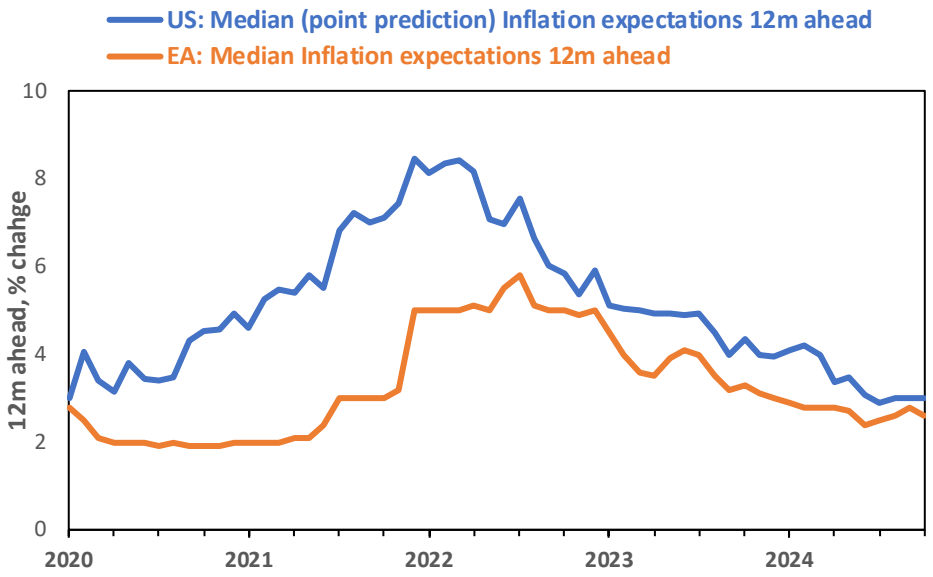
Policy rates responses: ECB, Fed



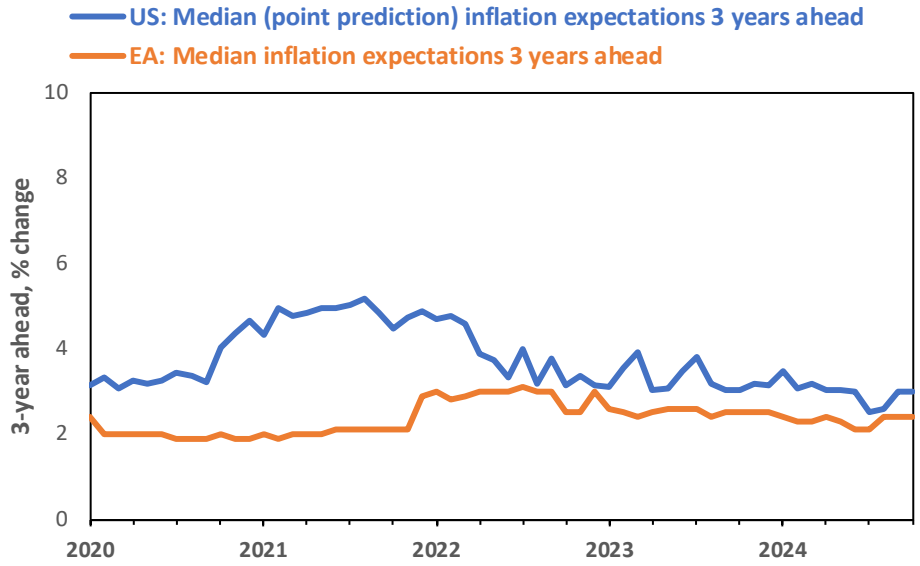
Source: Federal Reserve Bank of St.Louis, Bank of England

Inflation expectations: short and medium term in EA and US

Short term: 12m

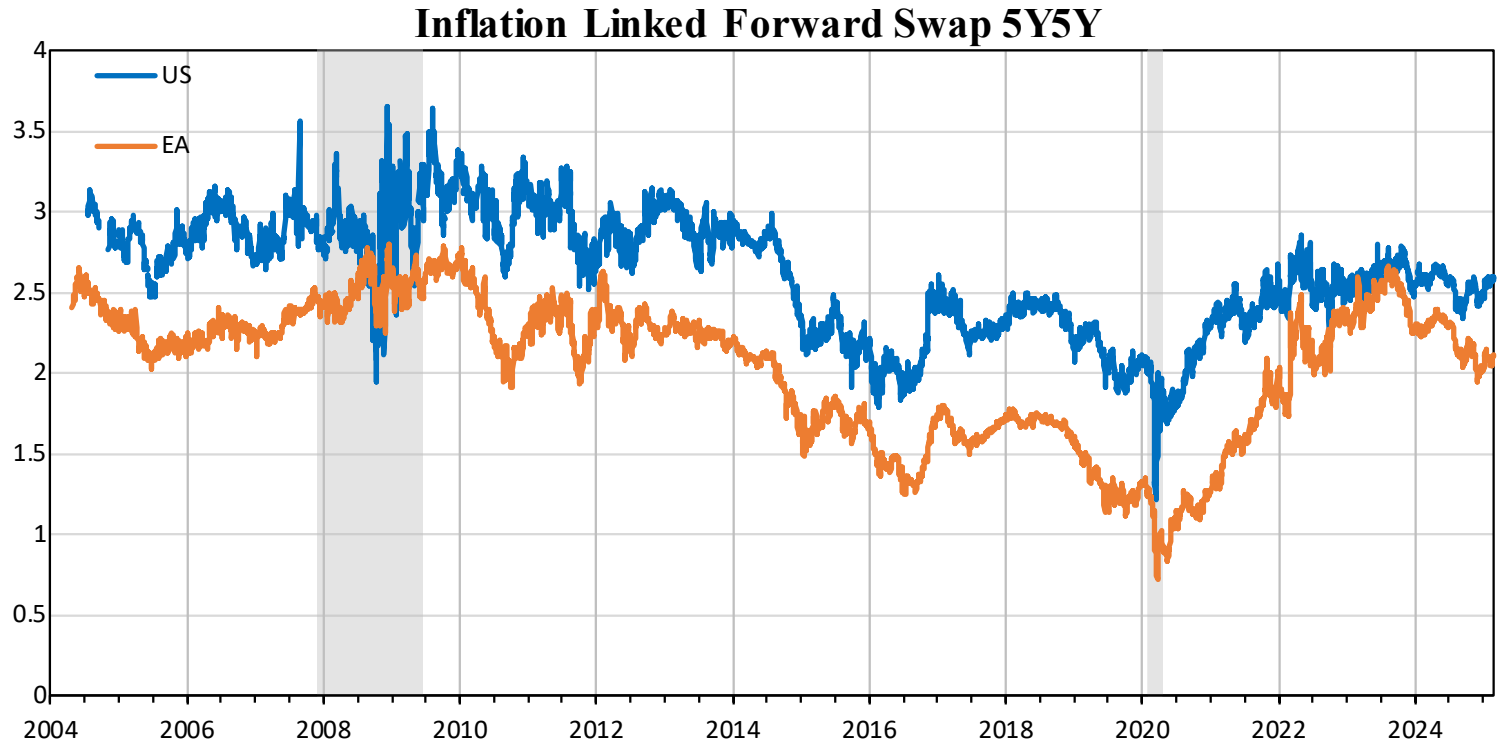


Medium term: 3 years



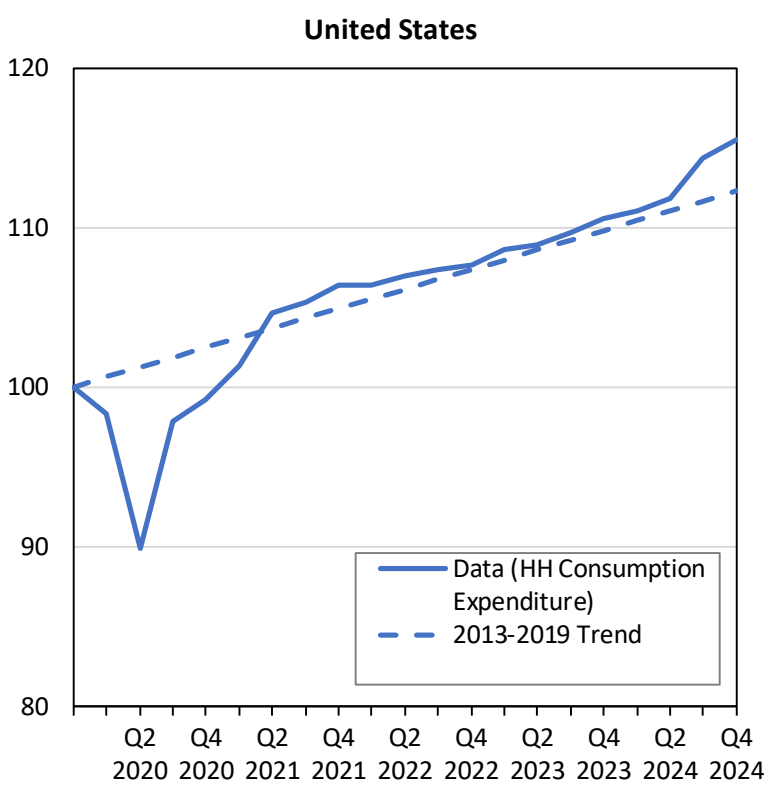
Source: US – New York Fed, Survey of Consumer Inflation Expectations; EA - ECB Consumer Expectations Survey

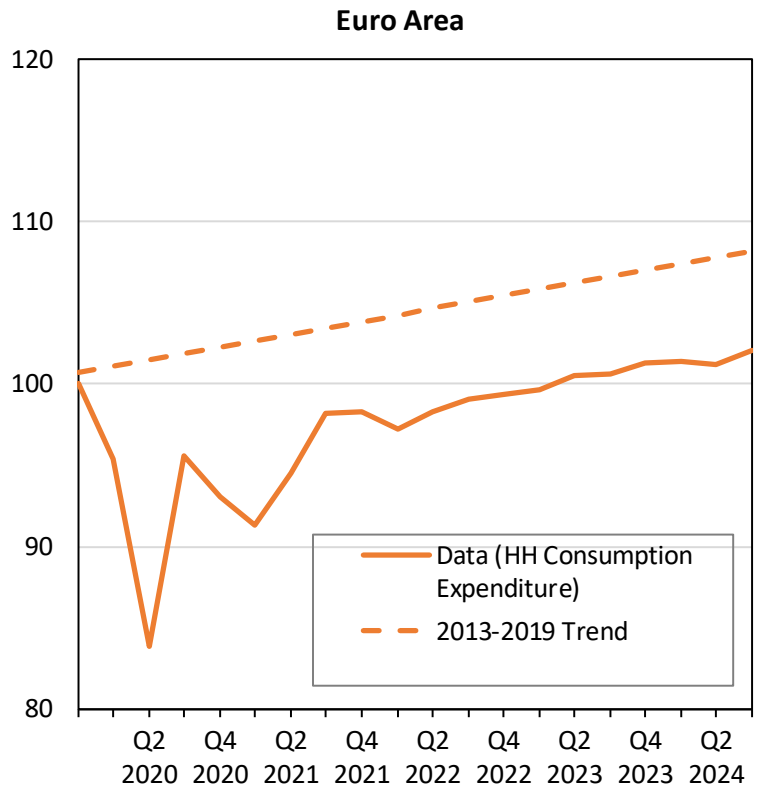
Longer term financial market-based measures of inflation expectations EA and US



Source: Bloomberg

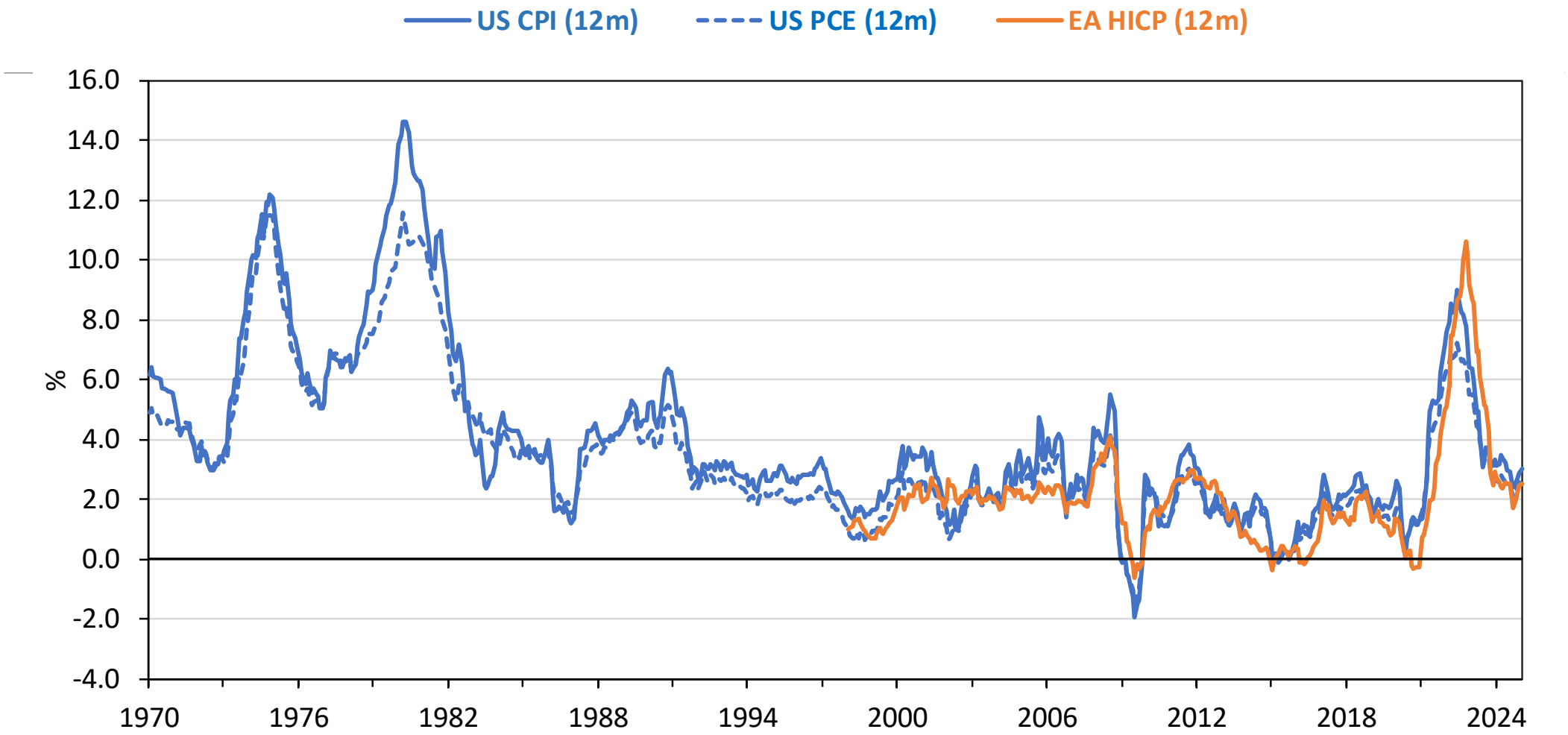
US: consumption 11% above pre-Covid level. EA: just above pre-Covid level





Source: US – LSEG Workspace/ BEA; EA – LSEG Workspace/Eurostat

EA and US Inflation – differences from 1970s



Source: US – FRED/BLS, FRED/BEA; EA – Eurostat.

A test of the monetary policy framework

Input: 1970's shocks plus a pandemic with a post 1990's policy framework

Outcome: Inflation back to target within reasonable period (given lags), anchored inflation expectations

Takeaway: flexible inflation targeting framework fared well

2. Where are we now?

Unwind of supply shocks

Restrictive monetary policy

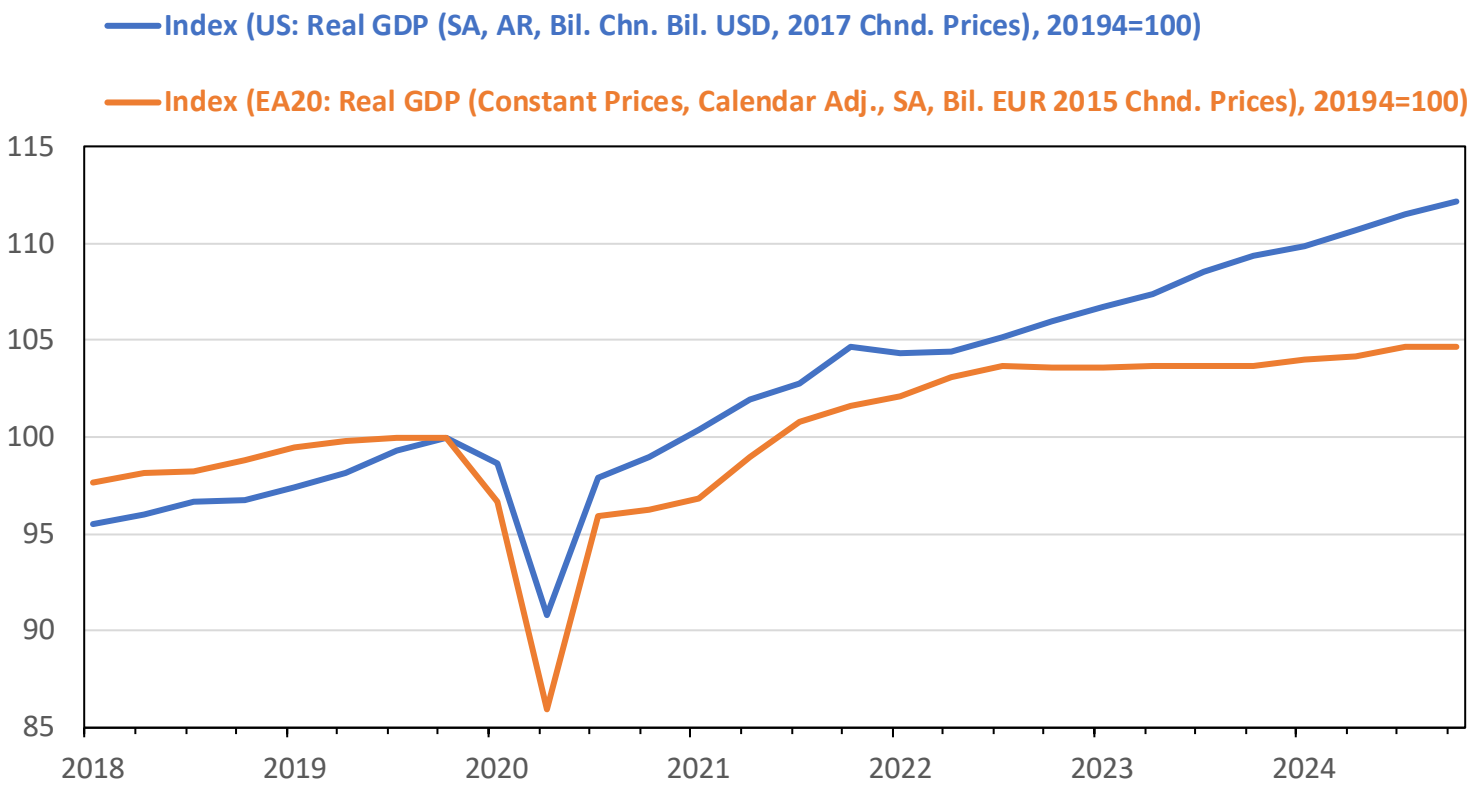
Two forces at play, supply and demand

Unwind of (-) supply shocks → Lower inflation, Stronger activity

Restrictive monetary policy → Lower inflation, Weaker activity

Combined impact → Lower inflation, Stagnation?

Real Gross Domestic Product EA and US



Source: US – LSEG Datastream/BEA; EA – LSEG Datastream/Eurostat

3. Where might we be heading?

(-) Tariffs and trade wars

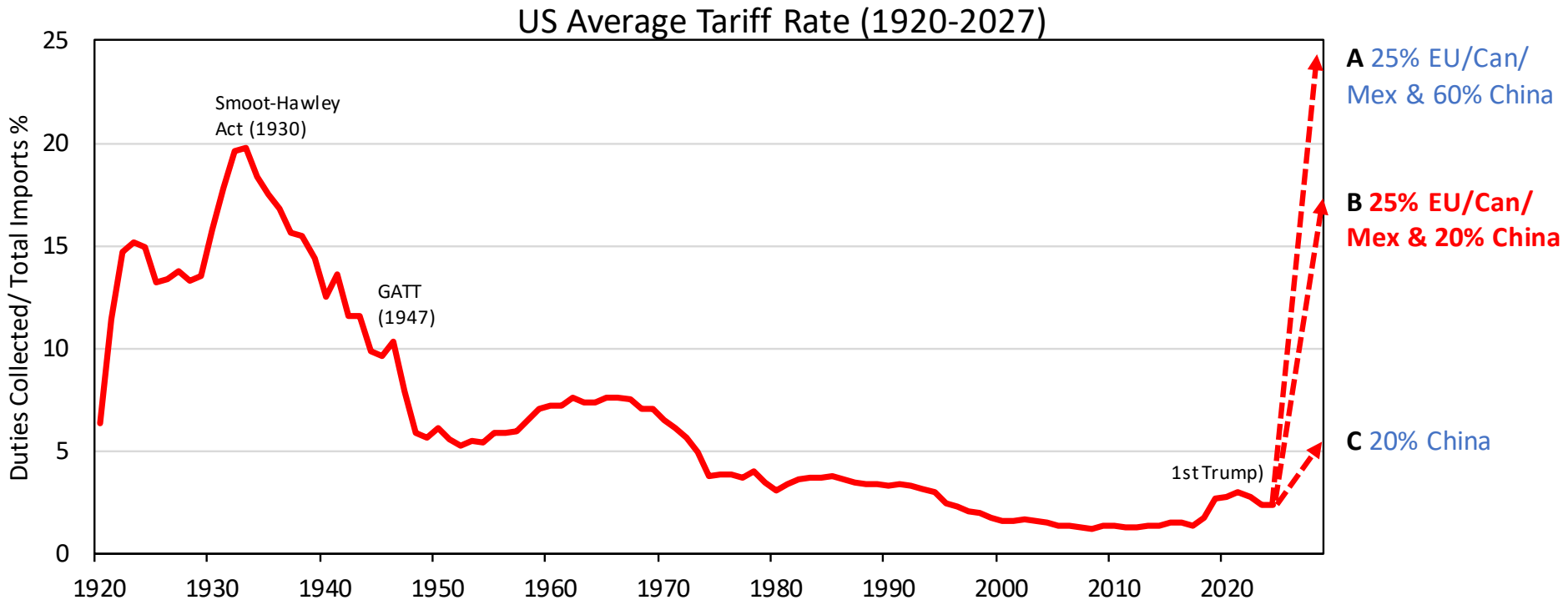
(-) Uncertainty

(+) Defence and infrastructure spending

(- +) Others: further geopolitical fragmentation, climate events, AI…

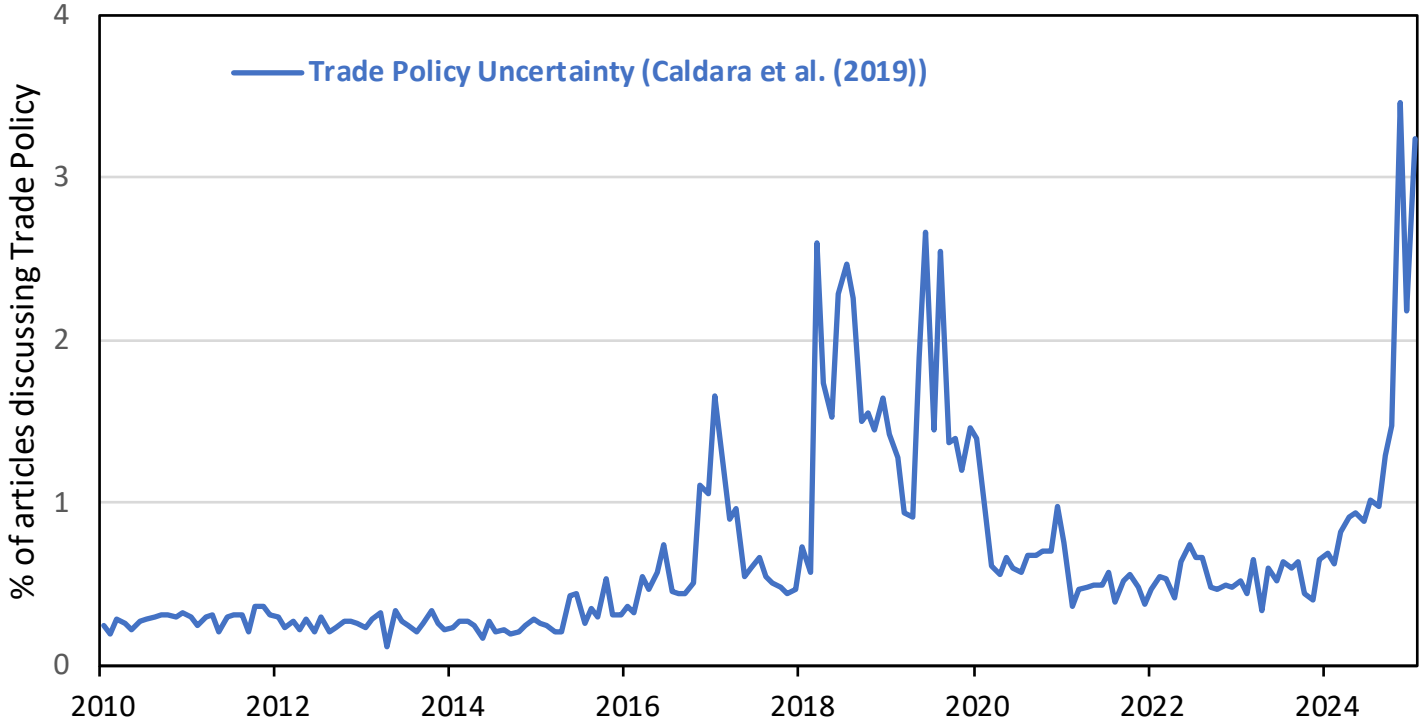
US Tariffs

Illustrative range of scenarios



Source: US Census Bureau, Historical Statistics of the United States: Colonial Times to 1970, Part II; US International Trade Commission, "U.S. imports for consumption, duties collected, and ratio of duties to values, 1891-2023, (Table 1)"; Tax Foundation calculations.

Trade Policy Uncertainty



Source: Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2019). The Economic Effects of Trade Policy Uncertainty. International Finance Discussion Papers 1256. https://doi.org/10.17016/IFDP.2019.1256

Impact of Tariffs

- Adverse impact on global growth
- Limited (?) price increases in US
- Ambiguous price effects elsewhere

Price effects

1. In the United States

   US Imports ≈ 10% of GDP; ≈ 6% from EU+Mex+Can+China. **Scenario B**: a 25pp increase in tariffs on all four implies a 1.5pp increase in inflation – direct one-off price impact

   - **(-)** Passthrough to retail prices may be reduced by: USD appreciation; exceptions; exporters cutting prices; importers cutting margins; trade diversion (imports from non-tariff countries)
   - **(+)** Impact on inflation may be increased by 2nd round effects

2. In countries on which tariffs are imposed (e.g., Canada, China, EU members, Mexico)

   - Lower (export/exportable) prices. With retaliation, imported good prices should increase

3. In third countries

   - Lower import prices of tariff-affected products (evidence on from Cavallo, Tenreyro, and Teti, forth.)

How should central banks think of tariff effects?

All else equal…

For third countries

- No tradeoff. Lower activity and lower price pressures

For US (or countries imposing retaliatory tariffs)

- Tradeoff. Lower activity and higher price pressures
  - ➢If price effects small: “see through”
  - ➢If price effects more substantial and risk of second round effects/tight labour markets: some tightening relative to no-tariff scenario

For all countries

- Increased uncertainty

3. Where we might be heading? (continued)

assuming no escalation of the war!

Increased defence and infrastructure spending: boost to demand in next ten years

Other factors to weigh:

1. Lower energy prices with the resolution of the war

2. Further fragmentation and climate change events: adverse productivity effects

- impact on both supply and demand (GE); ambiguous impact on inflationary pressures: anticipation could reduce demand more than supply (Ambrosino et al 2025)

3. AI: positive effects on productivity (of few?)
- uncertainty on its impact; open questions on ownership and distribution of income, etc.

Four Takeaways

1. The EA and the US faced different TOT shocks and fiscal impulses

2. The monetary policy framework worked well, returning inflation to target in reasonable time

3. Restrictive monetary policy is an imperfect tool against supply/cost-push shocks. All else equal, restrictiveness should be removed as the shock unwinds

4. All else is not equal (defence and infrastructure spending; tariffs and trade fragmentation; uncertainty, AI; war resolution and escalation risks; energy prices…)