BANQUE DE FRANCE
EUROSYSTÈME

Financial Times : « Monetary agility is the new name of the game »

Governor, You have hinted about a possible move towards greater monetary accommodation over the next six months. What do you actually have in mind? And under which scenarios do you think that could become necessary?

The key question is not yet what we will do. We cannot answer this question now for July, September or the following meetings. More than ever, since the latest military developments in Iran, we live in very uncertain times and it is a time for pragmatism. So, [any decision will be] data driven, meeting by meeting and this is not only the official mantra. For me, the core message is not what we will do, but how we think, and this is the question of agility. Everybody agrees on agility in principle. No one advocates rigidity. But I acknowledge this raises questions and the main question is — to use a French word, lisibilité — readability.

People must understand how we react. What we need now is to give more lights on our reaction function. Monetary policy doesn't have to choose only between committing forward guidance, which belonged to another period, and being blind and making only ad hoc decisions.

Has this changed over the past year? In many ways it was always the ECB rhetoric to say no pre-commitment, data-driven and data-dependent?

We are as Christine Lagarde said in a good position, and a somewhat new one.

If I look back, we had till Covid a period of too low inflation and the priority was very clear, including non-conventional policies. Then, we had a period of this unexpected inflation surge. We had to tighten monetary policy and we were efficient. To quote some Banque de France research, had we been in previous episodes where central banks' credibility was less clear, and inflation expectations were less anchored, we would have had to raise interest rates to 8 per cent instead of 4 per cent [to control inflation]. And then we have had a third stage where we could ease with eight rate cuts.

Now we are back to normal with a two and two story: 2 per cent interest rates, which happen to be the middle estimate of our neutral interest rate range, and 2 per cent inflation.

This is back to normal, but a neutral rate and a terminal rate are by nature different animals. They can be the same but they are not identical. This is where thinking a bit more about agility is the new name of the game.

I think we can be at once “readable” and agile.

If you compare the level of our policy rate with the BoE and the Fed, the ECB is at present significantly lower, including in real terms. Those who criticise the ECB for being too restrictive should look at this interesting sign of efficiency.

Milton Friedman made an argument about the fool in the shower, who added hot water when it was too cold, but the hot was already on its way and then he had to add cold later and was always late. Is this relevant to the ECB?

That is a long-standing question. But let us look at our reaction function, it has had three clear elements since early 2023: the inflation outlook, underlying inflation and transmission. The two last elements were very important in the tightening phase that we had, but as we are now back to normal, I think the first element has become more important. We have more trust in our forecast: obviously forecasts remain uncertain, but scenarios can help. This is for me an important yardstick.

Another key challenge in that context is this: How do we combine being agile with being “forceful and persistent”? We said we would be forceful and persistent in our 2021 monetary policy review, and we’ll probably repeat it this year.

If you commit to forward guidance with a fixed calendar, you are persistent but you cannot be agile. At present, such forward guidance is not relevant. Does it mean you have nothing to say? No. It’s more about signalling and if we give signals, they should be clearly state dependent and they should be ready to adapt symmetrically.

We also need to be ready to act not stronger, but sometimes faster. Let us be cautious about the temptation of wanting always to have more data and waiting: some over interpretation of the so called, “Brainard principle”. This could be a danger as we may risk falling into the “pitfall of cautiousness”. If the Central bank creates the impression that it waits for too long, it could lead to a de-anchoring of inflation expectations. So, we need to assess as fast as possible the data and be possibly ready, sometimes, to have shorter and swifter interest rate cycles.

What does it mean to act faster in practical terms? Does it mean more rate cuts earlier than markets anticipate?

Obviously, I will not give any indication about future meetings. Being pragmatic, data-driven, meeting by meeting, agile, does not mean that we give no lights about the way we think and how we will proceed. But what we will decide in due time will depend on the data.

Given that you say the reaction function is important, you will react fast and people need to have readability of your views, we have to get into hypothetical questions. What would make you want to reduce rates and what circumstances would make you want to raise them?

Let me stress the obvious: we'll closely monitor the oil price moves in the near future, linked to the conflict in the Middle East. The oil price per se is not nevertheless a sufficient guide for our reaction function. What we also need to look at is at least two other elements, the exchange rate and, at least as important, whether the rise in the oil price is temporary with limited spillovers or whether it has lasting effects. Here we should look at underlying inflation for the spillovers and inflation expectations for the lasting effects. If we were to see spillovers to underlying inflation and de-anchoring of inflation expectations, then we could possibly adapt monetary policy.

On the contrary, if we look at the present assessment of markets so far, inflation expectations remain moderate and we have seen a significant appreciation of the euro which compensates for the appreciation of the oil price. If that was confirmed, it could possibly lead in the next six months to a further accommodation. We will see how things evolve.

If we look at the latest ECB staff forecast, the estimate for inflation in 2026 is 1.6 per cent. Much of this is driven by energy prices prior to the latest escalation in the Middle East. But this is still a striking undershooting. How concerned are you that this undershooting could become more prevalent and permanent?

We will have to look at this. Seen by markets, the risk of undershooting is higher at present.
But there is a new major source of uncertainty, which is the oil price and the Middle East and this can go in both directions.

That said, we have one element which is different from the situation in the US regarding the unpredictability coming from protectionism. It will probably have an inflationary effect in the US (look at the last Fed dot plot). In the Euro area, it will have a negative effect on our growth, but it should not have an inflationary effect. Let me mention at least two reasons. If the EU applies tariffs in retaliation, which it has not done yet, they will be implemented only on US imports, while in the US they are implemented on all imports. And second, we have had a significant appreciation of the Euro by around 10 per cent since the start of the year.

One more point about the ECB staff forecast, part of the evolution of inflation has to do with commodity prices, but not all of it. There is a significant decrease in core inflation associated with much slower wage growth. And here is another element of confidence, which we have seen in France for years, but can now see elsewhere, including in Germany.

You have cited that markets imply a 40 per cent probability of inflation below 1.5 per cent in five years' time. Would you agree that this is a high probability of the ECB kind of facing too low inflation in five years' time? What's your interpretation of this 40 per cent probability?

We are not market driven. But my view so far is that, barring major exogenous shocks, if (I stress the if) there were a monetary move in the next six months, it could be rather in the direction of accommodation. But clearly, the latest military developments in the Middle East could induce a significant exogenous shock. Hence, no pre commitment to a policy path.

I still have to be annoying, I'm afraid. You said, "move", singular, or is it "moves"?

Are we here to discuss grammar? Seriously, my thoughts are to provide some principles and yardsticks to explain how we will analyse data, but anticipating now on data would be a professional mistake.

We're sort of getting closer now to where we think the European Union might end up with the Trump administration on tariffs. Let's say we end with the US administration keeping a 10 per cent universal tariff and not much more than that. So, the EU gets something similar to the UK deal. How does that affect your view of the Eurozone economy and how that might affect monetary policies?

I am not going to comment on the negotiations. The EU has to negotiate in a calm and united manner and so far it has. But that is only the "reactive" part of the agenda. We must negotiate with the other side of the Atlantic, but we can strengthen our side. Our economic trajectory will not only depend on the trade agreement, while I hope there will be one. If it failed, by the way our scenarios show that it would play in the direction of less inflation and growth for Europe.

We must add a positive agenda on growth and innovation, and this is about the implementation of the Draghi and Letta reports. Growth remains too weak in Europe. If what happens in the US has one virtue for Europe, it's to be a wake-up call. We have successfully built our monetary sovereignty 25 years ago: Reaching now our economic and financial sovereignty is at least as important as the trade negotiation. And here we are at risk of being too slow.

Can we talk about central bank independence? How dangerous is what is happening in the US at the moment?

Chair Powell with the FOMC shows admirably what an independent central banker should do: to tell the truth, and to ensure price and financial stability.

In many countries, there can be a political temptation to diminish independence and to attack it. But independence was not decided by central bankers and is not an aim in itself: it's a tool. There is a very strong correlation between independence, central bank credibility, anchoring of inflation expectations and the efficiency of monetary policy.

The ECB has arrived at 2 per cent inflation with moderate tightening (at 4 per cent rate at the highest) because there was a strong credibility of the ECB action. Importantly, in Europe, independence is in the treaty and is not under threat. It was something decided by democracy to have a more efficient monetary policy for the wellbeing of our citizens.

In the US, Powell's term will end next year, and President Trump may then appoint someone who's more in line with his views of monetary policy. What could that mean for the world economy and the ECB?

We will see.

But one aspect of the international scene is that the Eurozone now has much lower rates than the US. Does this have any economic effects right now rather than in the future? Do you think this is a sustainable position?

It shows one very important thing: the euro has brought monetary independence to the euro area. Remember this debate about decoupling in Spring 2024 — back then, there was this major question whether the two major central banks could actually decouple. We said that the answer was obviously yes — and it happened. And it did not create trouble on financial markets.

Take the counterfactual: In the 1980s and 1990s, when we did not have the euro and we had uncertainty or changes in US monetary policy, questions about US, it had immediate effects within Europe, the internal exchange rates and so on.

On long term interest rates, there have always been differences so we see them again, and there are various explanations for them, including growth expectations, fiscal policy etc. And If you look at the exchange rate, despite the fact that rates are lower in the Euro area, the exchange rate appreciated, which was a bit of a surprise. We take into account this disinflationary effect, quite a significant one. And It's probably a sign of increased confidence in Europe.

It could also reflect doubts about the US rather than more confidence in Europe.

I am a positive central banker, so allow me to focus on the positive side of the story.

As you pointed out, the ECB's independence is guaranteed in the treaty and would be very hard to change. But there might be de facto constraints like the high level of public debt that may limit the ECB's room to manoeuvre, with some people warning that Europe is flirting with a kind of mild form of fiscal dominance.

Let me be crystal clear about that. I see no risk of fiscal dominance. When we decided on QE, some people said: it was to help to fund governments. It was not. It was to fight the risk of too low inflation and — if you remember Covid — risk of deflation. And then, when the inflation surge happened, some people said, 'The ECB will not dare raise rates because it will be too difficult for governments to finance their debt'. But we increased rates without any hesitation and with great efficiency. I don't see any risk of fiscal dominance.

For each of the Euro area countries, the fiscal solution must come from fiscal policy. In France, it must reduce deficits to 3 per cent in 2029 in order to stabilise public debt to GDP; and to reach 3 per cent, the level of total expenditure should be stabilised in real terms. The fiscal path is clear, it's a matter for governments and political debate. It's not up to the ECB.