What's next for interest rates in Europe?

Spain's central bank chief, Pablo Hernández de Cos, clarifies the European Central Bank's new monetary policy strategy. He also explains why an interest rate hike is not expected in the short term, as three key conditions are not currently being met.

September 27, 2021

In July 2021, the European Central Bank (ECB) announced changes to its monetary policy strategy. Instead of aiming to keep inflation "below, but close to, 2%," the ECB said it would use 2% as its target, allowing "a transitory period in which inflation is moderately above target." The move gives the ECB more flexibility to deal with current economic conditions in the euro area.

Spain's central bank chief, Pablo Hernández de Cos, speaking with IESE professor Núria Mas

©IESE Business School

as part of IESE's Alumni Learning Program in September 2021, clarified the ECB's new strategy and the conditions that might lead to the ECB increasing rates.

Newer pressures

During the euro's first decade, economic shocks were mainly inflationary, so maintaining inflation rates that were "below, but close to, 2%" was feasible. However, the global financial crisis of 2008 ushered in a new phase characterized by *de*flationary shocks, with rates veering below target.

In this context, the ECB's old aim could be seen as asymmetric -- that is, policy responses were more forceful for upward target deviations than they were for downward ones. In the ECB's monetary policy strategy review, completed in July, the target was redefined to be "symmetric," allowing deviations above or below 2% for a time.

But when it comes to rate hikes that could put the brakes on economic recovery, there is no reason to be alarmed in the short term, according to Hernández de Cos, who sits on the ECB governing council. The conditions that would lead the ECB to adjust rates upward would include (1) inflation that exceeds 2% earlier than is currently expected, (2) inflation that is forecast to stay at that level over time, and (3) underlying inflation (that is, a measure of price pressures in the absence of economic shocks or other disturbances) that has also reached the 2% target.

Referring to a recent *Financial Times* article that reported that the ECB could raise rates as early as 2023, ahead of market expectations, Hernández de Cos insisted: "These three conditions that I have mentioned, under current conditions, don't allow us to anticipate that there will be an increase in 2023." In any case, he pointed out that the ECB's inflation objective is for the medium term, so fixating on fleeting signs of inflation is beside the point.

Hernández de Cos reiterated that the ECB remains fully committed to the Pandemic Emergency Purchase Program (PEPP), and that the recent decision to reduce the size of bond purchases does not mean that it is tapering: "This has absolutely nothing to do with the start of a process to progressively reduce the purchasing program," he said.

Regarding the ECB's action plan to include climate change considerations in its monetary policy strategy, he affirmed that this serves the ECB's objective of price stability, since the climate-related risks could well affect financial stability.

©IESE Business School

©IESE Business School