Europe’s Economic Outlook and Monetary Policy Space

WIIW-OeNB Global Economy Lecture

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The Big Picture

Where are we coming from?

Where are we now?

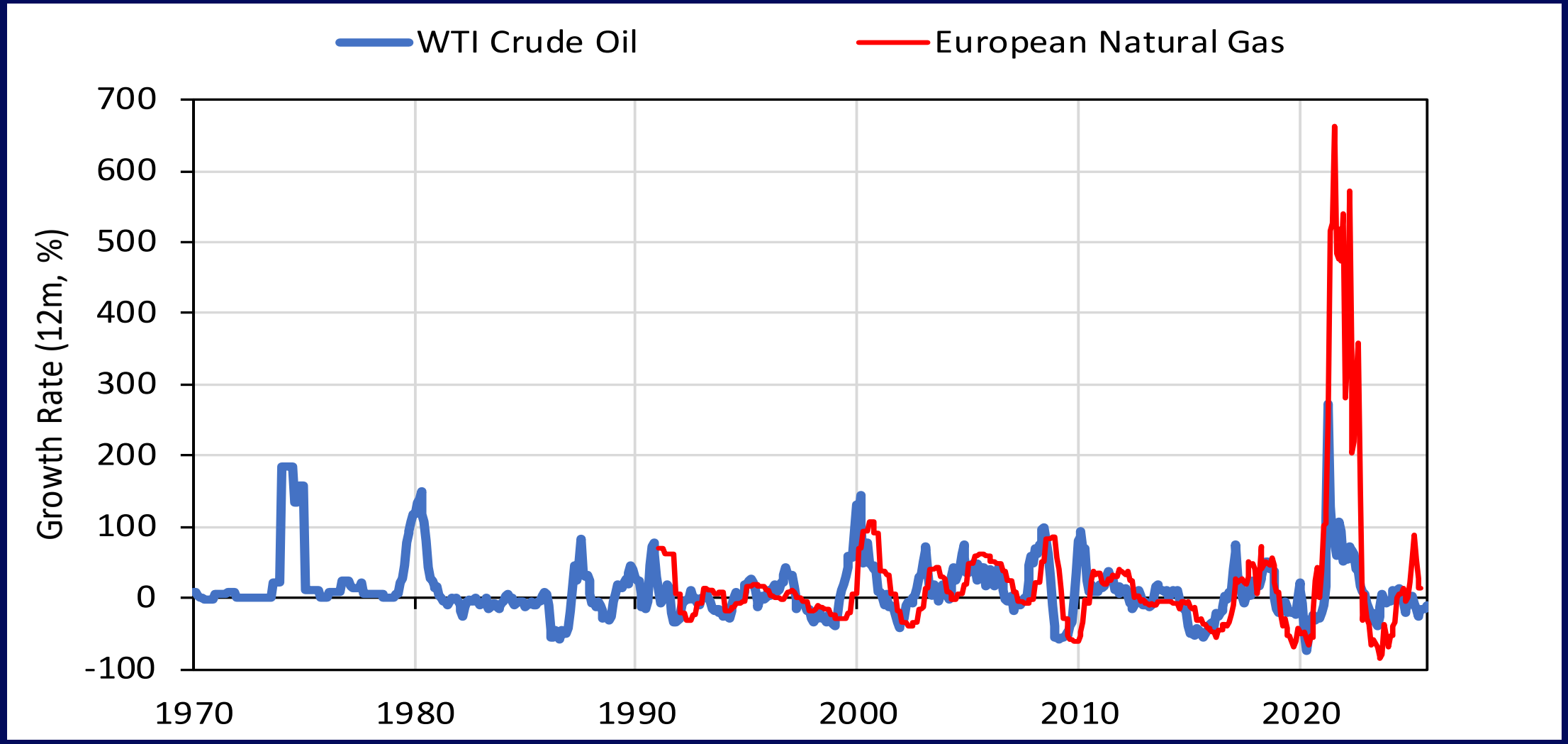
Where might we be heading to?

1. Where are we coming from?

Pandemic

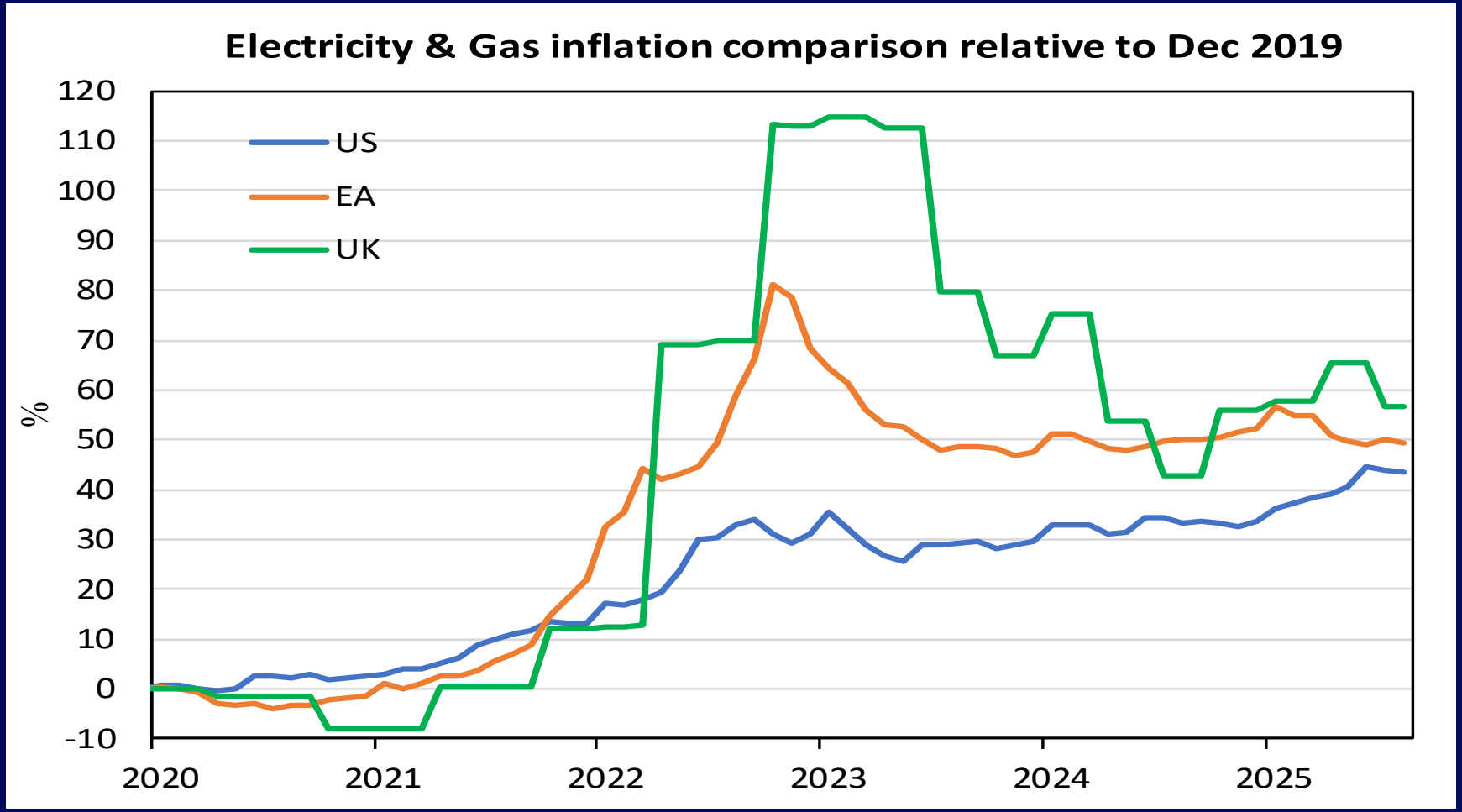
Invasion of Ukraine

Global Energy Prices: Oil and Gas



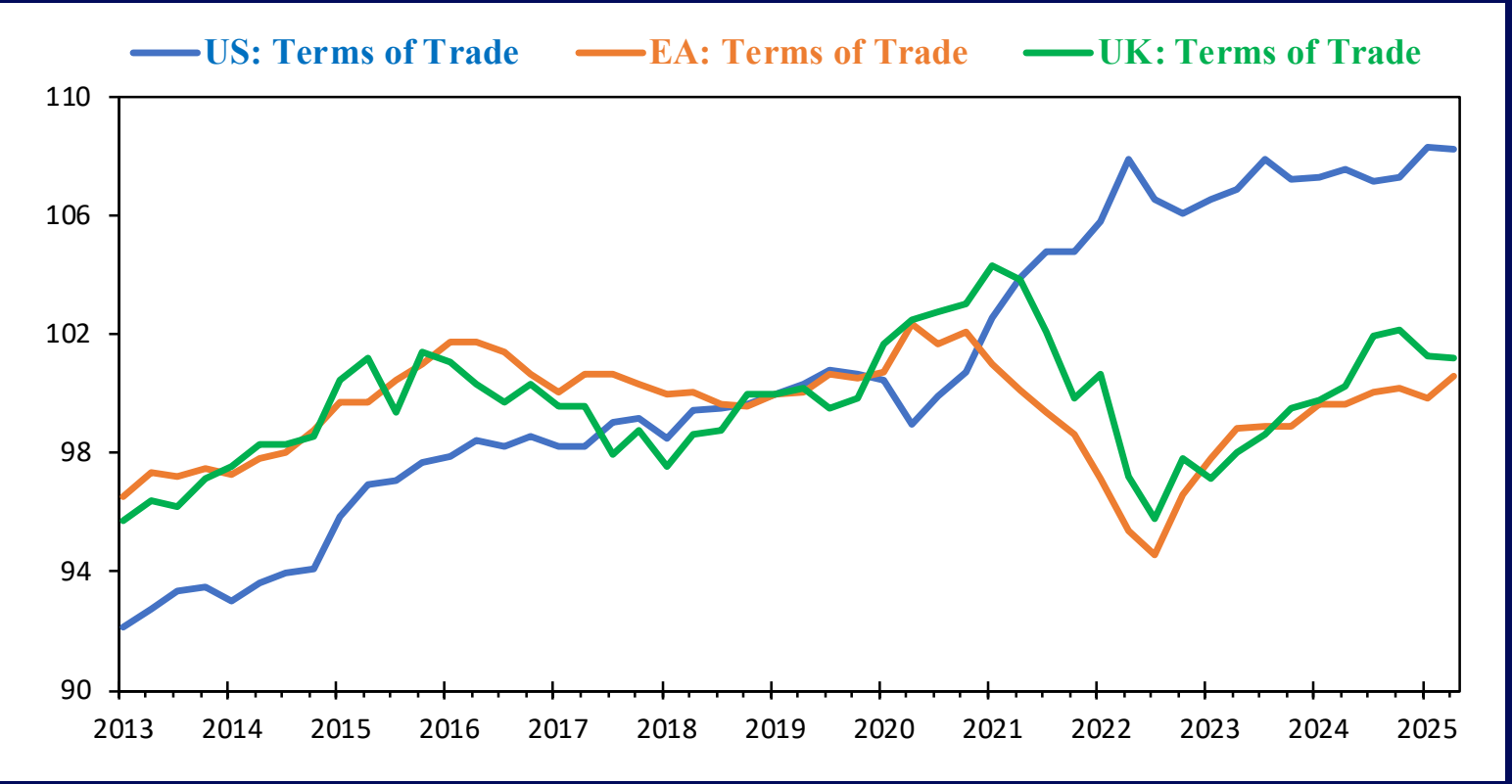
Source: Federal Reserve Bank of St. Louis/US EIA, Federal Reserve Bank of St. Louis/IMF

Retail energy prices: EA, US, UK



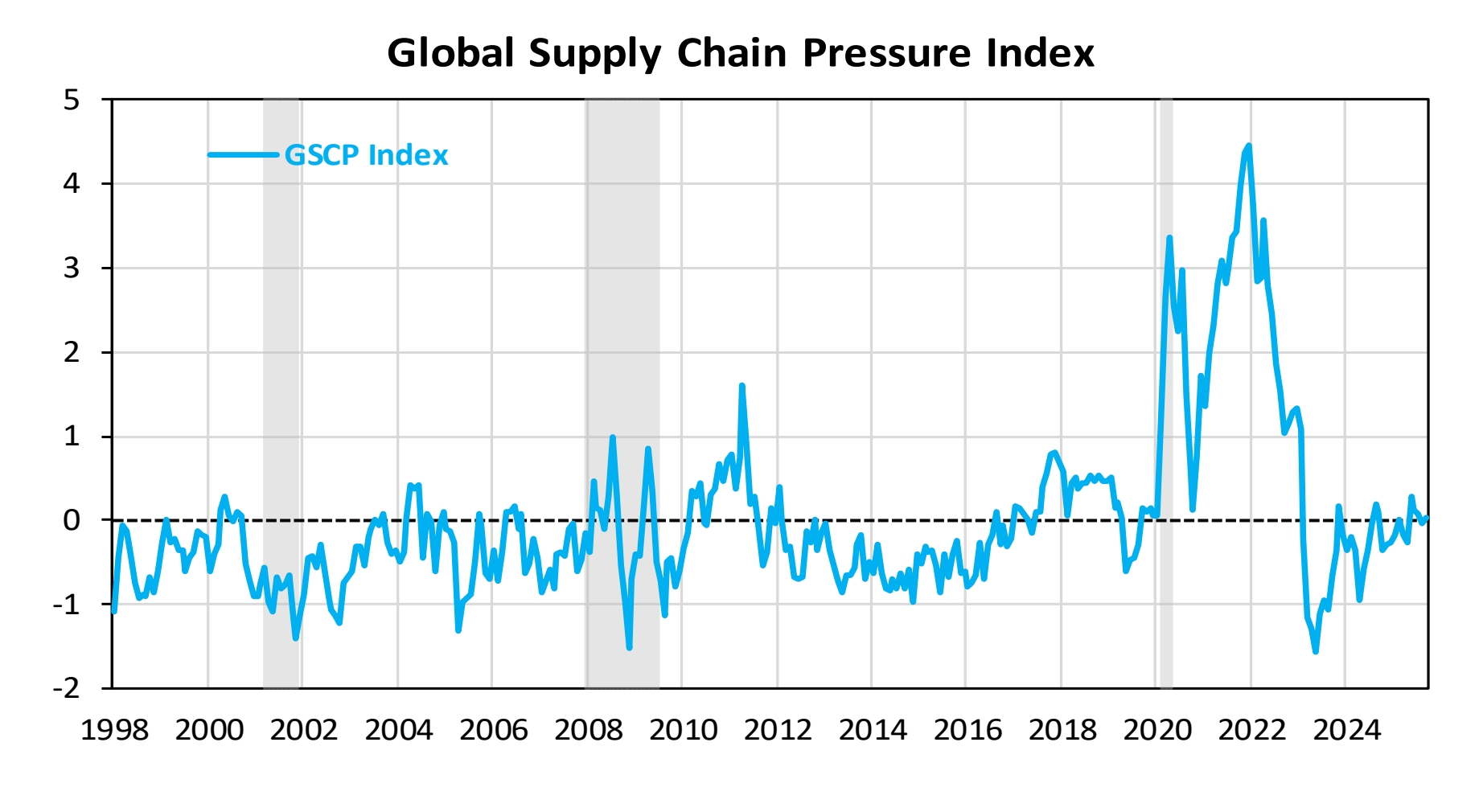
Source: US – BLS, EA – Eurostat; UK - ONS

Terms of Trade Shock: EA, UK, US



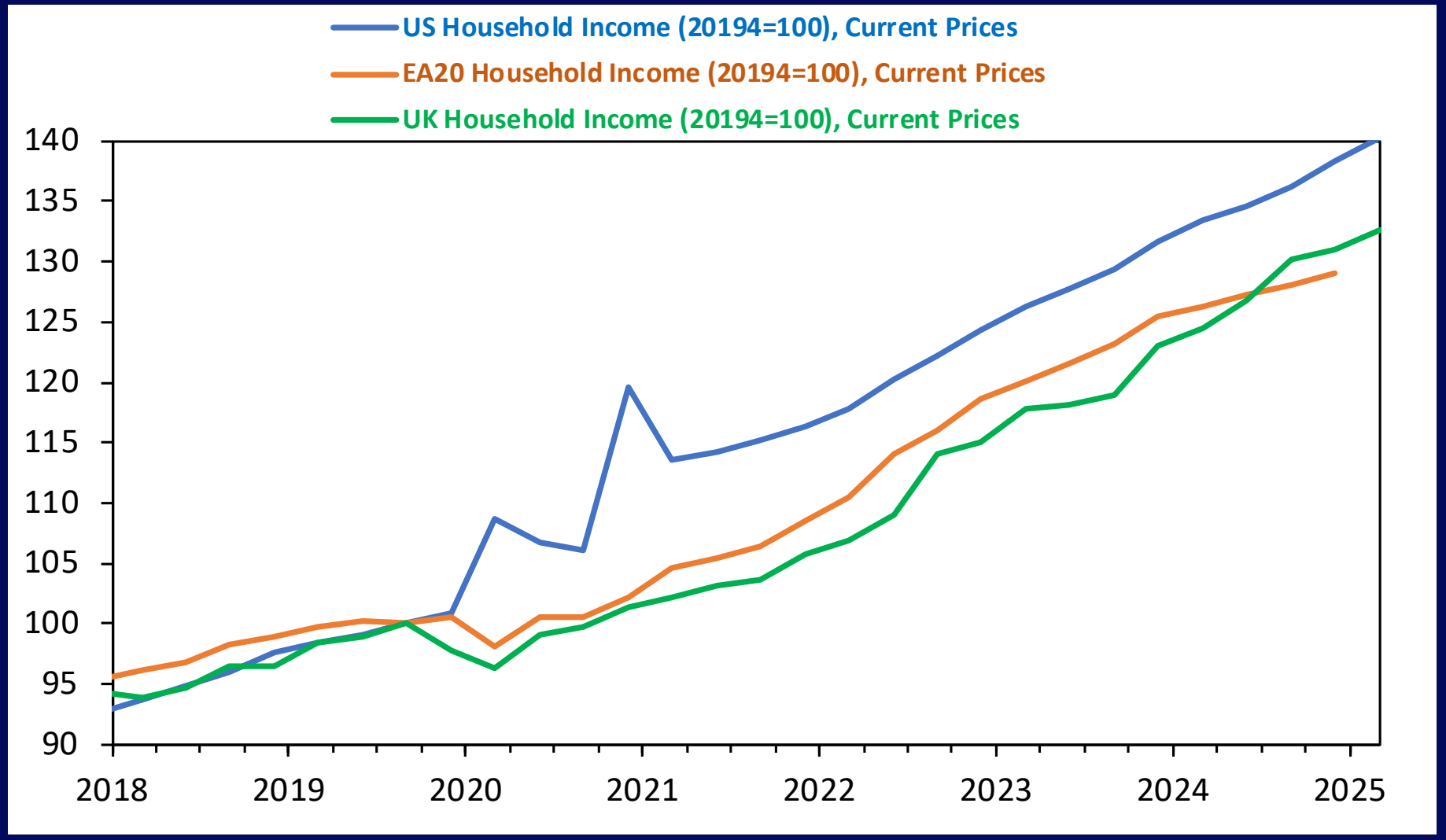
Source: US – BEA/Federal Reserve Bank of St. Louis; EA – ECB; UK - LSEG Datastream/ONS

Not just energy shock



Source: Federal Reserve Bank of New York

Households' Incomes EA, UK, US



Source: US – IMF/LSEG Workspace, Federal Reserve Bank of St. Louis; EA – IMF/LSEG Workspace, ECB, UK – IMF/LSEG Workspace, ONS

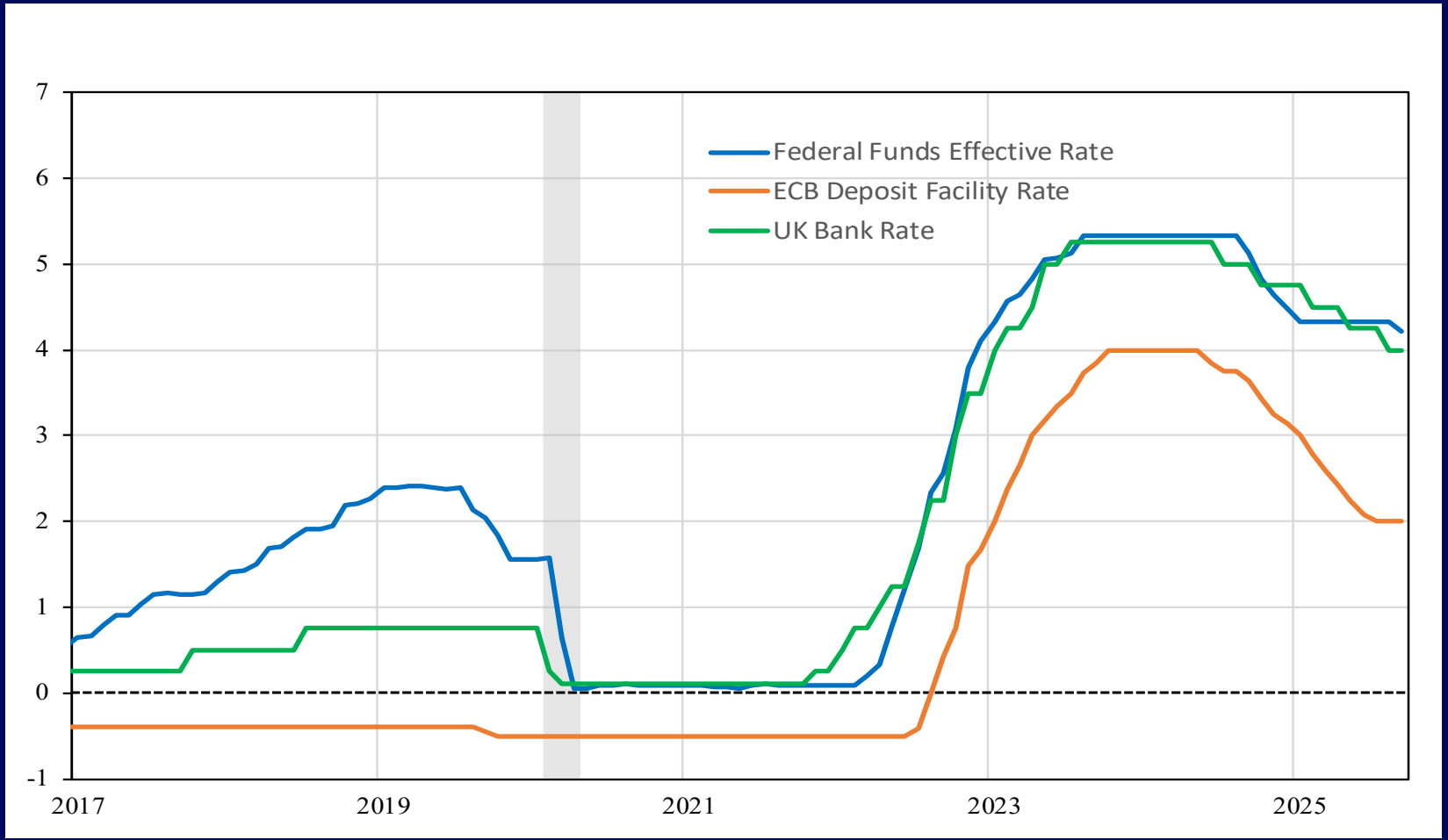
Rare events with different impacts

US: positive terms of trade shock plus large fiscal stimulus

EA/UK: negative terms of trade shock - more difficult tradeoff

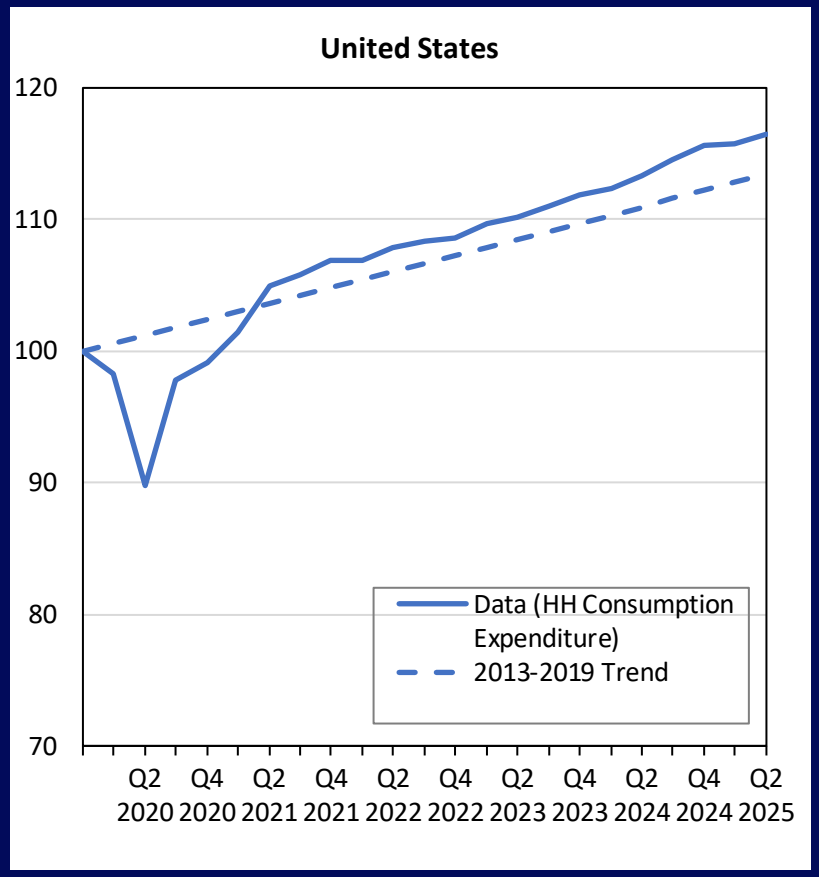
Monetary policy is an aggregate demand tool

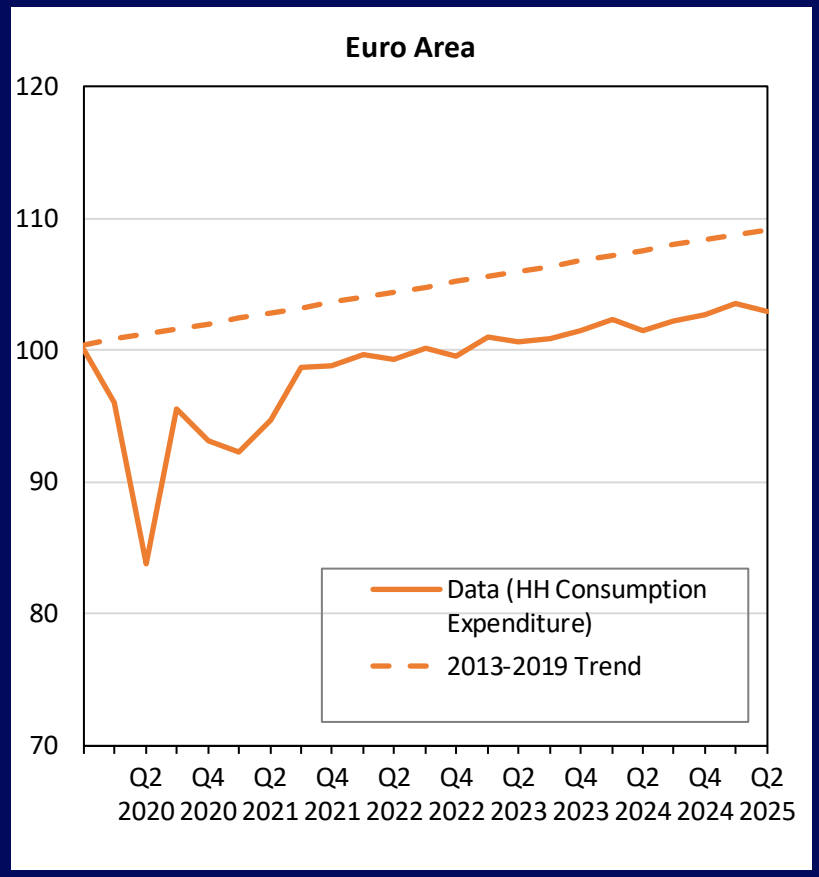
Policy rates responses: ECB, BoE, Fed

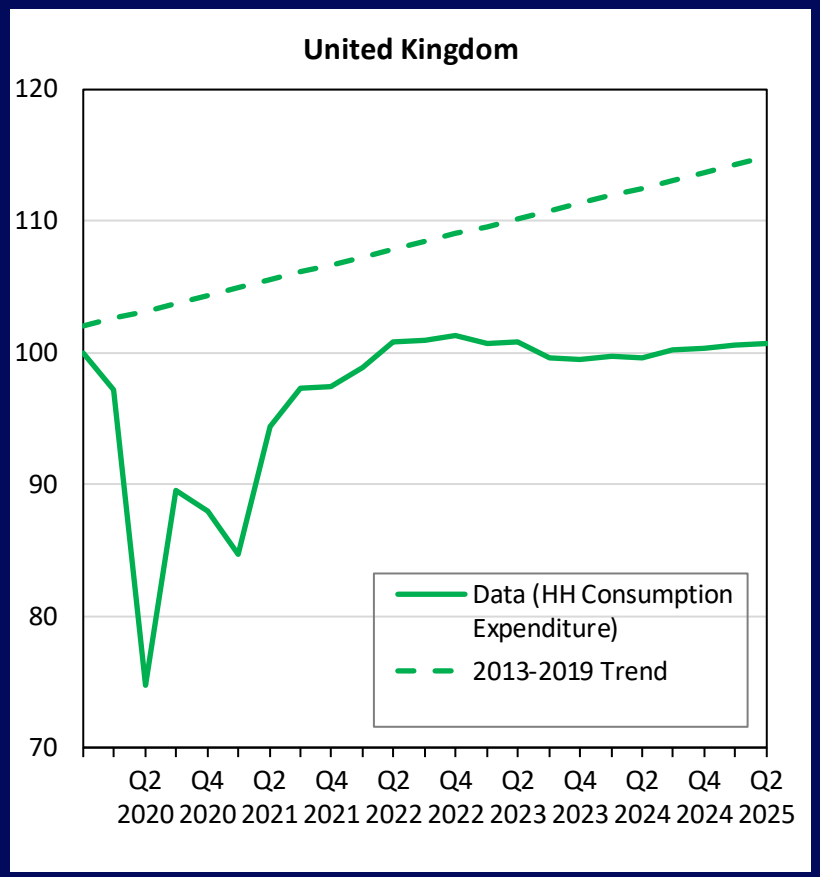


Source: US - Federal Reserve Bank of St.Louis; EA - Federal Reserve Bank of St.Louis /ECB; UK - Bank of England

Consumption 15% above pre-Covid level. EA/UK: just above pre-Covid level



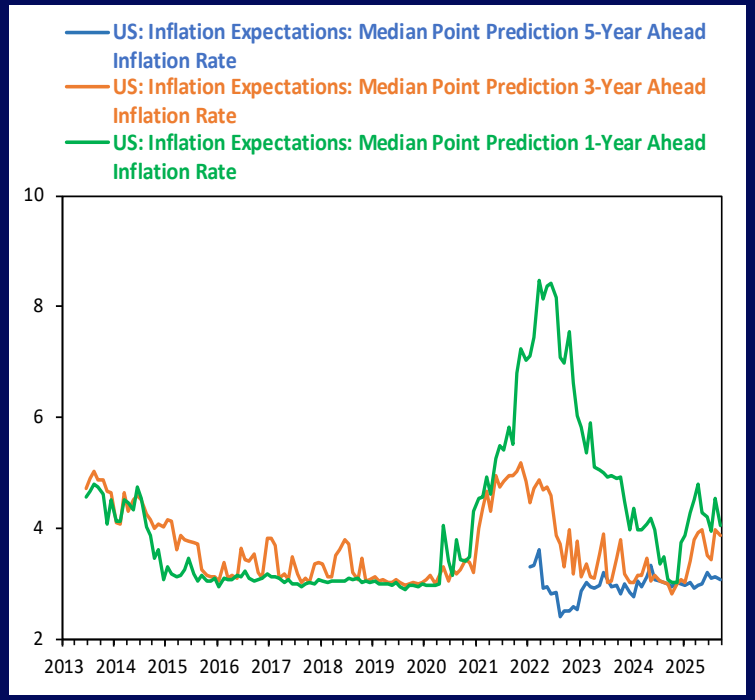




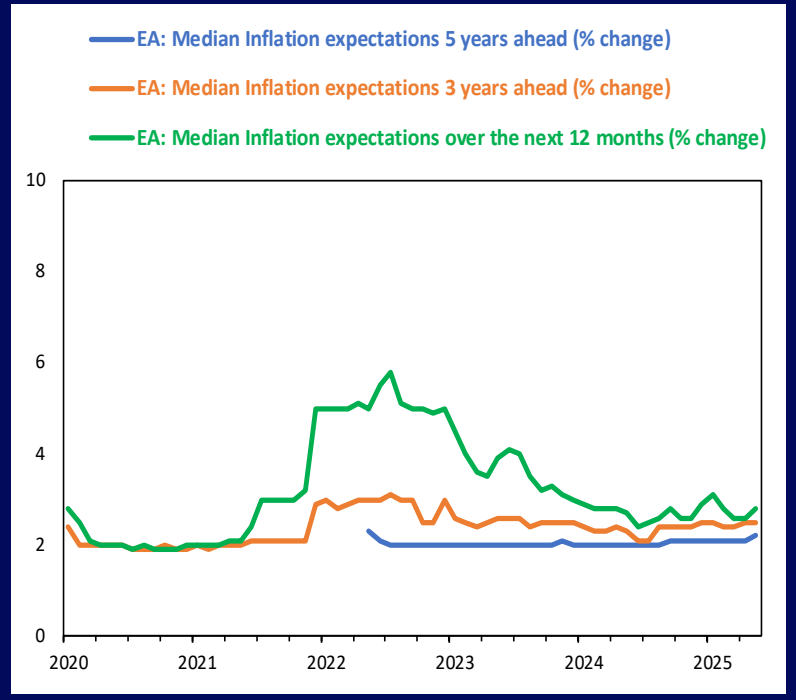
Source: US – BEA/LSEG Workspace; EA – Eurostat/LSEG Workspace, FRED/ECB; UK - ONS

Household Inflation Expectations: Little movement in long term measures

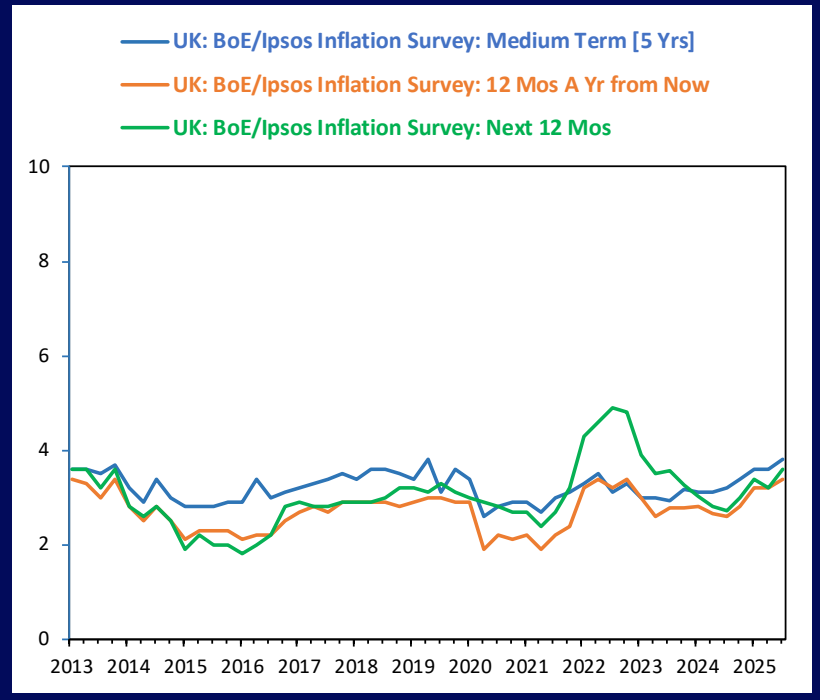
United States



Euro Area

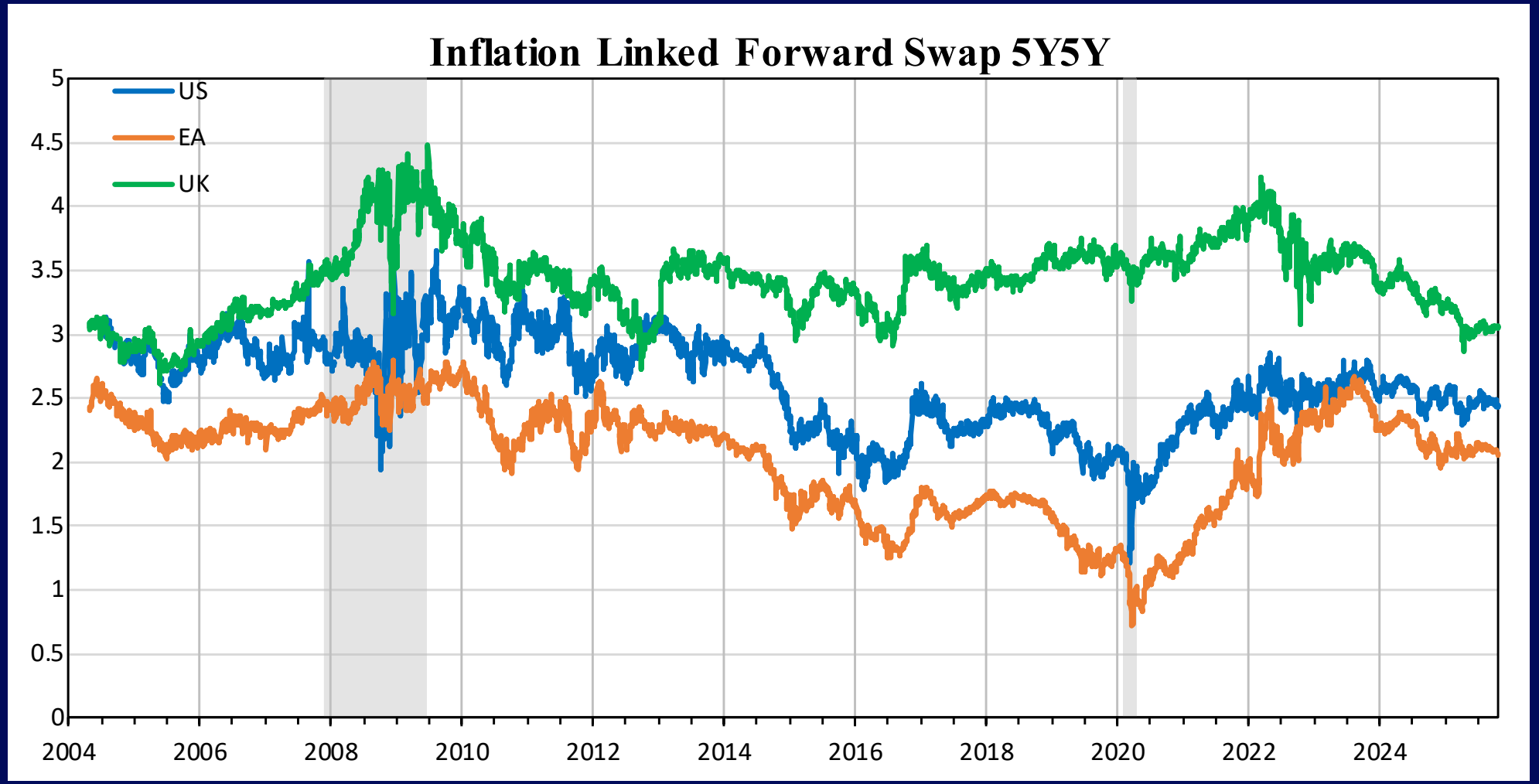


United Kingdom



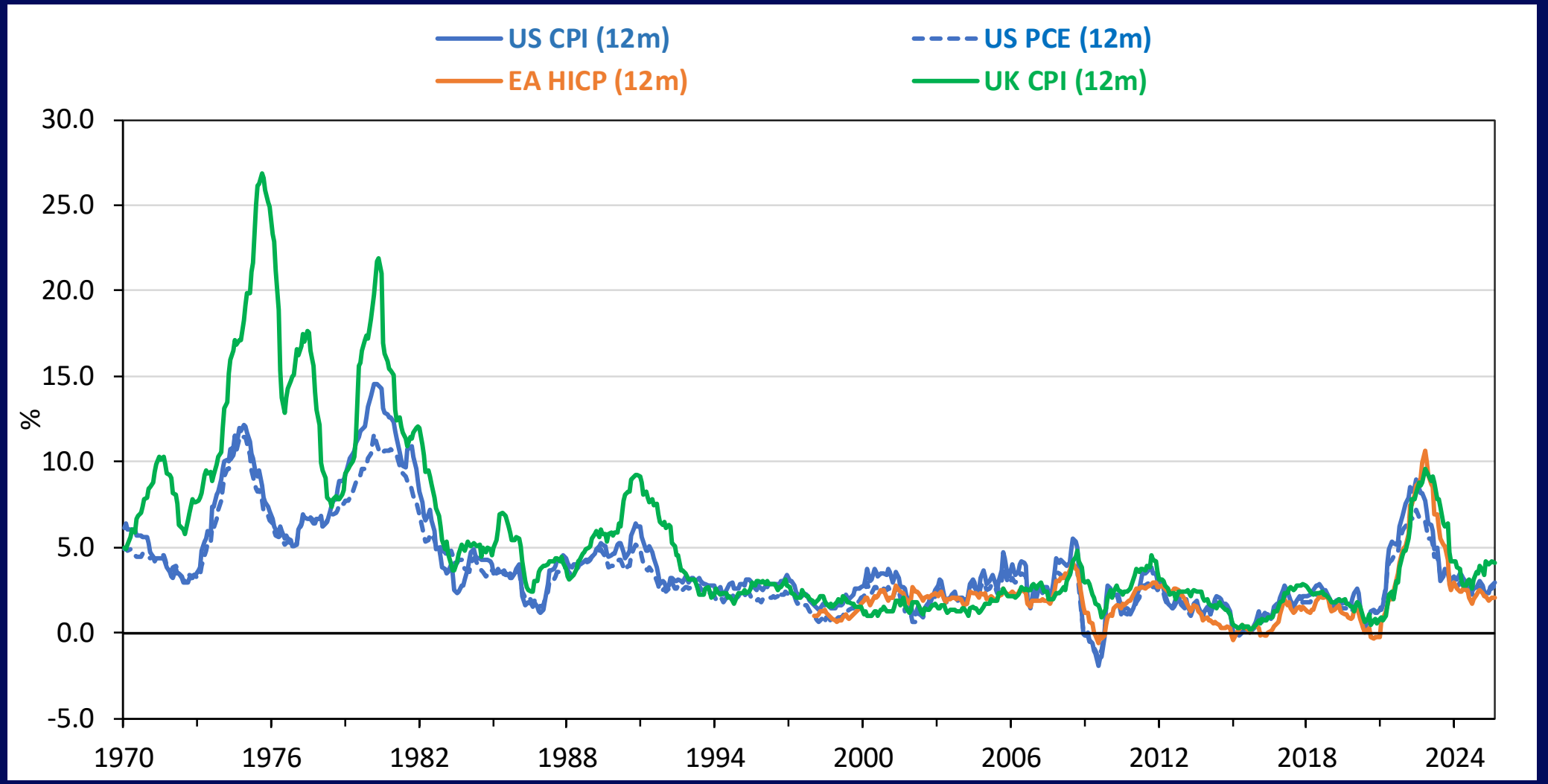
Source: US – New York Fed, Survey of Consumer Inflation Expectations; EA - ECB Consumer Expectations Survey; UK – BoE/Ipsos Inflation Survey

Markets' Longer Term Inflation Expectations: Convergence?



Source: Bloomberg

Inflation – differences from 1970s



Source: US – FRED/BLS, FRED/BEA; EA – ECB/Eurostat; UK - ONS

A test to the 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 transmission lags)

Takeaway: Flexible inflation targeting framework fared well

2. Where are we now?

Unwind of supply shocks

Effects of restrictive monetary policy (given lags)

Two forces at play in Europe and UK: supply and demand

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

Restrictive monetary policy → Lower inflation, Weaker activity

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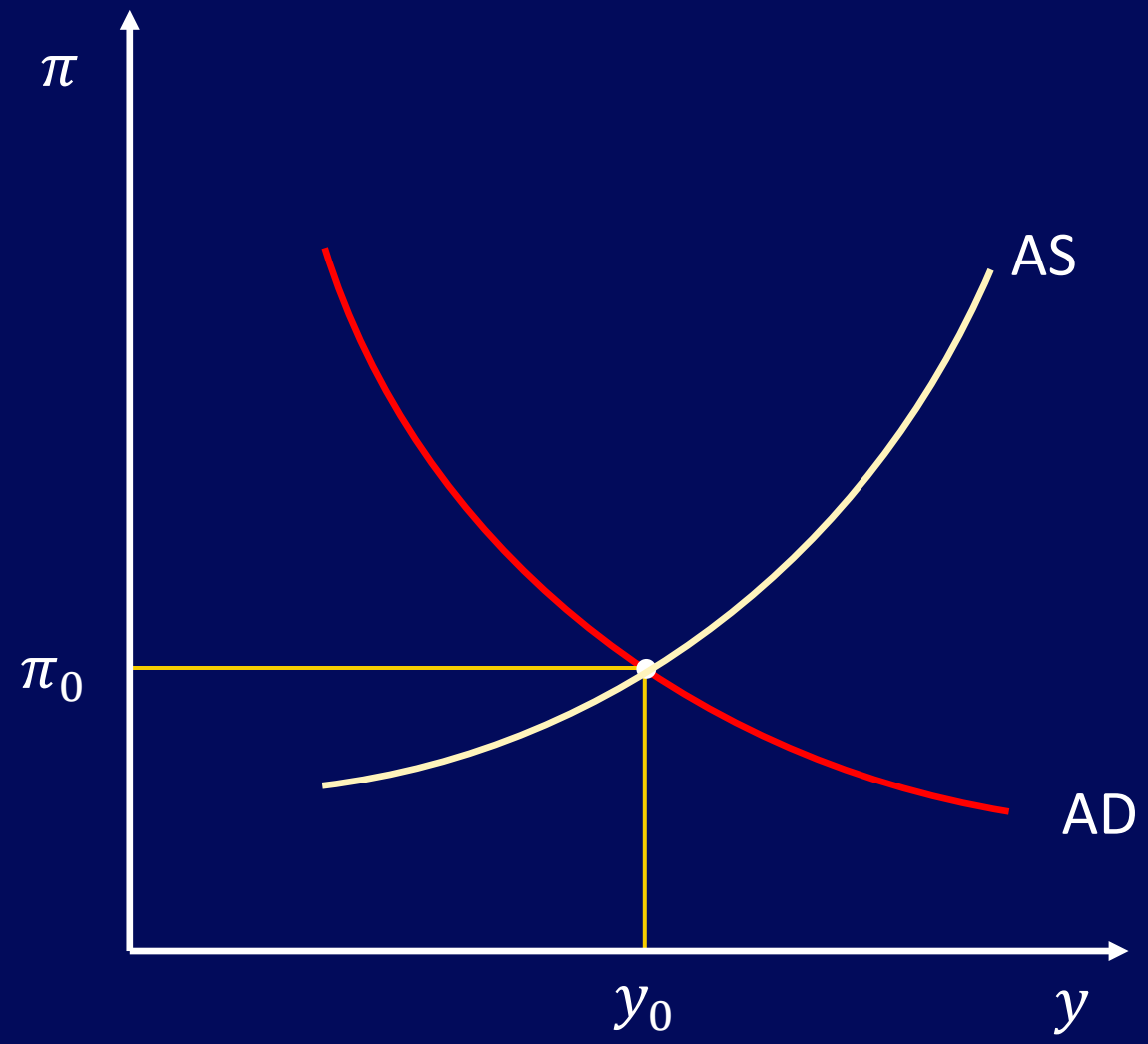
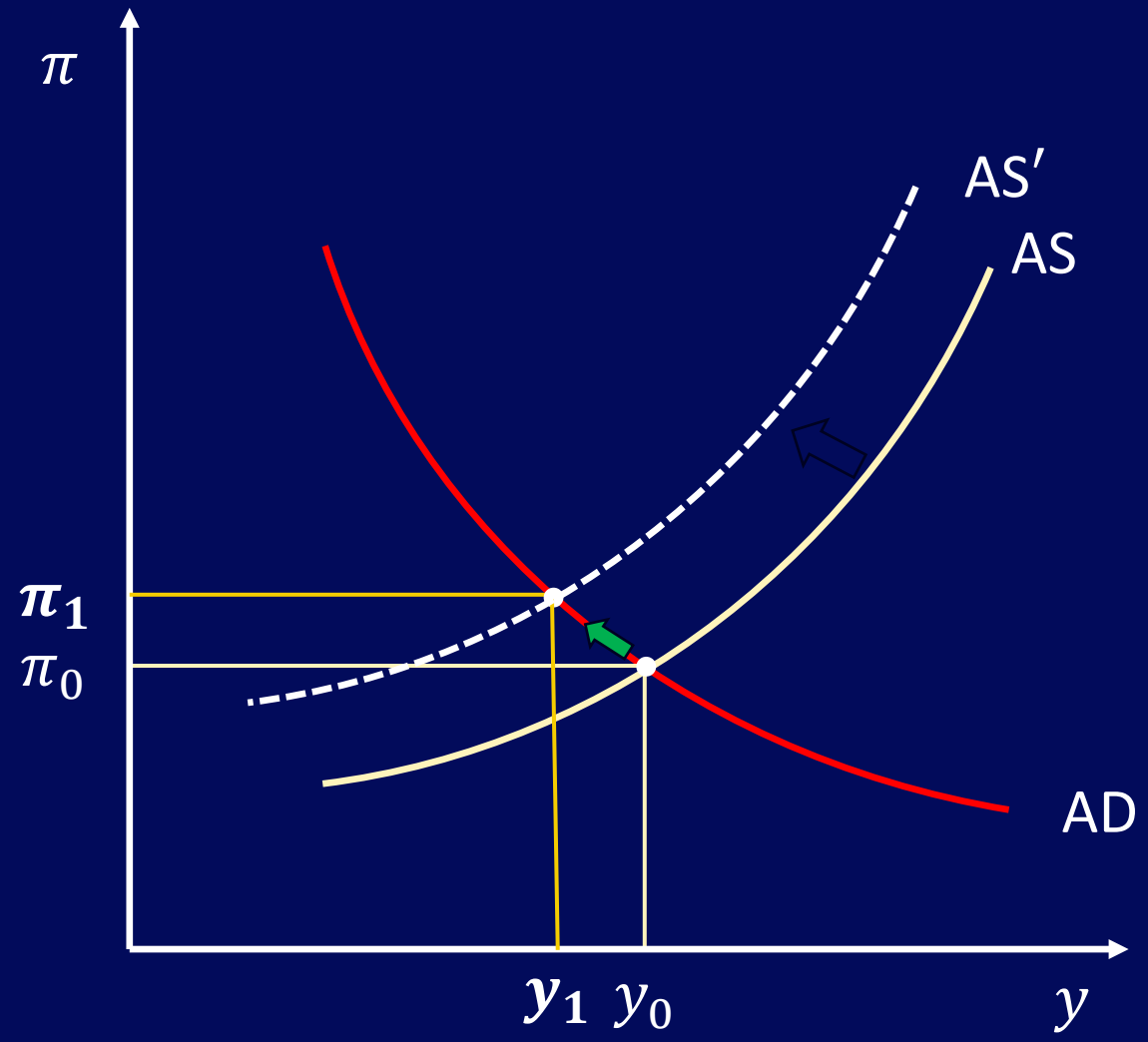
Combined impact → Lower inflation, Flat-ish activity

A summary in pictures:



Stage I. **Negative Supply shock**:

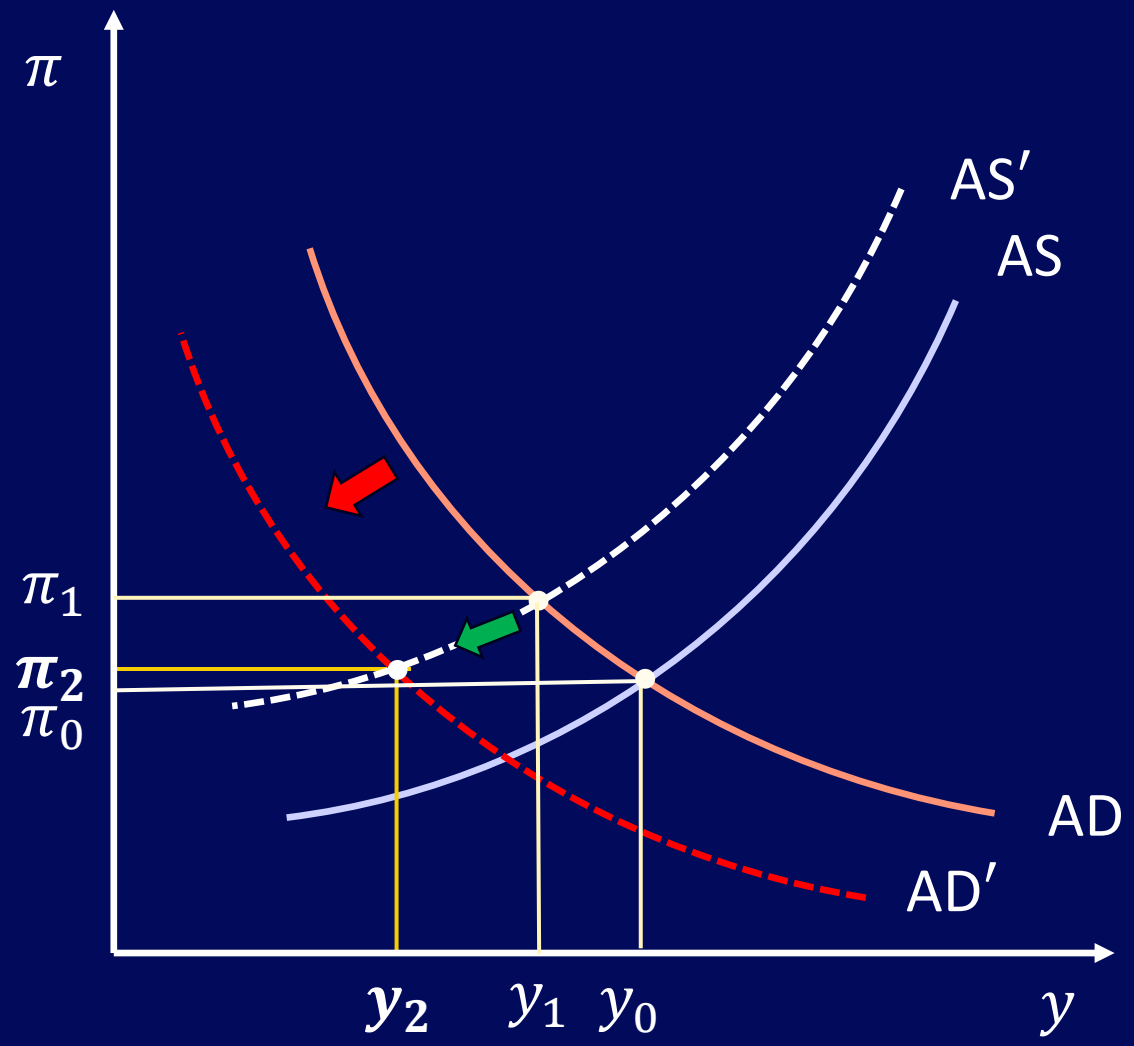
- Lowers activity
- Increases inflation



Stage II. **Increase in interest rates causes**:

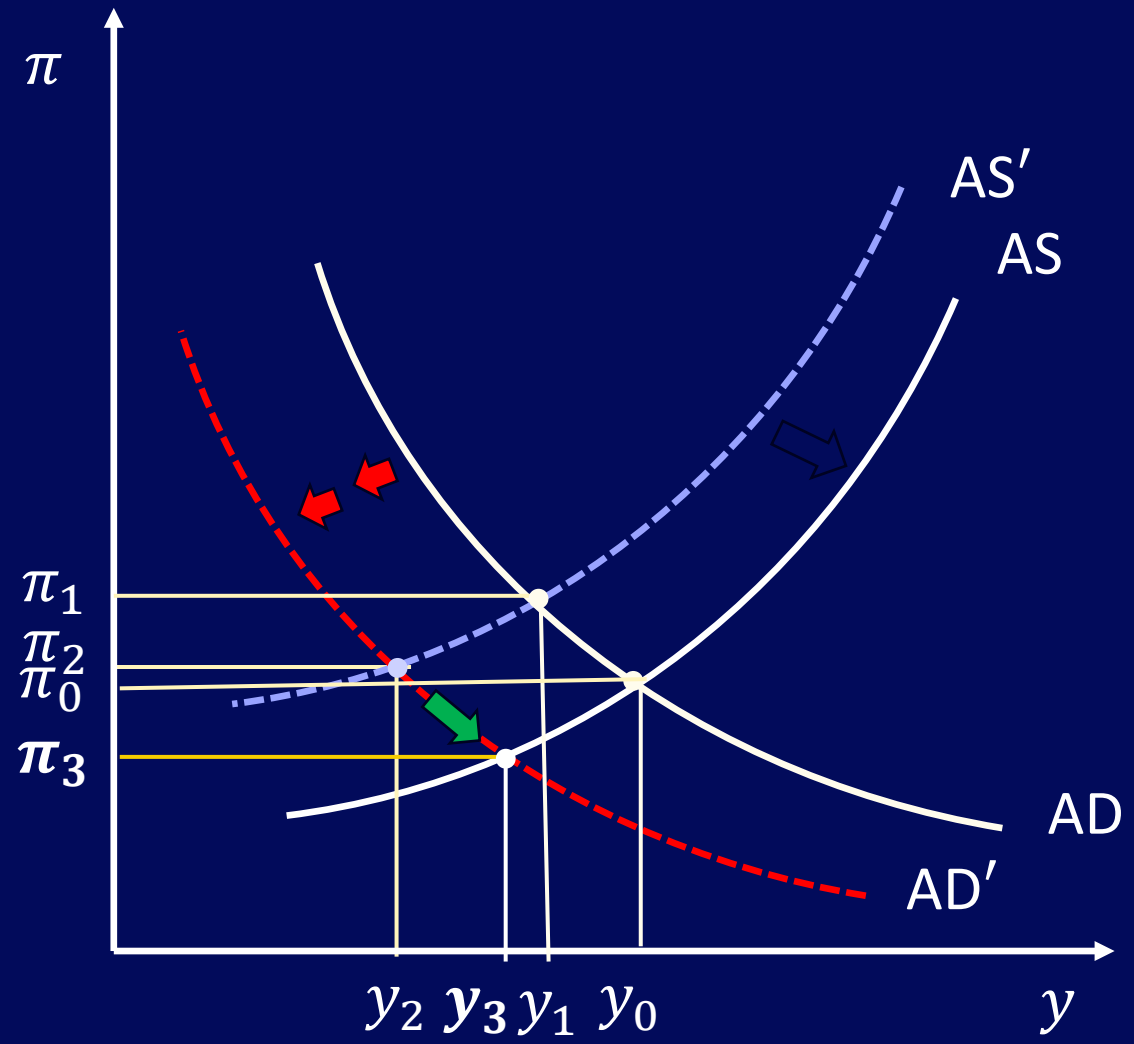
- Fall in demand, which exacerbates weakness in activity
- Downward pressure on inflation

(with lags)

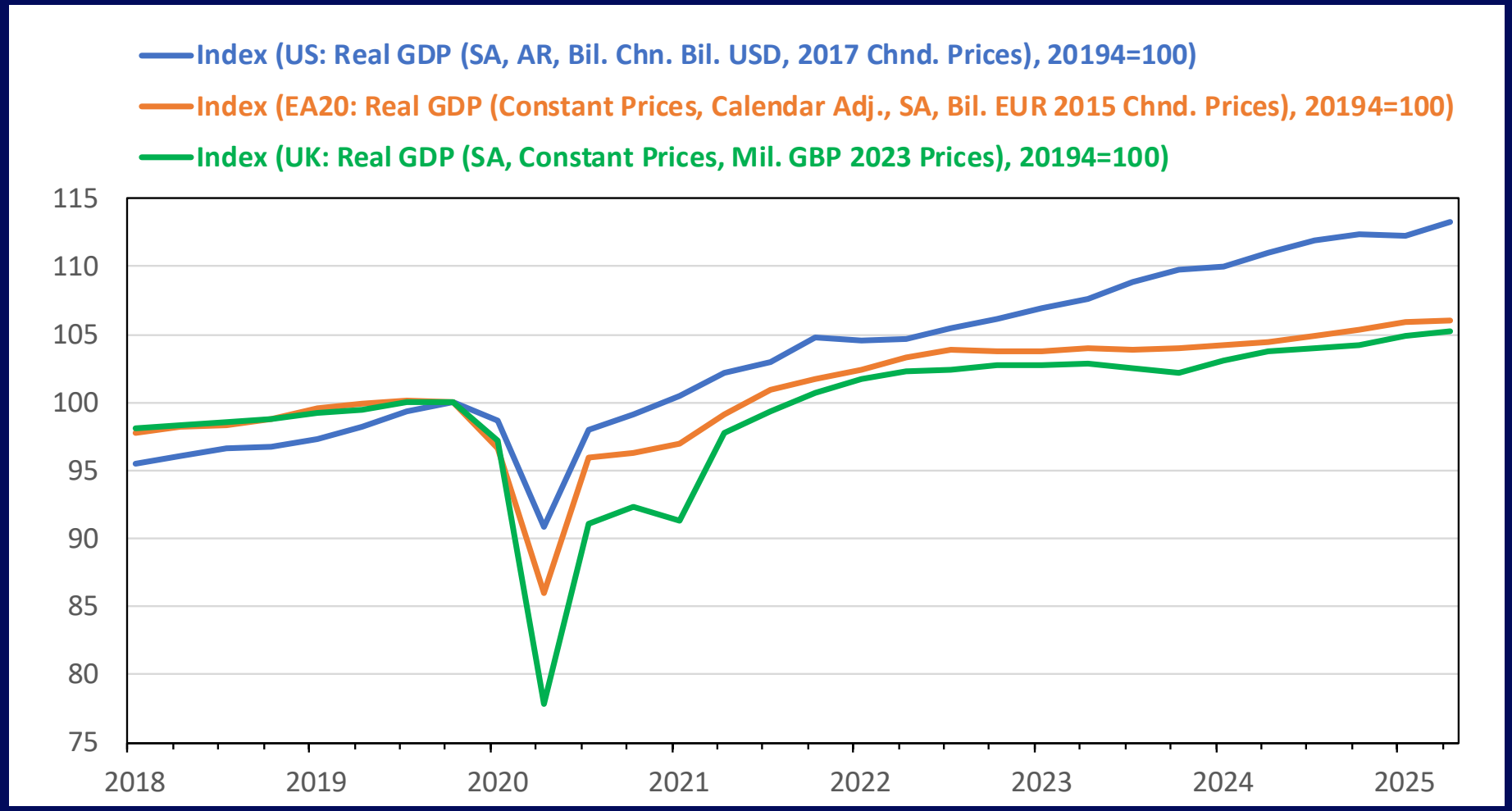


Stage III. **Unwind of supply shock** (while still higher interest rates)

- Some recovery in activity (though still weaker)
- Even lower inflation



Real Gross Domestic Product



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

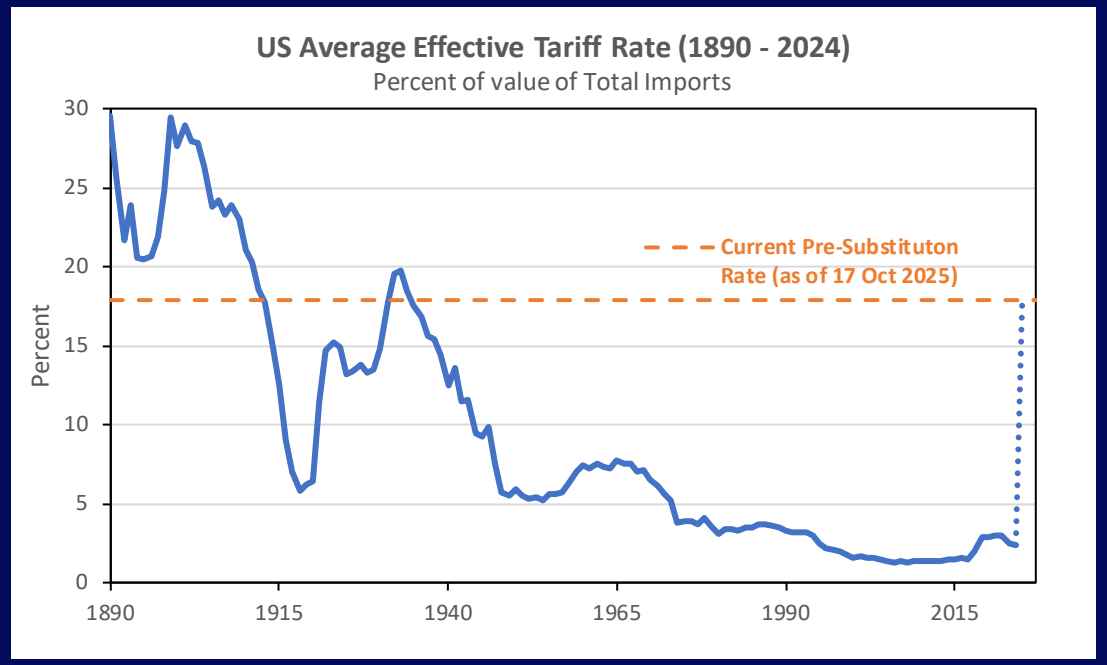
3. Where might we be heading?

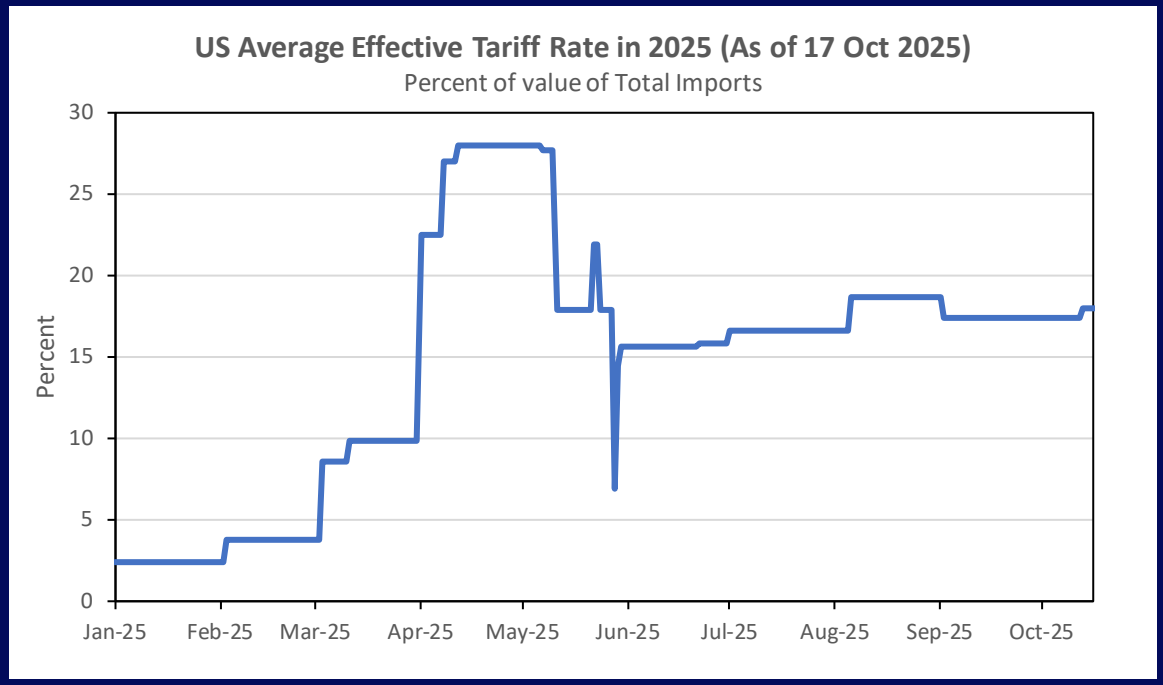
Short term

Tariffs and trade wars

Uncertainty

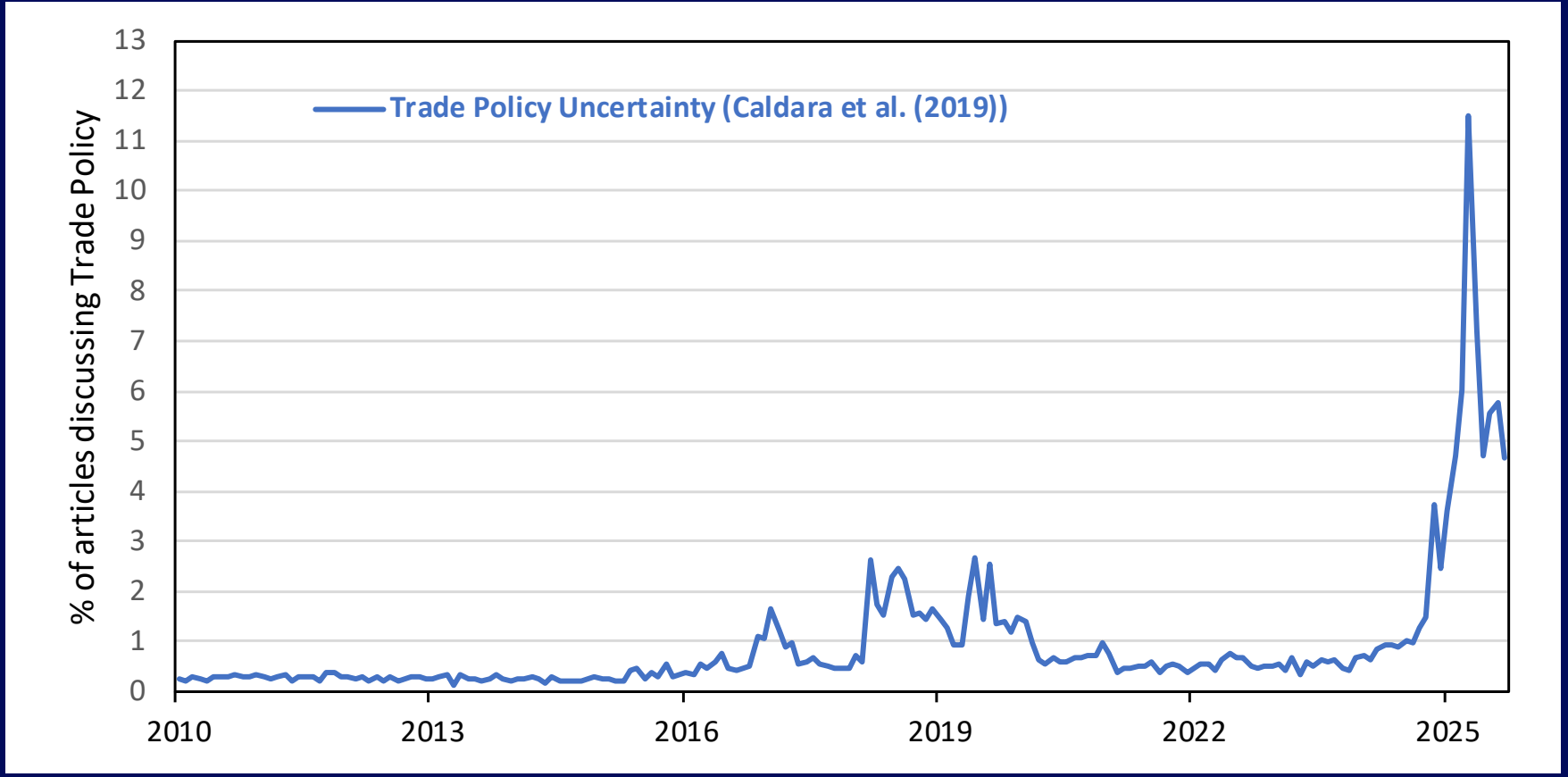
Size of Tariffs
1890 - Present





Source: The Budget Lab at Yale University. 2025. *State of U.S. Tariffs: October 17 2025*. Yale University. https://budgetlab.yale.edu/research/state-us-tariffs-october-17-2025

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. A 25pp increase in tariffs on all four implies a 1.5pp increase in inflation – direct one-off price impact

Passthrough in the past was reduced by: USD appreciation; exceptions; exporters cutting prices; importers cutting margins; trade diversion (imports from non-tariff countries). Might be increased by 2nd round effects

2. In countries on which tariffs are imposed

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

3. In third countries

Lower prices of tariff-affected products

Zoom in: EA Price effects of US Tariffs

1. ~~Dollar appreciation~~
2. ~~EA tariff retaliation~~
3. ~~Covid-type disruptions in supply networks~~
4. **Adverse impact on global growth**
5. **Lower demand for EA exports**
6. **Excess supply of foreign products**
7. Foreign companies increasing markups everywhere

(to make up for US shortfalls; only in markets with high seller's power; unlikely in competitive markets, e.g., low-end clothing, furniture)

How should central banks react to tariffs?

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 (delayed loosening)

For all countries

- Increased uncertainty

Medium term

3. Where we might be heading? (further ahead)

- Increased defence spending in Europe: demand boost
  - positive effect on supply capacity (Ilzetzki, 2024)
- Lower weight of US dollar on international portfolios
- Further economic fragmentation and climate change effects: adverse effects on productivity
  - weaker economy
  - impact on both supply and demand (GE)
  - ambiguous impact on inflationary pressures: anticipation will tend to reduce demand more than supply (Ambrosino, Chan and Tenreyro, 2025)
- AI: positive effects on productivity
  - Impact on both supply and demand (GE)
  - Disruption in labour market and human capital formation

Four Takeaways so Far

1. The US and EA/UK faced different TOT shocks and fiscal impulses: similar inflation, but hugely different activity paths

2. The EA/UK policy framework worked well in response to negative TOT; limited damage to future supply capacity

3. Divergent paths might continue: i) tariffs impact US & EA/UK differently; ii) Europe military/infrastructure spending boost

4. Continued uncertainty/fragmentation will lead to portfolio rebalancing, with less weight on USD/Treasuries/US assets

Policy Space

Policy Space: What if negative shocks materialise?

- Fiscal policy space at its limit

- Monetary policy space
  - QE frowned upon
  - Repo facilities for financial stability risks
  - Negative interest rates? (Mcleay, Tenreyro and von dem Berge 2025)

The (first) era of negative interest rates

Central Bank	Period	Rate Trough
Sveriges Riksbank	2015-2019	-0.50
Danmarks Nationalbank	2014-2022	-0.75
European Central Bank	2014-2022	-0.50
Swiss National Bank	2015-2022	-0.75
Bank of Japan	2016-2024	-0.10

The question

Is negative-interest rate policy effective at stimulating the economy?

Banks' views on negative rates

"Banks' interest margins are under pressure. I don't think this is a particularly sustainable or responsible policy. Negative rates ruin the financial system."

— Christian Sewing (CEO Deutsche Bank)

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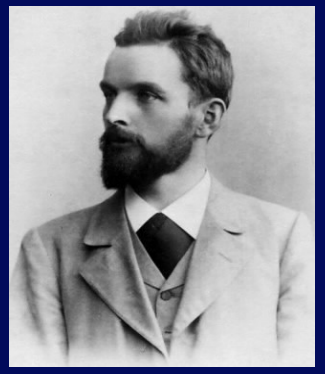
"Negative rates have been a net positive for the banking industry because they supported the euro area economy."

—Jean Pierre Mustier (CEO Unicredit)

A Long History of Thought on Negative Interest Rates



Silvio Gesell (1862 - 1930)

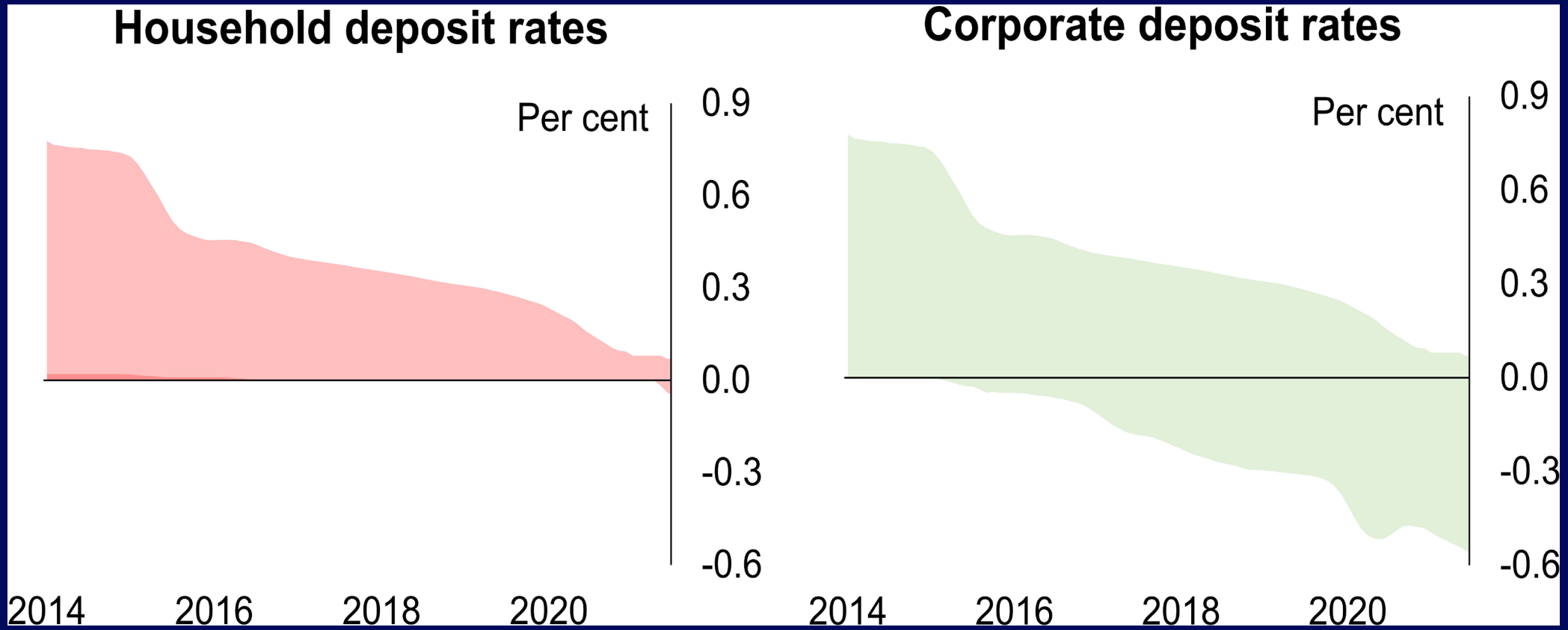
Robert Eisler (1882 - 1949)

"The idea behind stamped money is sound. But there is a great defect in Gesell's theory." (J. M.Keynes)

"One wonders whether Keynes might havere-evaluated his position had he been aware of the[.] proposal of Robert Eisler (1932), which in recenttimes has been taken up by Buiter (2009) and byAgarwal and Kimball (2015)." (K. Rogoff)

1. Transmission to household deposit rates is impaired but corporate deposit rates can fall below zero

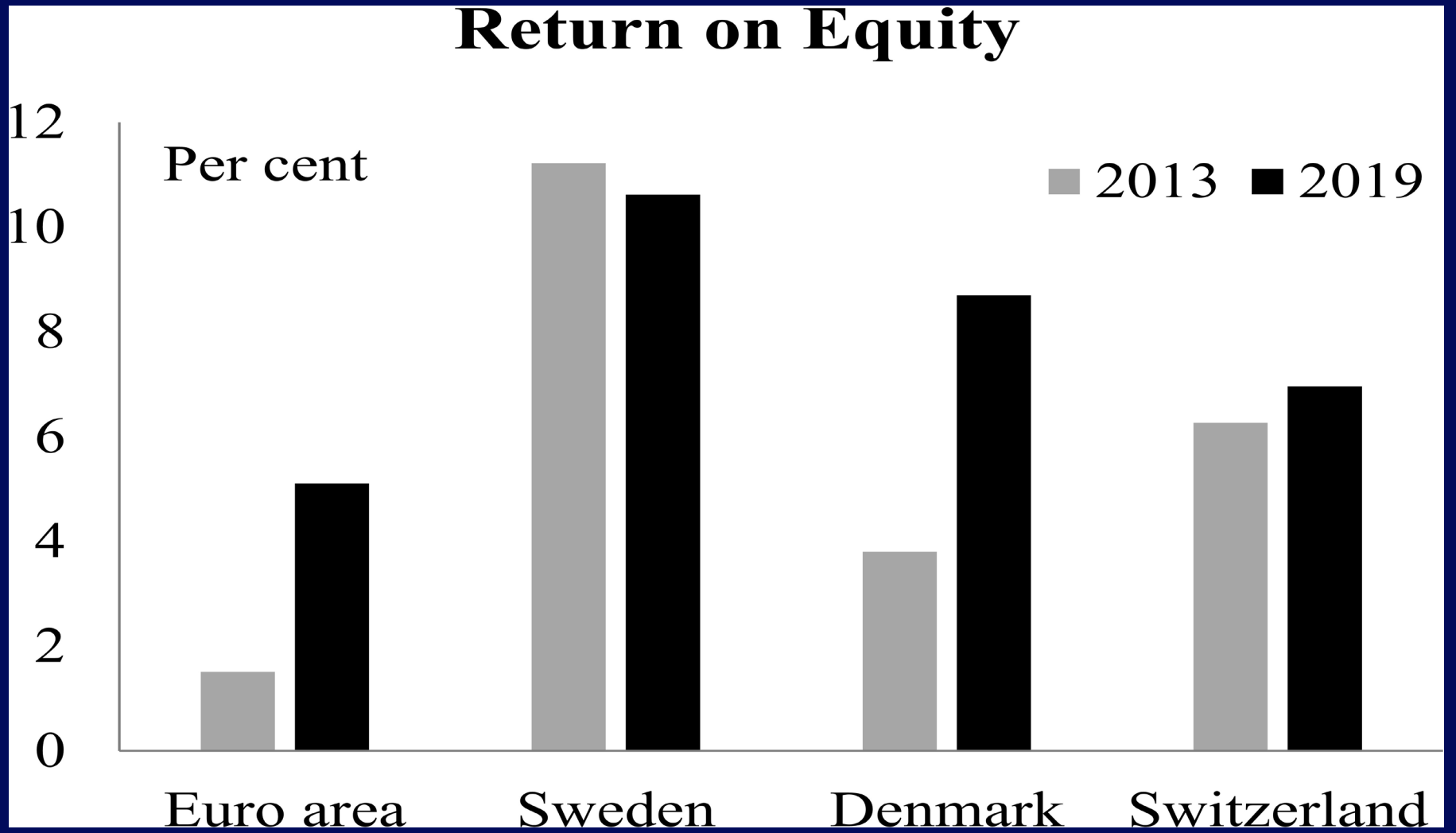
Range of deposit rates in NIRP countries



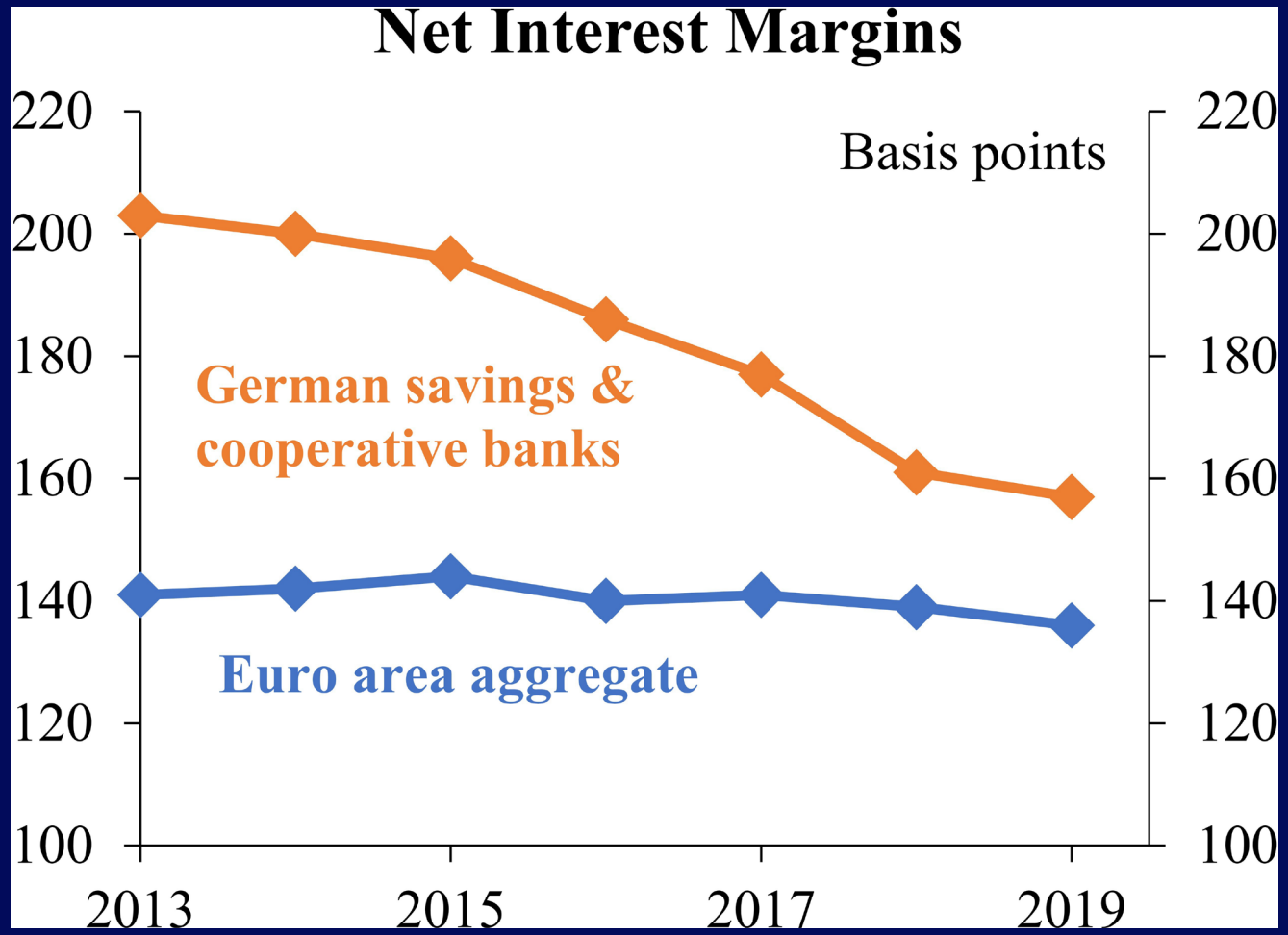
2. Aggregate transmission to bank lending rates and volumes is reduced and potentially delayed but typically remains positive

Region	Lending Rate Pass-Through	Source
Euro Area	50-80 %	Altavilla et al (2019)
Sweden	≈ 50 %	Erikson and Vestin (2019), Eggertsson et al (2019)
Denmark	≈ 50 %	Adolfsen and Spange (2020)
Switzerland	≈ 10-30 %	Baeriswyl et al (2021), Schelling and Towbin (2020)

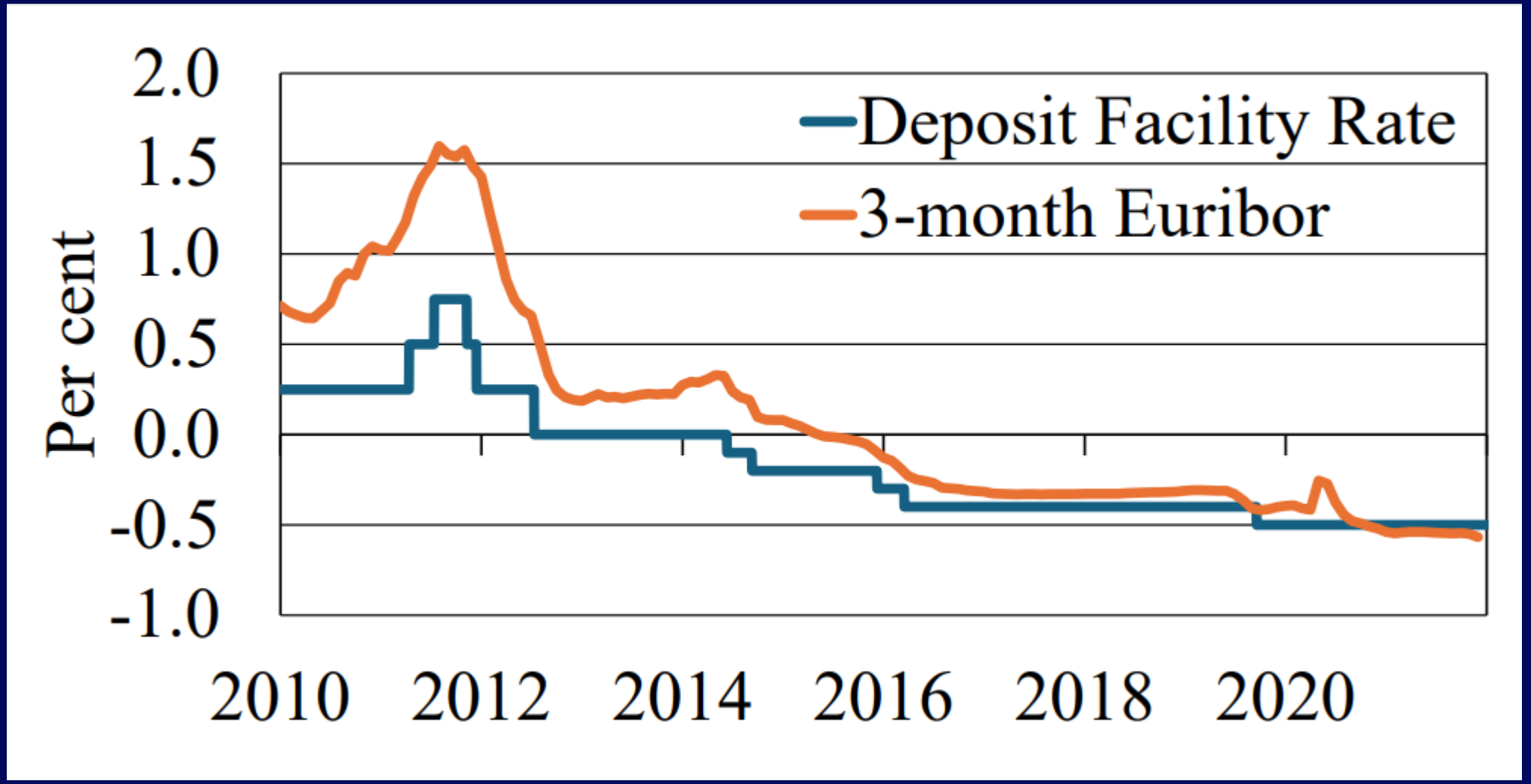
3. Aggregate banking sector profitability is not adversely affected and may even improve



4. High-deposit banks can come under profitability pressure but do not necessarily experience lending reversal



5. Broader financial market channels of transmission tend to work normally and do not appear to be constrained by a lower bound.



Key stylised facts

1. Transmission to household deposit rates is impaired but corporate deposit rates can fall below zero

2. Aggregate transmission to bank lending rates and volumes is reduced and potentially delayed but typically remains positive

3. Aggregate banking sector profitability is not adversely affected and may even improve

4. High-deposit banks can come under profitability pressure but do not necessarily experience lending reversal

5. Broader financial market channels of transmission tend to work normally and do not appear to be constrained by a lower bound

Existing literature

	ZLB on household deposits	Positive but reduced PT to lending	Small effects on bank profitability	Heterogeneous effects on banks
Abadi et al (2023)	✓	X	(✓)	X
Eggertsson et al (2023)	✓	X	(✓)	X
Ulate (2021)	✓	✓	X	X
Repullo (2020)	✓	(✓)	X	X

Synthesis: McLeay, Tenreyro and von dem Verge (2025)

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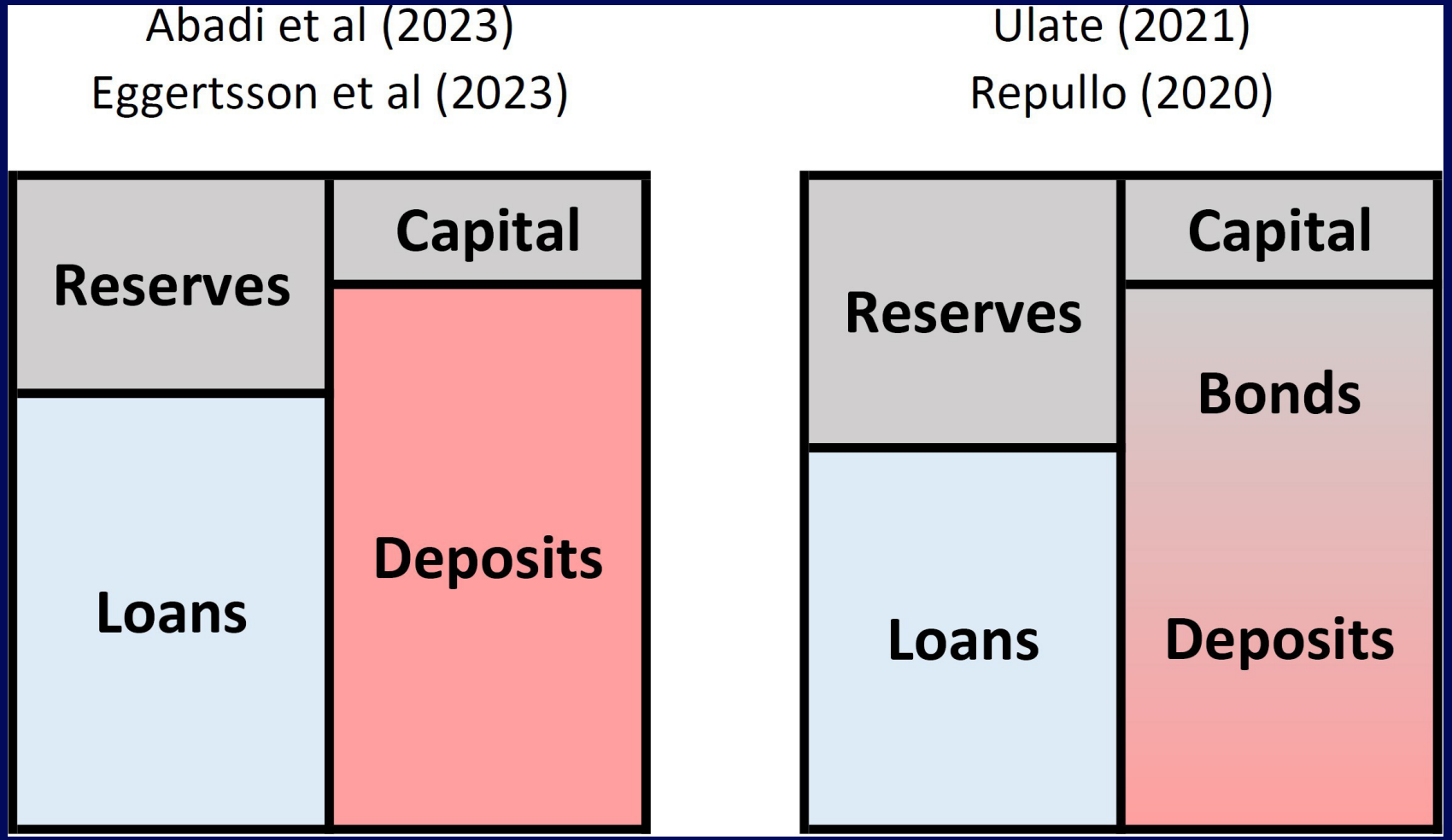
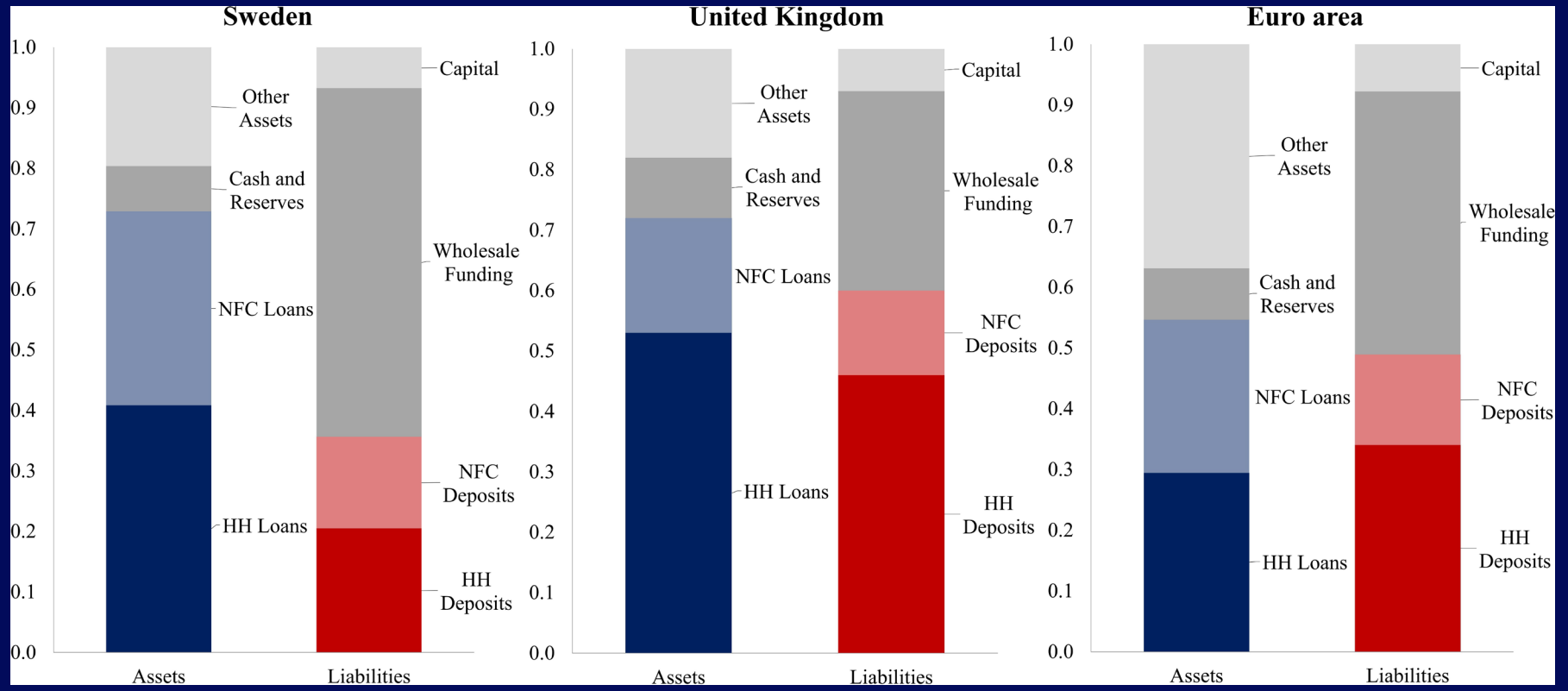
1. Closed economy models that miss the exchange rate channel
   ☞ We build an open economy model
2. Extreme assumptions on loan-deposit separability
   ☞ Our model nests the extremes
3. No bank heterogeneity
   ☞ We study competition between different funding models

Model bank balance sheets



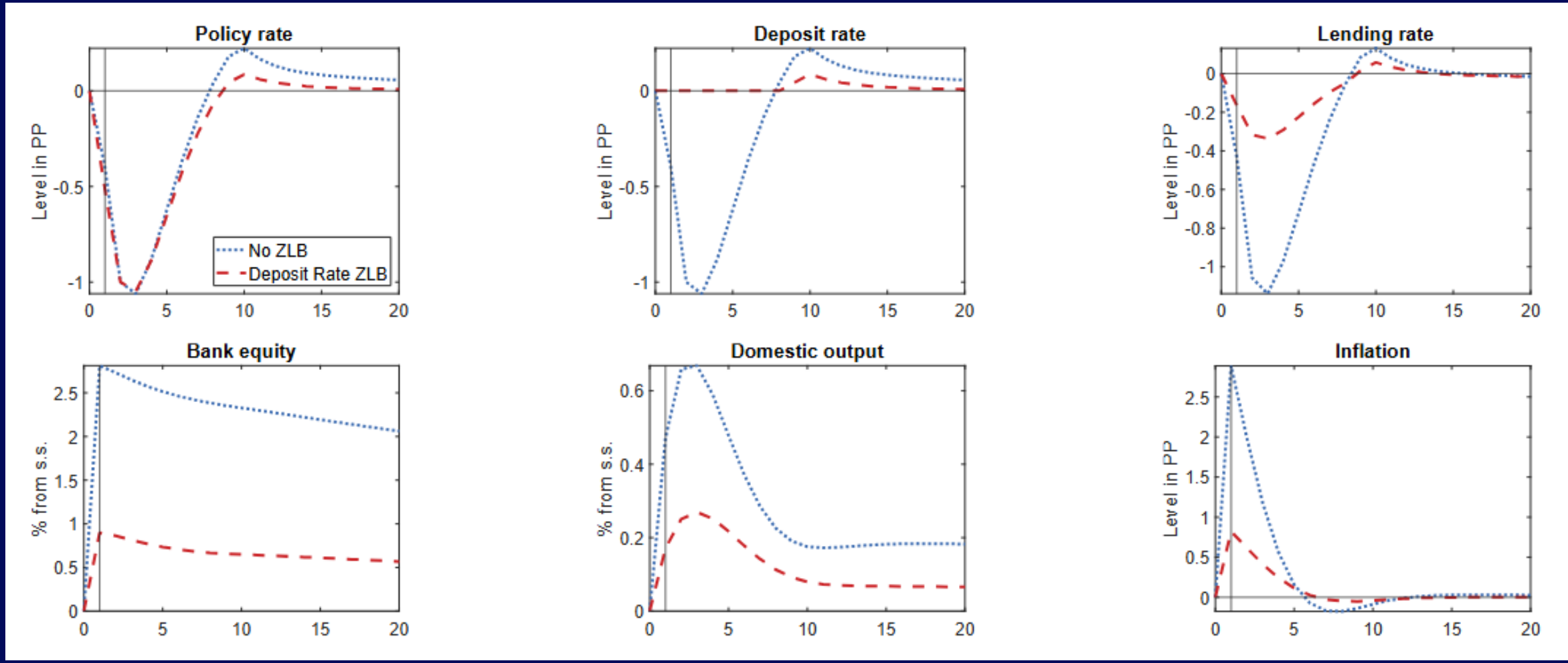
Actual bank balance sheets



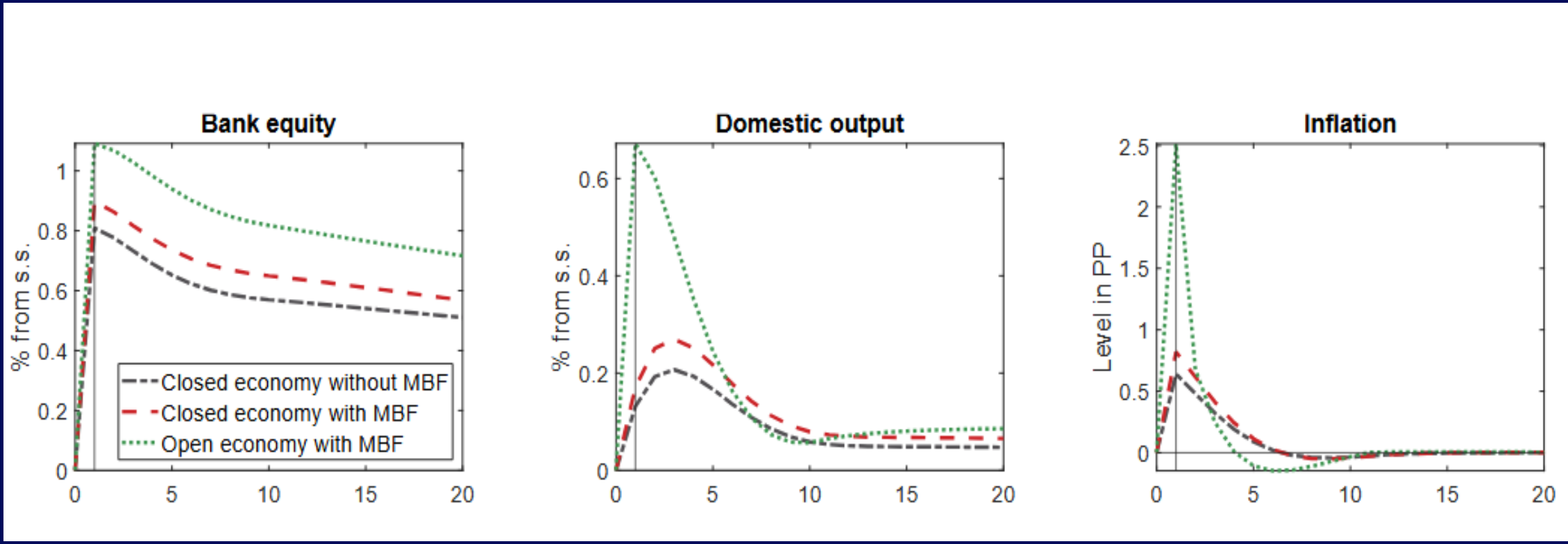
A macro model with bank heterogeneity in funding
(Mcleay, Tenreyro, von dem Berge 2025)

- Open economy macro model
- Blended funding model: deposit funding and market-base funding
- Bank heterogeneity: different funding models
- Nominal rigidities

The effectiveness of NIRP in a closed economy without market-based finance



Negative rates are more effective in open economies and economies with a role for market-based finance



Conclusions from model

- Lending increases in a realistic banking sector model
- Negative rates can help stimulate the economy, as long as banks are partly wholesale funded
- Impact is larger in more open economy with larger share of market-based finance

Broader conclusions

- Challenging confluence of tail events. Monetary policy framework robust to challenge

- Uncertainty not going away: more policy space needed

- Monetary policy cannot deal with real consequences

- Need for a real side strategy with at least three pillars

1. **Technological diversification** (Koren and Tenreyro AER 2013)
2. **Trade diversification** (Caselli, Koren, Lisicky and Tenreyro QJE 2020)
   - especially with low geopolitical-risk trading partners
   - reshoring makes countries more vulnerable
3. **Buffer building**
   - energy, water and other critical materials