IN-DEPTH ANALYSIS

European Parliament

EGOV
ECONOMIC GOVERNANCE AND EMU SCRUTINY UNIT

MONETARY POLICY

# Euro area monetary policy: Quarterly overview, July 2024

*This briefing paper provides a summary of key monetary policy developments and decisions taken by the ECB's Governing Council.*

## 1. Key developments

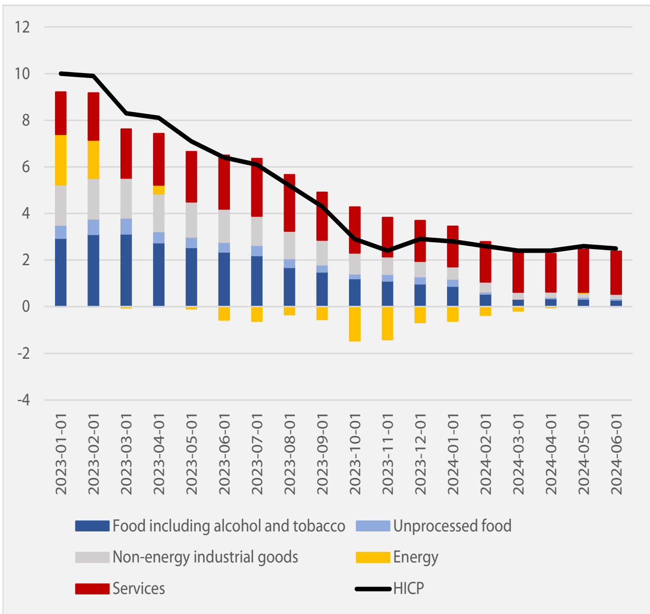
### Current inflation dynamics

**According to latest estimate by [Eurostat](), annual headline inflation rate (as measured by the harmonised index of consumer prices, HICP) decreased to 2.5% in June from 2.6% in May.**

**Core inflation (i.e. HICP inflation excluding energy and food) slightly decreased to 2.8% in June 2024.** In recent months, core inflation has been trending downward, fluctuating around 3%. The decline has been mostly supported by enhanced supply conditions, the transmission of prior declines of energy costs, and impacts of the restrictive monetary policy by the ECB.

**Figure 1** shows different contributions to headline inflation in the euro area.

**Figure 1**: Contributions to HICP inflation in euro area, percentage points




*Note: Last observation is June 2024.*
*Source: EGOV elaboration based on [Eurostat.]()*

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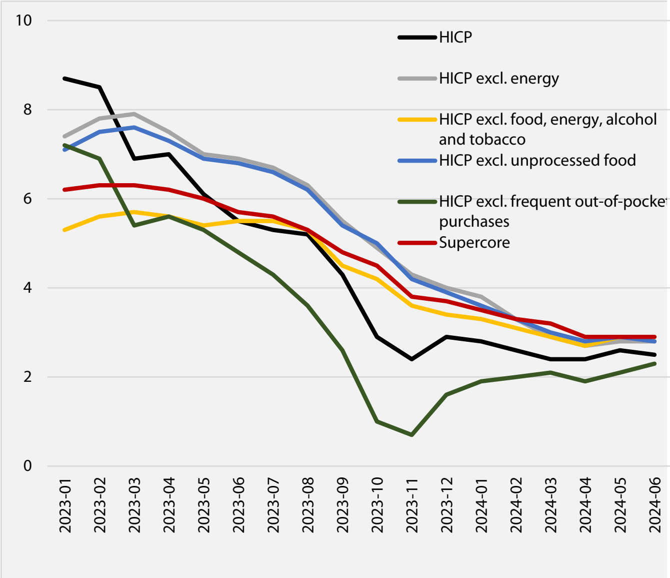
**Figure 2:** Underlying measures of inflation, in %




*Note: Frequent-out-of pocket purchases represent purchases made by consumers at least once a month, these are transactions that are paid for directly and actively; supercore includes only those items from the HICP inflation measure, excluding energy and food that are considered sensitive to economic slack, as indicated by the output gap.*
*Source: EGOV elaboration based on [Eurostat] and [ECB Data Portal].*

**Although some measures of underlying inflation increased in May due to one-off factors, most measures either stabilised or decreased slightly in June.** Domestic inflation[1] still remains high, driven by rising wages that compensate for past inflation, although unit labour cost growth decelerated in Q1 2024. Labour cost growth will stay high in the near term due to incremental wage adjustments and one-off payments. Moreover, in Q1 2024 decline of profits have helped counteract the inflation caused by higher unit labour costs, and this trend should continue in the near term. Among euro area countries, the trend of inflation convergence toward the ECB's 2% target is increasing, with some countries (e.g., IE, IT, LV, LT, SI, FI) even falling below the target.

**Figure 2** presents an overview of underlying measures of inflation in the euro area. Please refer to the Annex for headline (**Table 4**) and core (**Table 5**) inflation rates by Member State in the last 12 months.

**According to the ECB, inflation is expected to fluctuate around current levels through the rest of this year, influenced in part by energy-related base effects.** In the second half of the year, it is expected to decrease towards the ECB target due to slower growth in labour costs, the effects of the restrictive monetary policy, and the fading impact of prior inflationary pressures. **However, there remains a possibility of inflation exceeding expectations should wages or profits increase beyond forecasts**. Additional inflation risks include heightened geopolitical tensions, potential impacts from extreme weather events, and ongoing climate challenges that could drive up food prices. On the other hand, inflation could unexpectedly decrease if monetary policy effectively dampens demand.

**In a recent speech, ECB president Christine Lagarde reminded that the ECB has developed a framework that integrates forecasts with current data on underlying inflation and monetary transmission.** President Lagarde underscored that the ECB continues to grapple uncertainty on the trajectory of inflation, especially concerning how profits, wages, and productivity interact, and the possibility of new shocks on the supply side.

## Inflation forecasts

**According to the Eurosystem staff macroeconomic projections (June 2024), the ECB expects the 2% inflation target to be reached in the fourth quarter of 20254 one quarter later than the previous forecast suggested**. Headline inflation forecasts for 2024 and 2025 have been revised up by 0.2 percentage points (p.p.) mainly due to higher energy (commodity) prices and upward revision in core inflation. For 2025, food inflation is also expected to contribute to higher inflation, reflecting higher energy prices and labour costs. Core inflation has been slightly revised up mainly due to data surprises, in particular in services. The June projections are broadly in line with most recent inflation forecasts by other institutions (see **Table 1**).

[1] Domestic inflation includes goods and services intended for local consumption with minimal dependence on imports.

**The latest macroeconomic projections include a number of sensitivity and scenario analyses.** The alternative energy price path analysis suggests possible significant impacts on inflation, with upside risks to technical assumptions of the June projections on both oil and gas prices. The projections also include a specific scenario analysis on economic developments in China[2].

**Table 1:** Comparison of recent euro area headline and core inflation forecasts

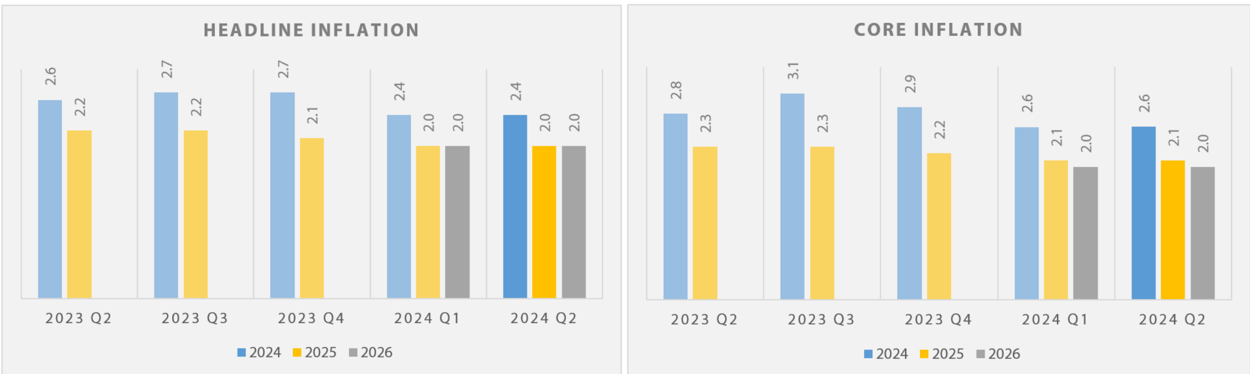
| Source | | 2024 | 2025 | 2026 |
|---|---|---|---|---|
| **ECB, June 2024** *Revision from Mar-24* | **Headline** | **2.5%** ↑*0.2 p.p.* | **2.2%** ↑*0.2 p.p.* | **1.9%** = |
| | **Core[3]** | **2.8%** ↑*0.2 p.p.* | **2.2%** ↑*0.1 p.p.* | **2.0%** / |
| **European Commission, May 2024** *Revision from Feb-24* | **Headline** | **2.5%** ↓*0.2 p.p.* | **2.1%** ↓*0.1 p.p.* | |
| | **Core[4]** | **2.7%** ↓*0.4 p.p.* | **2.1%** ↓*0.4 p.p.* | |
| **OECD, May 2024** | **Headline** | **2.3%** ↓*0.3 p.p.* | **2.2%** = | |
| | **Core[5]** | **2.6%** = | **2.1%** ↓*0.1 p.p.* | |

*Sources: Eurosystem staff macroeconomic projections June 2024, European Commission Spring 2024 forecast, OECD Economic Outlook May 2024.*

## Inflation expectations

**The latest Survey of Professional Forecasters (SPF) for the second quarter of 2024 shows unchanged expectations on headline and core inflation across all horizons.** As shown in **Figure 4** (left side), survey respondents are forecasting inflation to reach 2.4% in 2024 and 2% in 2025 and 2026.

**Figure 3**: SPF inflation forecasts, in %




*Source: EGOV elaboration based on ECB, SPF.*

[2] Upside and downside scenarios suggest a slight impact on euro area inflation (from +0.1 p.p. to -0.15 p.p.), with a more pronounced impact with China exporting disinflation in the adverse scenario (around -0.4 p.p. in 2025 and 2026). Finally, alterative scenarios in relation to productivity and their impact on inflation were assessed. In the optimistic scenario, the expected impact on inflation is minimal, while in the pessimistic scenario the impact is more pronounced, with +0.1 p.p. and +0.2 p. p. deviations from baseline in 2025 and 2026, respectively. For more information see ECB website.

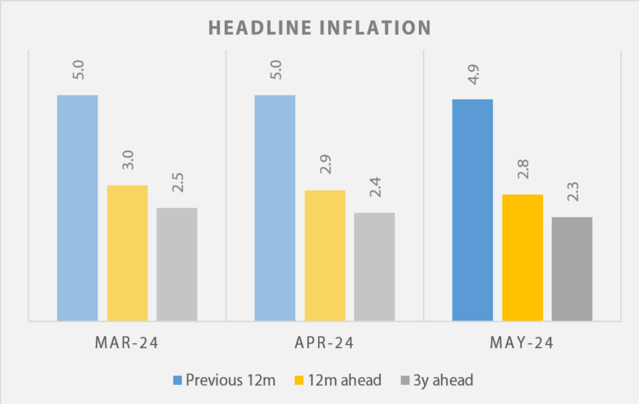
[3] The ECB's measure of core inflation excludes all food and energy.

[4] The European Commission's measure of core inflation excludes unprocessed food and energy. Variations are presented between estimates from May 2024 and November 2023.

[5] HICP excluding food, energy, alcohol and tobacco.

Core inflation (**Figure 4**, right side) was also unrevised for 2024 at 2.6%, while for 2025 and 2026 it is forecasted to reach 2.1% and 2%, respectively. Measured uncertainty remains high, and the balance of risks is to the upside and increased compared to the previous round. The main uncertainties and upside risks relate to labour market and wage developments and geopolitical factors. On the other hand, some respondents saw weak growth as a downside risk. Longer-term inflation expectations (five year ahead) appear anchored at the 2% target.

**Figure 4**: CES inflation expectations, median, in %




*Source: EGOV elaboration based on ECB, CES.*

**The Consumer Expectations Survey (CES) for May 2024 shows a gradual downward revision of inflation perceptions across horizons.** Consumer inflation perceptions continue on a downward path since 2023. For most of 2022 and first quarter of 2023, the forward-looking, 12-month ahead consumer inflation expectations hovered around 5%, then started before a short-lived increase between July and September 2023. Since then, consumers' expectations have been steadily decreasing, but still remaining noticeably above 2%, even in the 3-year horizon, in line with the systematic "upward bias" observed.[6] For an overview of the last 3 CES surveys, see **Figure 5**.

## Monetary policy transmission: latest bank lending survey (BLS)

**The ECB's latest euro area bank lending survey (BLS) (July 2024) shows a broadly unchanged tight level of credit standards in the second quarter of 2024.** While the demand for loans from enterprises continue to decline, for the first time since Q1 2022 the BLS reports an increase in households' demand for mortgages. The BLS assesses the tightening in credit standards across different categories of loans: credit to enterprises, households and consumer credit.

At headline level:

- **Credit standards for loans to enterprises tightened only marginally in the second quarter of 2024.** This is mostly driven by the banks' risk tolerance and shows that banks' risk perception is less relevant now than during the hiking cycle.
- **Credit standards to households for house purchases eased further. Net demand for housing loans increased for the first time since the beginning of 2022.** Though unexpected, this is the second consecutive quarter of net easing in credit standards. The increase in the demand for mortgages is however weaker than expected. Banks forecast demand to continue growing in the coming quarter. The BLS reports the first decrease in rejected application for mortgages since the beginning of 2021.
- **Credit standards for consumer loans tightened moderately while net demand for consumer credit also increased for the first time since 2022.** Banks continue to forecast credit standards to remain broadly unchanged in the next quarter. Should this be the case, it would be the first quarter without any additional tightening since mid-2022. Overall, the BLS records the lowest increase in rejected loans to consumer credit since Q2 2022.

[6] See D'Acunto, F., Charalambakis, E., Georgarakos, D., Kenny, G., Meyer, J. and Weber, M. (2024). "Household inflation expectations: an overview of recent insights for monetary policy", ECB Discussion Paper No 24.

This edition of the BLS also contained some ad hoc questions finding that:

- **Access to funding for debt securities and money markets has improved, whereas it deteriorated for short-term funding.** For the next quarter, banks expect a deterioration across all segments of funding.
- **Perceived credit risks seems to have driven a moderate tightening of credit standards for loans to enterprise and consumer credit , as well as their terms and conditions, in the first half of 2024.** Banks expect further tightening on credit standards for loans in H2 2024.
- **Lending conditions for firms have tightened further in all economic sectors, though to a varying degree,** e.g. small tightening in services and manufacturing and big in commercial real estate. Demand for enterprise loans has declined in most sectors. Credit conditions are expected to further tighten in the H2 2024 despite a moderate recovery in loan demand in most sectors.
- **The withdrawal of excess liquidity in the first half of 2024 had only a small impact on bank lending conditions.** Banks expect a similarly limited impact in the second half of 2024.

**The BLS also assessed how climate risks of euro area corporates and measures to tackle climate change contributed to a tightening (easing) on credit standards for brown (green and in-transition) firms in the past year**. This net tightening is less than expected. The recorded higher net demand for loans to green or in-transition firms seems to have also benefited from the issuance of green corporate bonds for the ECB's monetary policy asset portfolio. Looking ahead, banks expect a slightly stronger net tightening (easing) impact on credit standards for loans to brown (green and transition) firms in the next twelve months.

## 2. Governing Council's monetary policy decisions

### Interest rates and forward guidance

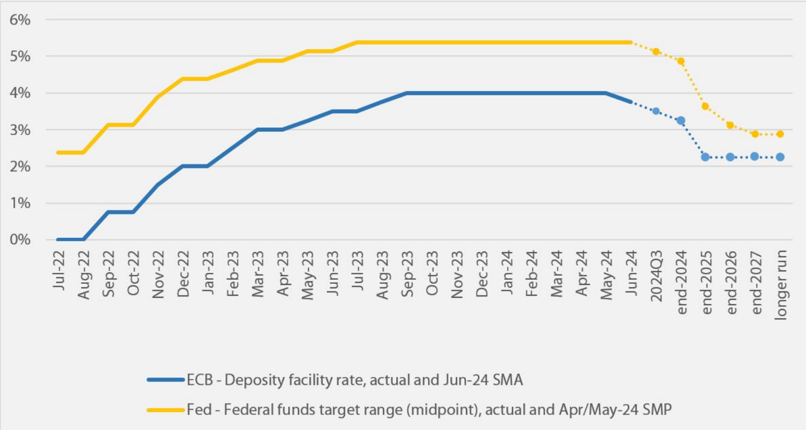
**In its last meeting on 18 July 2024, the Governing Council decided to keep key interest rates unchanged.** The recent incoming data largely confirms the ECB's earlier assessment of the medium-term inflation outlook. The interest rate on the deposit facility (DFR), main refinancing operations (MRO) and on the marginal lending facility (MLF) will remain unchanged at 3.75 %, 4.25% and 4.50%, respectively.

**Regarding president Lagarde's comments during the press conference, there was minimal new information.** So far, the ECB appears committed to its strategy of refraining from providing forward guidance, which aligns with the focus on data-dependency and a meeting-by-meeting approach. Lagarde mentioned that the discussion on possible rate cuts in September remains wide open. Thus, following last month's significant rate cut for the first time since July 2022, the ECB has offered minimal information about the direction of future discussions, leaving market participants to speculate about another potential move in early September.

**Minutes from the June meeting reveal differing perspectives on rate cuts.** It appears that analysts were correct in predicting that the ECB's rate cut decision in June was primarily influenced by prior commitments and the view that a cut was feasible but not pressing. The released minutes thus suggest that last month's rate cut does not necessarily indicate the start of a series of cuts. While most members supported the proposal to cut interest rates by 25 basis points (bps), given the expectation of reaching 2% inflation in 2026 and some room to lower rates while keeping a restrictive monetary policy stance, still some Governing Council members disagreed. Namely, members of the Council considered the risks to the inflation outlook as skewed to the upside, partly because of the ongoing economic recovery and heightened geopolitical risks since the last meeting. They argued that slightly missing the inflation target would be less problematic than persistently exceeding it. They also noted that cutting interest rates was not entirely consistent with data-dependency, and there was a case for maintaining interest rates at their current level during June meeting.

**Overall, the future direction of the ECB monetary policy stance remains uncertain and complex** as balancing data dependency with reputational risks has become increasingly delicate. The next major debate at the Governing Council table is scheduled for early September.

**Figure 5**: ECB and Fed, actual and market-expected interest rate paths



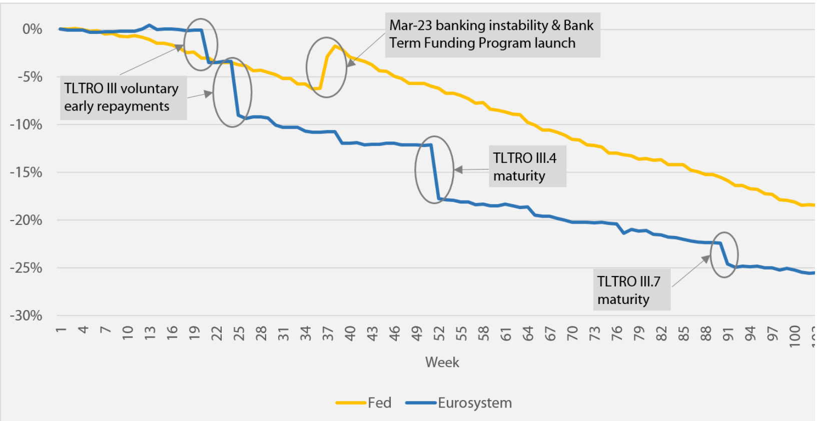

*Source: EGOV elaboration based on ECB's Survey of Monetary Analysts, June 2024, Federal Reserve Bank of New York's Survey of Market Participants, April/May 2024.*

*Notes: Dotted lines represent forecasts.*

**Concerning market expectations, the June 2024 Survey of Monetary Analysts (SMA) suggests two further interest rate cuts (of 25 bps each) by the end of the year.** From there, the DFR is expected to be further cut four times in 2025, arriving to 2.25% at end-2025, where it is expected to remain until the end-2027 and beyond. **Figure 6** shows the expected path of the DFR and, for comparison, the Fed's federal funds target range, as projected by market participants.

## Balance sheet reduction

**Figure 6**: Eurosystem and Federal Reserve, balance sheet reduction by week since July 2022

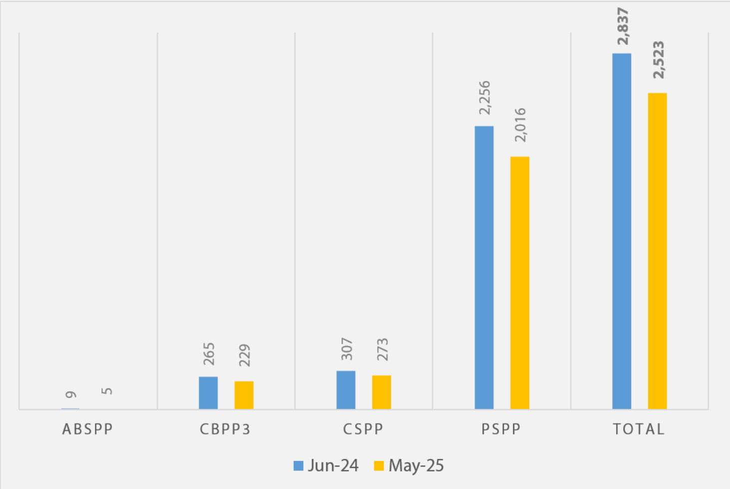



*Source: EGOV elaboration based on ECB and Federal Reserve.*

**The reduction of the Eurosystem's balance sheet is underway and implemented through quantitative tightening (QT, reduction of APP and PEPP holdings) and the repayments under TLTRO III.** The reduction so far has been primarily driven by the latter. As shown in **Figure 7**, TLTRO III repayments and the launch of the Fed's Bank Term Funding Program in March are two principal reasons why the Eurosystem's balance sheet has so far been reduced relatively more than that of the Fed.

## Asset purchase programmes

**Figure 8**: Eurosystem planned QT by APP programme, EUR million



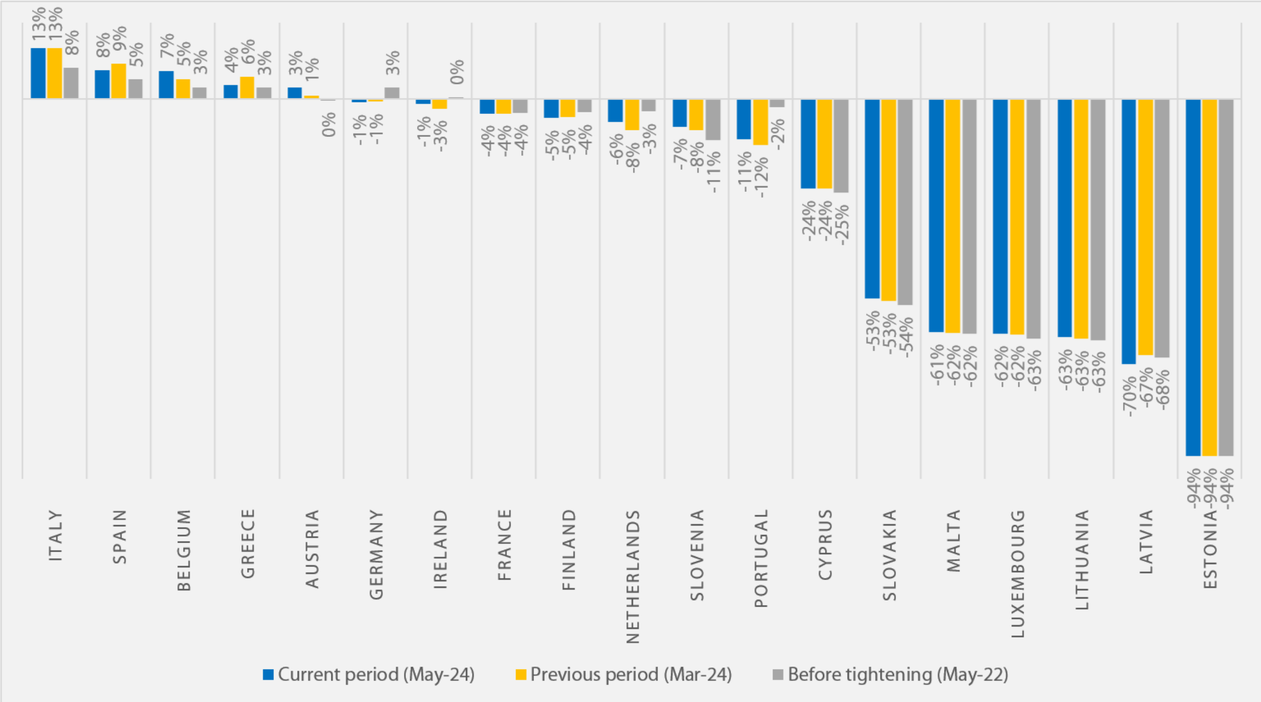

*Source: EGOV elaboration based on ECB ([APP holdings](); [APP redemptions]()).*

**The ECB is continuing with QT through a gradual unwinding of APP holdings, by stopping reinvestments of maturing assets and letting them "run off" the Eurosystem's balance sheet**. In a first phase, between March and June 2023, the run-off was limited to EUR 15 billion per month. Then, from July 2023 onwards, the limits were removed and principal repayments are no longer reinvested. This means that the stock of assets held by the Eurosystem is reduced at a pace that depends on the monthly amount of redemptions. Looking forward, in the 12-month period between June 2024 and May 2025, the monthly expected average is EUR 28 billion, with large variations from EUR 11.6 billion in August 2024 to EUR 41.6 billion in March 2025. These variations are driven by differences in monthly redemption amounts in the largest component of the APP, the public sector purchase programme (PSPP).

**In December 2023, the Governing Council decided to change the approach with the PEPP and include it into the QT operation**. According to the previous forward guidance, PEPP reinvestments were supposed to continue in full until at least the end of 2024. The December 2023 decision marks a shift, as from July 2024, PEPP reinvestments will be reduced by EUR 7.5 billion on average per month, and from January 2025 reinvestments will be discontinued altogether. Until then, reinvestments will continue to be conducted flexibly across Member States.

**PEPP reinvestments, therefore, will continue to act as a "first line of defence against fragmentation", only until the end of 2024**. After that, the ECB will rely on the TPI (and Outright Monetary Transactions, OMT, which remains part of the toolkit, as stated in the TPI announcement) to deal with fragmentation risks. Using the ECB's bi-monthly reporting, Figure 9 shows the latest (as of May 2024) deviation of PEPP public sector holdings from the capital key, with a comparison with the previous reporting period (March 2024) and with the last full period before the monetary policy tightening cycle began (May 2022).

**Figure 9**: PEPP public sector holdings, deviation from the capital key, in %

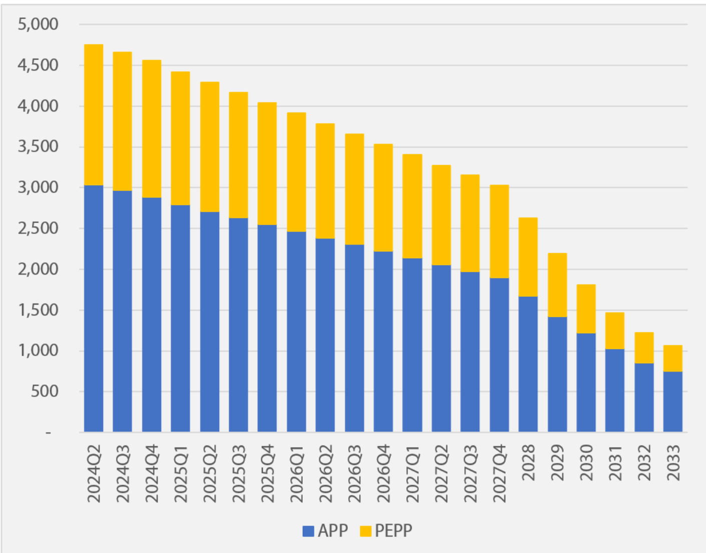



*Source: Authors' own elaboration based on ECB, [bimonthly breakdown of public sector securities under the PEPP](#).*

*Notes: Croatia joined the euro area after the net purchases under the PEPP had stopped. The deviation from the capital key takes into account PEPP [cumulative net purchases of public sector securities](#) (excluding supranational) and uses the [share of paid-up capital](#) of Eurosystem NCBs (excluding the Croatian National Bank).*

**Current market expectations suggest QT continuing in parallel with interest rate cuts.** Market expectations of the future unwinding of the APP and PEPP portfolios suggest a moderate and stable reduction over the next 10 years, with an expected amount of over EUR 1 trillion on the Eurosystem balance sheet in 2033. **Figure 10** shows expected future APP and PEPP holdings, based on the June 2024 SMA. Respondents' APP indications suggest an average monthly reduction of EUR 27 billion until the end of 2027. Concerning the PEPP, modest reductions of about EUR 15 billion average per month on average are expected from 2025, when the ECB will stop reinvestments. Unlike the APP, the ECB currently does not publish the monthly redemption amounts for the PEPP, making it impossible to estimate the pace of unwinding. The weighted average maturity of public sector asset holdings under the PEPP is 7.33 years.

**Figure 10**: Market expectations for Eurosystem asset holdings under APP and PEPP, median, EUR billion




*Source: EGOV elaboration based on [SMA, June 2024](#).*

### Targeted longer-term refinancing operations (TLTROs)

**Through TLTROs, the ECB provides longer-term financing to euro area credit institutions at favourable terms, with incentives to encourage lending to the real economy**[7]. With the steep and successive increases in the deposit facility rate, i.e. the rate that banks receive for overnight deposits at the ECB, that started in July 2022, the existing TLTRO III conditions became no longer tenable.

**In October 2022, the Governing Council decided to update the TLTROs III conditions to complement the current tightening environment**. From 23 November 2022 and until the operations maturity or the early repayment, the interest rate should be indexed to the average applicable key ECB interest rates over this period, thus incentivising banks to repay early. Three additional early repayment dates were made available.

**The TLTRO III repayments have contributed most significantly to the reduction of the Eurosystem's balance sheet, with more than EUR 2.26 trillion repaid by euro area banks**. Since the Governing Council's October 2022 decision, banks made voluntary early repayments amounting to more than EUR 1.1 trillion. The largest tranche of TLTROs (TLTRO III.4) of EUR 477 billion matured on 28 June 2023. As of July 2024, the outstanding amount under TLTRO III is EUR 76 billion, with the remaining two operations maturing in September and December 2024 (**Table 2**). The Governing Council maintains that that it will continue assessing how this contributes to its monetary policy stance.

**Table 2:** Overview of TLTRO III outstanding amounts, EUR billion

| TLTRO III operation | Maturity date | Alloted amount | Outstanding amount |
|---|---|---|---|
| **1** | 28-Sep-2022 | 3.40 | 0.00 |
| **2** | 21-Dec-2022 | 97.72 | 0.00 |
| **3** | 29-Mar-2023 | 114.98 | 0.00 |
| **4** | 28-Jun-2023 | 1308.40 | 0.00 |
| **5** | 27-Sep-2023 | 174.46 | 0.00 |
| **6** | 20-Dec-2023 | 50.41 | 0.00 |
| **7** | 27-Mar-2024 | 330.50 | 0.00 |
| **8** | 26-Jun-2024 | 109.83 | 0.00 |
| **9** | 25-Sep-2024 | 97.57 | 42.24 |
| **10** | 18-Dec-2024 | 51.97 | 34.21 |
| **TOTAL** | | **2,339.24** | **76.45** |

*Notes: Figures may not add up due to rounding. Source: EGOV elaboration based on ECB, open market operations.*

## 3. Monetary policy in other jurisdictions

### United States

**Throughout the four meetings held so far in 2024, the Federal Open Market Committee (FOMC) of the US Federal Reserve (Fed) has kept its target range for the federal funds rate between 5.25% and 5.5%.** The decision was unanimous. This target was first set in July 2023 and confirmed since then, representing the highest level in US interest rates in 23 years.

**Recent signals of cooling of the labour market and an easing of price pressures are now pushing expectations of a cut in interest rates during the upcoming meeting**. While a cut seems unlikely to take

[7] The TLTRO III programme started in September 2019 with 10 quarterly operations having a maturity of three years. Initial conditions applicable under TLTRO III were eased on several occasions: in September 2019, and then in response to the COVID-19 pandemic in March, April and December 2020. Banks achieving certain lending benchmarks could benefit from interest rates as low as -1%.

place in the FOMC meeting of 30 and 31 July, market participants are confident it might happen during the 17-18 September meeting.

**In early July, the Chair of the Fed, Jerome Powell, indicated that "considerable progress" had been made in the fight against inflation and that the US labour market is showing signals of cooling.** In this respect, it is important for the Fed to avoid restraining the economy excessively by keeping interest rates too high but reiterated that "*more good data*" would be needed before lowering the general interest rate level, reiterating the adoption of a "*meeting by meeting*" approach.

**Recent data from the US Bureau of Labour Statistics show an increase in the unemployment rate in June to 4.1% from 4% in May, despite expectations that it would have remained unchanged**. This is a level that was last recorded in November 2021. This slight increase in the unemployment rate was accompanied by a slowdown in jobs growth. The data are particularly relevant as the minutes of the June FOMC meeting suggest that the Fed is particularly focused on later labour market developments, suggesting that the materialisation of downside risks could prompt action on the interest rate levels.

**In June 2024, the headline inflation, as measured by the Consumer Price Index for All Urban Consumers (CPI-U), has fallen more than expected to 3.0% from 3.3% in May 2024.** This is the third consecutive month in which inflation has slowed down (on an annual basis) and it is the first time since June 2023 that inflation reached the level of 3.0%. In June, headline inflation fell by 0.1% on a monthly basis, in spite of expectations of an increase. For the first time since 2020, the Bureau of Labour Statistics recorded a fall in monthly consumer prices basis. Core CPI instead rose by 3.3% in June, though less than the expected 3.4%.

**While these data seem to point to a likely cut in the target range for the federal funds rate by the end of September, political headwinds might however constrain the actions of the Fed.** In what could be seen as an interference with the Fed's independence, former US President and frontrunner for the Republican Party for the presidential elections Donald Trump has in fact warned Powell not to cut interest rates before the vote in November. The September meeting of the Fed would in fact be the last one before the vote on 5 November.

## United Kingdom

**In 2024, the Monetary Policy Committee (MPC) of Bank of England (BoE) held its Bank Rate at the level of 5.25%.** This is the highest level in 16 years and was originally set in August 2023. In the latest MPC meeting of 20 June 2024, Members voted by a majority of 7 to 2 to keep the policy rate at 5.25% in what was called a "*finely balanced*" decision. This seems to be paving the way for potential cuts in the future, though it remains uncertain whether the MPC will decide to lower rates already at its next meeting on 1 August. The decision came despite headline inflation, as measured by the Consumer Price Index (CPI) reached its 2% target in May 2024 for the first time since July 2021.

**The latest figures from the Office of National Statistics indicate that CPI headline inflation in June 2024 remained at the 2% target unchanged from May 2024**.This remains slightly above the 1.9% forecast of market analysts, thus making it harder to foresee a cut in interest rates in August. The MPC has indicated that it is getting closer to lower rates but uncertainty remains on underlying price pressures. Services inflation remains higher than expected and steady at 5.7% in June 2024. It was expected to fall to 5.6%. The chief economist of the BoE, Huw Pill, suggested that while the bank has made "*substantial progress*", key drivers of UK inflation were displaying "*uncomfortable strength*". Figures on the UK economy show a potential overheating with growth figures above expectations. This might further compound challenges for the MPC to lower rates in August. Already before the June meeting, the BoE had forecasted that CPI inflation could further rise later in the year sitting at 2.6% by the end of 2024.

## 4. Fiscal challenges for monetary policy

In the latest edition of its bi-annual Financial Stability Review (May 2024 FSR)[8], the ECB focuses on the relation between financial stability and fiscal policy, which can have notable implications for the conduct of monetary policy, e.g. putting upward pressure on inflation or restraining the room for a Transmission Policy Instrument (TPI) intervention. Failing to bring public finances to sustainable **levels could, on the one hand, drive inflationary pressure upward and challenge the actions of the central bank and, on the other, bring back fragmentation on sovereign debt markets.** This would challenge the effective transmission of the monetary policy stance. For a further discussion, please see **Box 1**.

**The FSR highlights that fiscal vulnerabilities remain in case of unexpected lower growth levels and warns of risks of fiscal slippages as debt is rolled over at higher interest rates.** The risk of fiscal slippage, the ECB warns, is further increased by the electoral agenda of 2024 and 2025 as well as by uncertainties on how the new EU budgetary framework will be implemented, potentially leading to repricing of sovereign debt. While interest costs are set to rise across the board, this becomes particularly pressing for those countries with higher short-term refinancing needs. Overall, the ECB notes that some Member States have missed targets in 2023 and that the overall weak productivity matched by high debt and deficit levels could further push risk premia on the grounds of concerns for higher sovereign risk, with adverse macro-financial stability surprises.

**Box 1: Monetary policy and the new economic governance framework**

**The revision to the Stability and Growth Pact entered into force at the end of April 2024** and brought forward a number of changes to promote a country-specific approach for fiscal consolidation (where needed). The reform requires Member States to present multi-annual fiscal plans detailing how to achieve reduction of public debt and deficit ratios as well as commitment to potential reforms and investments necessary to extend the period over which the fiscal adjustment takes place.

**The ECB seems to be supporting fiscal consolidation efforts as this would contribute to price stability by reinforcing the transmission of monetary policy and prevent the risk of fiscal dominance in presence of high debt levels.** The objectives of the new governance framework could therefore contribute to safeguarding ECB's independence. The incentive for structural reforms embedded in the framework could raise the growth potential, reducing longer-term inflationary pressures. Nevertheless, fiscal consolidation efforts might clash with the need to invest in key EU priorities forcing the ECB to balance its price stability mandate with broader economic concerns.

**The reform also sought to strengthen the applicability of the excessive deficit procedure (EDP).** As 7 Member States are likely to become subject to an EDP to rein in excessive deficit levels, this could restrict the scope for the ECB to temporarily intervene in sovereign debt markets through the potential activation of the Transmission Protection Instrument (TPI). The TPI was announced as a tool to prevent self-fulfilling debt spirals and address potential fragmentation in the euro area due to market speculation. Among its eligibility criteria, the ECB indicated compliance with the EU economic governance framework, including "*not being subject an excessive deficit procedure*". While the ECB suggested that the activation of the TPI would be based on a holistic assessment of its criteria, it remains uncertain whether the absence of an EDP is a critical precondition for ECB action.

**The FSR also displays some scepticism on recent decline of public debt ratios in the euro area from the peaks of the COVID-19 pandemic**. The ECB indicates that this is mostly driven by a recovery in nominal GDP that has *"more than offset the impact of higher debt service costs on debt levels"*. Yet, in the new macroeconomic environment, with *"little changes expected to structural primary balances"* and weaker income growth expected, the fall in debt ratios is taking place at slower paces, implying higher debt levels in the short/medium term in most countries relative to the pre-pandemic period. Structural concerns on

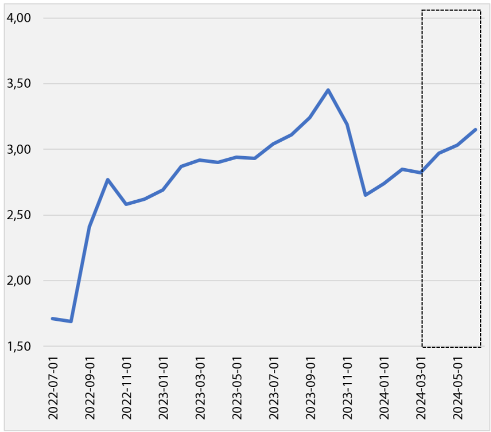
[8] The ECB publishes the FSR twice a year in May and November.

growth and productivity in the euro area also compound the vulnerability of public finances to future shocks, further threatening the financial stability outlook.

**Beyond sovereigns, the FSR notes that households and firms are exposed to rising debt servicing as previously contracted low interest rate debt is repricing at higher rates**. In turns, this increases their vulnerabilities and further restrain the capabilities to service their debt. This especially threatens larger real estate firms and lower income households that might find it harder to repay their debts. **The materialisation of risks to economic growth, including geopolitical risks, could lead could lead to disorderly adjustments in financial markets, increased debt servicing challenges and worsening asset quality of euro area banks**. While so far banks display strong liquidity positions, including despite a repayment of over 90% of funds borrowed under TLTROs, profitability margins might be impacted in the long term.

## The reaction of financial markets to the French election

**Figure 11**: French government 10-year bond yields, in %




*Source: ECB Data Portal.*
*Notes: Last observation is June 2024. Monthly data.*

**The unexpectedly announced French elections in early June, brought fresh uncertainty to the financial markets, prompting investors to pivot their focus towards debt management (Figure 11).** The turmoil, which resulted in the largest weekly increase on record in the spread between French and German 10-year bond yields (83 bps) and a USD 200 billion decline in the value of French stocks, was viewed as manageable by (some) policymakers. Yields on 10-year French government bonds rose by as much as 10 bps to 3.2%, an unprecedented level since the 2012 euro area sovereign debt crisis. The market response has even extended beyond France, widening the spreads in other euro area countries like Italy. ECB officials, according to Bloomberg, at the time perceived no urgent need to take over the recent market turbulence affecting France.

**While market conditions have now stabilised, concerns about French debt sustainability persist post-elections, keeping the threat of a sovereign debt crisis on the horizon.** Investors remain cautious about the potential market impact, warning of possible volatility in coming months, although they believe the worst-case scenario is behind France. Investors are likely to demand higher interest rates on French government borrowing for years due to ongoing fiscal challenges. France's deficit exceeds the 3% of GDP Treaty limit and is expected to remain well above the threshold until 2027.



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## ANNEXES

**Table 3**: Headline HICP inflation rates by euro area Member State, %

| | Jul-23 | Aug-23 | Sep-23 | Oct-23 | Nov-23 | Dec-23 | Jan-24 | Feb-24 | Mar-24 | Apr-24 | May-24 | Jun-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BE | 1,7 | 2,4 | 0,7 | -1,7 | -0,8 | 0,5 | 1,5 | 3,6 | 3,8 | 4,9 | 4,9 | 5,4 |
| DE | 6,5 | 6,4 | 4,3 | 3,0 | 2,3 | 3,8 | 3,1 | 2,7 | 2,3 | 2,4 | 2,8 | 2,5 |
| EE | 6,2 | 4,3 | 3,9 | 5,0 | 4,1 | 4,3 | 5,0 | 4,4 | 4,1 | 3,1 | 3,1 | 2,8 |
| IE | 4,6 | 4,9 | 5,0 | 3,6 | 2,5 | 3,2 | 2,7 | 2,3 | 1,7 | 1,6 | 2,0 | 1,5 |
| EL | 3,5 | 3,5 | 2,4 | 3,8 | 2,9 | 3,7 | 3,2 | 3,1 | 3,4 | 3,2 | 2,4 | 2,5 |
| ES | 2,1 | 2,4 | 3,3 | 3,5 | 3,3 | 3,3 | 3,5 | 2,9 | 3,3 | 3,4 | 3,8 | 3,6 |
| FR | 5,1 | 5,7 | 5,7 | 4,5 | 3,9 | 4,1 | 3,4 | 3,2 | 2,4 | 2,4 | 2,6 | 2,5 |
| HR | 8,0 | 8,4 | 7,4 | 6,7 | 5,5 | 5,4 | 4,8 | 4,8 | 4,9 | 4,7 | 4,3 | 3,5 |
| IT | 6,3 | 5,5 | 5,6 | 1,8 | 0,6 | 0,5 | 0,9 | 0,8 | 1,2 | 0,9 | 0,8 | 0,9 |
| CY | 2,4 | 3,1 | 4,3 | 3,6 | 2,4 | 1,9 | 2,1 | 2,1 | 1,6 | 2,1 | 3,0 | 3,0 |
| LV | 6,6 | 5,6 | 3,6 | 2,3 | 1,1 | 0,9 | 1,1 | 0,6 | 1,0 | 1,1 | 0,0 | 1,5 |
| LT | 7,2 | 6,4 | 4,1 | 3,1 | 2,3 | 1,6 | 1,1 | 1,1 | 0,4 | 0,4 | 0,9 | 1,0 |
| LU | 2,0 | 3,5 | 3,4 | 2,1 | 2,1 | 3,2 | 3,0 | 3,2 | 3,2 | 3,0 | 3,2 | 2,8 |
| MT | 5,6 | 5,0 | 4,9 | 4,2 | 3,9 | 3,7 | 3,7 | 3,0 | 2,7 | 2,4 | 2,3 | 2,2 |
| NL | 5,3 | 3,4 | -0,3 | -1,0 | 1,4 | 1,0 | 3,1 | 2,7 | 3,1 | 2,6 | 2,7 | 3,4 |
| AT | 7,0 | 7,5 | 5,8 | 4,9 | 4,9 | 5,7 | 4,3 | 4,0 | 4,1 | 3,4 | 3,3 | 3,1 |
| PT | 4,3 | 5,3 | 4,8 | 3,2 | 2,2 | 1,9 | 2,5 | 2,3 | 2,6 | 2,3 | 3,8 | 3,1 |
| SI | 5,7 | 6,1 | 7,1 | 6,6 | 4,5 | 3,8 | 3,4 | 3,4 | 3,4 | 3,0 | 2,5 | 1,6 |
| SK | 10,3 | 9,6 | 9,0 | 7,8 | 6,9 | 6,6 | 4,4 | 3,8 | 2,7 | 2,4 | 2,6 | 2,4 |
| FI | 4,2 | 3,1 | 3,0 | 2,4 | 0,7 | 1,3 | 1,1 | 1,1 | 0,6 | 0,6 | 0,4 | 0,5 |
| EA | **5,3** | **5,2** | **4,3** | **2,9** | **2,4** | **2,9** | **2,8** | **2,6** | **2,4** | **2,4** | **2,6** | **2,5** |

*Source: ECB Data Portal.*

**Table 4**: Core (excl. energy and food) HICP inflation rates by euro area Member State, %

| | Jul-23 | Aug-23 | Sep-23 | Oct-23 | Nov-23 | Dec-23 | Jan-24 | Feb-24 | Mar-24 | Apr-24 | May-24 | June-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BE | 6,1 | 6,5 | 5,6 | 5,6 | 5,0 | 5,0 | 4,9 | 4,0 | 3,8 | 3,4 | 3,1 | 3,5 |
| DE | 6,2 | 6,3 | 4,8 | 4,2 | 3,5 | 3,4 | 3,4 | 3,5 | 3,2 | 2,9 | 3,5 | 3,1 |
| EE | 7,9 | 7,4 | 6,6 | 5,2 | 5,2 | 5,0 | 5,0 | 5,0 | 4,9 | 5,7 | 5,1 | 4,5 |
| IE | 4,7 | 4,4 | 4,0 | 4,3 | 3,6 | 4,1 | 3,8 | 3,2 | 2,8 | 2,3 | 2,5 | 2,3 |
| EL | 5,4 | 5,4 | 4,2 | 3,6 | 2,8 | 3,3 | 3,1 | 3,0 | 3,4 | 3,1 | 2,8 | 3,3 |
| ES | 4,4 | 4,3 | 3,9 | 3,8 | 3,4 | 3,5 | 3,2 | 3,3 | 3,1 | 2,7 | 3,0 | 3,2 |
| FR | 4,3 | 4,0 | 3,6 | 3,5 | 2,9 | 2,9 | 2,7 | 2,5 | 2,2 | 2,3 | 2,3 | 2,4 |
| HR | 9,5 | 9,1 | 7,3 | 7,5 | 6,8 | 6,1 | 5,2 | 5,3 | 5,4 | 5,2 | 4,9 | 4,1 |
| IT | 4,7 | 4,0 | 4,1 | 3,8 | 3,3 | 3,0 | 2,8 | 2,6 | 2,2 | 2,2 | 2,2 | 2,1 |
| CY | 3,5 | 3,1 | 3,5 | 2,8 | 3,1 | 2,4 | 2,6 | 2,9 | 2,5 | 1,8 | 3,0 | 2,5 |
| LV | 9,0 | 8,1 | 7,2 | 5,9 | 5,2 | 4,4 | 3,8 | 3,5 | 3,8 | 3,4 | 3,1 | 3,8 |
| LT | 10,1 | 9,4 | 8,2 | 7,1 | 6,2 | 5,3 | 4,7 | 4,6 | 3,8 | 3,5 | 3,3 | 2,7 |
| LU | 4,3 | 3,9 | 3,8 | 3,9 | 3,6 | 3,8 | 3,6 | 3,3 | 3,4 | 2,4 | 2,5 | 3,1 |
| MT | 5,0 | 4,1 | 4,2 | 3,6 | 3,2 | 2,7 | 2,5 | 2,4 | 2,2 | 1,8 | 1,9 | 2,2 |
| NL | 7,2 | 7,0 | 5,1 | 4,7 | 3,9 | 3,3 | 3,4 | 2,8 | 3,1 | 2,3 | 2,5 | 3,4 |
| AT | 7,6 | 7,4 | 6,9 | 6,1 | 6,0 | 5,9 | 5,3 | 5,0 | 4,8 | 4,1 | 4,0 | 3,7 |
| PT | 5,8 | 6,2 | 5,1 | 4,7 | 3,7 | 3,3 | 2,9 | 2,6 | 3,2 | 2,4 | 3,5 | 2,7 |
| SI | 7,3 | 6,9 | 6,6 | 5,9 | 5,1 | 4,4 | 3,9 | 4,2 | 4,0 | 3,3 | 3,0 | 2,4 |
| SK | 9,2 | 8,6 | 8,2 | 7,7 | 7,1 | 6,8 | 5,4 | 4,8 | 3,9 | 3,6 | 3,7 | 3,5 |
| FI | 4,5 | 3,7 | 3,6 | 3,6 | 2,7 | 2,7 | 2,9 | 2,7 | 2,1 | 1,7 | 1,5 | 1,8 |
| EA | **5,5** | **5,3** | **4,5** | **4,2** | **3,6** | **3,4** | **3,3** | **3,1** | **2,9** | **2,7** | **2,9** | 2,8 |

*Source: ECB Data Portal.*

**Table 5**: Composite cost of borrowing, households for house purchase, %

| | Jun-23 | Jul-23 | Aug-23 | Sep-23 | Oct-23 | Nov-23 | Dec-23 | Jan-24 | Feb-24 | Mar-24 | Apr-24 | May-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BE | 3.6 | 3.6 | 3.7 | 3.8 | 3.8 | 3.8 | 3.9 | 3.7 | 3.7 | 3.5 | 3.4 | 3.5 |
| DE | 4.0 | 4.0 | 4.1 | 4.1 | 4.2 | 4.2 | 4.1 | 3.9 | 3.9 | 3.9 | 3.9 | 4.0 |
| EE | 5.6 | 5.9 | 5.9 | 6.0 | 6.3 | 6.1 | 5.9 | 5.9 | 5.9 | 5.8 | 5.8 | 5.7 |
| IE | 4.0 | 4.0 | 4.1 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 4.0 |
| EL | 4.1 | 4.2 | 4.2 | 4.3 | 4.6 | 4.5 | 4.4 | 4.6 | 4.5 | 4.3 | 4.4 | 4.2 |
| ES | 3.8 | 3.9 | 4.0 | 4.0 | 4.0 | 3.9 | 3.8 | 3.8 | 3.7 | 3.6 | 3.6 | 3.6 |
| FR | 3.0 | 3.2 | 3.3 | 3.4 | 3.4 | 3.5 | 3.6 | 3.6 | 3.5 | 3.5 | 3.5 | 3.5 |
| HR | 3.1 | 3.3 | 3.5 | 3.5 | 3.6 | 3.6 | 3.6 | 3.6 | 3.7 | 3.7 | 3.7 | 3.7 |
| IT | 4.2 | 4.2 | 4.4 | 4.3 | 4.4 | 4.6 | 4.4 | 4.2 | 4.2 | 4.1 | 4.0 | 4.0 |
| CY | 4.0 | 4.1 | 4.4 | 4.5 | 4.8 | 5.2 | 5.1 | 5.1 | 4.9 | 4.6 | 4.5 | 4.4 |
| LV | 5.6 | 5.7 | 5.8 | 5.9 | 5.9 | 5.9 | 5.8 | 5.8 | 5.8 | 5.8 | 5.8 | 5.7 |
| LT | 5.6 | 5.7 | 5.8 | 5.8 | 5.9 | 5.9 | 5.6 | 5.7 | 5.7 | 5.7 | 5.6 | 5.5 |
| LU | 4.2 | 4.3 | 4.3 | 4.3 | 4.2 | 4.3 | 4.4 | 4.3 | 4.2 | 4.2 | 4.2 | 4.2 |
| MT | 2.3 | 2.2 | 2.1 | 2.1 | 2.2 | 2.1 | 2.2 | 2.1 | 2.1 | 2.1 | 2.0 | 2.1 |
| NL | 3.9 | 3.9 | 3.9 | 4.0 | 3.8 | 4.1 | 4.1 | 4.0 | 3.9 | 3.8 | 3.9 | 3.8 |
| AT | 3.9 | 4.1 | 3.9 | 3.8 | 4.1 | 4.2 | 4.1 | 4.0 | 4.1 | 4.1 | 4.0 | 4.0 |
| PT | 4.2 | 4.3 | 4.4 | 4.4 | 4.5 | 4.5 | 4.5 | 4.4 | 4.2 | 4.2 | 4.0 | 4.0 |
| SI | 4.1 | 4.2 | 4.1 | 4.1 | 4.1 | 4.1 | 4.1 | 4.0 | 3.9 | 3.9 | 3.8 | 3.8 |
| SK | 3.9 | 3.9 | 3.9 | 3.9 | 4.0 | 4.1 | 4.0 | 4.0 | 4.1 | 4.2 | 4.1 | 4.2 |
| FI | 4.0 | 4.1 | 4.2 | 4.4 | 4.4 | 4.4 | 4.3 | 4.1 | 4.2 | 4.2 | 4.2 | 4.2 |
| EA | **3.9** | **3.8** | **3.9** | **3.9** | **3.9** | **4.0** | **4.0** | **3.9** | **3.8** | **3.8** | **3.8** | **3.8** |

*Source: ECB Data Portal.*

**Table 6**: Composite cost of borrowing, non-financial corporations, %

| | Jun-23 | Jul-23 | Aug-23 | Sep-23 | Oct-23 | Nov-23 | Dec-23 | Jan-24 | Feb-24 | Mar-24 | Apr-24 | May-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| BE | 4.9 | 4.9 | 5.0 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.1 |
| DE | 5.0 | 5.2 | 5.3 | 5.3 | 5.6 | 5.4 | 5.4 | 5.4 | 5.3 | 5.4 | 5.4 | 5.3 |
| EE | 6.2 | 6.3 | 6.6 | 6.9 | 6.7 | 7.0 | 7.0 | 6.8 | 7.2 | 7.2 | 6.7 | 6.9 |
| IE | 5.5 | 5.8 | 5.8 | 6.2 | 5.9 | 6.0 | 5.7 | 6.0 | 6.1 | 6.4 | 6.4 | 5.8 |
| EL | 5.7 | 6.2 | 6.4 | 6.1 | 6.1 | 6.2 | 6.0 | 6.0 | 6.0 | 6.3 | 6.0 | 5.5 |
| ES | 4.5 | 4.7 | 4.9 | 4.8 | 5.0 | 5.0 | 5.0 | 4.9 | 4.9 | 4.9 | 4.9 | 4.9 |
| FR | 4.4 | 4.6 | 4.5 | 4.6 | 4.8 | 4.9 | 4.9 | 4.8 | 4.9 | 4.8 | 4.8 | 4.5 |
| HR | 4.8 | 4.7 | 4.9 | 4.8 | 5.2 | 5.2 | 5.3 | 5.1 | 5.2 | 5.1 | 5.1 | 5.2 |
| IT | 5.1 | 5.1 | 5.1 | 5.4 | 5.5 | 5.6 | 5.5 | 5.6 | 5.4 | 5.4 | 5.4 | 5.5 |
| CY | 5.6 | 5.8 | 5.8 | 5.6 | 6.0 | 6.0 | 5.6 | 5.8 | 6.0 | 5.7 | 5.6 | 5.7 |
| LV | 5.6 | 6.5 | 6.2 | 6.2 | 6.8 | 6.9 | 6.1 | 6.9 | 6.4 | 6.9 | 6.7 | 6.8 |
| LT | 6.2 | 6.2 | 6.6 | 6.5 | 6.9 | 6.6 | 6.4 | 6.5 | 6.4 | 6.4 | 6.3 | 6.5 |
| LU | 3.4 | 3.8 | 3.7 | 4.1 | 4.3 | 4.4 | 4.6 | 4.4 | 4.4 | 4.4 | 4.0 | 4.1 |
| MT | 4.8 | 5.5 | 6.1 | 4.0 | 5.3 | 5.0 | 4.6 | 4.6 | 4.1 | 4.8 | 4.9 | 4.4 |
| NL | 4.0 | 4.1 | 4.2 | 4.3 | 4.4 | 4.3 | 4.5 | 4.3 | 4.2 | 4.5 | 4.4 | 4.2 |
| AT | 4.5 | 4.8 | 5.0 | 5.0 | 5.1 | 5.1 | 5.1 | 5.1 | 5.1 | 5.1 | 5.2 | 5.0 |
| PT | 5.5 | 5.7 | 5.9 | 5.8 | 5.9 | 6.0 | 5.8 | 5.7 | 5.7 | 5.8 | 5.7 | 5.7 |
| SI | 5.1 | 5.0 | 5.0 | 5.2 | 5.6 | 5.3 | 5.5 | 5.4 | 5.5 | 5.2 | 5.5 | 5.5 |
| SK | 5.7 | 5.4 | 6.0 | 5.8 | 6.1 | 6.0 | 5.8 | 6.1 | 6.2 | 6.2 | 6.2 | 5.8 |
| FI | 4.9 | 5.1 | 5.1 | 5.3 | 5.1 | 5.4 | 5.2 | 5.4 | 5.4 | 5.4 | 5.4 | 5.4 |
| EA | **4.8** | **4.9** | **5.0** | **5.1** | **5.3** | **5.2** | **5.2** | **5.2** | **5.1** | **5.2** | **5.2** | **5.1** |

*Source: ECB Data Portal.*