MNI Connect:
What tail or head winds for Monetary Policy

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Main takeaways

1. Medium term macro outlook remains clouded by geopolitical, institutional and policy uncertainty; effectiveness of German fiscal expansion? China trade... and still waiting for the Draghi report implementation boost...

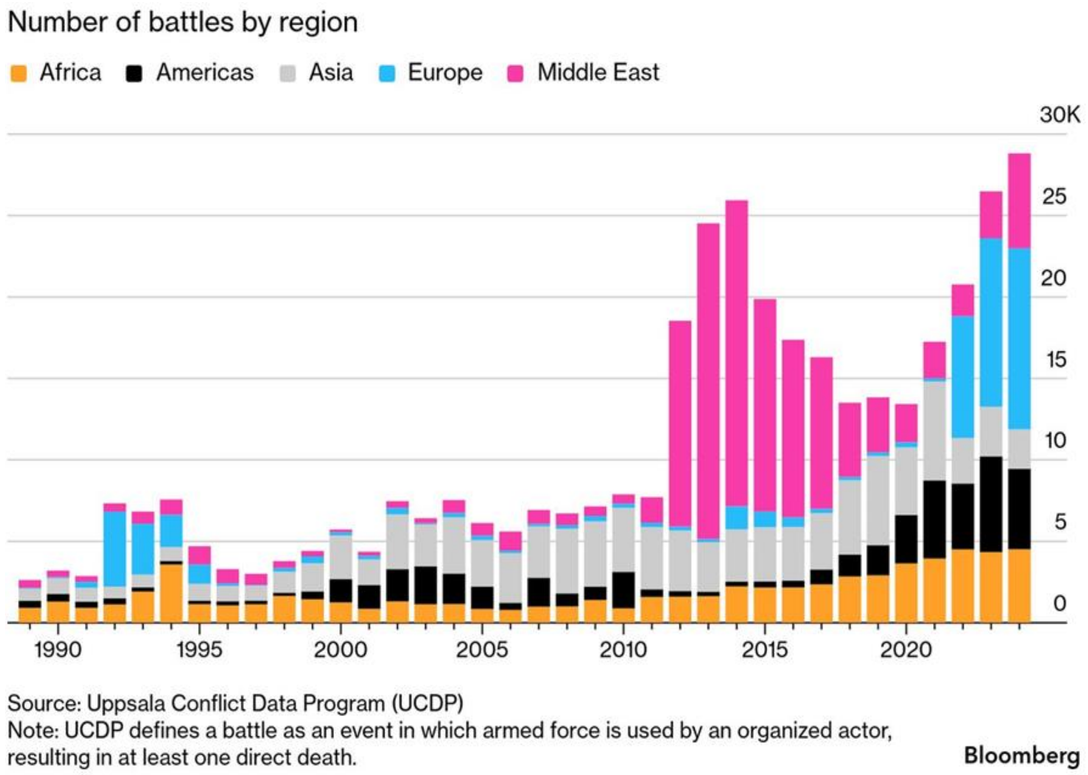
2. However, short term macro outlook somewhat better than expected, mainly due to resilient services sector and robust labour market

3. Core inflation, in particular sticky services prices, requires continued monitoring.

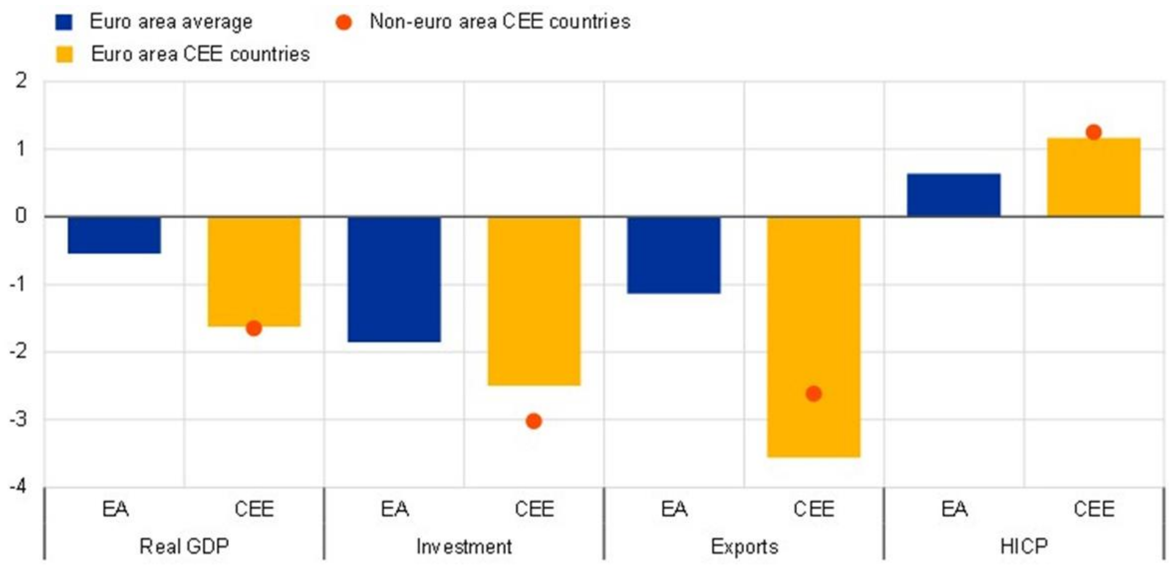
4. **Monetary policy:**
   1) Still in a good place – inflation close to 2%, interest rates at about the neutral level;
   2) Headwinds from fiscal policy: higher budget deficits, government debts may complicate monetary policy in the coming years.
   3) Same modus operandi: meeting-by-meeting, data dependent, no unique and predetermined rate path, full flexibility...

Geopolitical uncertainty clouding macro and policy outlook; symmetric vs asymmetric transactionalism

Number of battles by region



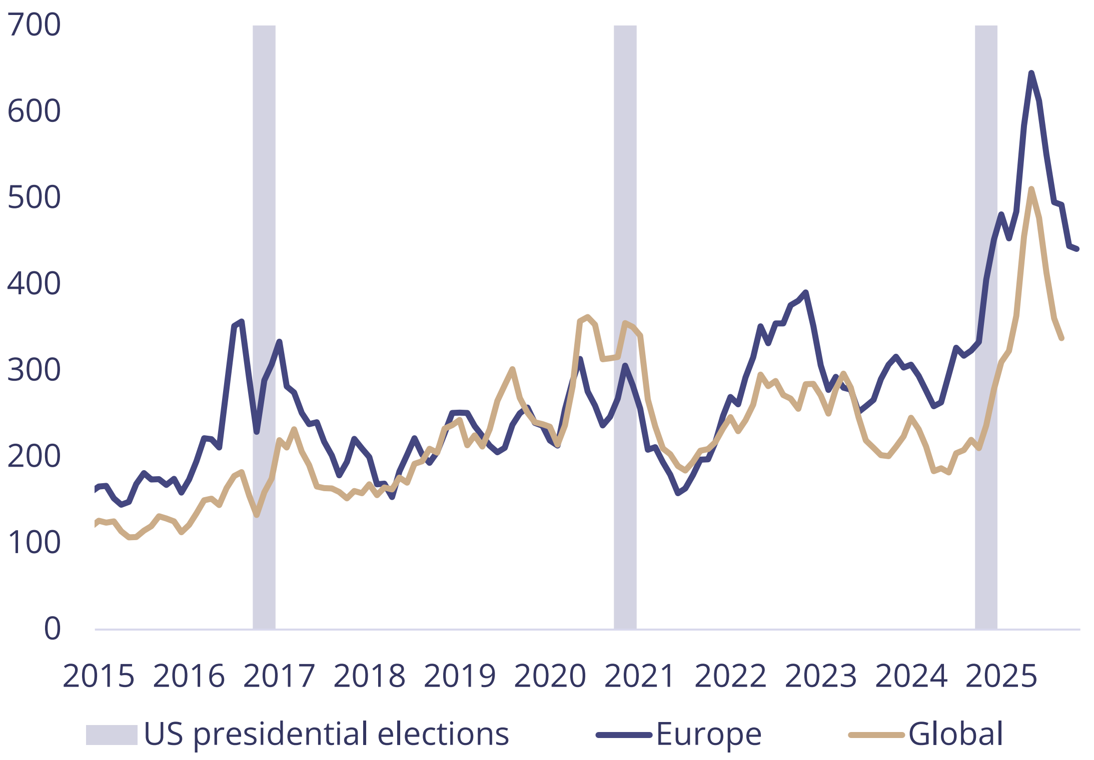
Economic impact of the geopolitical shock stemming from the Ukraine war beyond long-term trends (percentage points)



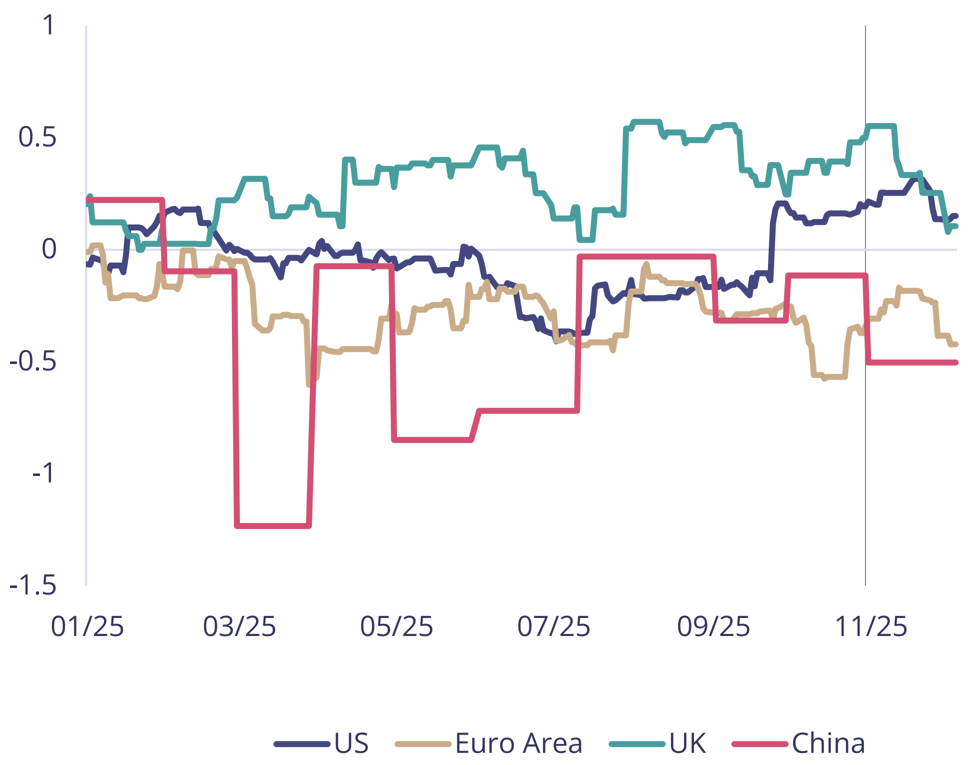
Source: ECB, https://www.ecb.europa.eu/press/blog/date/2025/html/ecb.blog20251128~fb427b2a3c.en.html

Policy uncertainty to persist; markets vulnerable to sharp corrections if sentiment turns

Economic Policy Uncertainty and US Presidential Elections (index; 3m-MA)



Bloomberg Economic Surprise Index (points)



Sources: Bloomberg; Economic Policy Uncertainty Project (Davis, S., 2016. "An Index of Global Economic Policy Uncertainty," Macroeconomic Review)

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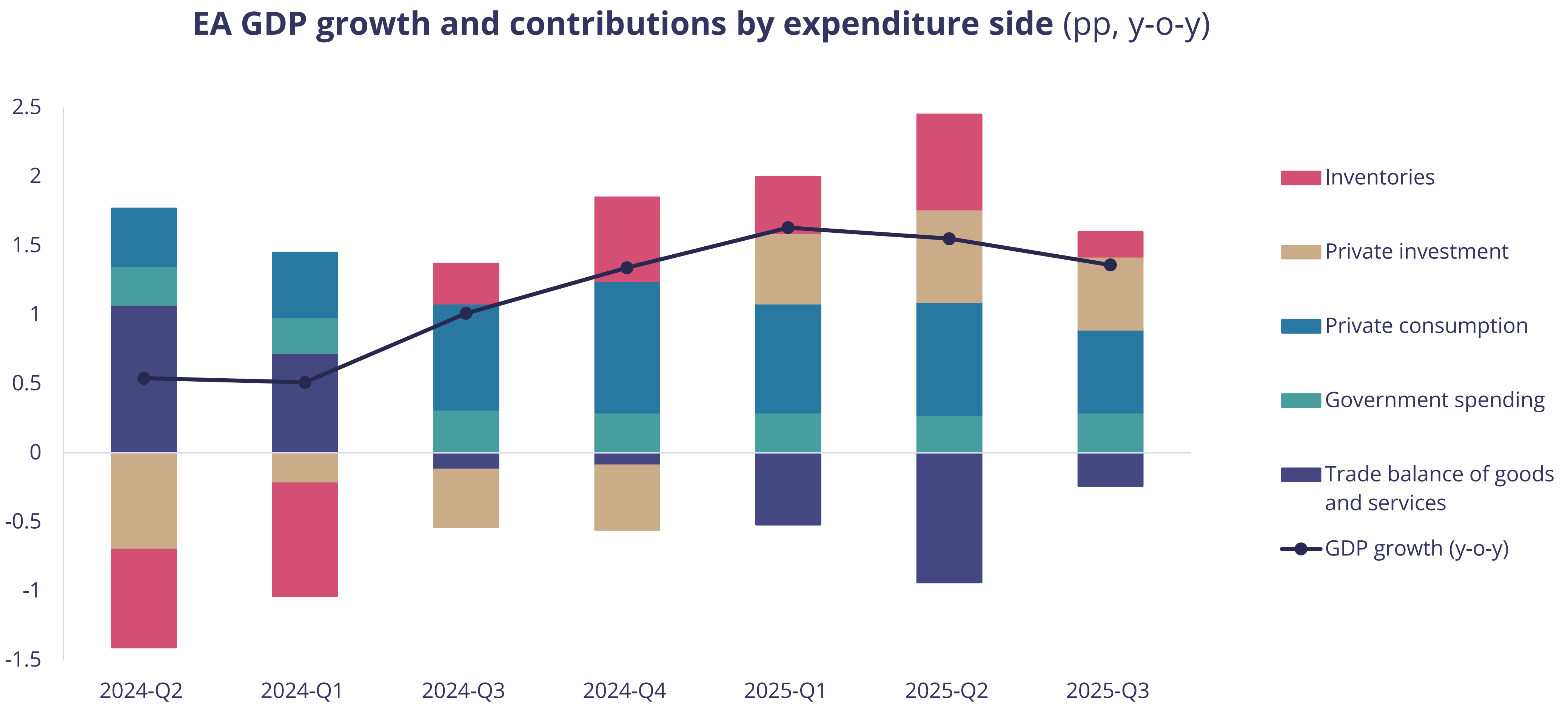
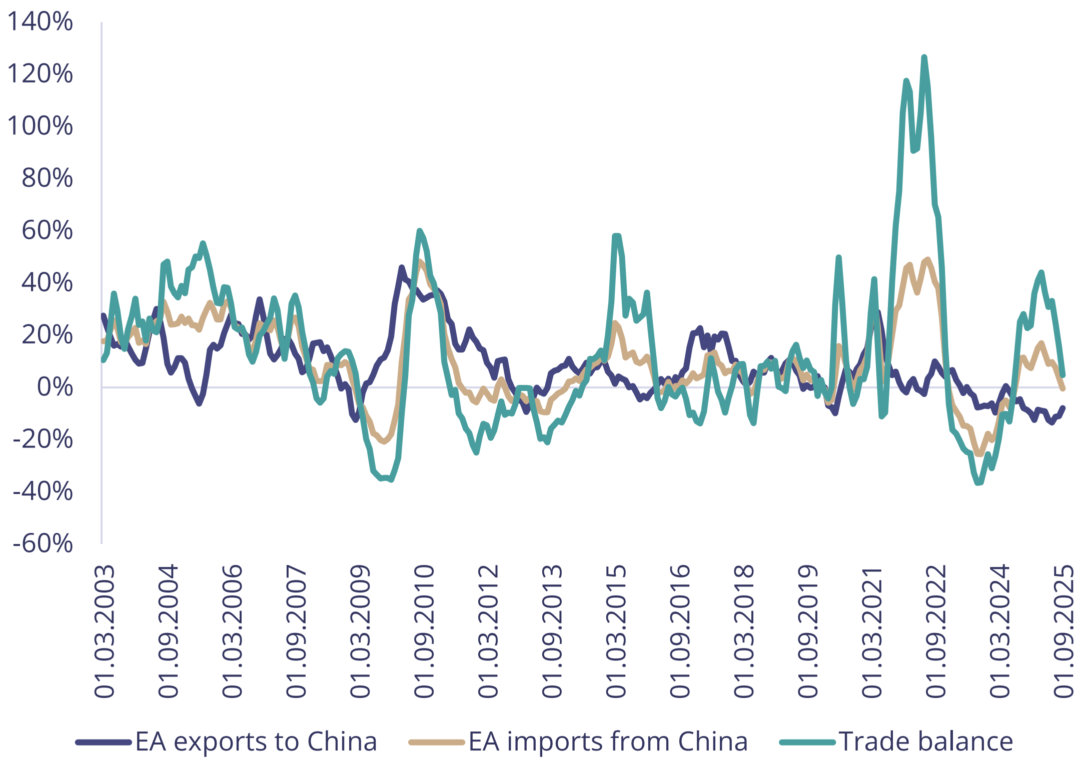
Euro area growth holds up better than expected amid trade headwinds



Source: Eurostat.

Euro area trade deficit with China keeps widening

EA and China goods trade (3MA, y-o-y)



Last observation 09.2025

Source: Eurostat, Bank of Latvia calculations.

EA and China annual goods trade (euro)

*2025 first nine months annualized

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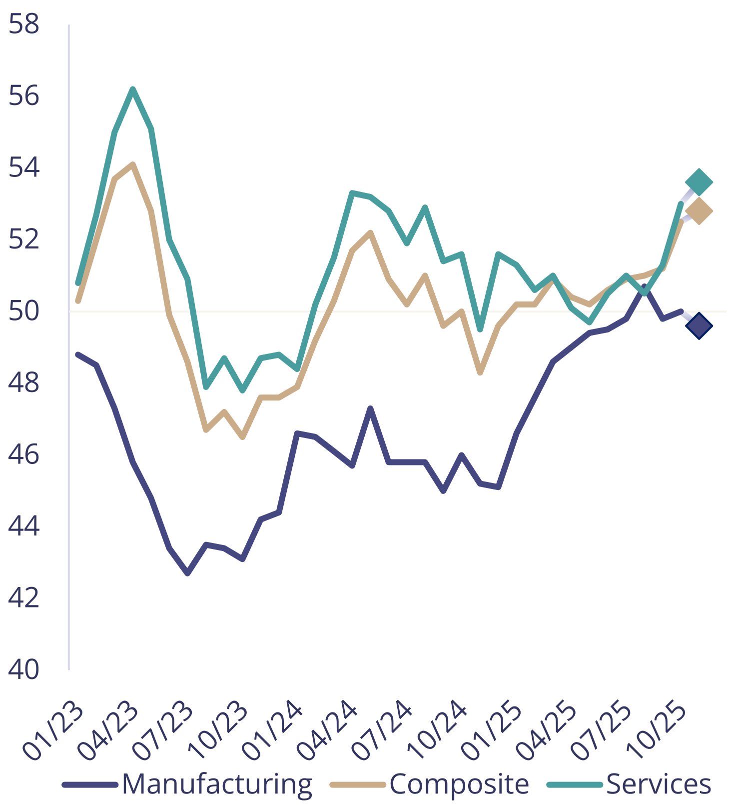
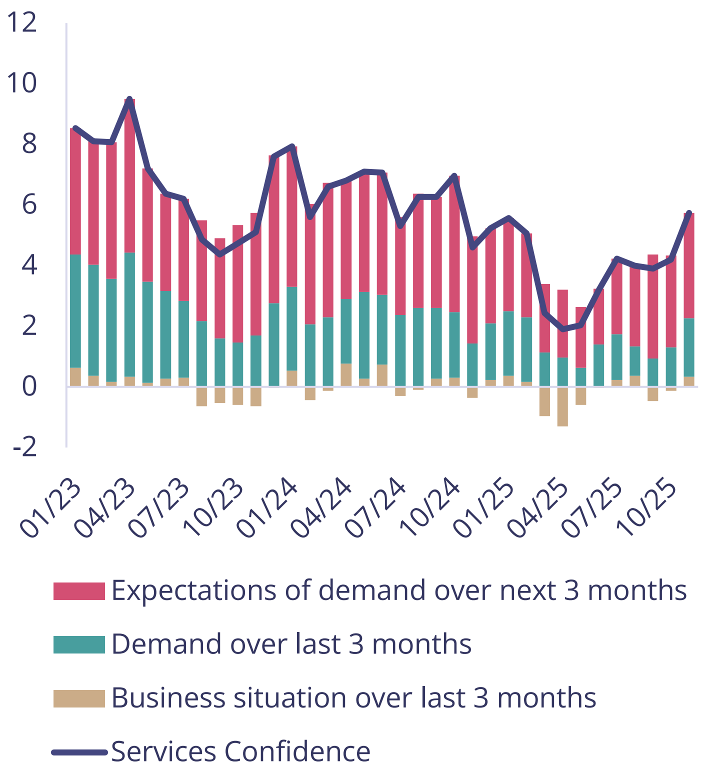
Economy supported by resilient services sector

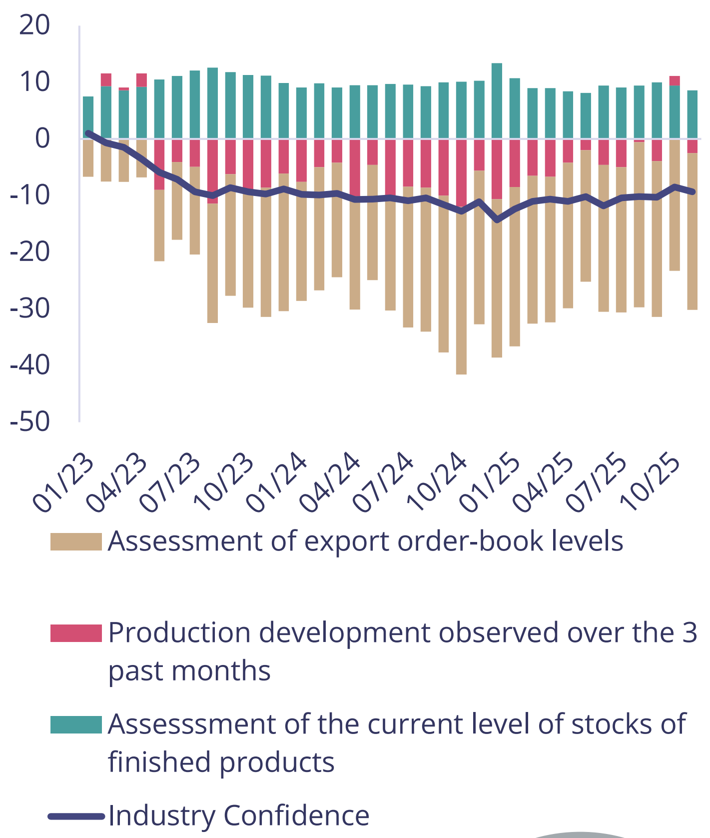
EA PMI (balance of answers)



Decomposition of services confidence (balance of answers)



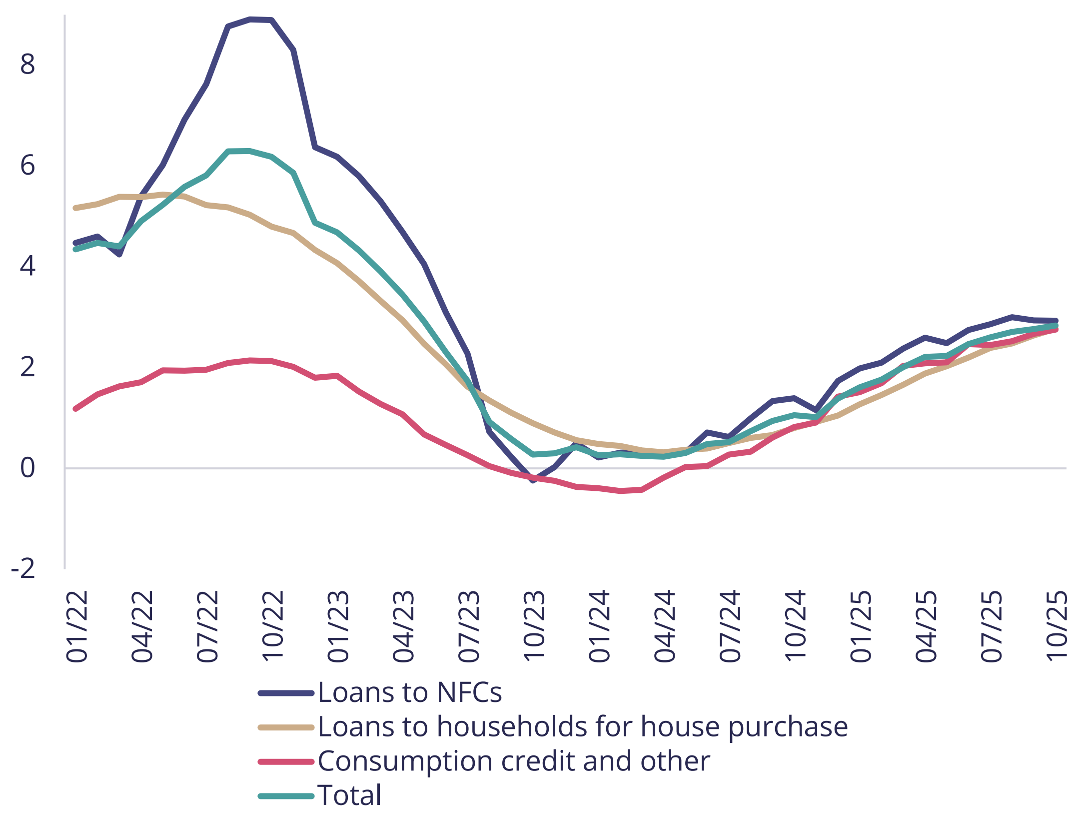
Decomposition of industry confidence (balance of answers)



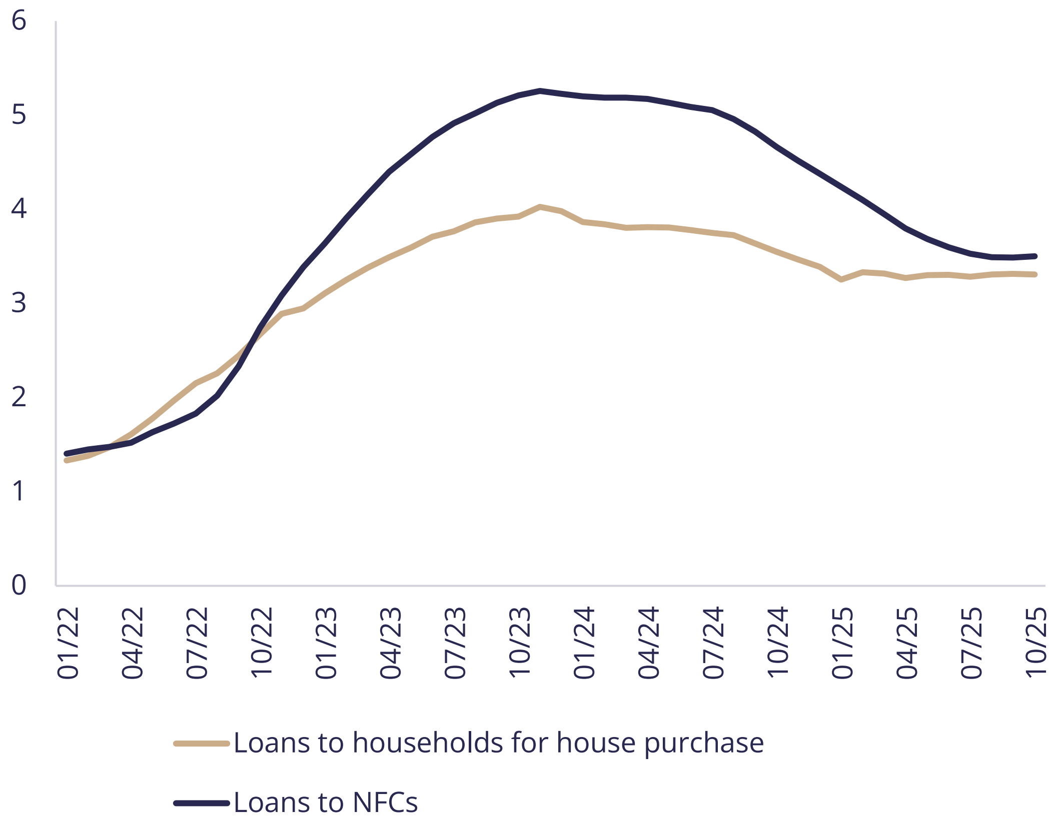
Source: S&P Global., European Commission.

Lending provides support to the economy, but still below nominal GDP growth

Euro area MFI loan growth (y-o-y; %)



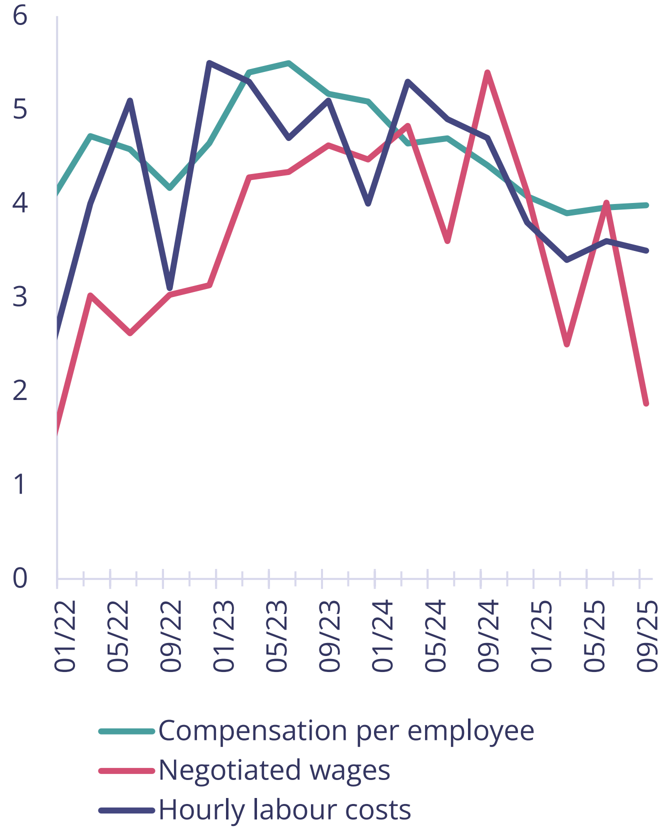
Interest rates on new MFI loans (3-month avg; %)



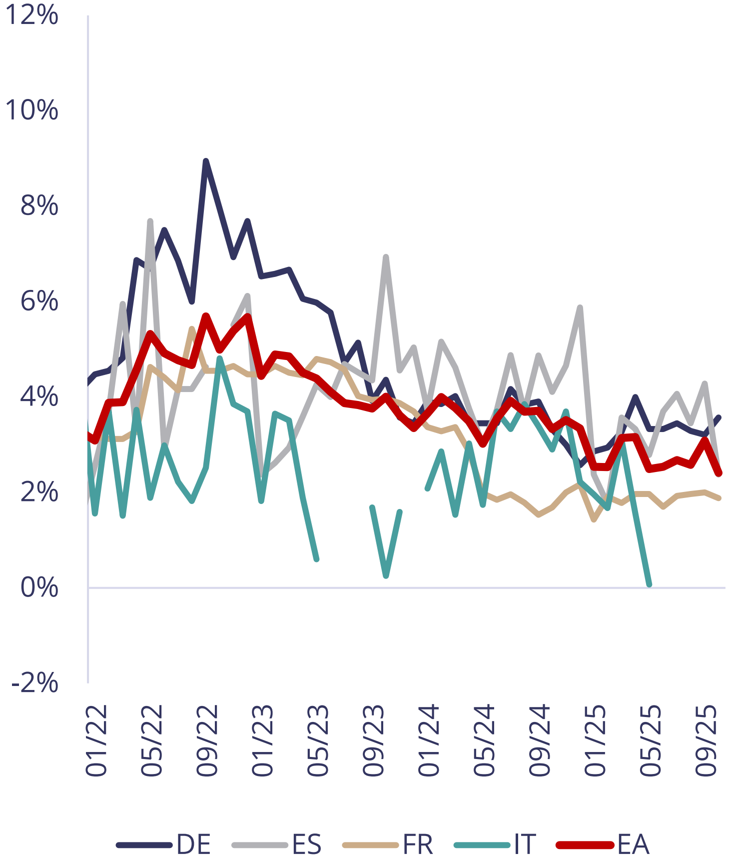
Source: MFI interest rates (ECB MIR); Balance Sheet Items(ECB BSI).

Softening wage growth, with forward tracker indicating further moderation

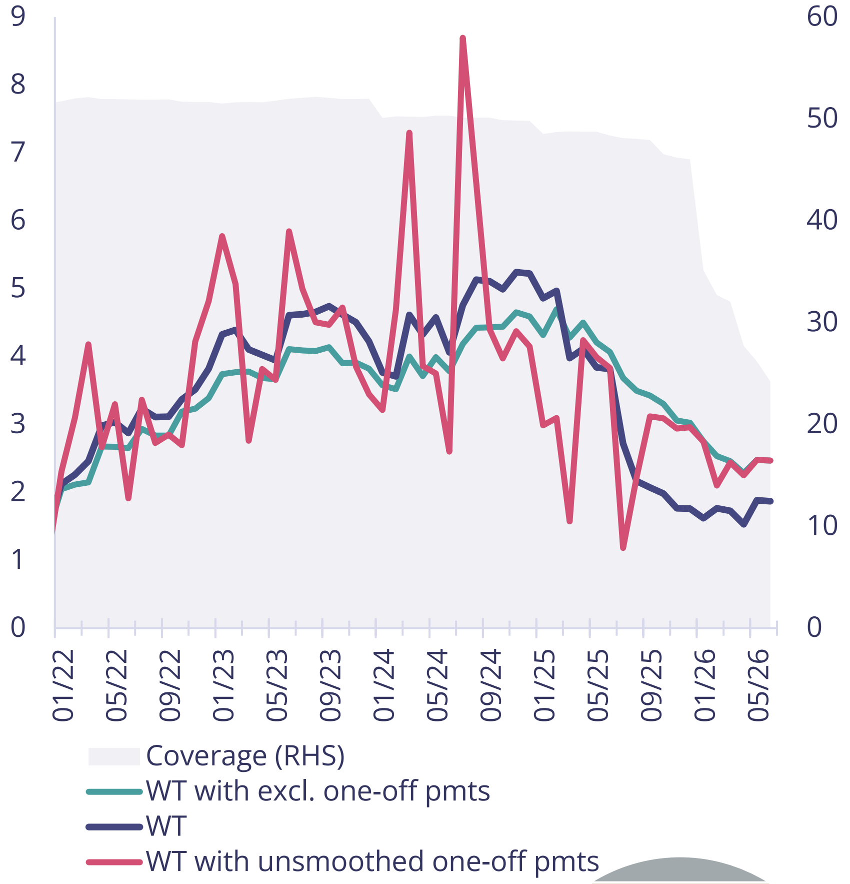
Labour costs (y/y growth rates, %)



Indeed Wage Tracker (y/y growth rates, %)



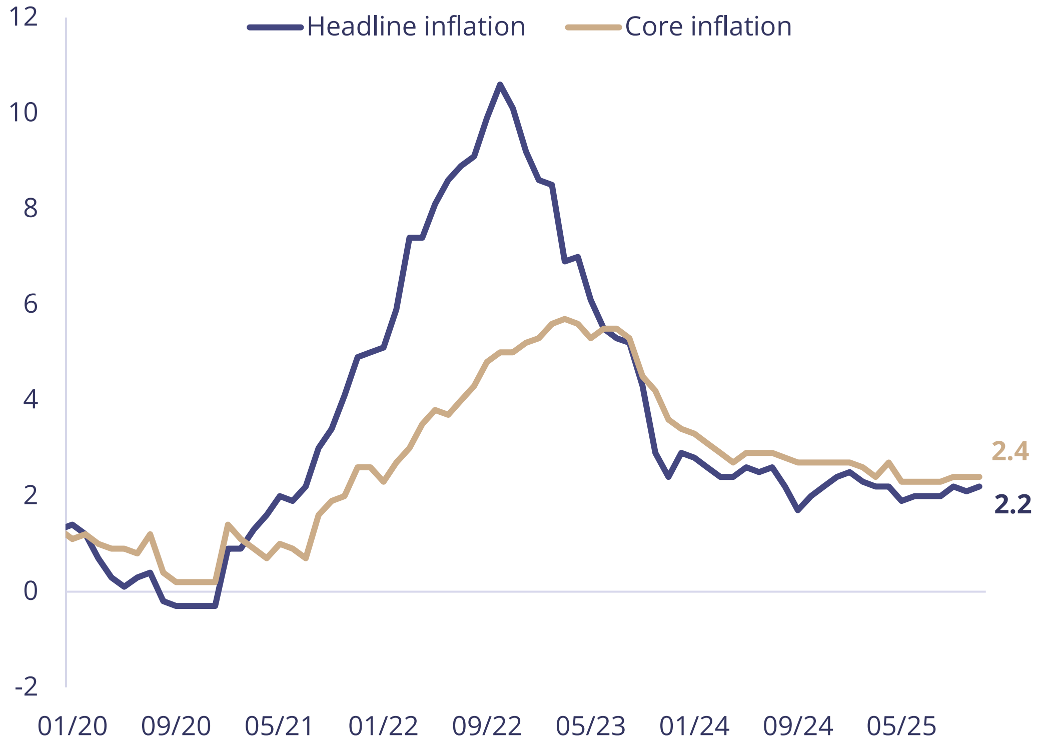
ECB Wage tracker (y/y growth rates, %)



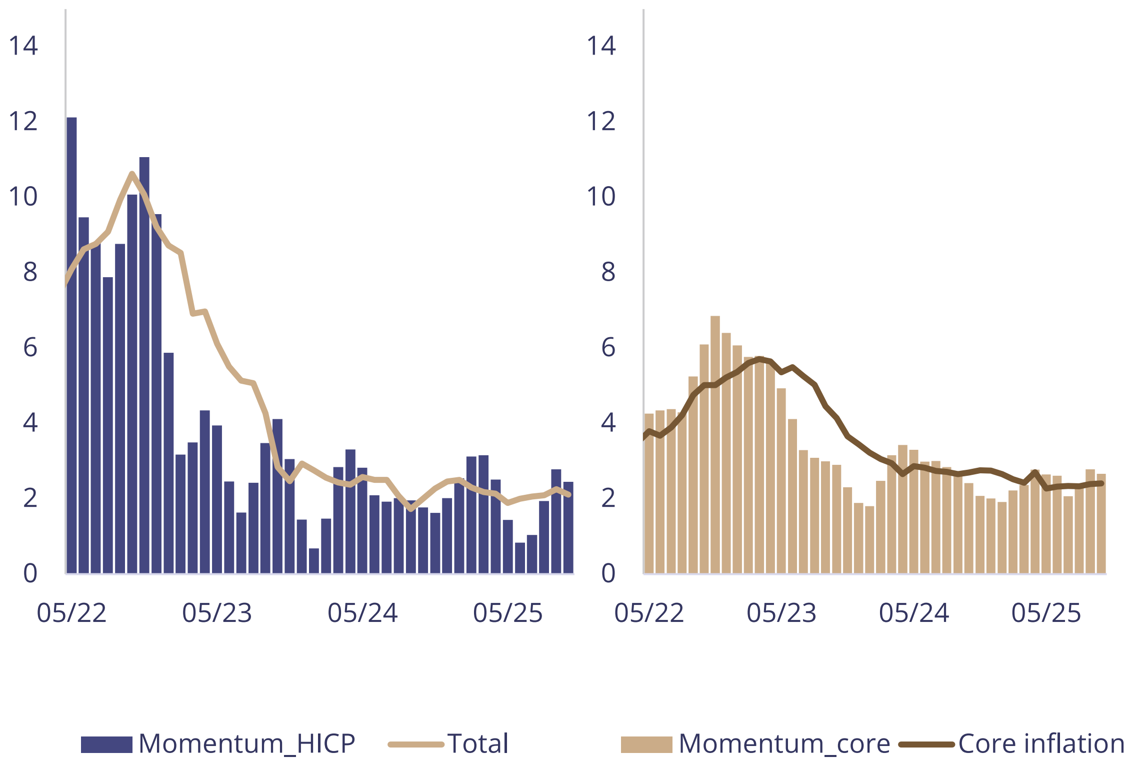
Source: ECB, Eurostat

Headline inflation close to the target, but some pick-up in momentum recently

HICP, HICP ex. food and energy, y/y, %



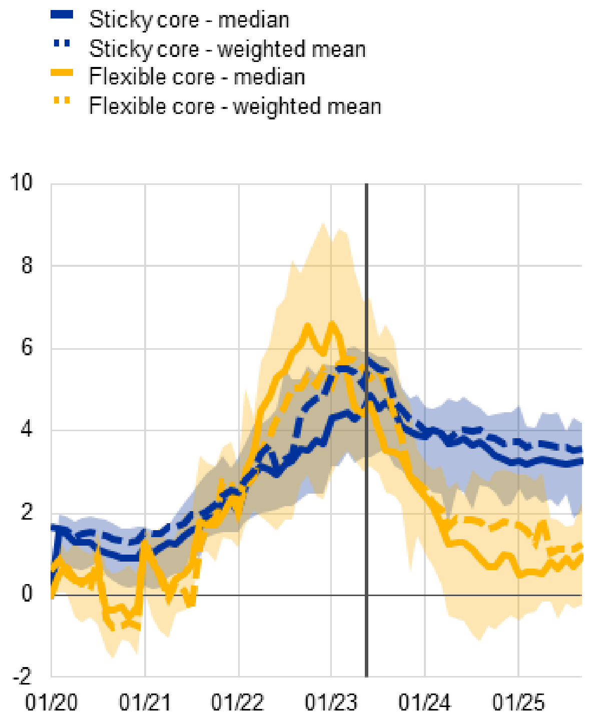
Momentum (sa, 3m over 3m annualized)



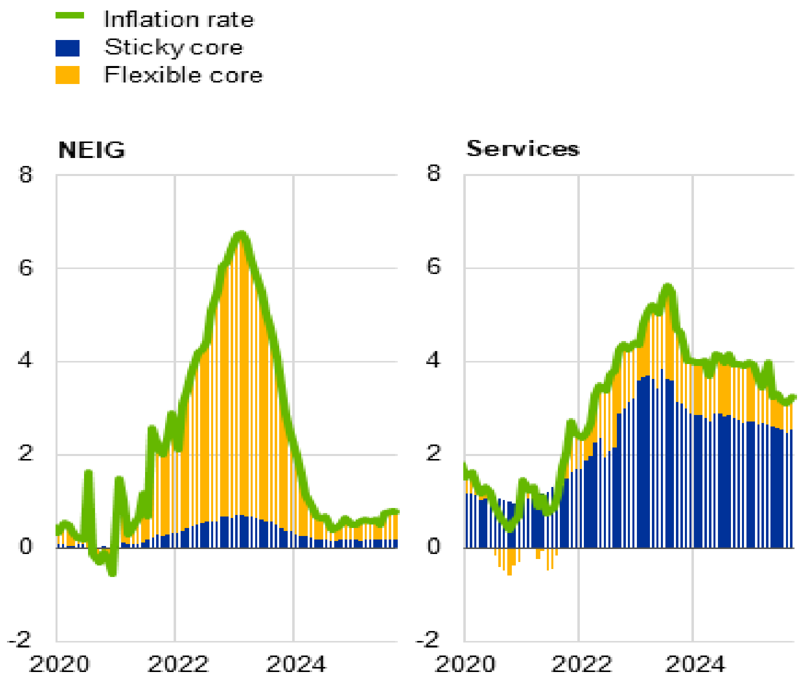
Source: Eurostat, Latvijas Banka staff calculations.

Services inflation remains sticky, but softer wage growth to gradually feed through

Distribution of year-on-year price changes for sticky and flexible HICPX items (annual percentage changes)



Contribution of sticky and flexible items to NEIG and services inflation (annual percentage changes and percentage point contributions)



Sources: Eurostat, Gautier et al. (2024) and ECB, https://www.ecb.europa.eu/press/economic-bulletin/focus/2025/html/ecb.ebbox202507_06~c6af720c0d.en.html

Notes: "Sticky core" includes 39 HICPX items at the COICOP four-digit level and "Flexible core" includes 33. The weighted mean of sticky and flexible core inflation is based on the respective HICP weights. The median is calculated on the basis of the year-on-year inflation rates of all items in each subcategory and shaded areas represent the range of year-on-year rates (25th to 75th percentile). The vertical grey line in panel a) indicates peak HICPX inflation (March 2023). The latest observations are for September 2025.

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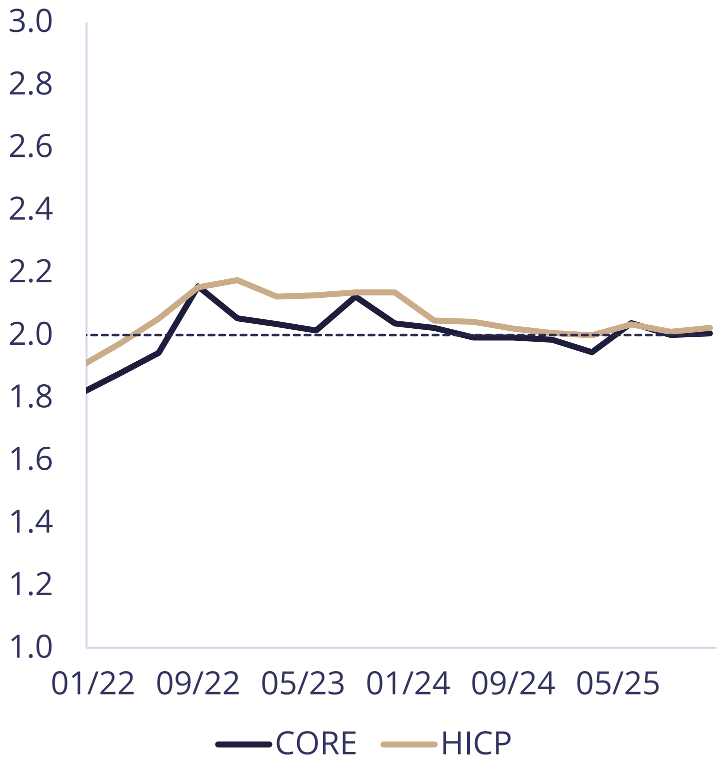
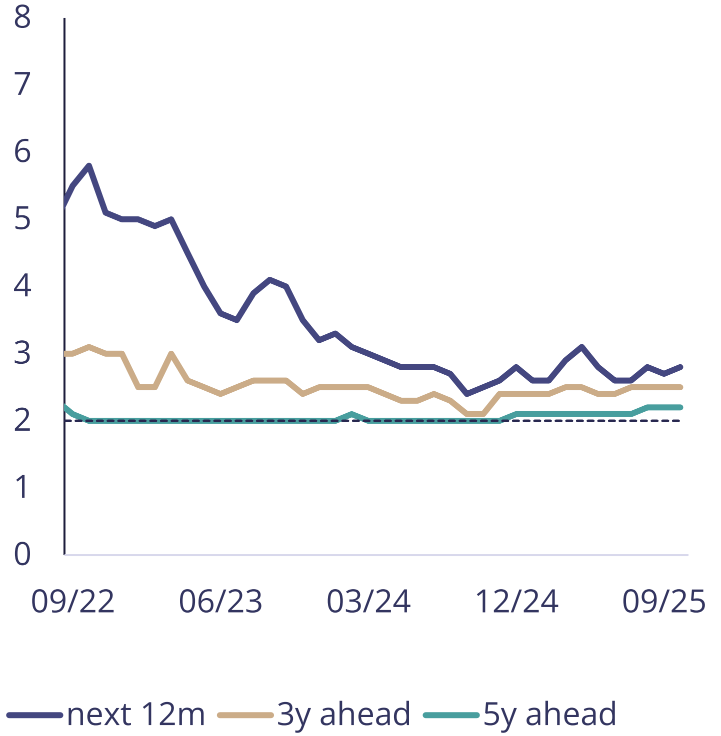
Inflation expectations broadly stable and well anchored

Long term euro area inflation expectations, SPF



Swap implied inflation expectations in EA (%)

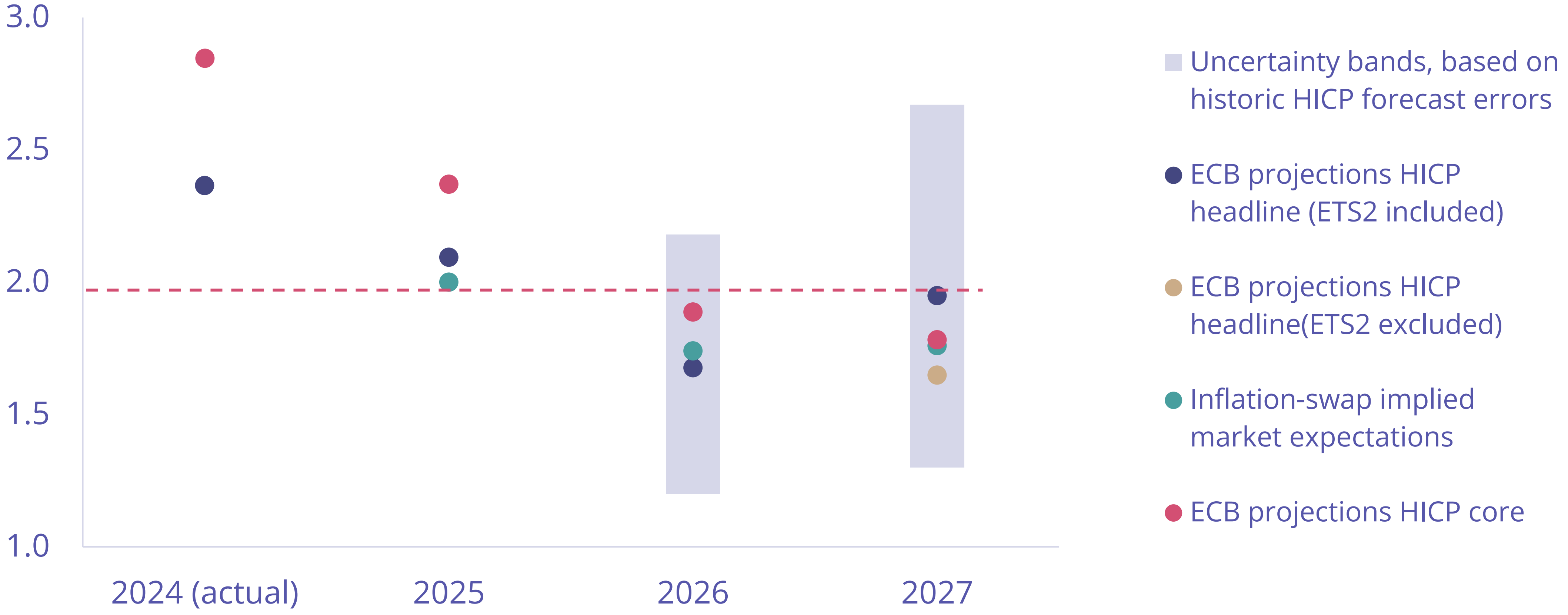
ECB Consumer expectation Median expectations for inflation



Source: Bloomberg, ECB, LB calculations.

Temporary undershoot of headline inflation mainly due to energy and food prices, later introduction of ETS2

Inflation projections, based on September 2025 MPE, and marked-based inflation expectations, 2025-2027 (%)

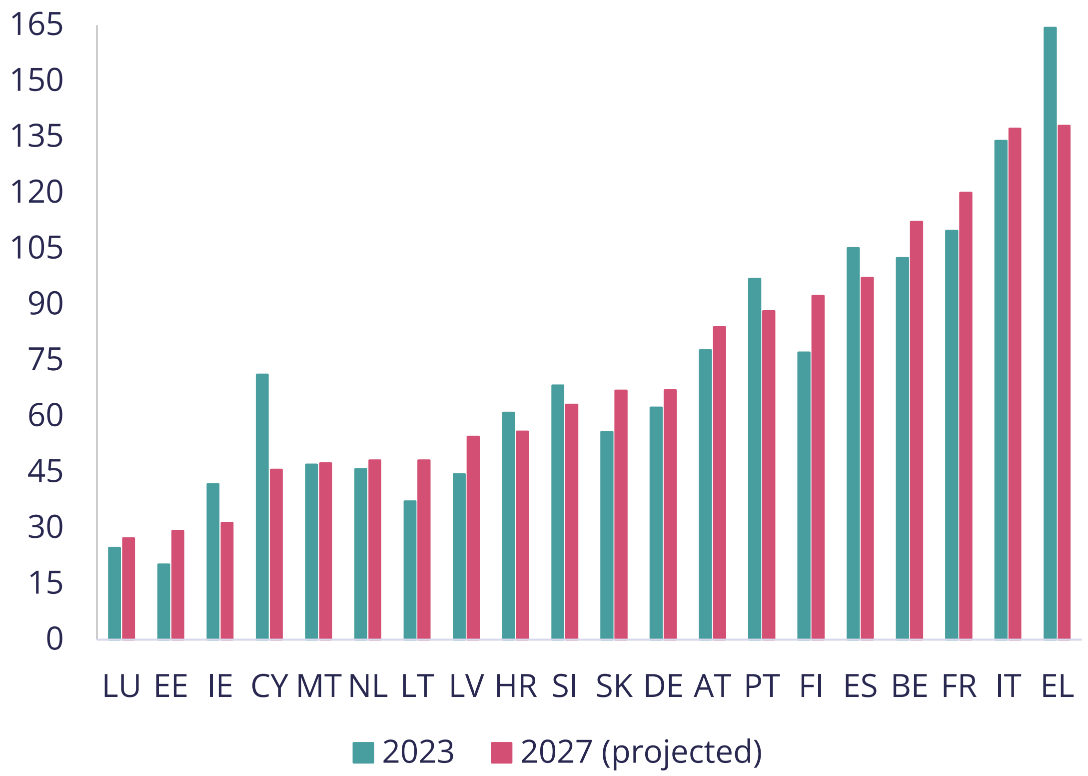


Sources: London Stock Exchange Group Plc; Bloomberg.

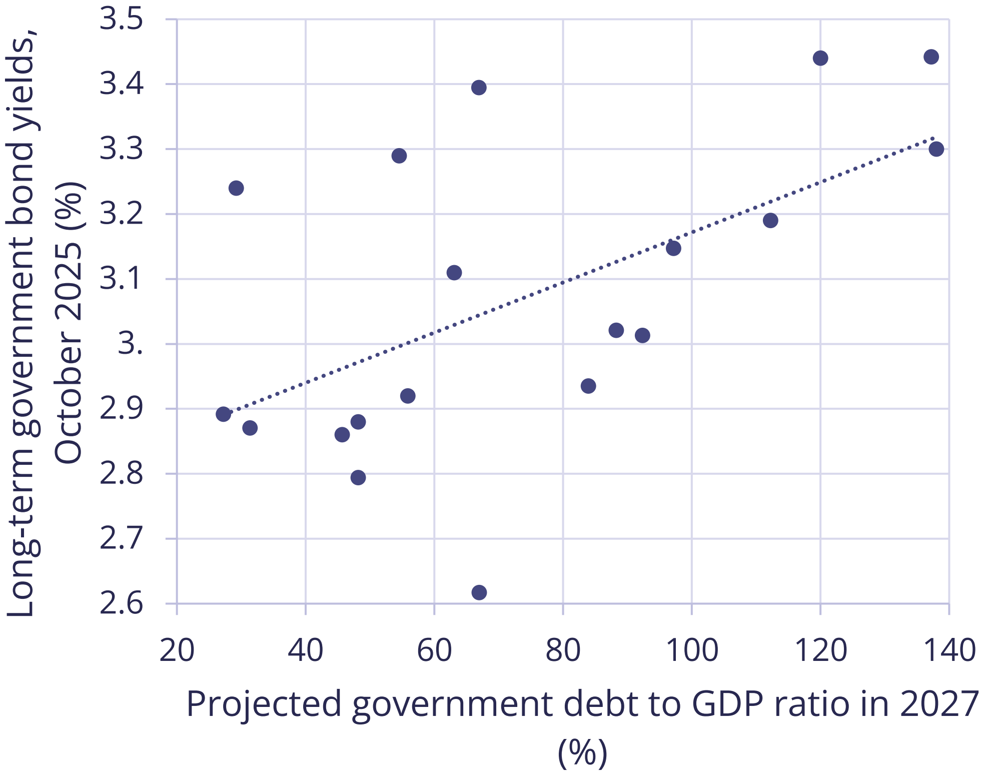
Notes: Uncertainty bands are constructed as +/- 1 mean absolute error (MAE) of HICP projections over t+1 and t+2 periods, MAE errors are estimated based on BMPE and MPE rounds over period from 2009 to 2024. Projections for 2022 HICP excluded from the analysis.

Higher debt levels lead to higher yields and offsetting some of the past monetary easing

Government debt in EA countries (% of GDP)



Government bond yields and projected government debt in EA countries



Source: Eurostat, EC autumn 2025 forecast.

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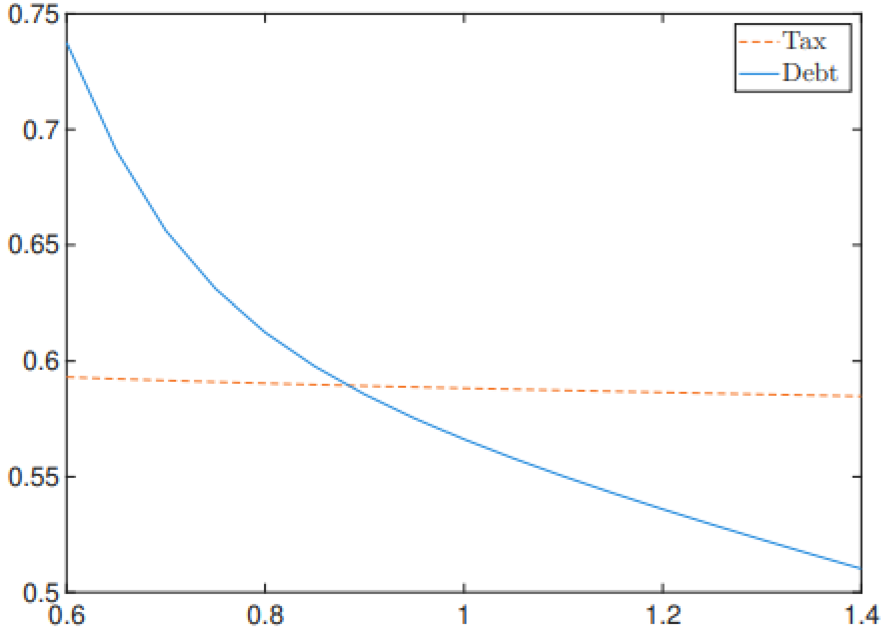
Implications of higher debt for monetary policy: rising probability of (inflationary) tax hikes (left); higher natural rate (right)

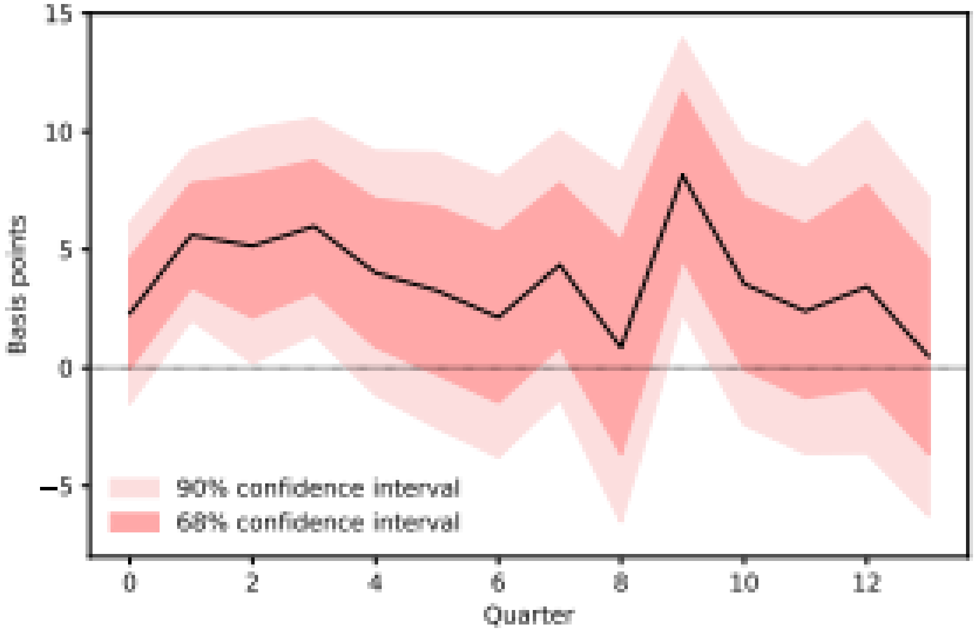
Fiscal multiplier to a government spending shock



Notes: This figure plots the initial output response to a one-time shock in government spending, with a shock size of one percentage point. The x-axis represents the annualized debt-to-GDP ratio. The y-axis is reported in levels.

Source: Wu et.al. (2025) Fiscal Policy: Financing and Indebtedness; https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5242220

IRF of r ∗ to a 1 pp increase in the government debt-to-GDP ratio



Source: Campos et.al (2024); Navigating by falling stars: monetary policy with fiscally driven natural rates https://www.bis.org/publ/work1172.htm

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Thank you!