

# MNI Connect: Monetary policy when the road ahead is uncertain

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Member of the ECB's Governing Council

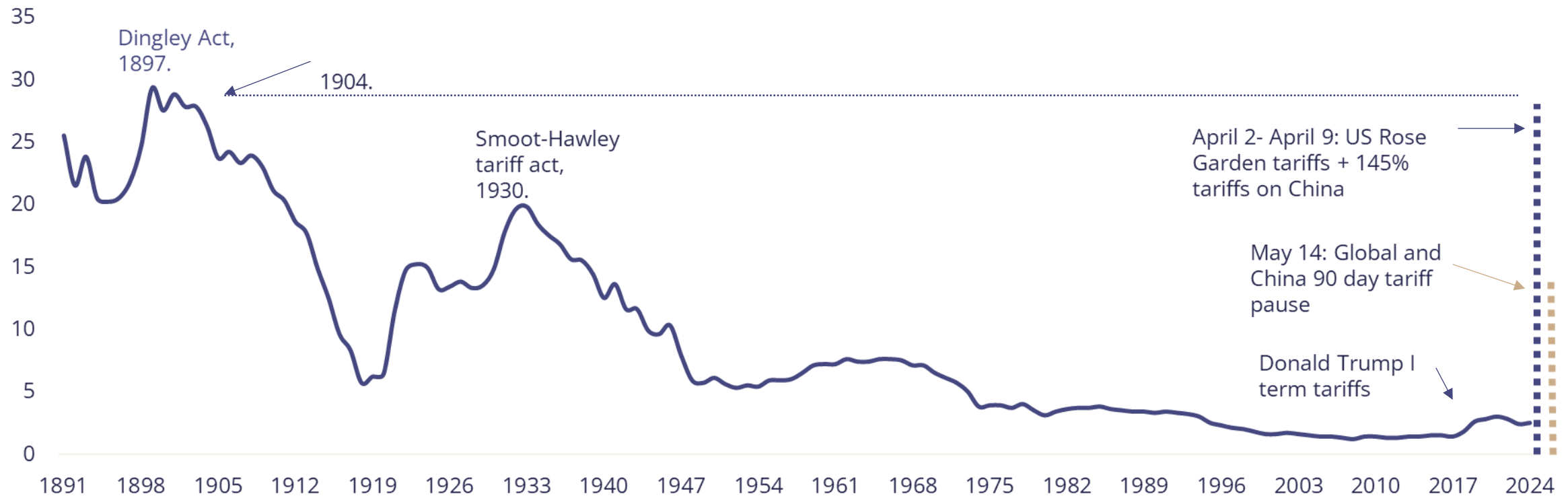


# Main takeaways

- ① Geopolitical tensions and elevated uncertainty will continue to act as a drag on growth, even if the worst-case scenarios for global trade can be avoided.
- ② Uncertainty affects economy both through the real side (e.g. by delaying the recovery in private consumption) and financial market conditions (e.g. by increasing term premia).
- ③ Higher military spending may provide some boost to economic activity, but positive spillovers may diminish with concerns about public debt levels.
- ④ **Monetary policy:**
  - 1) Focus on the baseline remains, but with a significant role for various risk scenarios;
  - 2) If baseline holds, we are close to the terminal rate which stabilizes inflation around 2% over medium term;
  - 3) Data dependency and meeting-to-meeting approach still the name of the game, as probability of risk scenarios higher than in the past.

# Recent tariff proposals by the US administration just decimal points short of reaching the turn of past centuries' highs

**US average import tariff** (tariff revenues to total imports, %)



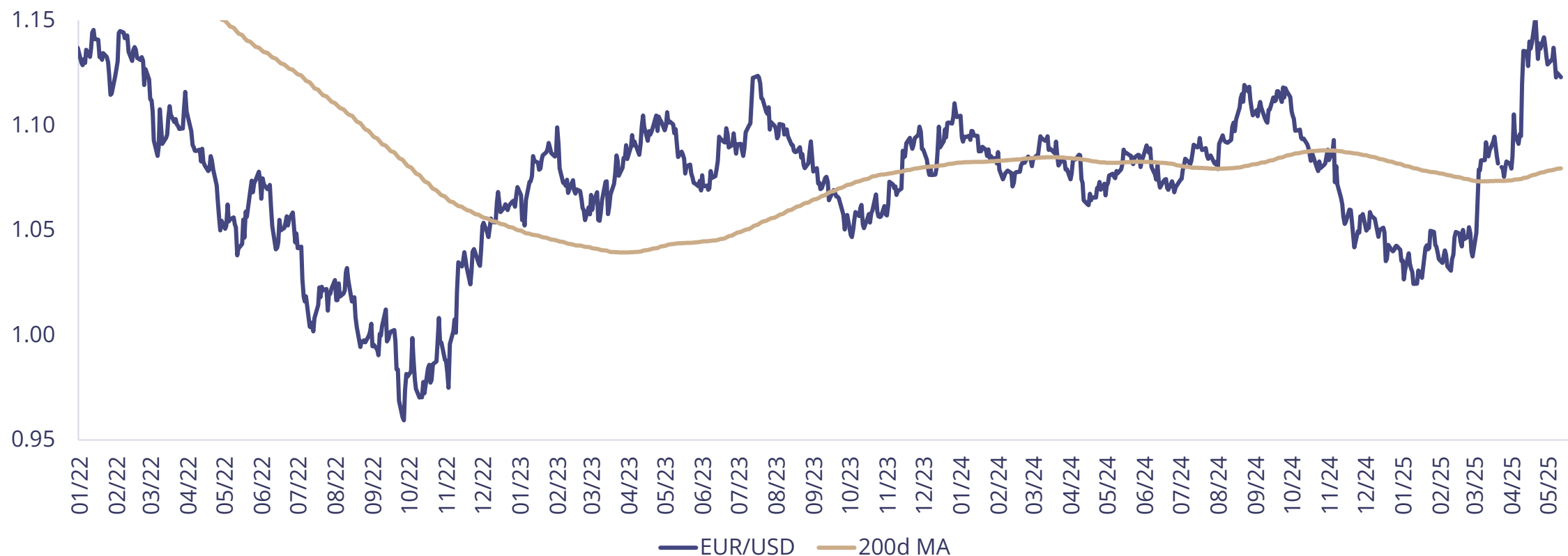
# Fragmentation of global trade clearly a drag on economic growth

## IMF World Economic Outlook Forecast (% change)

	Projections		Difference from January 2025 WEO Update	
	2025	2026	2025	2026
Global	2.8	3	-0.5	-0.3
US	1.8	1.7	-0.9	-0.4
Euro area	0.8	1.2	-0.2	-0.2
Germany	0	0.9	-0.3	-0.2
France	0.6	1	-0.2	-0.1
Spain	2.5	1.8	0.2	0
Italy	0.4	0.8	-0.3	-0.1

# Euro rises on U.S. growth concerns, pulls back as the US tariff stance softens

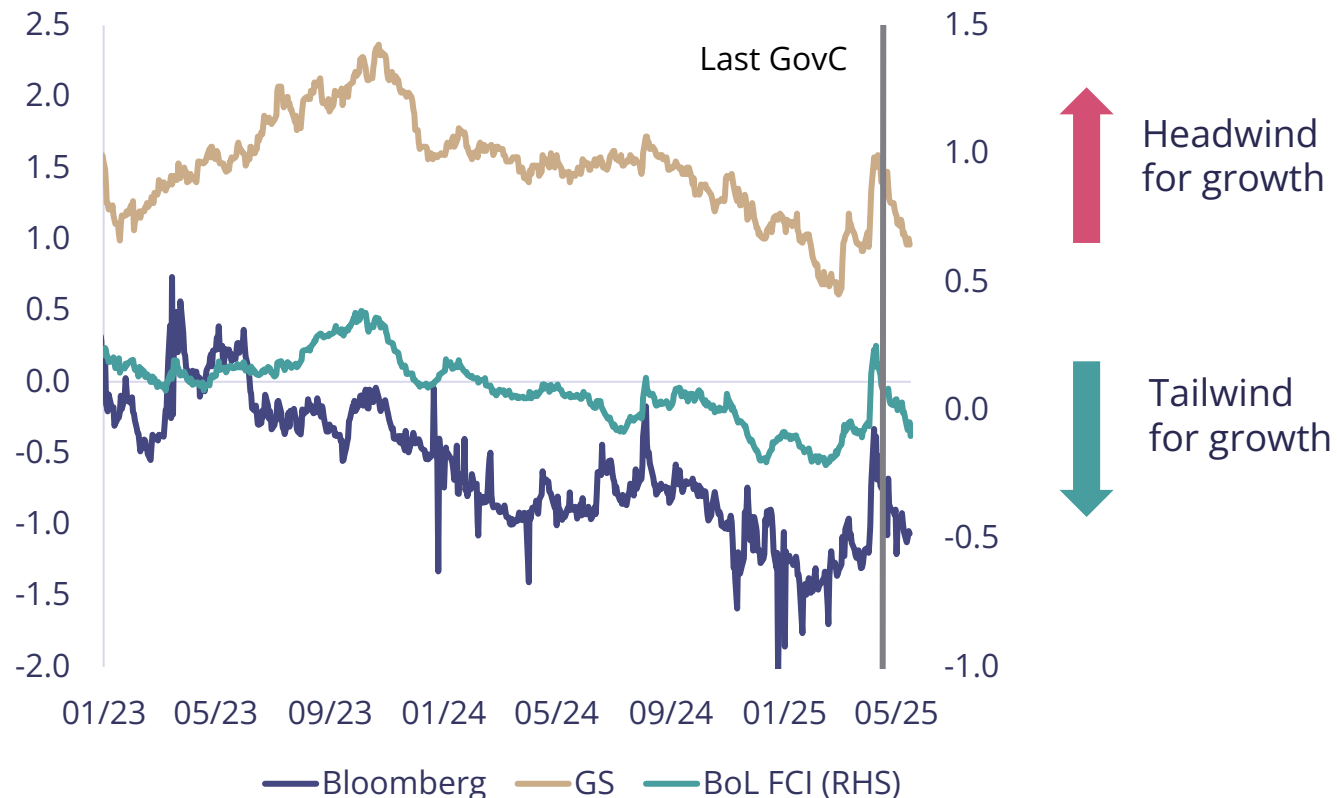
## EUR/USD



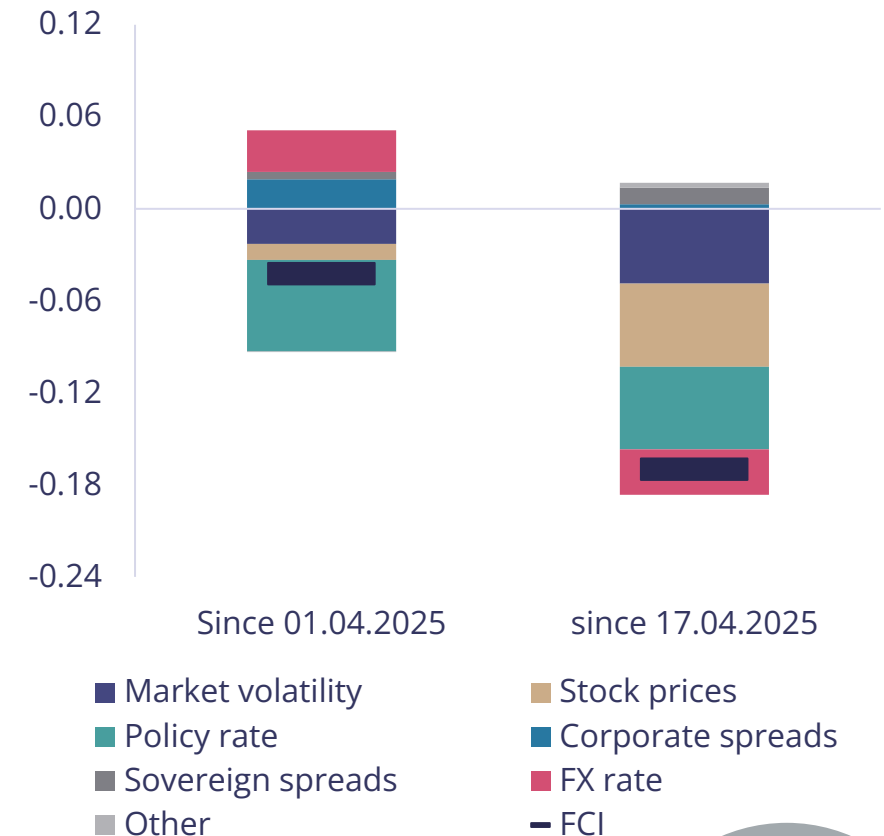


# Financial market volatility makes the calibration of appropriate monetary policy stance more challenging

**Financial conditions indices** (Stdv. from LT avg.)

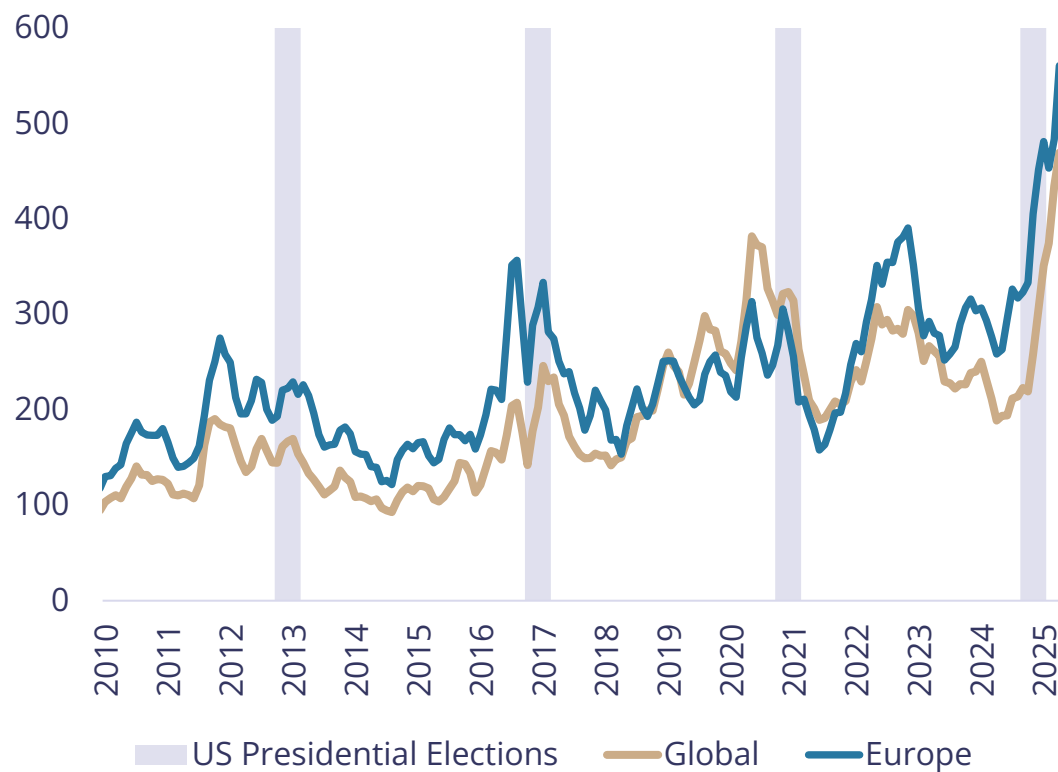


**Decomposition of changes in Bank of Latvia financial conditions index** (Stdv. from LT avg.)



# Uncertainty remains elevated, likely to persist for some time even if immediate trade tensions were to subside

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

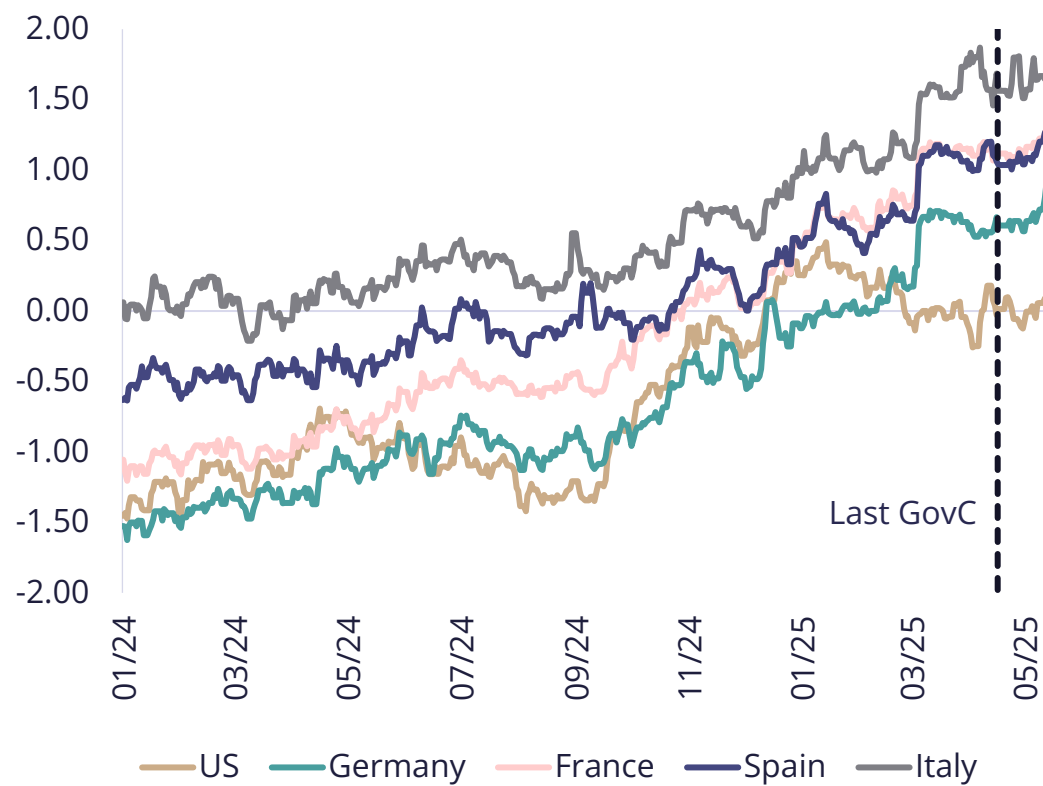


**Bloomberg Economic Surprise Index (points)**

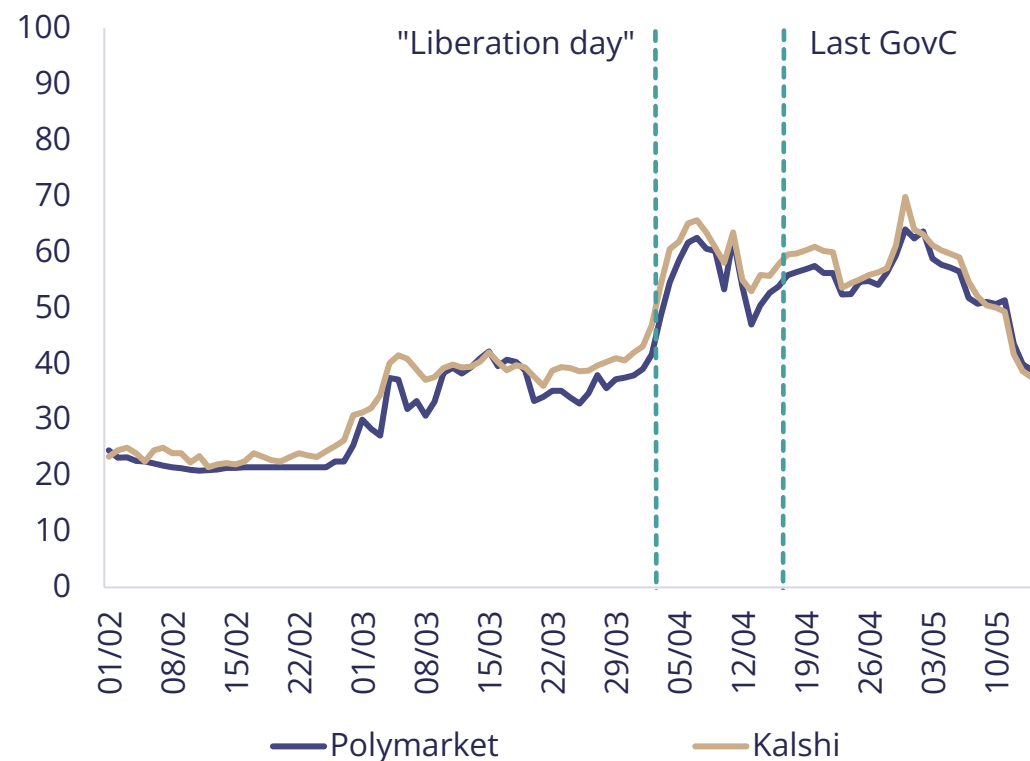


# Uncertainty, subdued growth outlook weighing on investor sentiment, likely adding to term premium of interest rates

Government bond spreads: 10Y-3M (pp)



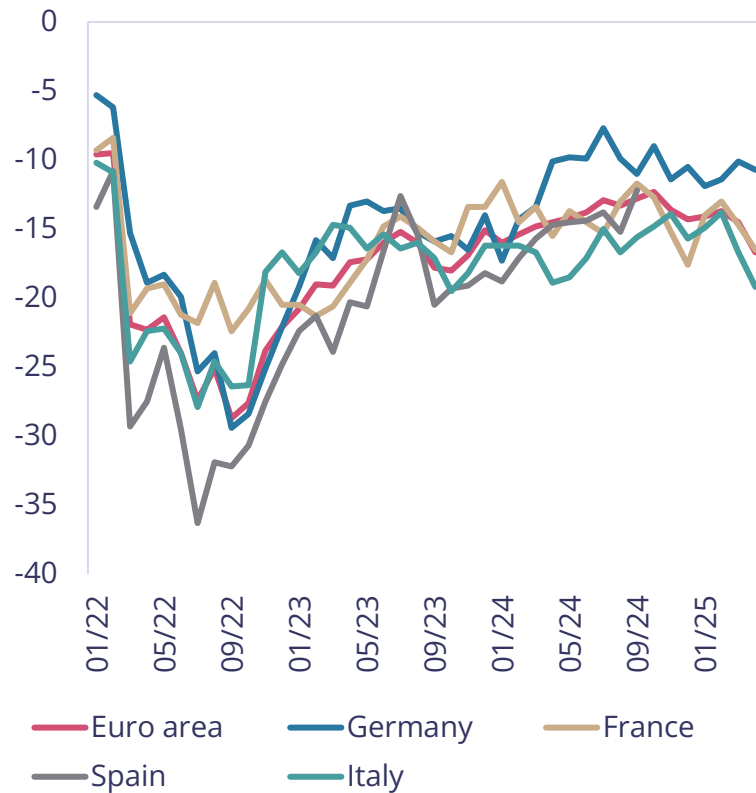
Probability of US recession in 2025 from betting markets (%)



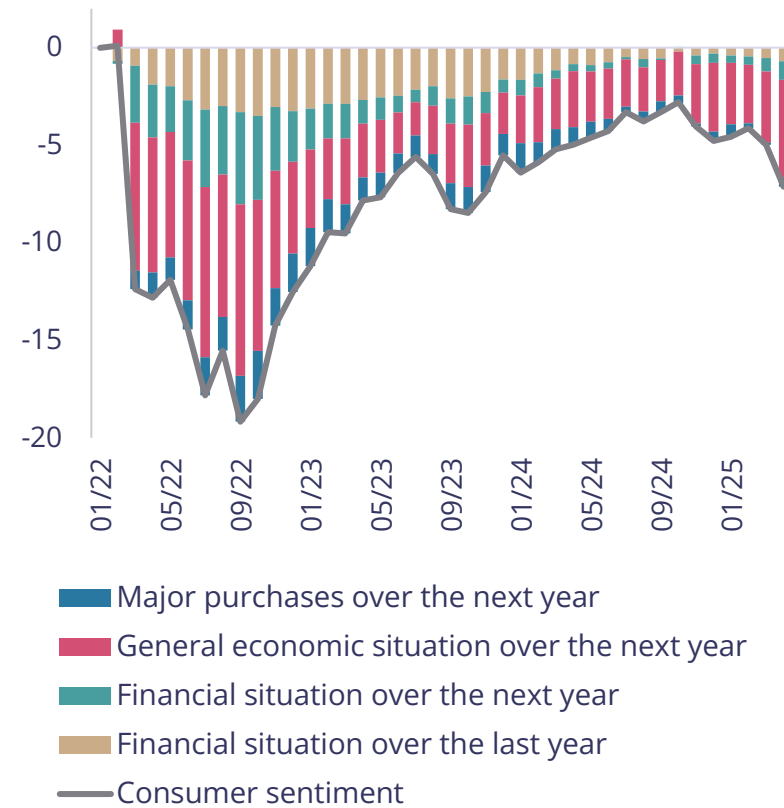


# Elevated uncertainty impairs consumer confidence, adding downside risks to private-consumption driven growth prospects

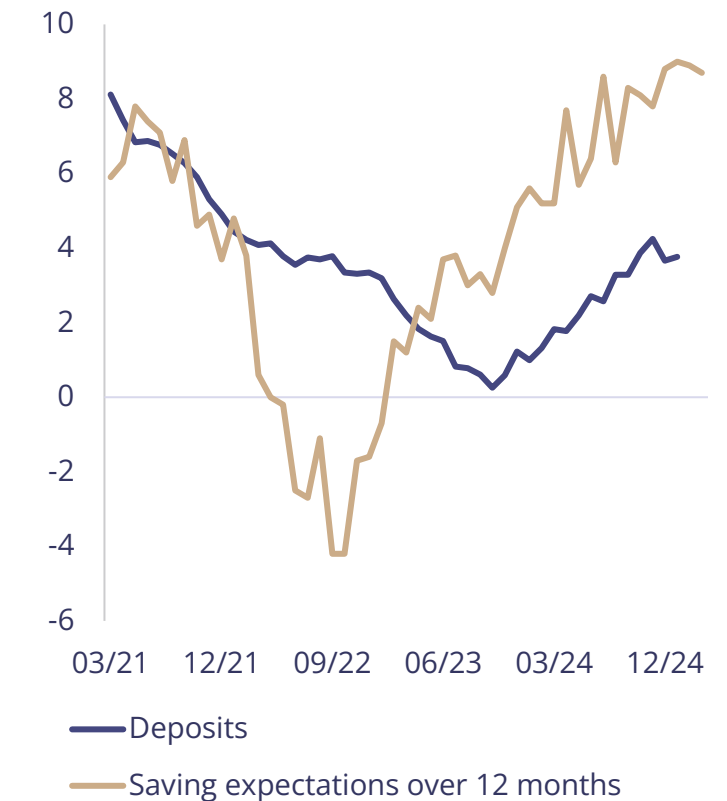
**Consumer confidence**  
(balance of answers)



**Decomposition of consumer sentiment**  
(change in balance compared to 2022)

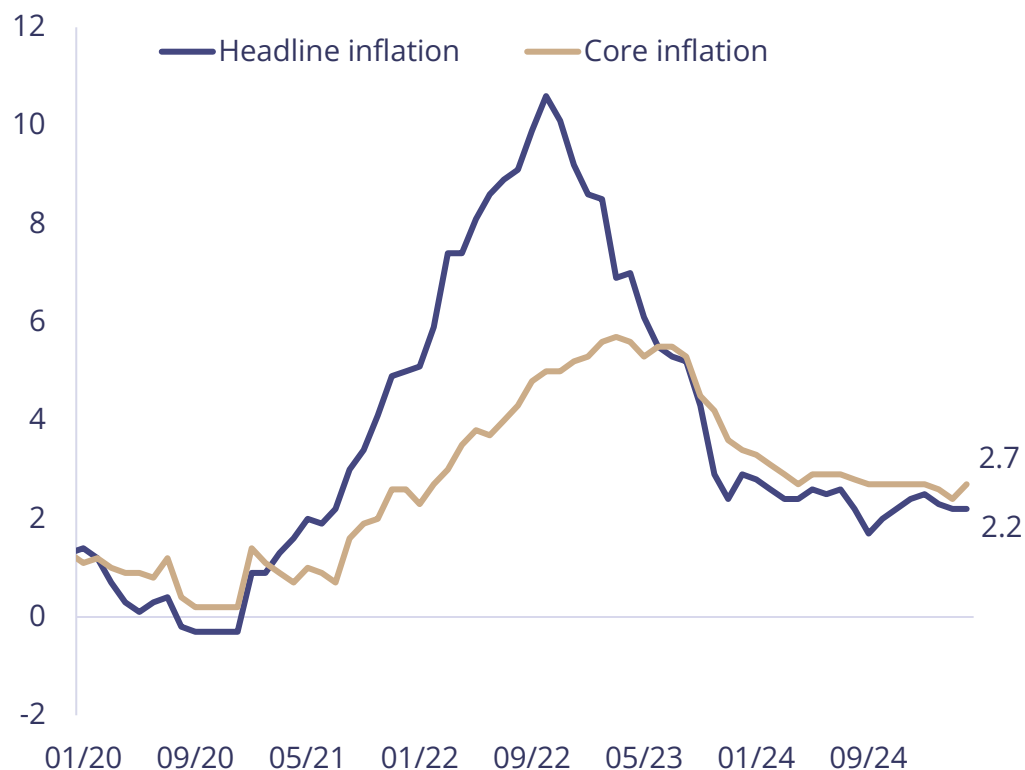


**EA households' deposit growth and saving expectations** (%; y-o-y)

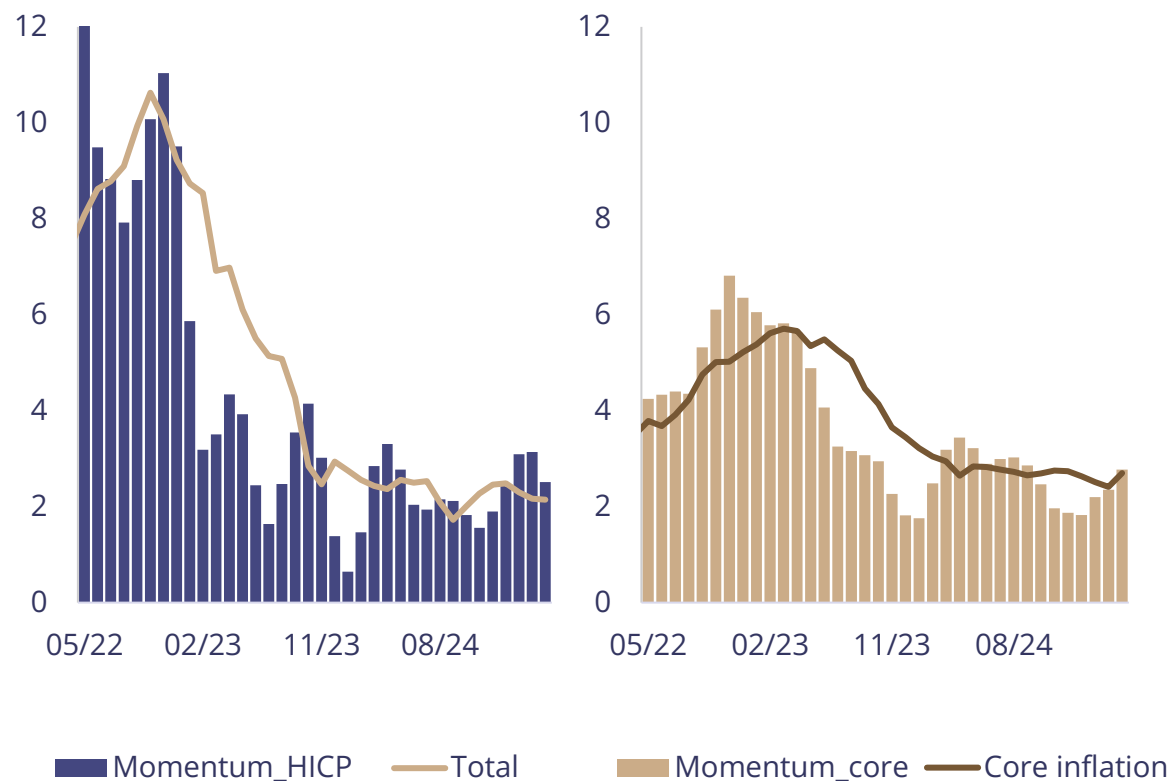


# Inflation close to target, but momentum increases for services inflation must be monitored

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



**Momentum (sa, 3m over 3m annualized)**



# Fiscal expansion and defence spending: inflation impact depends on implementation, especially its supply side

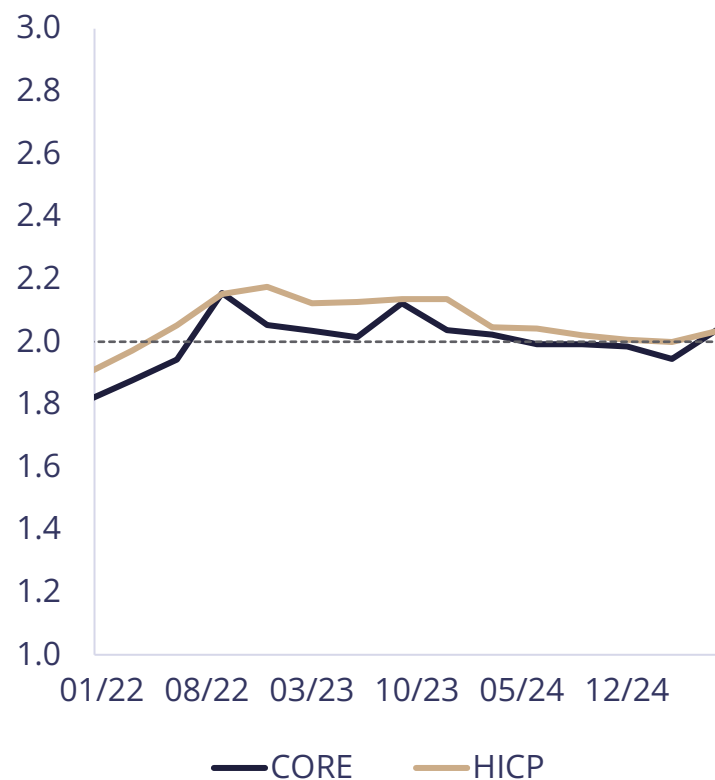
- ReArm Europe EUR 800 billion:
  - EUR 150 billion in loans backed by the EU budget
  - EUR 650 billion in fiscal space assuming all members activate the National Escape Clause (NEC)
- The NEC allows additional defence spending capped at 1.5% of GDP per year for 2025–2028
- Germany eased its debt brake for defence and pledged €500 bn in infrastructure spending over 12 years

## Euro area countries by whether they are requesting the defence escape clause

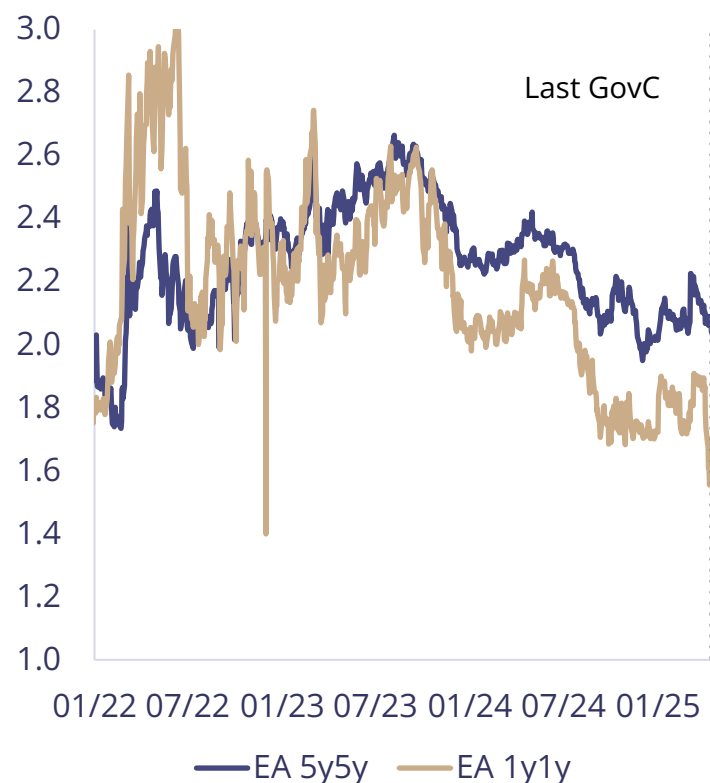
Countries that have requested the escape clause	Countries that have plans to request the escape clause	Countries not utilizing the escape clause
Belgium, Estonia, Finland, Germany, Greece, Latvia, Portugal, Slovakia, Slovenia	Croatia	Austria, France, Ireland, Italy, Cyprus, Lithuania, Luxembourg, Malta, the Netherlands, Spain

# Inflation expectations: potential impact from trade disruptions and higher government spending

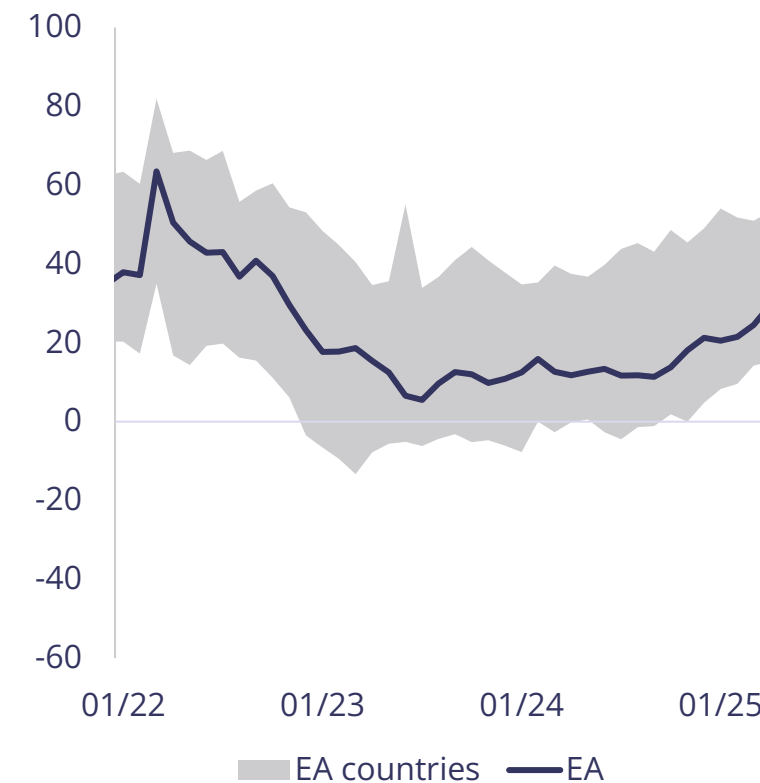
## Long term euro area inflation expectations, SPF



## Swap implied inflation expectations in EA (%)

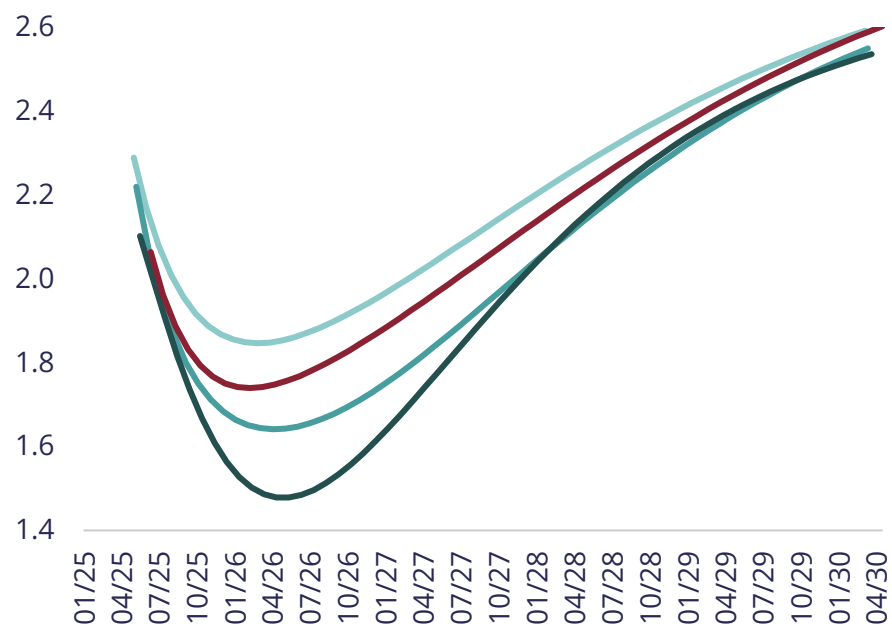


## Consumer inflation expectations, survey



# Market implied future rates closer to the levels before the tariff announcement

EUR OIS implied 1m forward rates (% p.a.)



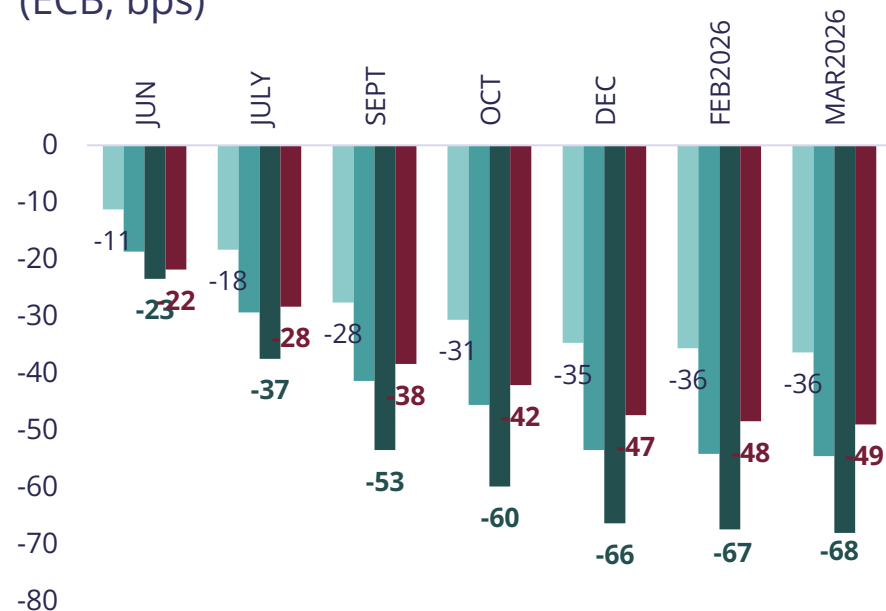
- Day before reciprocal tariff announcement (02-Apr)
- Day before announcement of reciprocal tariff pause (08-Apr)
- Last GovC (17-Apr)
- Last (13-May)

Change in EUR 5Y OIS (pp)



- Global risk
- US Macro
- US MP
- EA Macro
- EA MP
- model change

Implied cumulative expected policy rate changes from current rates by meeting (ECB; bps)



- Day before announcement of reciprocal tariffs (02-Apr)
- Day before announcement of reciprocal tariff pause (08-Apr)
- Last GovC (17-Apr)
- Last (13-May)

# Summary: both downside and upside risks to inflation, but with different time horizons

- Escalating geopolitical tensions and trade tariffs are likely to have a negative impact on economic activity and lead to a more persistent period of elevated uncertainty, thus contributing to downward pressure on inflation;
- Higher defence spending likely to have an upward pressure on inflation:
  - Through higher domestic spending;
  - Higher investment might change the long-term balance of savings and investments (higher  $r^*$ ), making monetary policy relatively more accommodative unless adjusted accordingly.
- Do these two effects offset each other? Not necessarily.
- Downside risks to inflation likely to occur over more short-term periods, while upside risks materializing over a more medium-term horizon.
- Monetary policy to react accordingly





*"..in our monetary policy decisions, we have to stand ready for the unpredictable, which is why I think it makes a lot of sense to be ready, to be agile..."*

**Christine Lagarde**

Frankfurt am Main, 17 April 2025

# Agility of monetary policy in practice

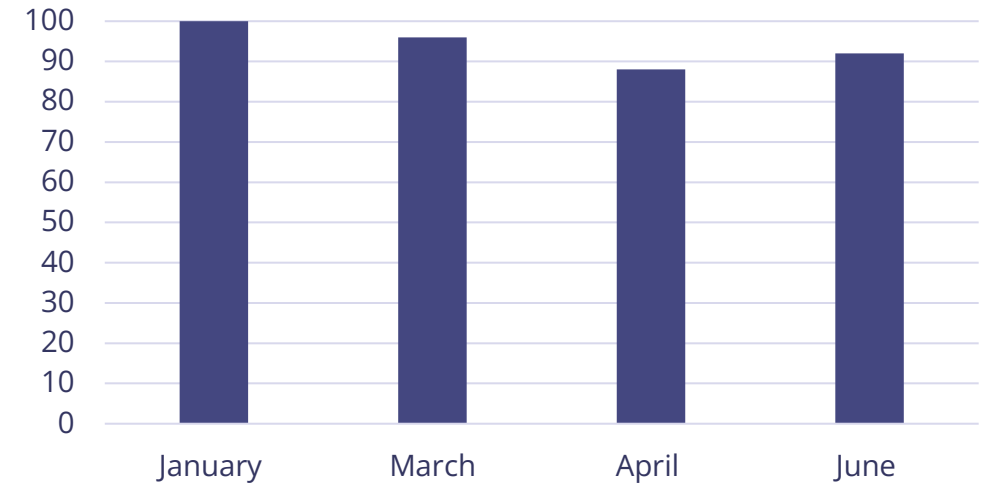
- Previously, main focus on the baseline, as risk scenarios relatively low probability events.
- Now, given the excessive levels of uncertainty, various risk scenarios with higher probability than before.
- Monetary policy still should focus on baseline – it still is the most likely scenario, compared to all others.
- Nevertheless, it may be the case that, although most likely, baseline probability is below 50%.
- So scenario analysis becomes a much more important analytical framework.
- For that, frequent assessment (of whether the baseline still holds) and adaptation of plans (if circumstances change).
- Data dependency, meeting-to-meeting approach still the name of the game.
- **What implications for next decisions?**
  - If current baseline holds - > we will soon reach terminal rate;
  - If either inflationary or deflationary risk scenario materializes - > monetary policy will react accordingly.

Despite elevated uncertainty in the economy, little uncertainty about ECB GovC decisions.

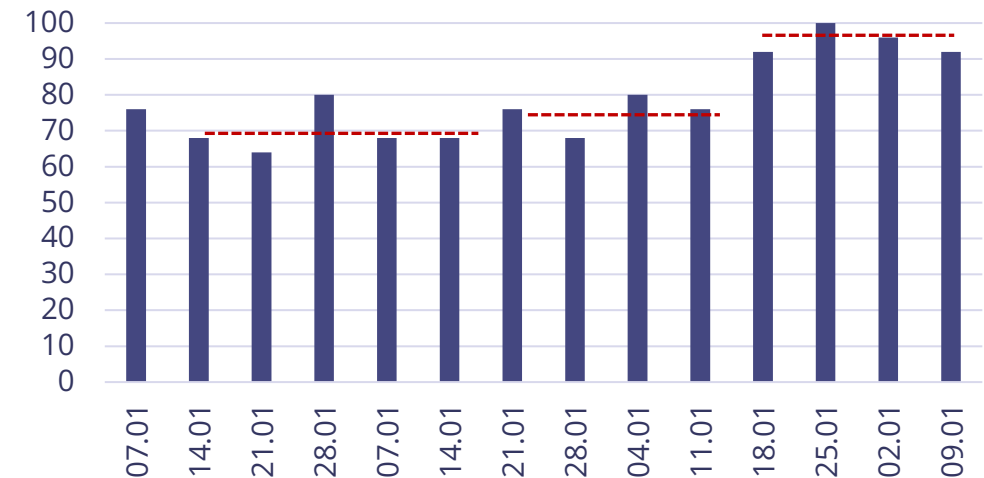
Question for discussion - Why?

- Financial markets understand the ECB reaction function well and so interpret the developments in the economy in a similar way to the ECB :)
- Despite claims to the contrary, ECB continues providing a too detailed forward guidance on future rate path to markets :/
- Markets are the tail that wags the dog, ECB validating market expectations every time :(

**OIS implied probabilities of a 25bp rate cut two weeks before the GovC meetings in 2025 (in %)**



**OIS implied probability of a 25bp rate cut in June 2025 GovC meeting (in %), February-May 2025**



Source: Bloomberg



Thank you!