Flash Economics

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Is restrictive monetary policy really necessary?

The ECB has raised the deposit facility rate from 2% to 2.5%, and financial market participants expect a further 50 basis point increase in the policy rate. In addition:

- the ECB continues to reduce the size of its balance sheet, by EUR 35 billion a month, now that reinvestments under the various programmes have ended;
- long-term interest rates are rising (the 10-year yield stands at 3.30% in Germany and 4.80% in France) owing to the global shortage of savings; long-term interest rates are therefore higher than the nominal growth rate.

Monetary and financial conditions in the euro zone are therefore restrictive. Are they too restrictive?

Admittedly, euro-zone inflation reached 4% in October 2026. But there is no sign of wage growth accelerating, and inflation excluding energy and unprocessed food stands at only 2.2%, close to the 10-year inflation swap rate (2.14%). The central question is therefore this: should the ECB continue to contribute to the rise in long-term interest rates by further reducing the size of its balance sheet (quantitative tightening)? The risk is that this would cause business investment and housing investment to fall, and accelerate the rise in public debt ratios.

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Increasingly restrictive monetary and financial conditions in the euro zone

Monetary and financial conditions in the euro zone are becoming **increasingly restrictive**, with:

- the actual and **expected increases in the ECB's policy rates** (**Charts 1A, 1B and 1C**);

Chart 1A
Euro zone: ECB deposit facility rate (%)

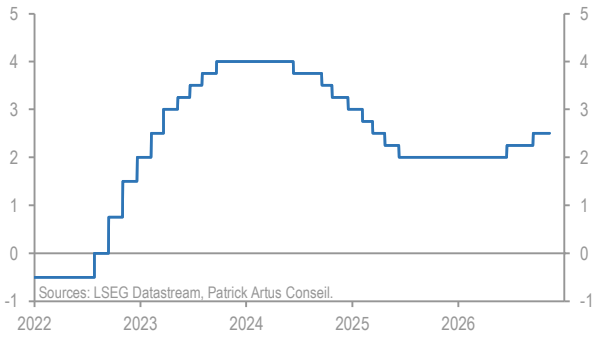


Chart 1B
Euro zone: 3-month Euribor futures (%)

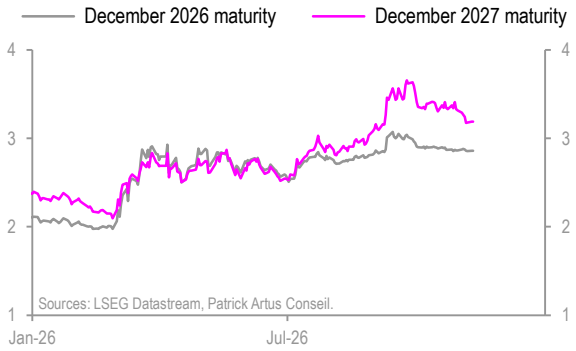
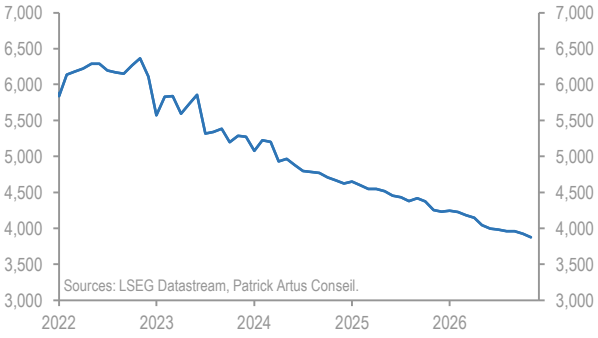


Chart 1C
Germany: 2-year government bond yield (%)



- **continued quantitative tightening** (the ECB is still reducing the size of its balance sheet, **Chart 2**);

Chart 2
Euro zone: Monetary base (EUR bn)



- **the rise in nominal and real long-term interest rates** (**Charts 3A and 3B**).

Chart 3A
10-year government bond yields (%)

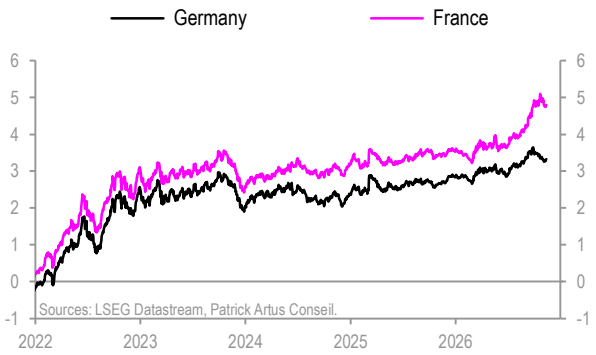
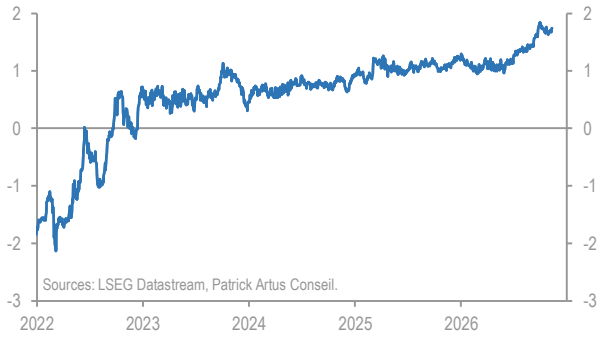


Chart 3B
Euro zone: Real 10-year government bond yields (%)



The question is therefore this: **does the inflation risk justify such restrictive monetary and financial conditions?**

Is there a high risk of inflation in the euro zone?

Headline inflation in the euro zone reached 4% in October 2026 (**Chart 4A**). This surge in inflation is due **to rising energy and unprocessed food prices** (**Chart 4B**).

Chart 4A
Euro zone: Inflation (HICP, Y/Y, %)

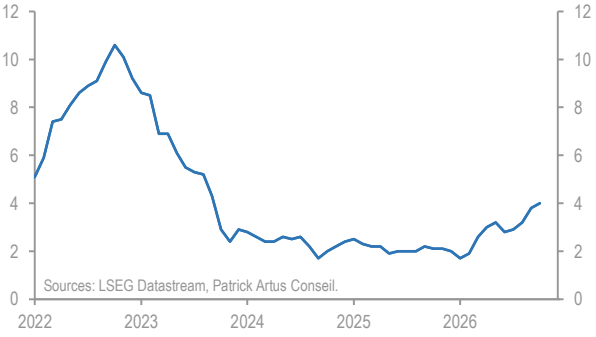
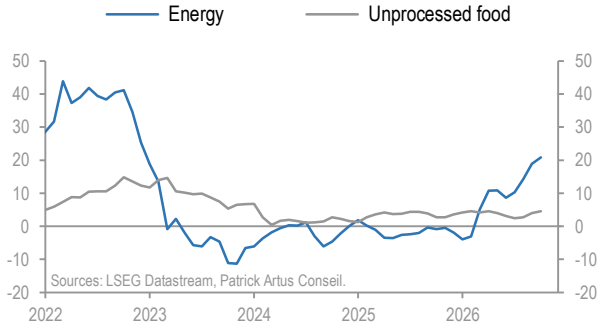


Chart 4B
Euro zone: Consumer prices for energy and unprocessed food* (Y/Y, %)



* Harmonised Index of Consumer Prices (HICP).

For the time being, there is no sign of higher energy and food prices passing through **to wages or to inflation excluding energy and unprocessed food** (**Charts 5A and 5B**).

Chart 5A
Euro zone: Nominal compensation per employee (Y/Y, %)

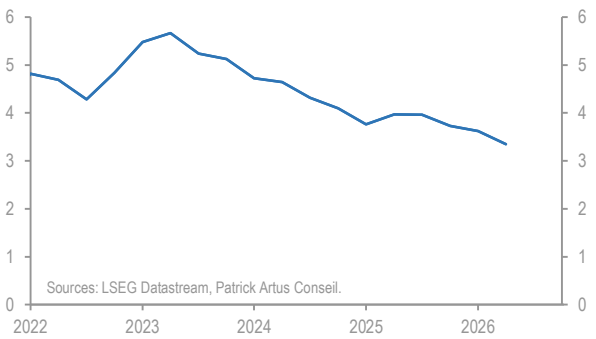
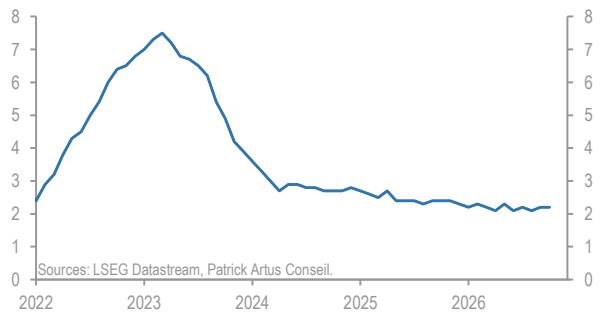


Chart 5B
Euro zone: HICP excluding energy and unprocessed food (Y/Y, %)



The ECB wage tracker, which is updated with signed wage agreements, points to expected wage growth of 2.6% in 2026 and 2.7% in the first quarter of 2027. Even with modest productivity gains, unit labour costs in the euro zone are expected to rise by less than 2% in 2027.

The risks associated with a restrictive monetary and financial policy

These risks are clearly identified:

- a slowdown in business investment (Chart 6A) and in housing investment (Chart 6B);
- a faster rise in public debt ratios (Chart 7).

Chart 6A
Euro zone: Investment by non-financial corporations
(as % of GDP)

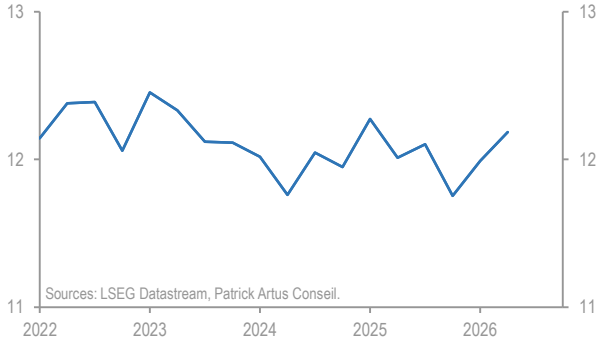


Chart 6B
Euro zone: Housing investment
(in volume terms, as % of GDP)

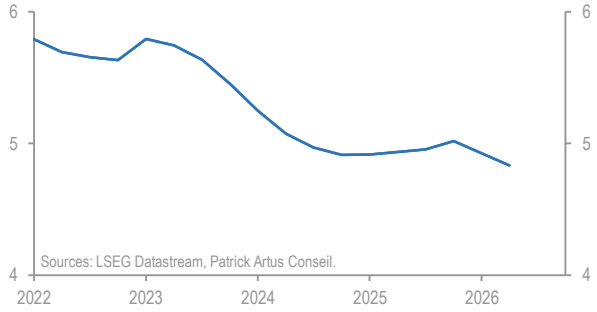
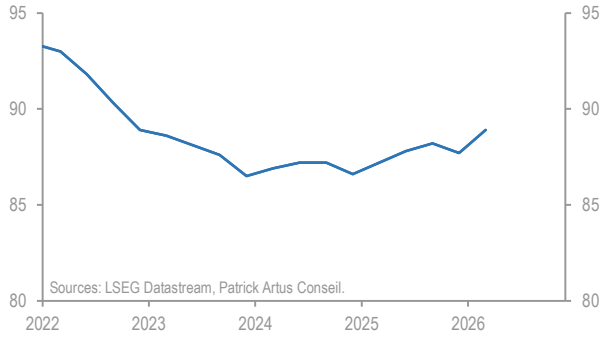


Chart 7
Euro zone: Public debt (as % of nominal GDP)



Conclusion: the ECB must be certain that core inflation threatens to rise before continuing with a restrictive monetary policy

In raising its policy rates and continuing to reduce the size of its balance sheet, the ECB is anticipating that the rise in headline inflation will lead to faster wage growth and higher core inflation, of which there is no sign today.

It needs to be sure that core inflation threatens to rise, because a restrictive monetary and financial policy has very significant drawbacks: a decline in investment, at a time when there is already underinvestment, and a faster rise in the public debt ratio, at a time when it is already rising rapidly.

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