



Euro area monetary policy and inflation

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March 3, 2026

Monetary Policy and the Eurosystem



Transmission to Latvian economy



Euro area and global challenges

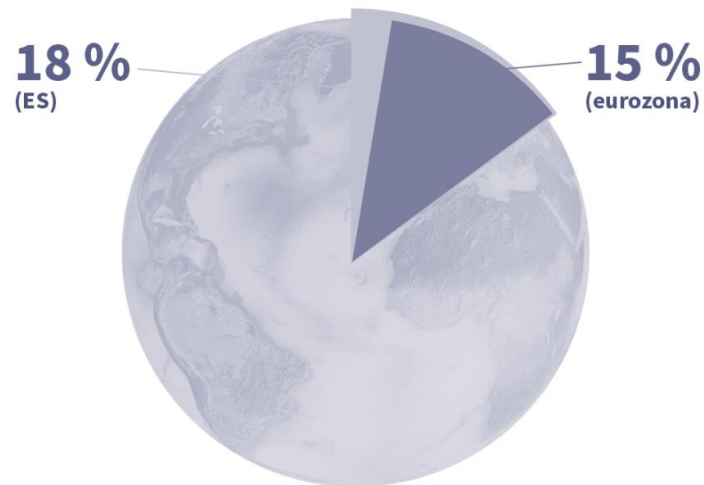
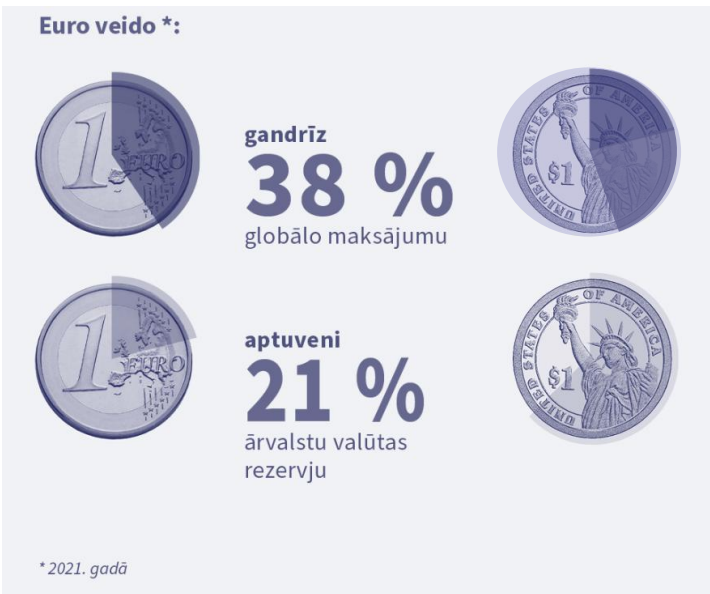


Euro is the second most important currency globally

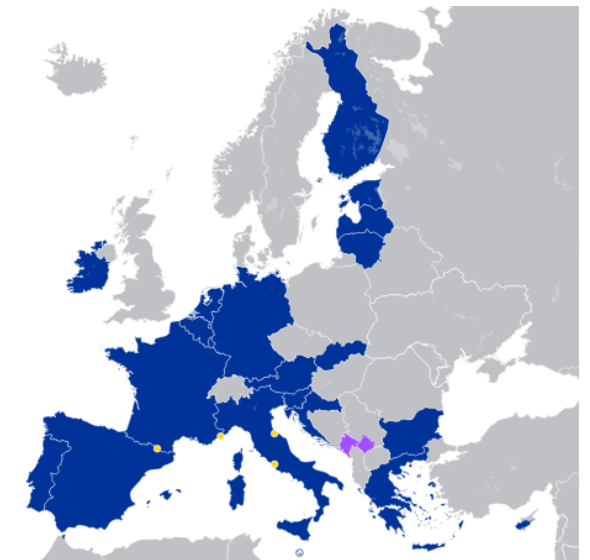
The euro is an important part of global payments

The EU and euro area are actively involved in global trade

More than 347 million people use the euro in their everyday payments



* kā daļa no IKP, kas izteikts dolāros (2021)



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ΤΡΑΠΕΖΑ ΤΗΣ ΕΛΛΑΔΟΣ
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БЪЛГАРСКА НАРОДНА БАНКА
ЕВРОСИСТЕМА

Joining the euro has several benefits



Reduced exchange rate risk, that helps facilitate international trade and cooperation



Facilitates investment by creating a more stable and predictable economic environment



Increased competition through more transparent and comparable prices



Lower interest rates for euro area households, companies and governments



Security of payment systems, which allows for near instant execution of transactions



Lower transaction costs for households and companies



Maintaining Latvian Lats and implementation of independent monetary policy

The many tasks of the Eurosystem

Main tasks	Other tasks
Define and implement monetary policy	Advisory function
Conduct foreign exchange operations	Maintenance and dissemination of statistical information
Promote smooth operation of payment systems	Circulation of banknotes
Hold and manage euro area's foreign currency reserves	International cooperation
	Supervision and financial stability

ECB monetary policy target

- The primary objective – **ensuring price stability** (Treaty on the Functioning of the European Union, also known as the Maastricht Treaty, Article 127, adopted in 1992).



ECB monetary policy target

- The primary objective – **ensuring price stability** (Treaty on the Functioning of the European Union, also known as the Maastricht Treaty, Article 127, adopted in 1992).
- Price stability is interpreted as **an annual inflation rate of 2%** in the medium term.
- Inflation is determined based on the Harmonized Index of Consumer Prices (HICP).



Why 2% inflation in the medium term?



A clear target

Inflation target is clear and predictable. It gives you an idea of how much prices are likely to change.

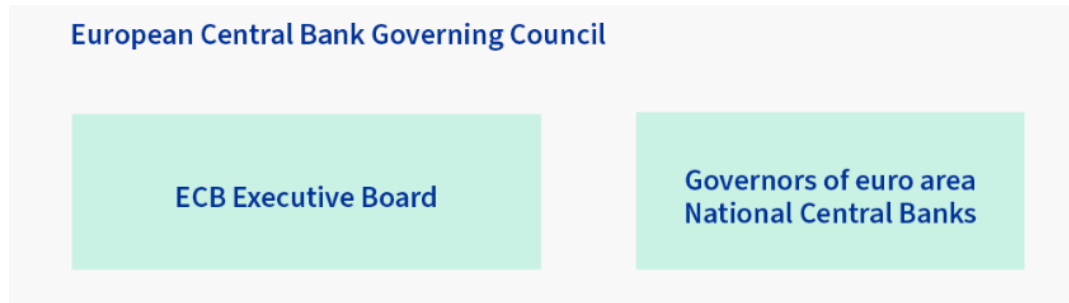
A safety margin

To have a safety margin against the potential risks of deflation.

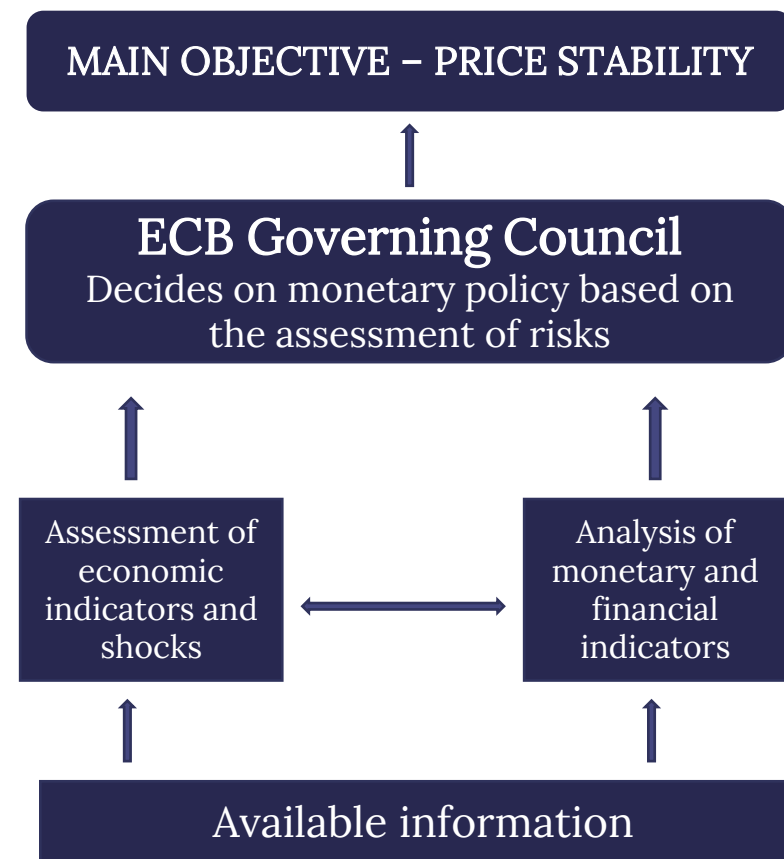
Country differences

To leave room for differences in inflation across euro area countries.

ECB's Governing Council meets eight times per year to decide on the direction of monetary policy



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The ECB's Governing Council



What are the tools at the disposal of the ECB?

Conventional instruments

Key policy
interest rates

Refinancing
operations

Reserve
requirements

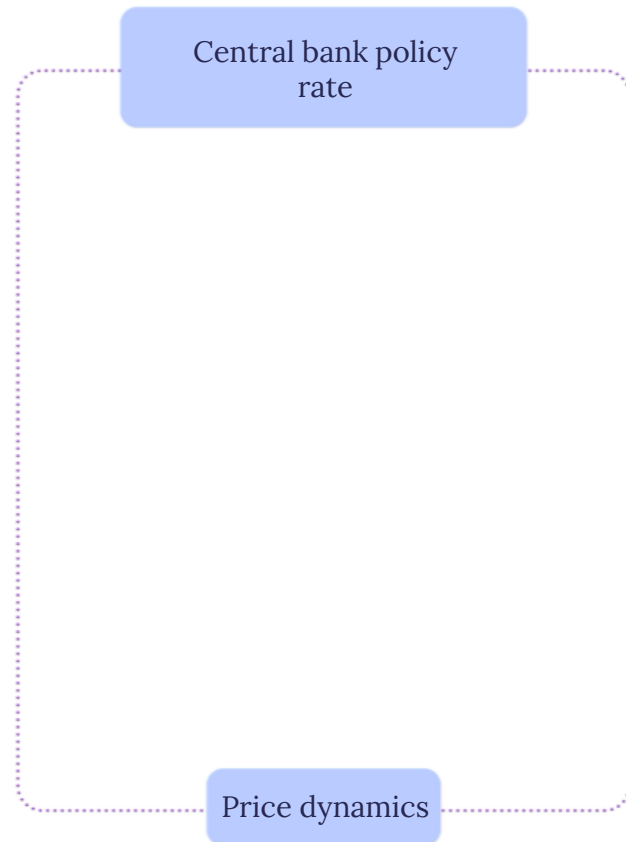
Unconventional instruments

Asset
purchase
programs
(APP)

Additional
liquidity
operations
(TLTRO)

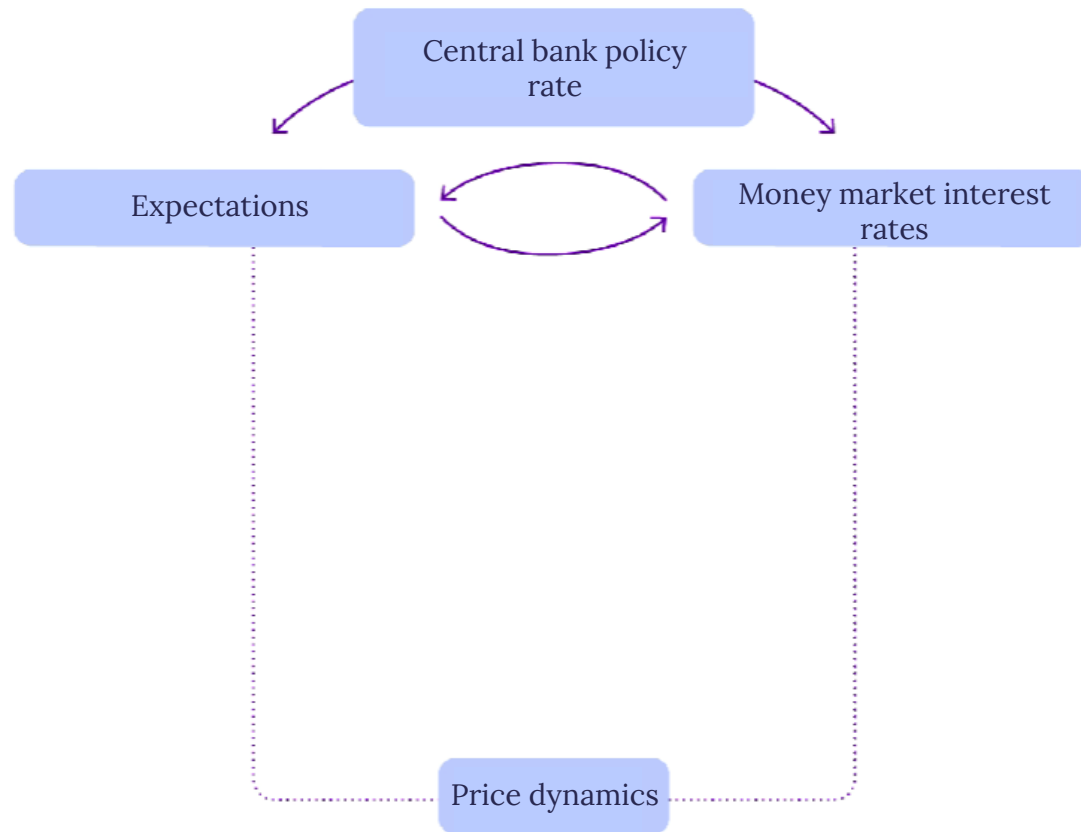
Forward
guidance

What is monetary policy transmission and how does it work?



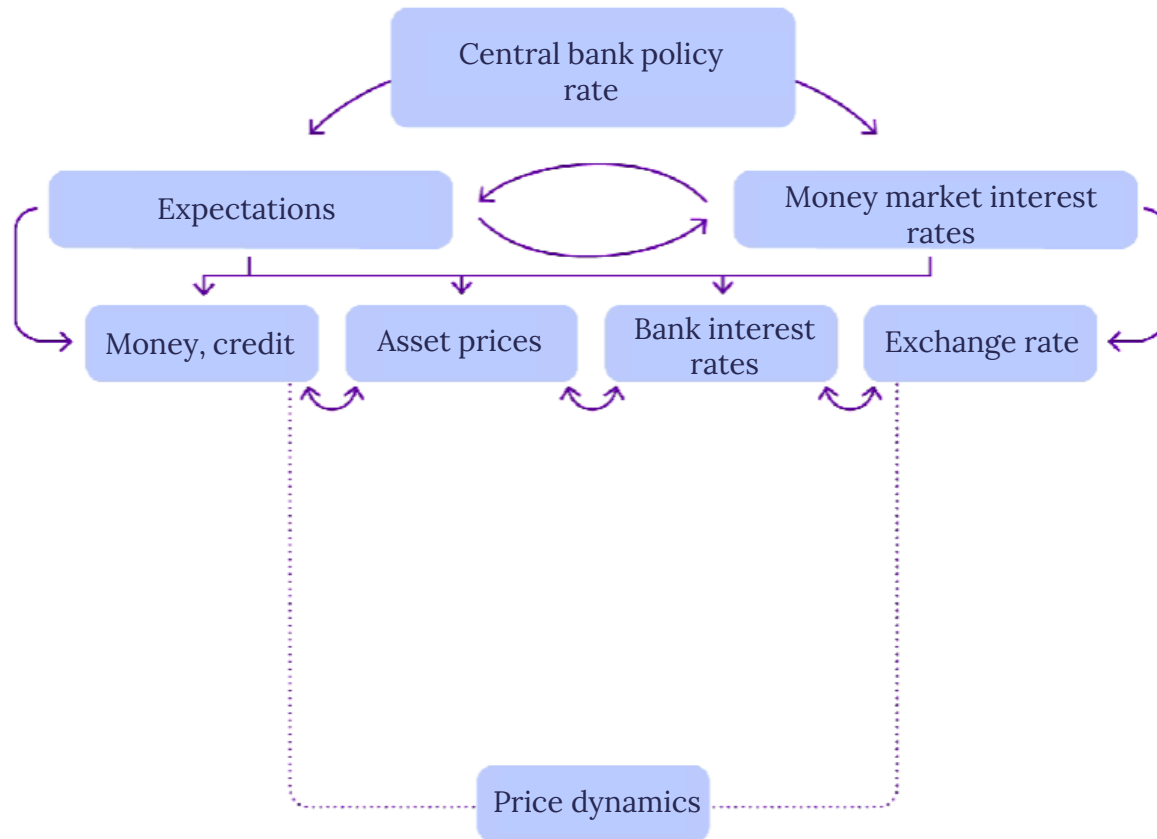
- **Monetary policy transmission** is simply the chain of events that between monetary policy decisions and economic processes such as inflation.

What is monetary policy transmission and how does it work?



- When a central bank makes changes to its key policy interest rates, **money market interest rates** change accordingly.
- Frequently the decisions and the information provided by central banks affects the **expectations** of the economic outlook as well as future interest rates.

What is monetary policy transmission and how does it work?

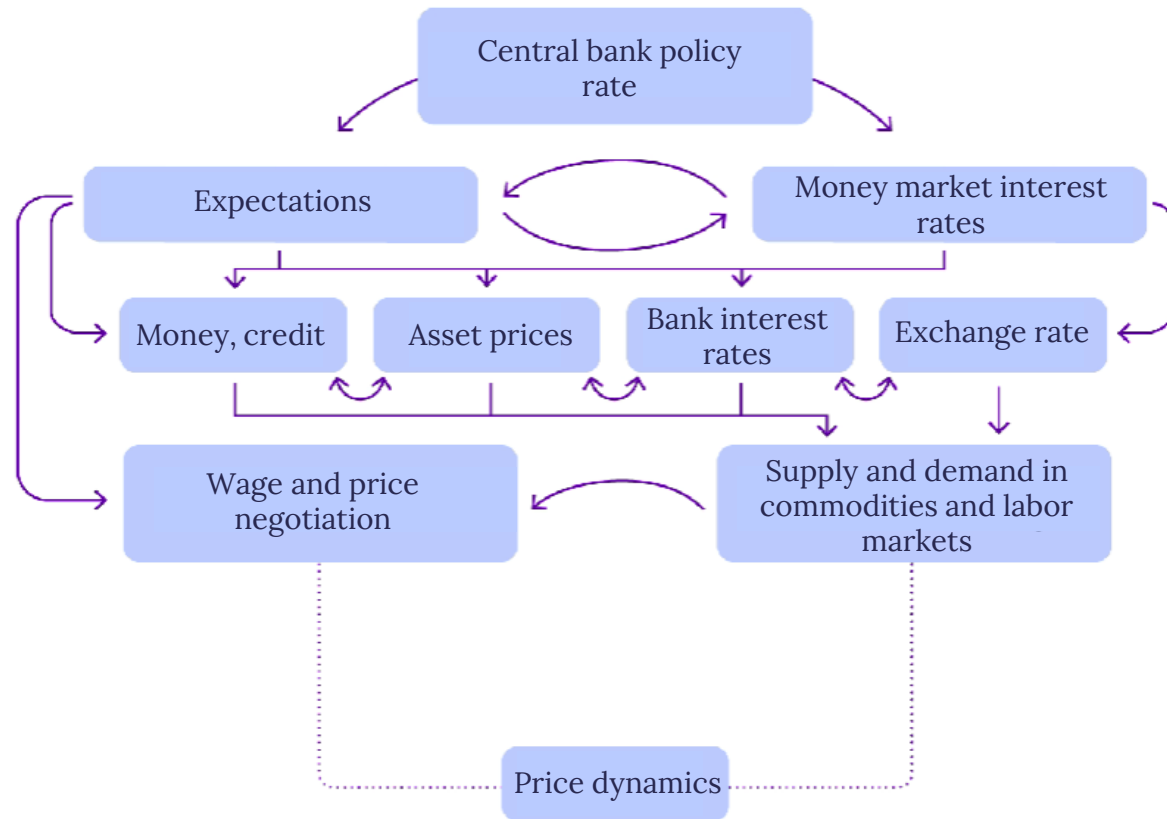


Changes in interest rates and expectations are reflected **across different financial market segments**.

For example (ceteris paribus), when the central bank raises interest rates:

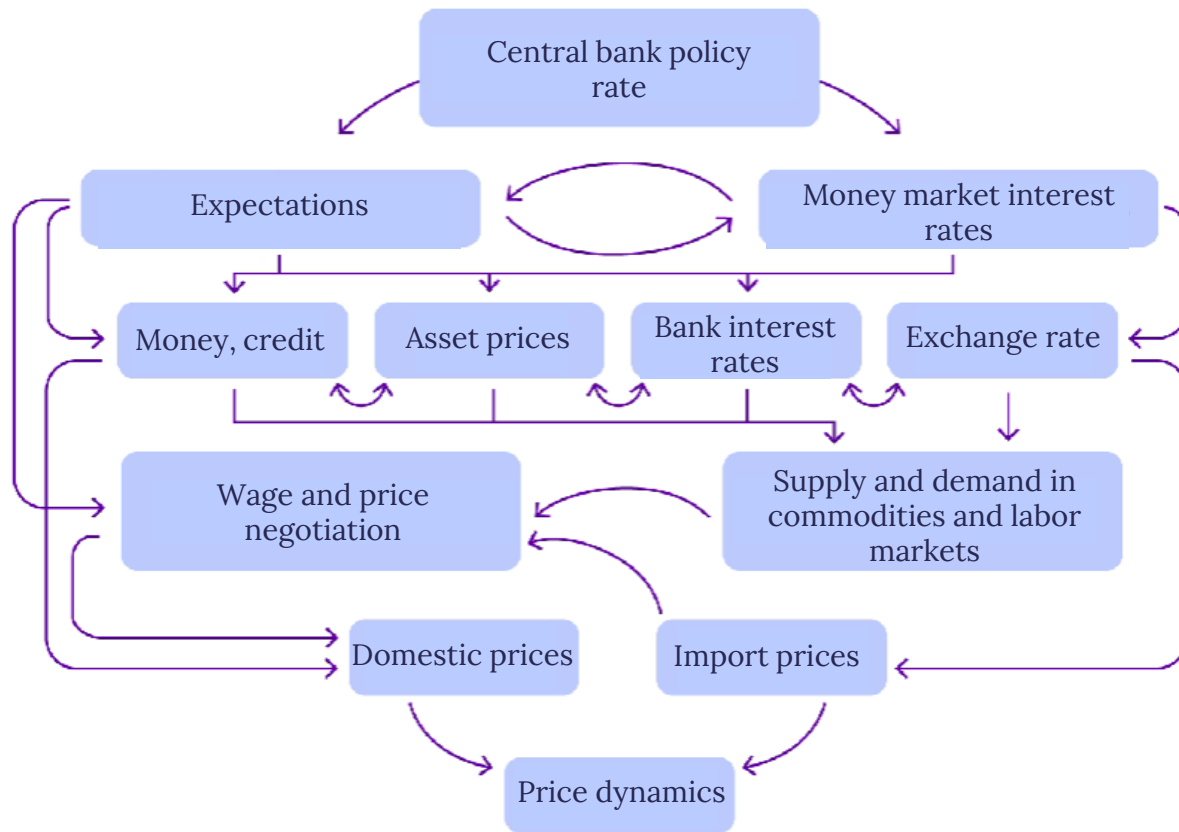
- Borrowing costs increase
- Bank financing becomes less available
- Asset prices decline
- The exchange rate appreciates (interest rate parity)

What is monetary policy transmission and how does it work?



- Afterwards the effects are transmitted **from the financial markets to the real economy.**
- Expectations about the future affect wage negotiations, procurement prices and eventually prices in stores.
- At the same time higher interest rates and limited credit supply dampens economic activity.

What is monetary policy transmission and how does it work?

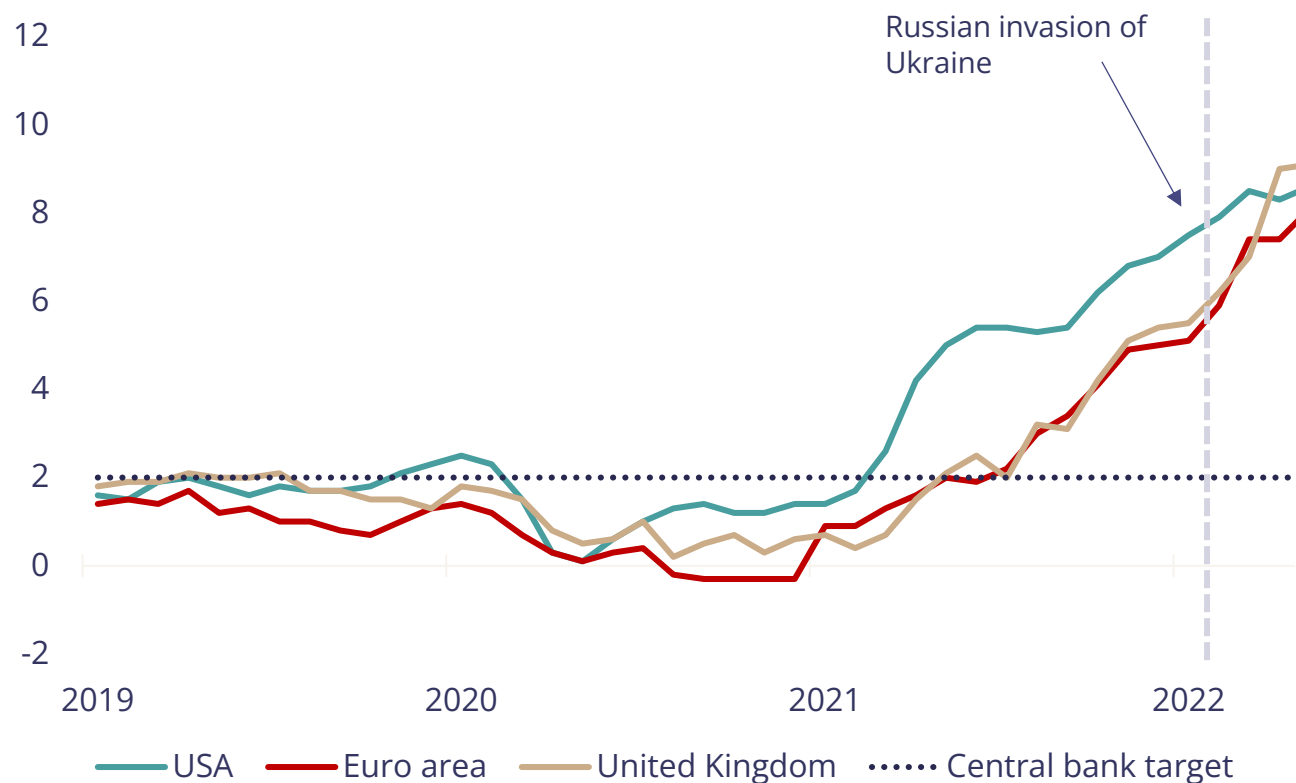


If interest rates rise and the euro appreciates:

- Importers benefit (imports become cheaper)
- Exporters face challenges (exports become more expensive)
- Rising rates reduce demand. Firms try to maintain market share by competing on prices or lowering them.
- **Softer price increases** (or even price decreases) results in lower wage pressures. Consequently, inflationary pressures decrease as well.

Monetary policy in action – rapid increase of inflation not only in the euro area but also in many other developed countries

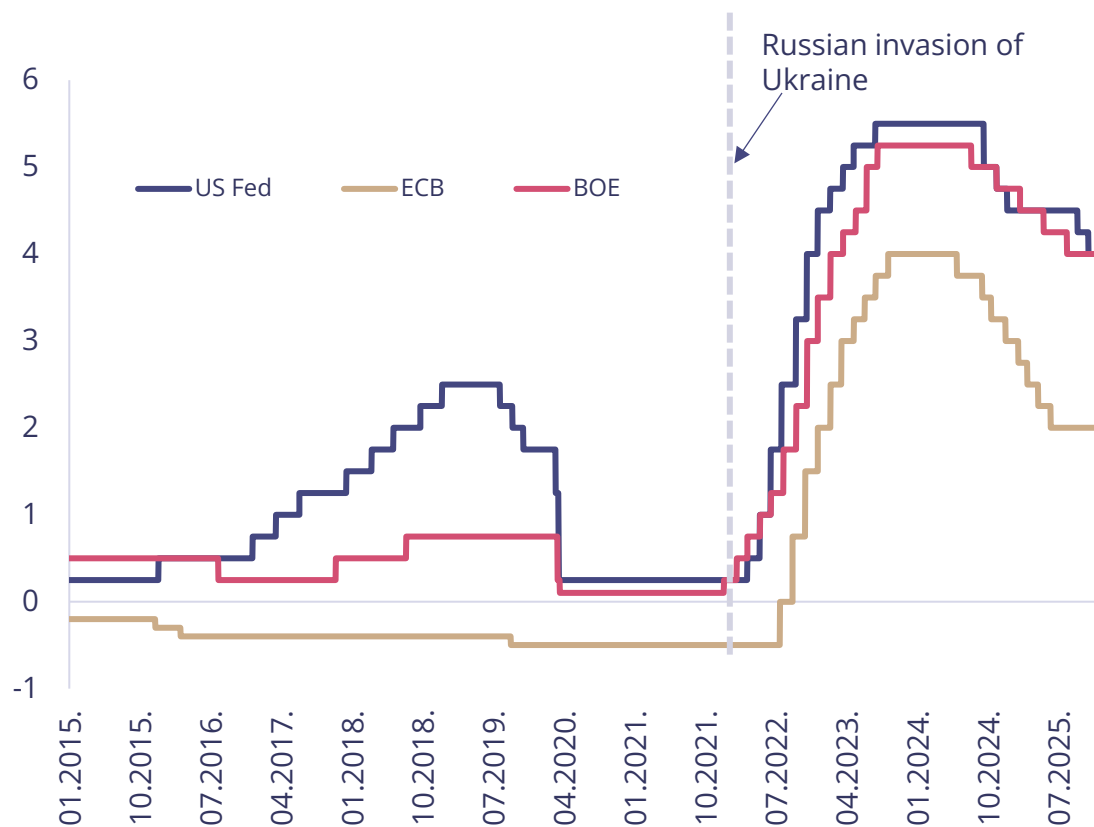
Annual rate of inflation (%)



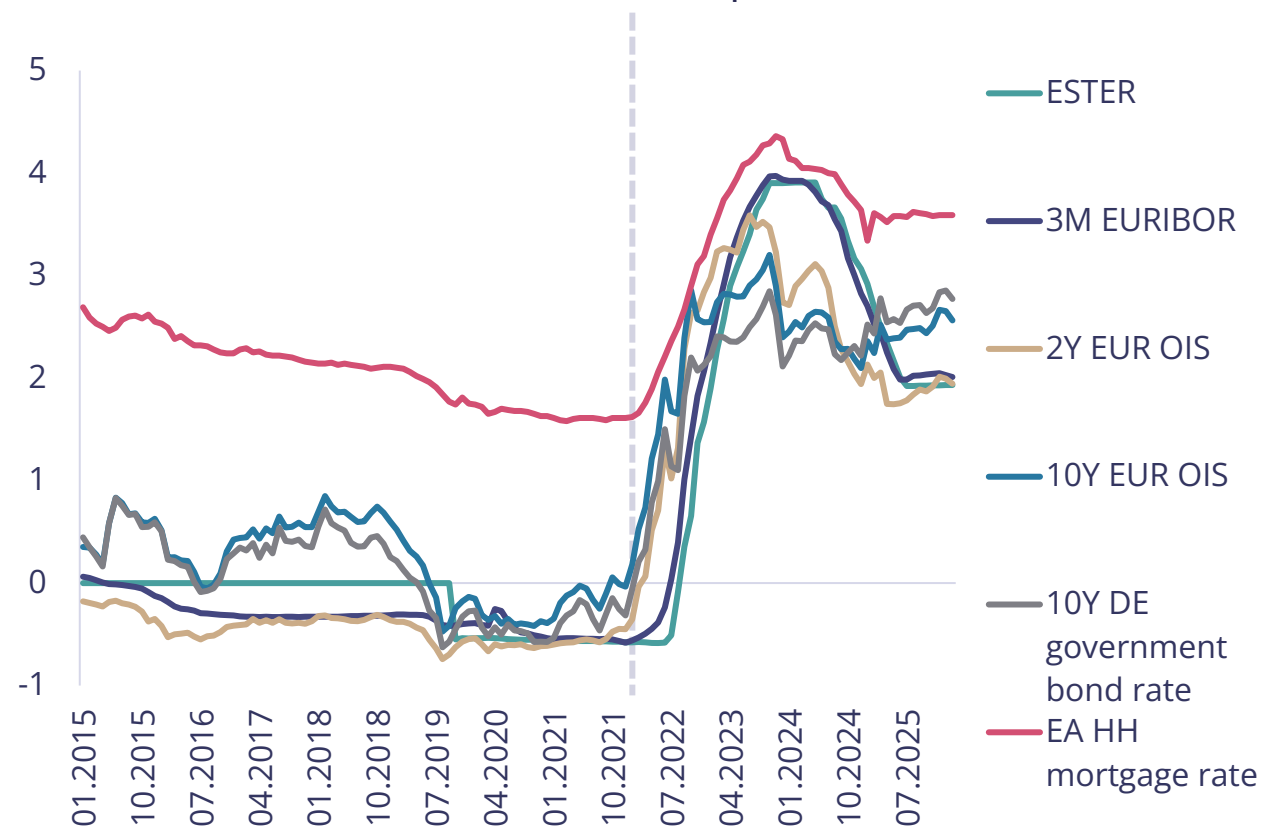
- Moderate increase in inflation observed already after 2021.
- With the Russian invasion of Ukraine inflationary pressures accelerate.
- It becomes abundantly clear that central banks need to respond forcefully.

Reacting to rapid inflationary pressures, central banks react deploying tools at their disposal

Main policy interest rates (%)

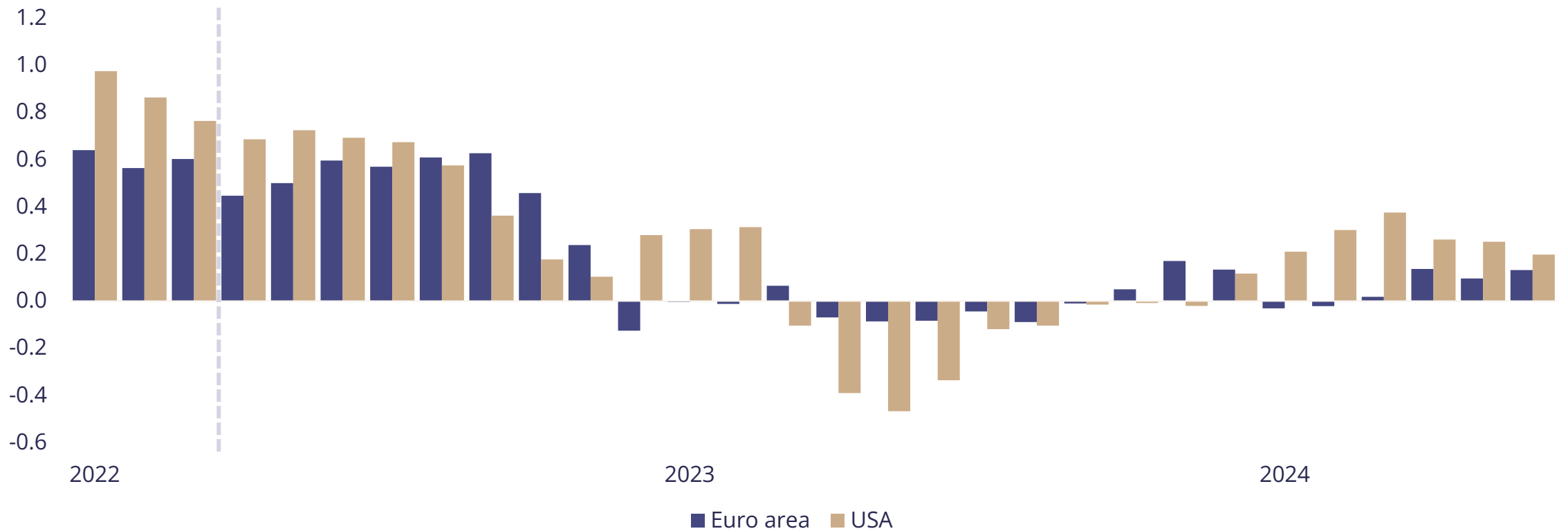


Interest rates in euro area (% p.a.)

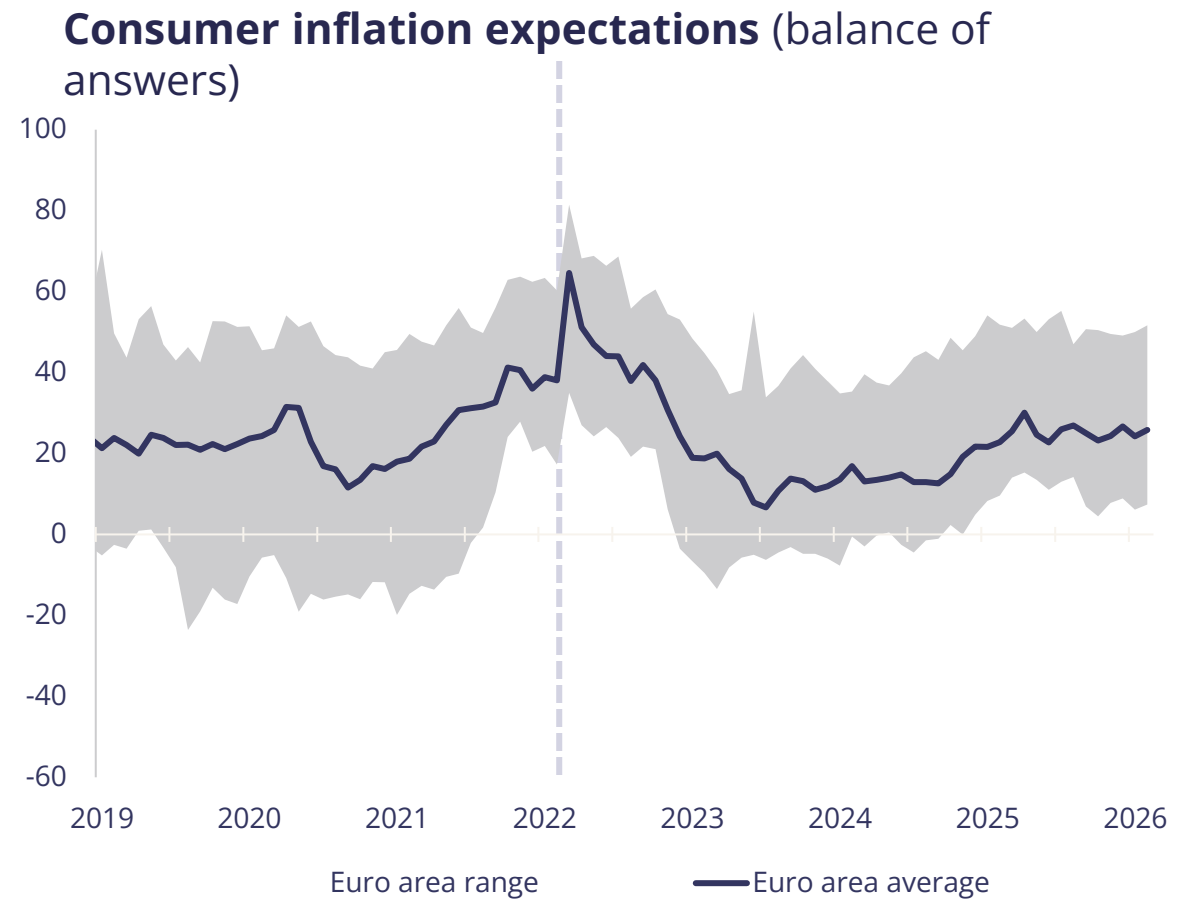
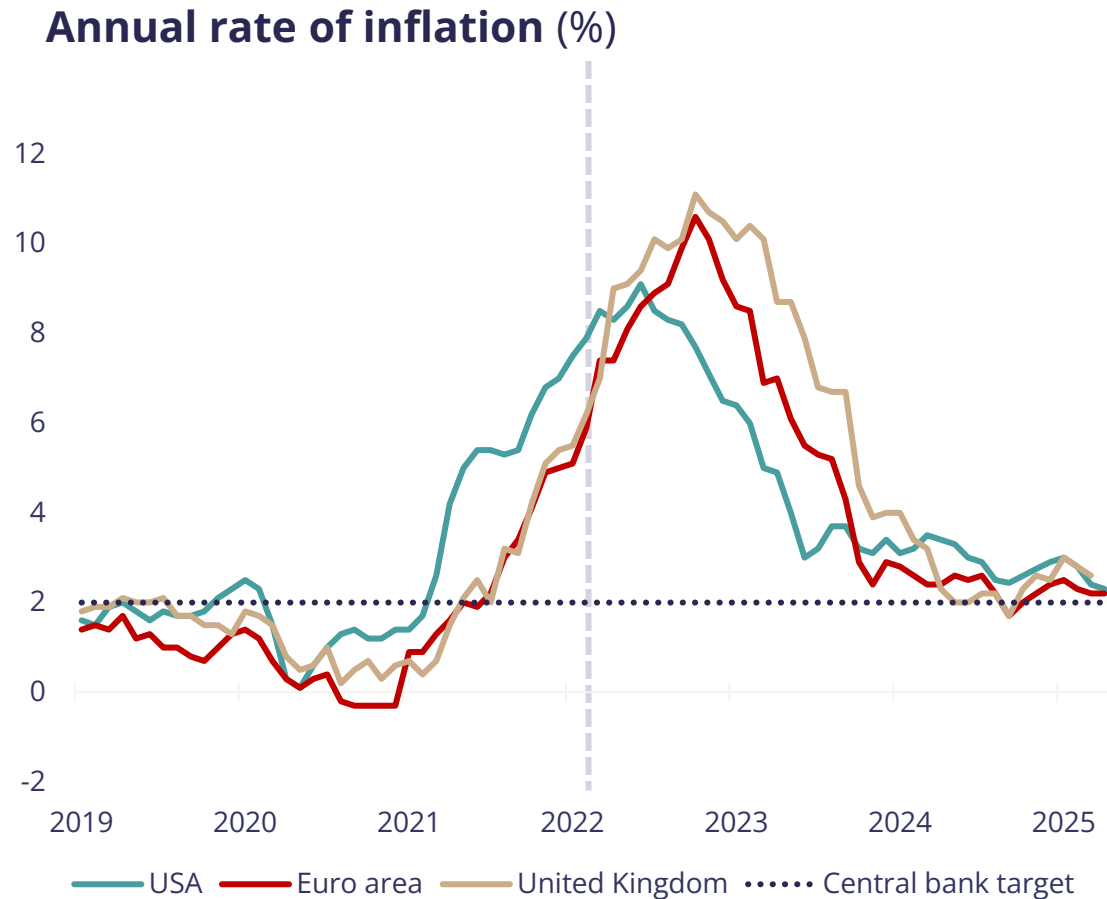


Credit growth abates

Real credit growth
(%; monthly changes)

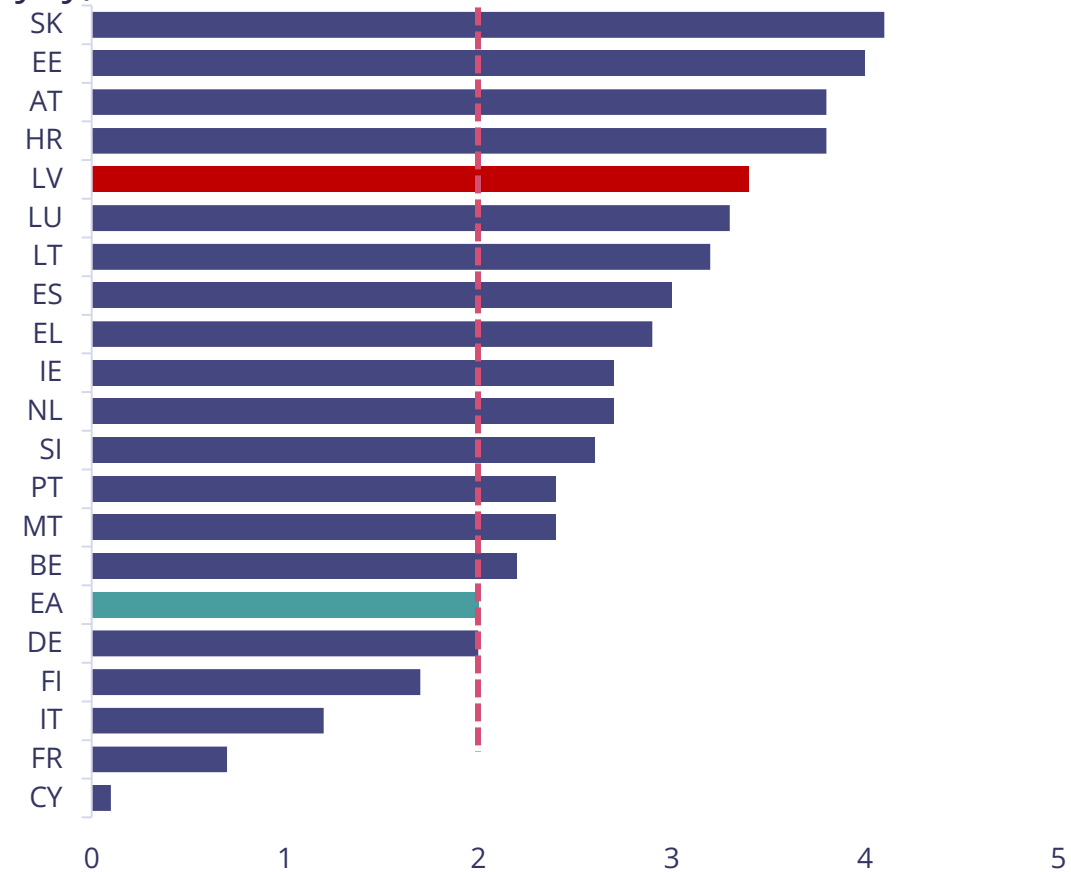


Inflation and inflation expectations decrease as a response...

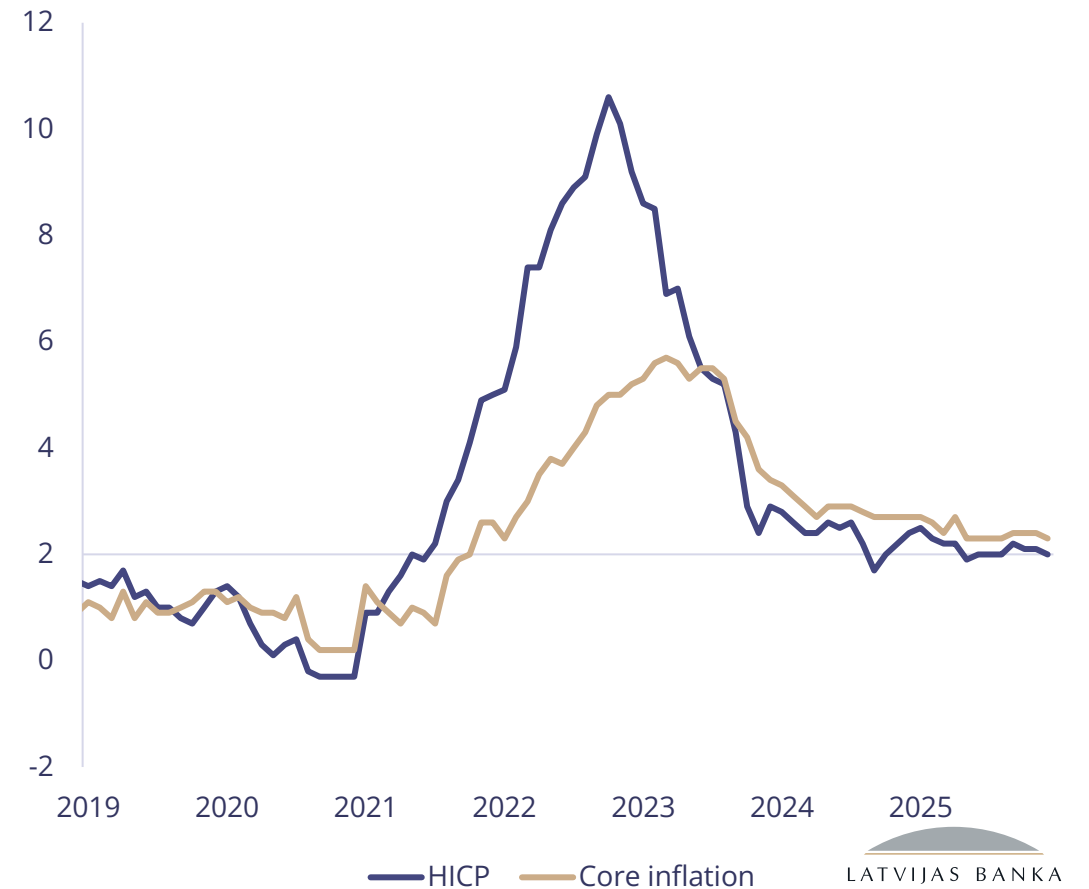


... but we cannot become complacent

Annual rate of inflation in December 2025 (%; yoy)

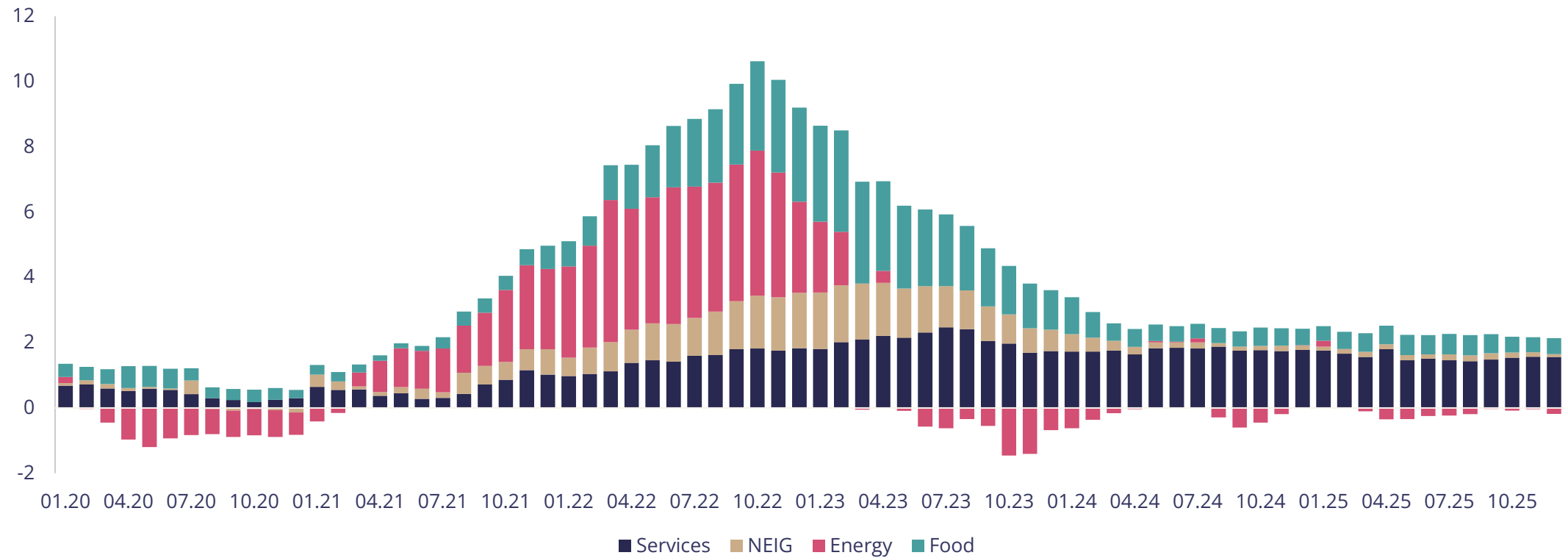


Annual rate of inflation and core inflation in euro area (%; yoy)



Services inflation remains stubborn

Decomposition of the annual rate of inflation in the euro area (%)

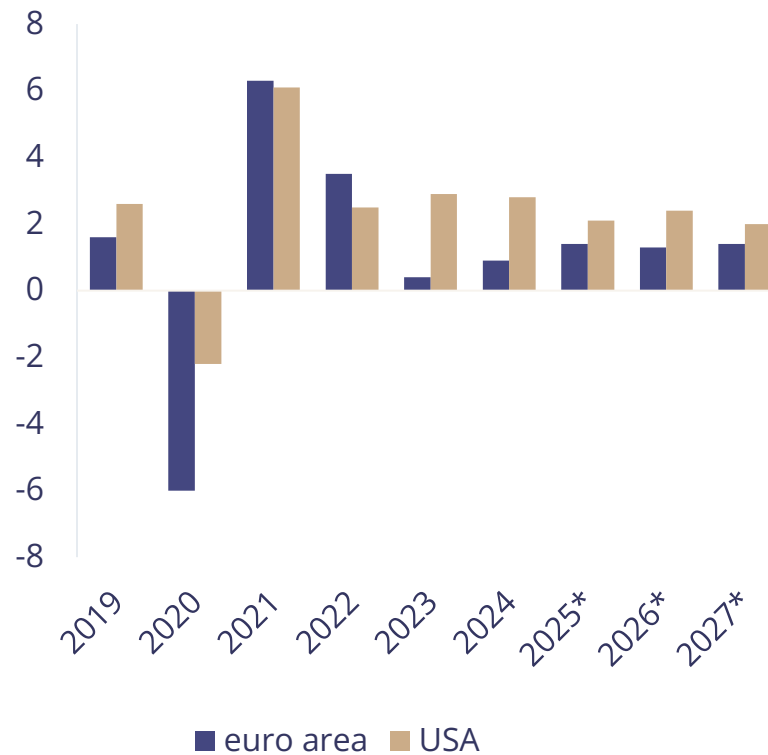


Weak economic growth is concerning

Unemployment rate in the euro area (% of economically active citizens)



Real GDP growth and forecasts* (%)



Monetary Policy and the Eurosystem



Transmission to Latvian economy



Euro area and global challenges



What determines the strength of monetary policy transmission?



What determines the strength of monetary policy transmission?

How quickly lending rates change?

Link between financial markets and the real economy



Transmission strength

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How quickly deposit rates change?

Link between financial markets and the real economy



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Transmission strength

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Transmission strength

How leveraged are companies and households?

How much governments borrow?

What determines the strength of monetary policy transmission?

How quickly lending rates change?

Trade linkages

How quickly deposit rates change?

Link between financial markets and the real economy



Transmission strength

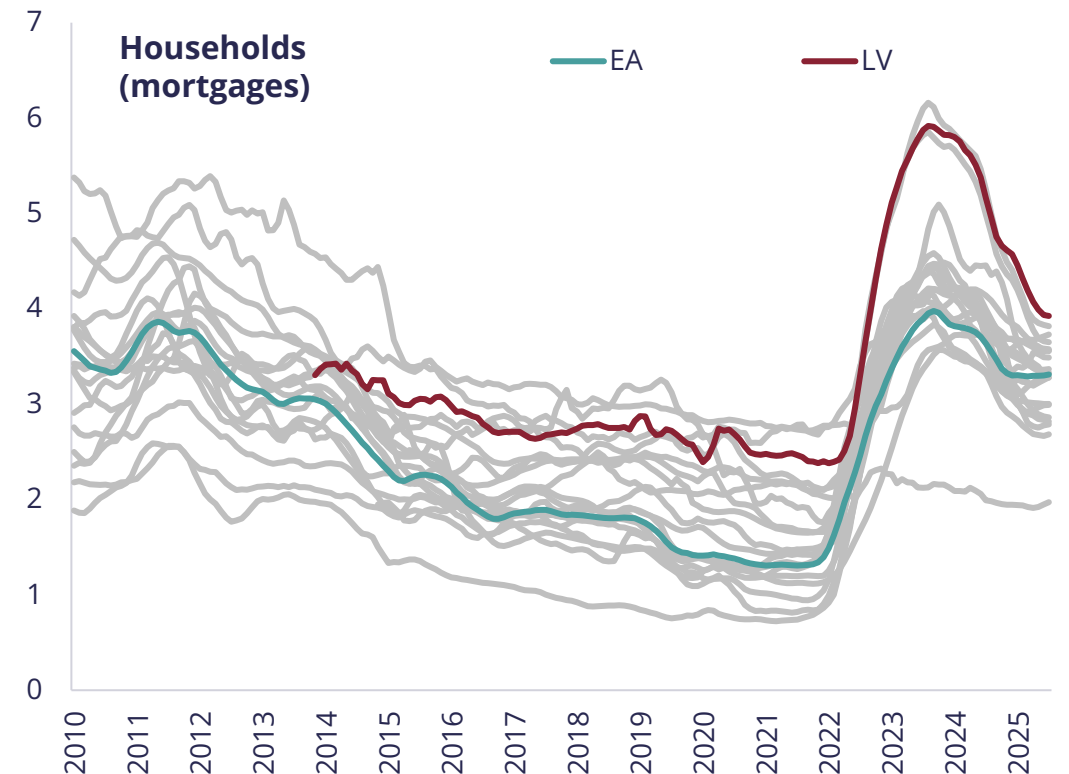
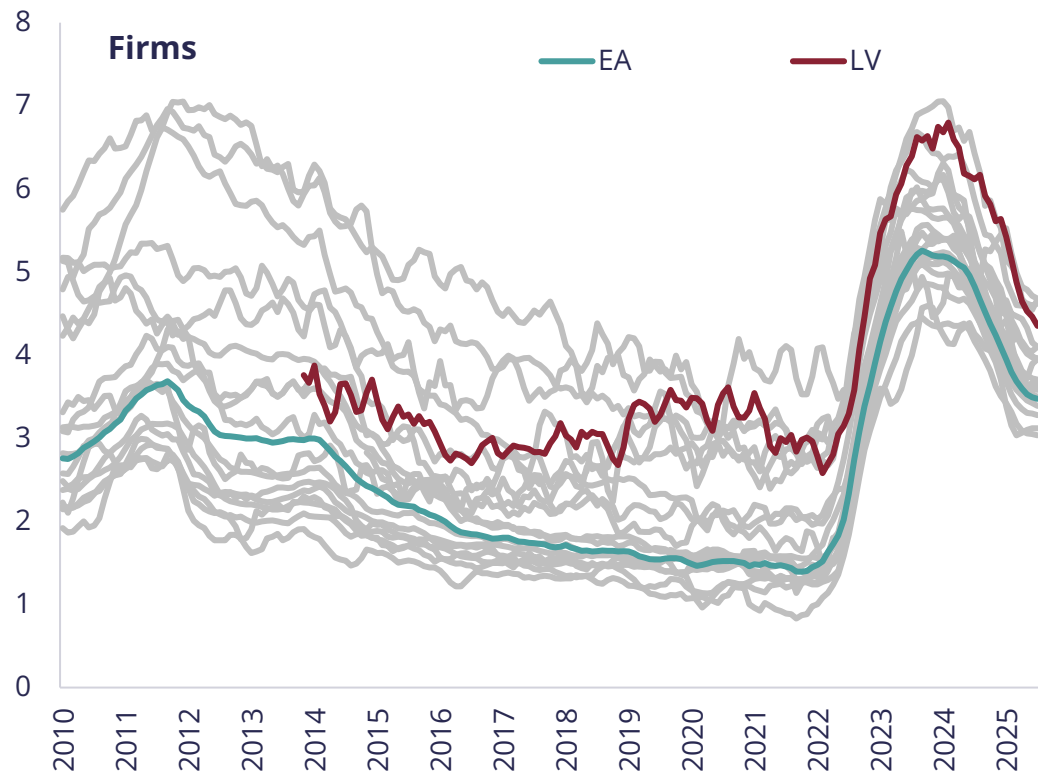
How leveraged are companies and households?

How attentively market participants listen to the central bank?

How much governments borrow?

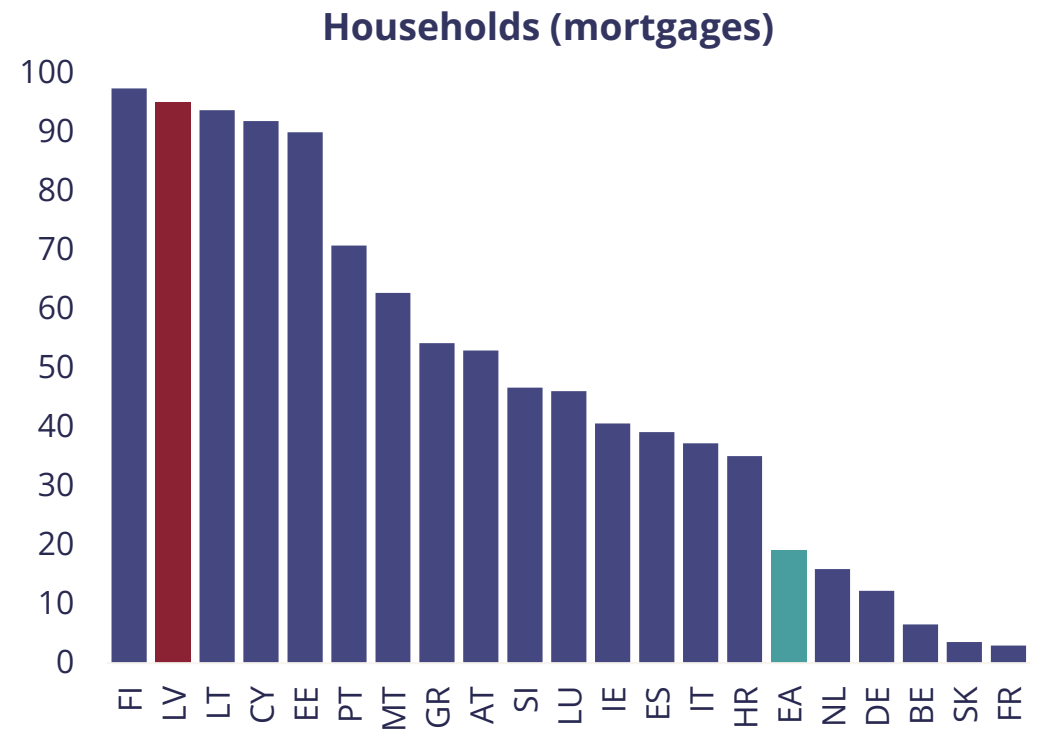
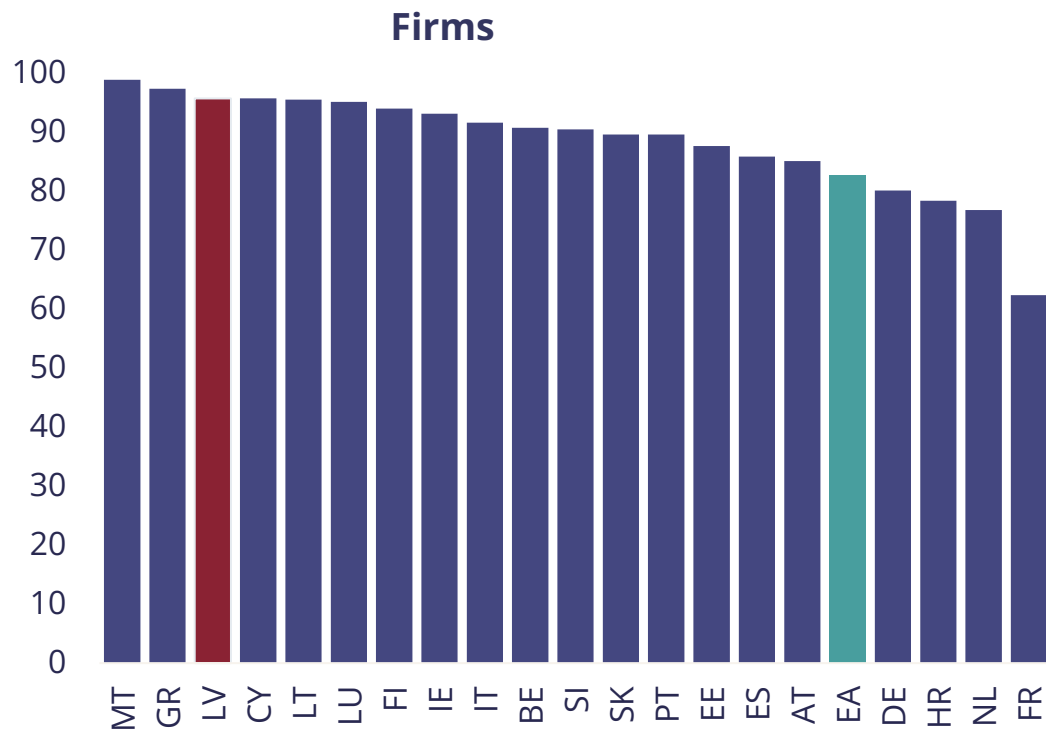
Lending rates adjusted quickly in Latvia

Interest rates on newly issued euro loans to households and firms in the euro area (%; 3-month MA)



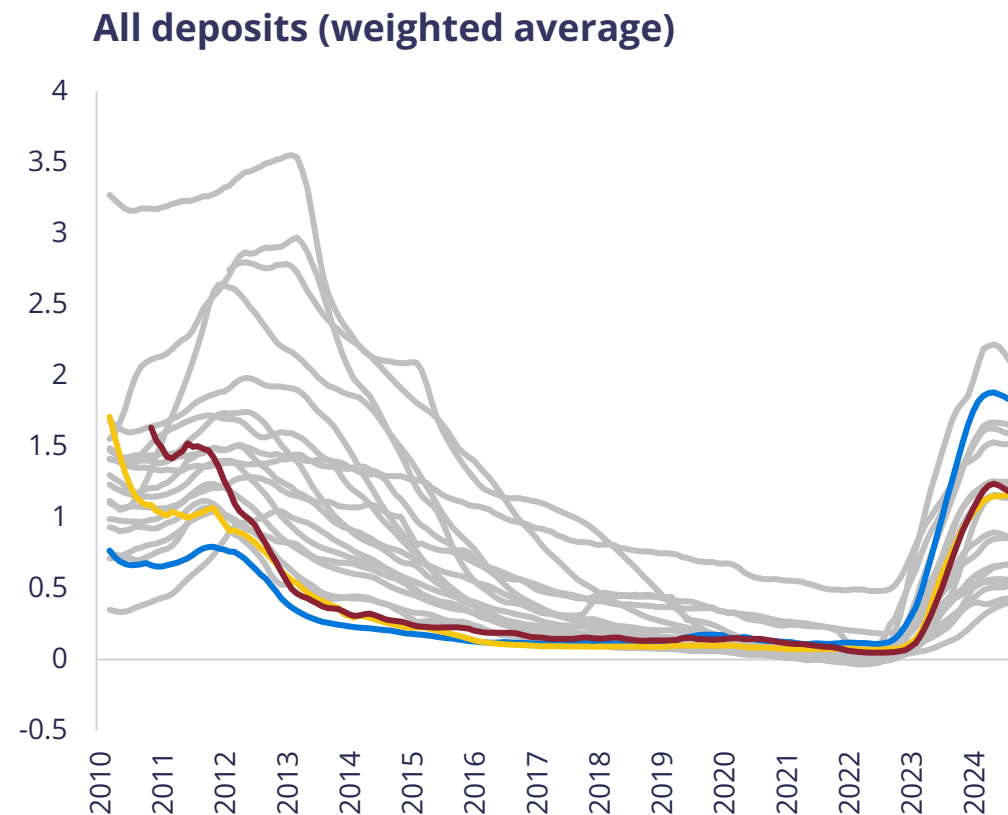
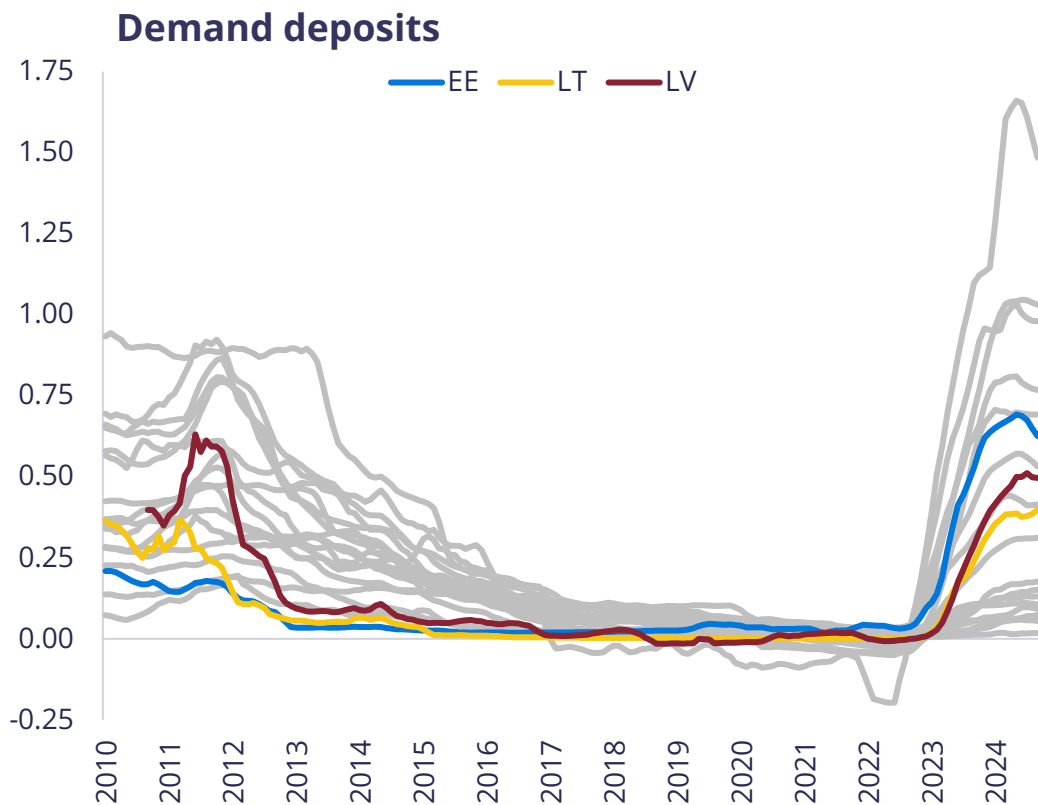
Floating rate loans are more common in Latvia

Share of floating rate loans (% , 2014-2024 avg.)



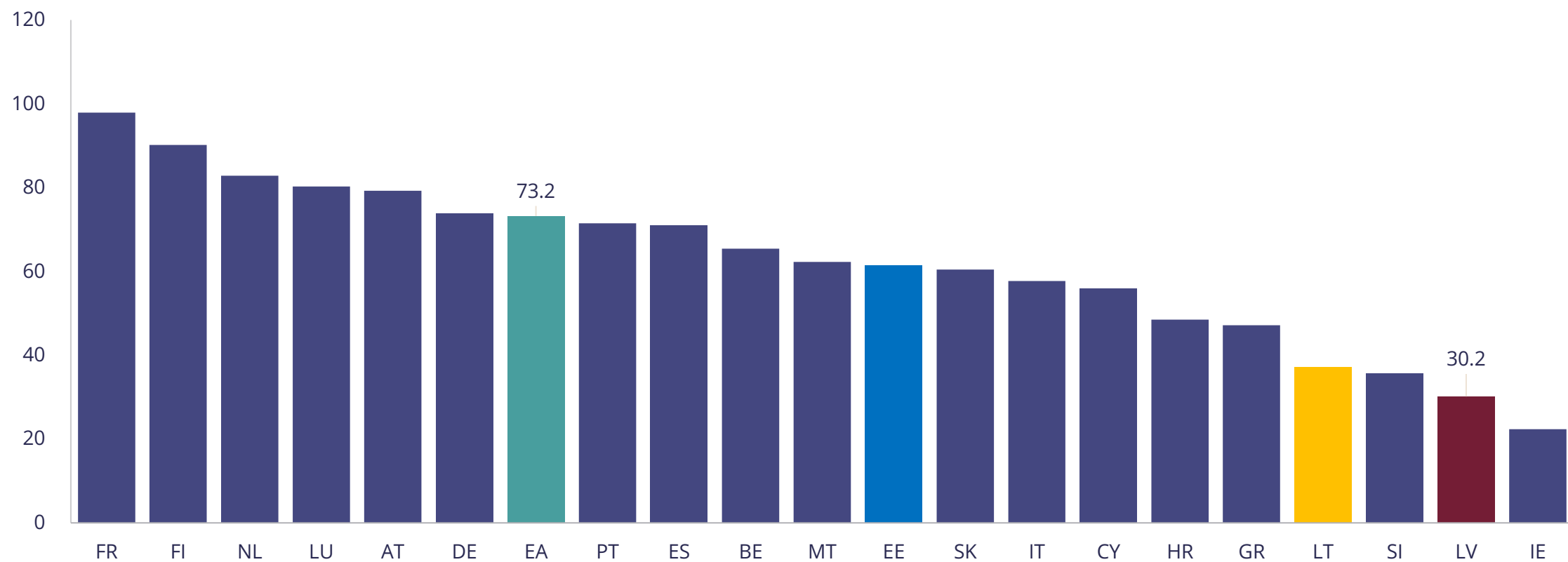
Deposit rates have also increased but not at the same pace as lending rates

Deposit rates in euro area countries (% , 3-mēn. vid.)



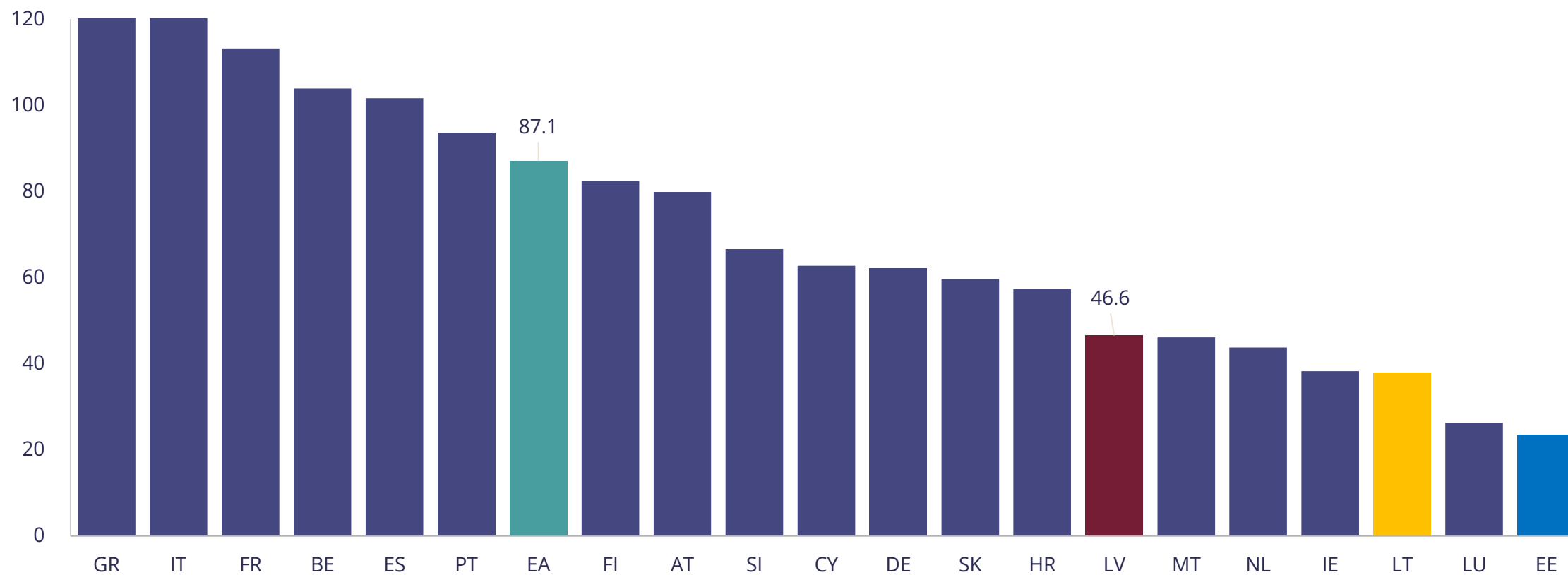
Lending amount are relatively low in comparison to other euro area countries

Outstanding amount of household and non-financial company loans in euro area countries 2024Q1
(% of GDP)



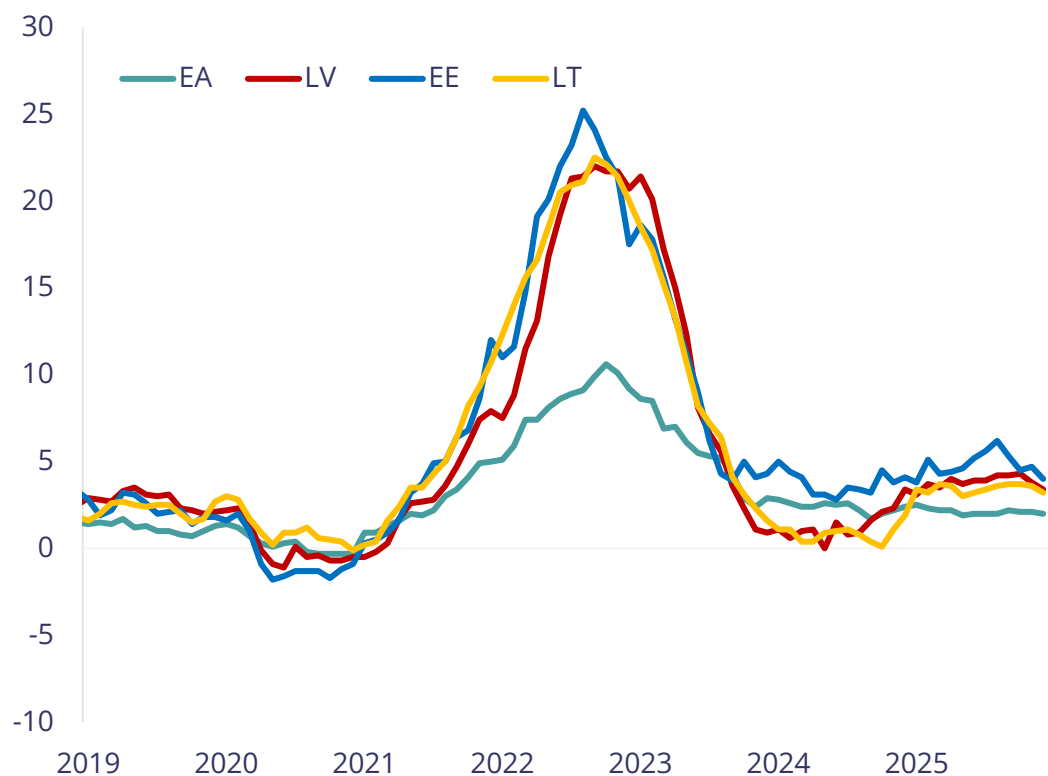
Government debt level on of the lowest in the euro area

Euro area government debt levels in 2023 (% of GDP)



If transmission happens quickly in Latvia, why was inflation so high?

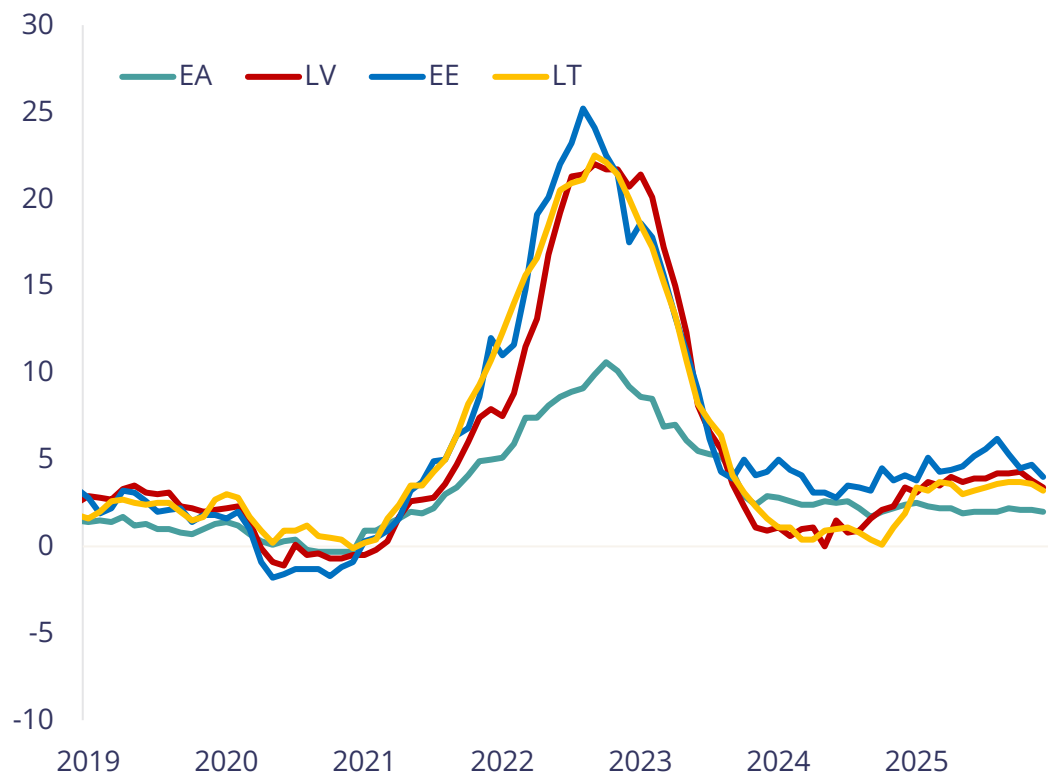
Annual rate of inflation in the Baltics (%)



- **Monetary policy does not work instantaneously and takes to work through the economy**
- **Monetary policy and its transmission is just one of the factors shaping inflation dynamics**

If transmission happens quickly in Latvia, why was inflation so high?

Annual rate of inflation in the Baltics (%)



- **Monetary policy does not work instantaneously and takes time to work through the economy**
- **Monetary policy and its transmission is just one of the factors shaping inflation dynamics**
- Proportionally we consume more products and services which saw the highest price increases (fuel, electricity, heat, transportation)
- Government support was different across countries
- Country specific factors



Monetary Policy and the Eurosystem



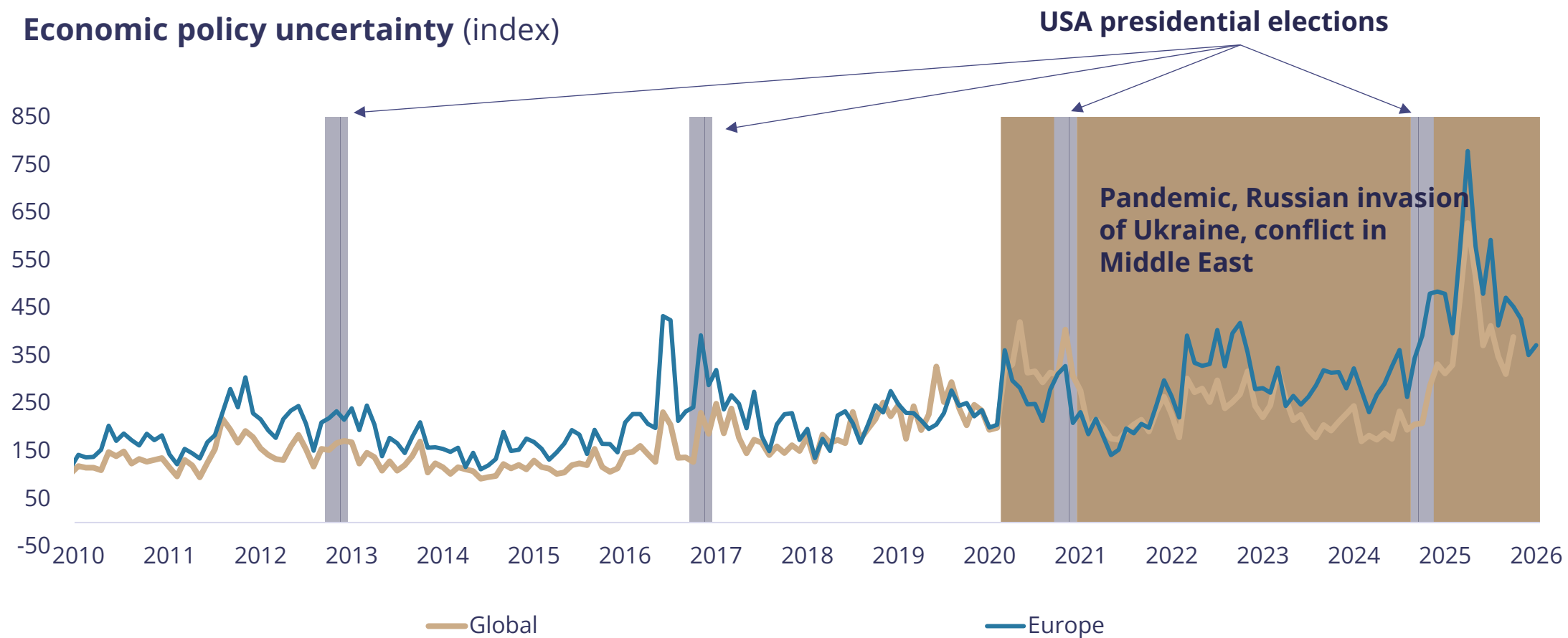
Transmission to Latvian economy



Euro area and global challenges



Historically high levels of uncertainty



Geopolitical tensions are on the rise



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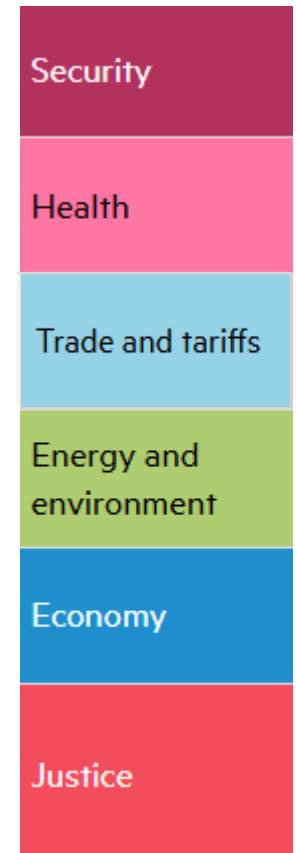
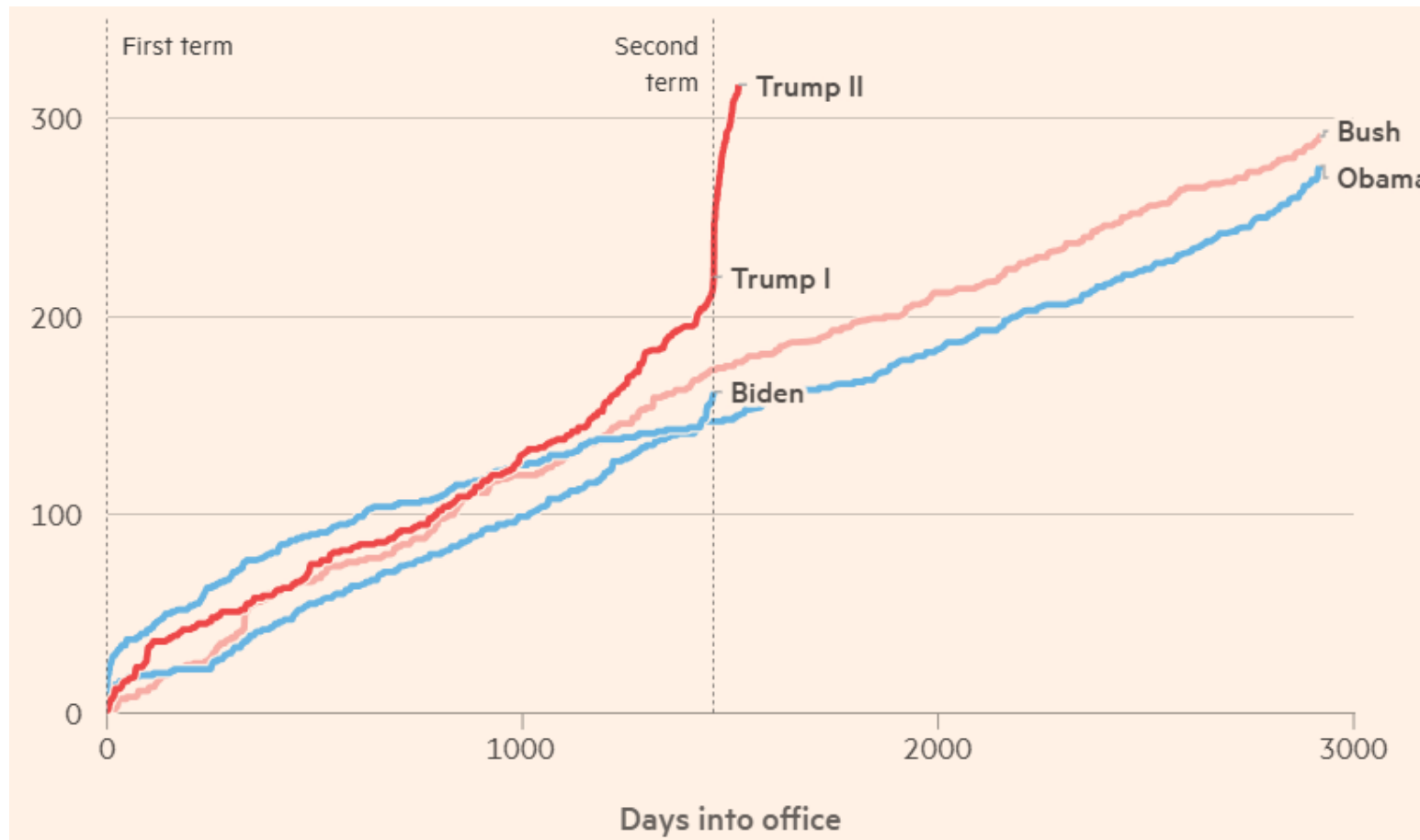
200km

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Trump wants to reclaim the Panama Canal

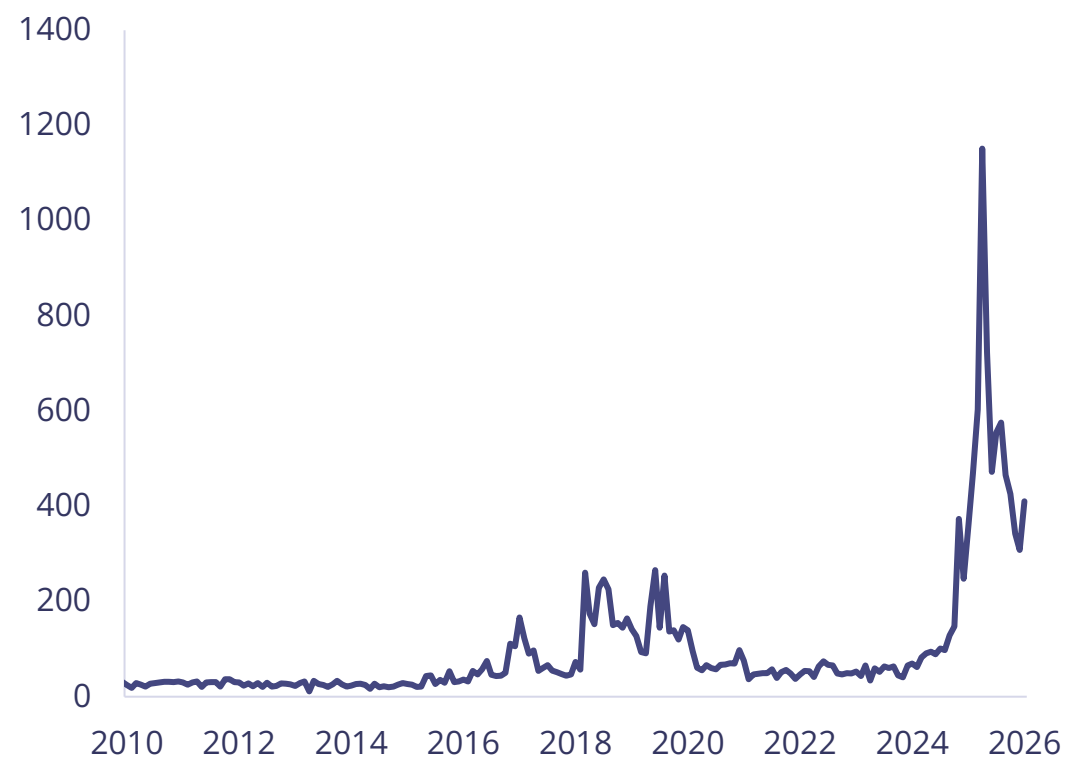
The US political stance on several issues has changed rapidly

Running total of US executive orders signed



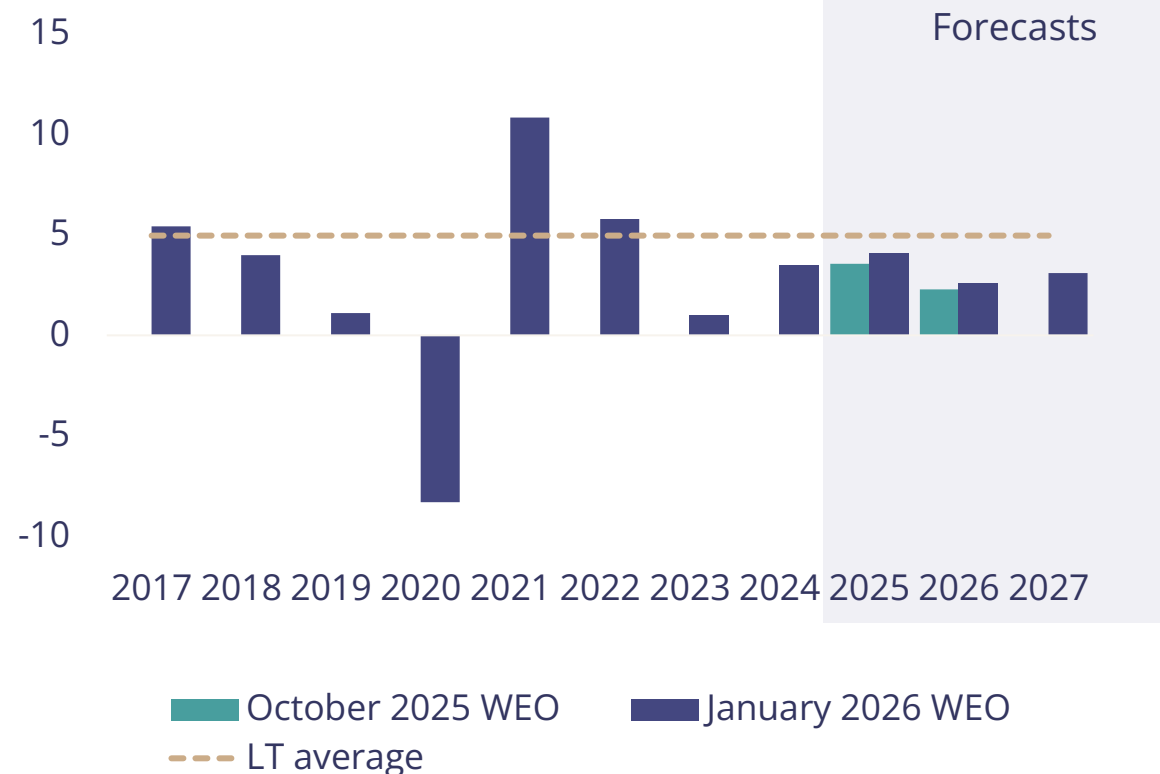
High uncertainty has deteriorating impact on global trade

Trade policy uncertainty (index)



Source: Caldara, Dario, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino, and Andrea Raffo (2020), "The Economic Effects of Trade Policy Uncertainty," *Journal of Monetary Economics*, 109, pp.38-59.

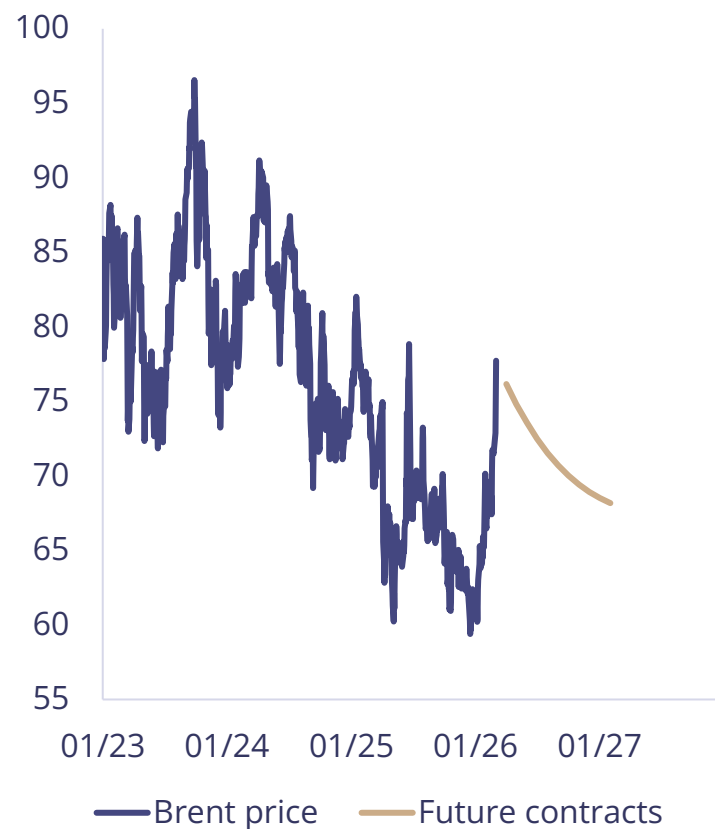
World trade volume (annual rate of change; %)



Source: IMF

Commodity prices become more volatile and unpredictable

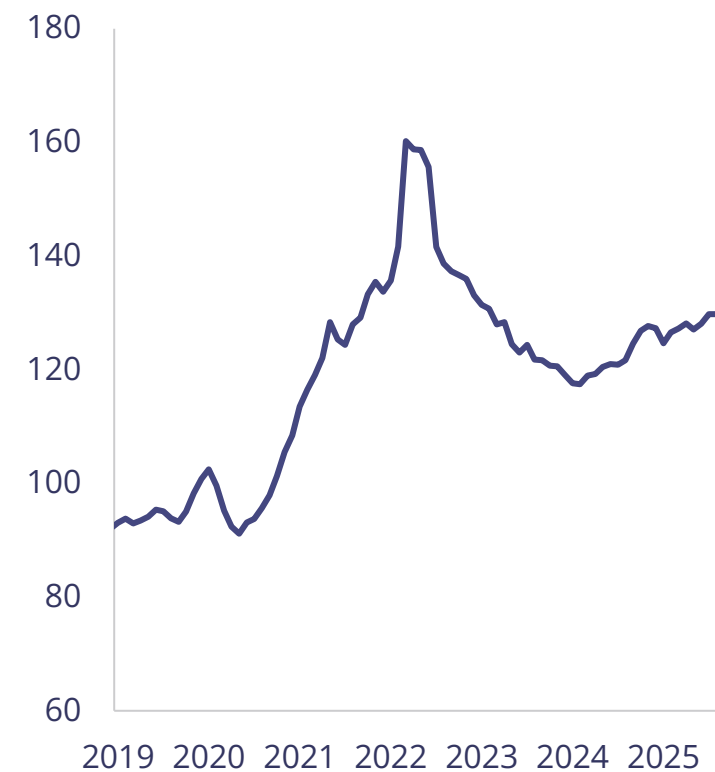
Brent crude oil price (USD/ bbl)



Natural gas price in the Dutch exchange (EUR/MWh)



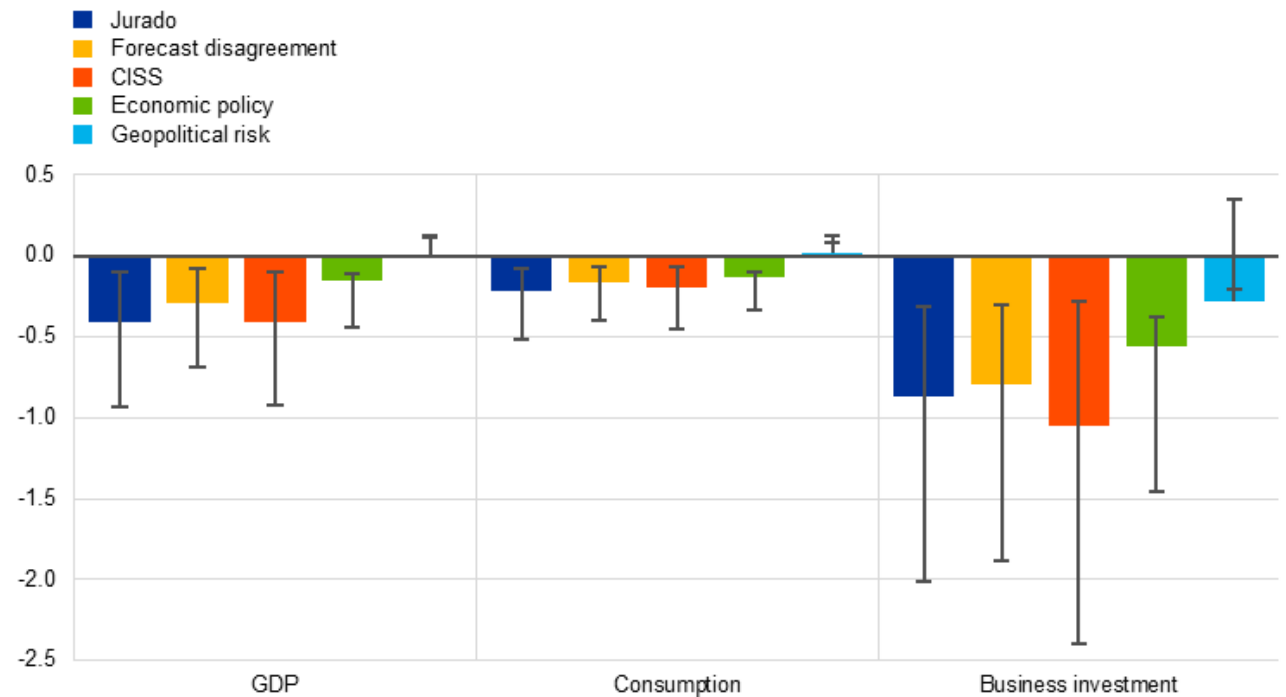
Food prices (FAO Index, 2016=100)



Rising uncertainty will be a headwind for further economic growth

The BVAR models include GDP, consumption, business investment, the GDP deflator and one of the uncertainty (risk) measures at a time. The rise in uncertainty reflects an increase of one standard deviation in the uncertainty measure. The results reported in the chart refer to the effects after four quarters. The whiskers refer to 68% credible intervals.

Impact of rises in uncertainty measures (percentage deviation from the trend)



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Traineeship

Trainee grant

As of 1 December 2023, the trainee grant is the exact amount of €1,170 per month. The trainee grant is increased to €2,120 per month for trainees who have completed at least two years of PhD study and who apply for a traineeship vacancy that requires such a level of qualification.

Thank you for your attention!

Presentation will also be available on
www.makroekonomika.lv