Central Banks

ECB sets stage for crucial December decision on bond purchases and other measures

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- **The ECB will "moderately" slow purchases under the PEPP program during the next quarter**
- **Inflation projections are raised, but they remain well below 2% in the medium term and the ECB continues to see current pressures as temporary**
- **The discussion on future of the PEPP and other measures is postponed until December**

As expected, **the ECB** left its key benchmark interest rates and broader policy guidance unchanged today, and **announced a moderate slower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) for next quarter,** as compared to that in the previous two quarters –currently at roughly 80bn euros per month-. **The decision was taken by unanimity** by the Governing council on the back of favourable financing conditions and slightly better inflation outlook.

Elaborating on the new move, the ECB chief C. Lagarde made clear that **it was not a "tapering", but just a calibration of current purchases.** She didn't provide any details on the exact quantity of the PEPP purchases reduction, but tempered expectations of an immediate significant decrease as she underlined that the reduction will be "moderate". We expect next quarter purchases to hover around 70/60bn euros per month. Moreover, **any decision on what will happen after PEPP** (as the program ends in March) **will be discussed in December, as well as other potential measures, including the limit issues and capital key for APP and TLTROs.** Lagarde clarified that by then the ECB will have a better view on the future of these measures as it will have new projections, including forecasts for 2024.

The updated macroeconomic forecasts came as expected. **Inflation was revised upwards over the forecast horizon**, **but the current surge in prices is expected to be largely temporary driven by one-off measures** (VAT hike, delayed summer sales in 2020) **and strong base effects after the reopening of the economy,** as social restrictions ease. Headline inflation is projected to average 2.2% in 2021, but it will subsequently return clearly below the ECB's target to 1.7% and 1.5% in 2022 and 2023, respectively, as those factors fade away and the supply and demand imbalances ease. Core inflation will edge up gradually as the recovery progresses and the economic slack declines (1.3% in 2021, 1.4% in 2022 and 1.5% in 2023). The ECB is closely watching second round effects, but for the moment they do not see signs of it.

Regarding the economic outlook, the 2Q21 growth was stronger than expected, which offsets a slight downgrade of growth expected for 2H21 due to the more persistent supply bottlenecks and the effects of the more infectious Delta variant. Altogether, the GDP growth forecast for 2021 is increased from 4.6% to 5%, while the projections for 2022 and 2023 remain broadly unchanged at 4.6% and 2.1%, respectively. **Risks remain balanced and they are largely related to the evolution of the pandemic and supply shortages.**

All in all, the meeting was in line with expectations and, barring new shocks, we will not have more relevant news until December. In this regard, **we expect some kind of transition or "bridge program" between PEPP and APP as a backstop to avoid a financial cliff when the PEPP expires,** possibly endowed with leftover funds from PEPP. We find it more difficult for the ECB to provide more flexibility or increase purchases for the more permanent APP given the lack of consensus within the Board, although this possibility is not out of the cards.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in light grey and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE).

1.1. Christine Lagarde, President of the ECB,

Luis de Guindos, Vice-President of the ECB

Frankfurt am Main, ~~22 July~~9 September 2021

Good afternoon, the Vice-President and I welcome you to our press conference.

~~At today's meeting, the Governing Council focused on two main topics: first, the implications of our strategy review for our forward guidance on the key ECB interest rates; and, second, our assessment of the economy and our pandemic measures.~~

~~In our recent strategy review, we agreed a symmetric inflation target of two per cent over the medium term. Our policy rates have been close to their lower bound for some time and the medium-term outlook for inflation is still well below our target. In these conditions, the Governing Council today revised its forward guidance on interest rates. We did so to underline our commitment to maintain a persistently accommodative monetary policy stance to meet our inflation target.~~

~~In support of our symmetric two per cent inflation target and in line with our monetary policy strategy, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we see inflation reaching two per cent well ahead of the end of our projection horizon and durably for the rest of the projection horizon, and we judge that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term. This may also imply a transitory period in which inflation is moderately above target.~~

~~Let me turn to the assessment of the economic outlook and our pandemic measures.~~

~~The recovery in the euro area economy is on track. More and more people are getting vaccinated, and lockdown restrictions have been eased in most euro area countries. But the pandemic continues to cast a shadow, especially as the delta variant constitutes a growing source of uncertainty. Inflation has picked up, although this increase is expected to be mostly temporary. The outlook for inflation over the medium term remains subdued.~~

~~We need to preserve favourable financing conditions for all sectors of the economy over the pandemic period. This is~~The rebound phase in the recovery of the euro area economy is increasingly advanced. Output is expected to exceed its pre-pandemic level by the end of the year. With more than 70 per cent of European adults fully vaccinated, the economy has largely reopened, allowing consumers to spend more and companies to increase production. While rising immunity to the coronavirus means that the impact of the pandemic is now less severe, the global spread of the Delta variant could yet delay the full reopening of the economy. The current increase in inflation is expected to be largely temporary and underlying price pressures are building up only slowly. The inflation outlook in our new staff projections has been revised slightly upwards, but in the medium term inflation is foreseen to remain well below our two per cent target.

Financing conditions for firms, households and the public sector have remained favourable since our previous quarterly assessment in June. Favourable financing conditions are essential for the ~~current rebound to turn into a lasting expansion~~economy to continue its recovery and to offset the negative impact of the pandemic on inflation.~~ Therefore, having confirmed our June~~

Based on a joint assessment of financing conditions and the inflation outlook, ~~we continue to expect~~the Governing Council judges that favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) ~~over the current quarter to be conducted at a significantly higher pace than during the first months of the year~~than in the previous two quarters.

We also confirmed our other measures~~ to support our price stability mandate~~, namely the level of the key ECB interest rates, our forward guidance on their likely future evolution, our purchases under the asset purchase programme (APP), our reinvestment policies and our longer-term refinancing operations, as detailed in the ~~press release~~press release published at 13:45 today. We stand ready to adjust all of our instruments, as appropriate, to ensure that inflation stabilises at our two per cent target over the medium term.
I will now outline in more detail how we see the economy and inflation developing, and then talk about our assessment of financial and monetary conditions.

1.2. Economic activity

The economy rebounded by 2.2 per cent in the second quarter of the year~~ and, as restrictions are eased,~~, which was more than expected. It is on track for strong growth in the third quarter. ~~We expect manufacturing to perform~~The recovery builds on the success of the vaccination campaigns in Europe, which have allowed a significant reopening of the economy.

With the lifting of restrictions, the services sector is benefiting from people returning to shops and restaurants and from the rebound in travel and tourism. Manufacturing is performing strongly, even though ~~supply bottlenecks are holding back~~ production ~~in the near term. The reopening of large parts of the economy is supporting a vigorous bounce-back in the services sector. But the delta~~continues to be held back by shortages of materials and equipment. The spread of the Delta variant ~~of the coronavirus~~has so far not required lockdown measures to be reimposed. But it could ~~dampen this~~slow the recovery in ~~services, especially in tourism~~global trade and ~~hospitality~~the full reopening of the economy.

~~As people return to shops and restaurants and resume travelling, consumer~~Consumer spending is ~~rising. Better job prospects,~~ increasing~~ confidence and continued government support are reinforcing~~, although consumers remain somewhat cautious in the light of the pandemic developments. The labour market is also improving rapidly, which holds out the prospect of higher incomes and greater spending. ~~The ongoing~~Unemployment is declining and the number of people in job retention schemes has fallen by about 28 million from the peak last year. The recovery in domestic and global demand is further boosting optimism among ~~businesses. This supports~~firms, which is supporting business investment.~~ For~~

At the ~~first~~same time~~ since the start of the pandemic, our bank lending survey indicates that funding of fixed investment is an important factor driving the demand for loans to firms.~~

~~We expect economic activity to return to its pre-crisis level in the first quarter of next year. But~~, there ~~is still a long~~remains some way to go before the damage to the economy caused by the pandemic is ~~offset. The number of people in job retention schemes has been declining but remains high. Overall, there are still 3.3~~overcome. There are still more than two million fewer people employed than before the pandemic, especially among the younger and lower skilled. The number of workers in job retention schemes also remains substantial.

~~Ambitious~~To support the recovery, ambitious, targeted and coordinated fiscal policy should continue to complement monetary policy~~ in supporting the recovery.~~. In ~~this context~~particular, the Next Generation EU programme ~~has a key role to play. It~~ will ~~contribute to~~help ensure a stronger and uniform recovery across euro area countries. It will also accelerate the green and digital transitions~~ and~~, support ~~necessary~~ structural reforms ~~that~~and lift long-term growth.

We expect the economy to rebound firmly over the medium term. Our new staff projections foresee annual real GDP growth at 5.0 per cent in 2021, 4.6 per cent in 2022 and 2.1 per cent in 2023. Compared with our June staff projections, the outlook has improved for 2021 and is broadly unchanged for 2022 and 2023.

1.3. Inflation

Inflation ~~was 1.9~~increased to 3.0 per cent in ~~June~~August. We expect inflation to ~~increase~~rise further ~~over the coming months and~~ this autumn but to decline ~~again~~ next year. ~~The current increase is largely being driven by higher energy prices and by base effects from the sharp fall~~ This temporary upswing in inflation mainly reflects the strong increase in oil prices ~~at the start of the pandemic and~~ since around the ~~impact~~middle of last year, the reversal of the temporary VAT reduction in Germany~~ last year. By early 2022, the impact~~, delayed summer sales in 2020 and cost pressures that stem from temporary shortages of materials and equipment. In the course of 2022 these factors should ~~fade out as they~~ ease or will fall out of the year-on-year inflation calculation.

~~In the near term, the significant slack in the economy is holding back underlying inflationary pressures. Stronger demand and temporary cost pressures in the supply chain will put some upward pressure on prices. But weak wage growth and the past appreciation of the euro mean that price pressures will likely remain subdued for some time.~~

~~There is still some way to go before the fallout from the pandemic on inflation is eliminated.~~Underlying inflation pressures have edged up. As the economy recovers~~,~~ further, and supported by our monetary policy measures, we expect underlying inflation to rise over the medium term~~, although remaining below our target. While measures~~. This increase is expected to be only gradual, since it will take time for the economy to return to operating at full capacity, and therefore wages are expected to grow only moderately. Measures of longer-term inflation expectations have ~~increased, they~~continued to increase, but these remain some distance from our two per cent target.

The new staff projections foresee annual inflation at 2.2 per cent in 2021, 1.7 per cent in 2022 and 1.5 per cent in 2023, being revised up compared with the previous projections in June. Inflation excluding food and energy price inflation is projected to average 1.3 per cent in 2021, 1.4 per cent in 2022 and 1.5 per cent in 2023, also being revised up from the June projections.

1.4. Risk assessment

We see the risks to the economic outlook as broadly balanced. Economic activity could outperform our expectations if consumers ~~spend~~become more confident and save less than currently expected~~ and draw more rapidly on the savings they have built up~~

~~during the pandemic~~. A faster improvement in the pandemic situation could also lead to a stronger expansion than currently envisaged. ~~But growth~~If supply bottlenecks last longer and feed through into higher than anticipated wage rises, price pressures could ~~underperform our expectations~~be more persistent. At the same time, the economic outlook could deteriorate if the pandemic ~~intensifies~~worsens, which could delay the further reopening of the economy, or if supply shortages turn out to be more persistent than currently expected and hold back production.

1.5. Financial and monetary conditions

The recovery of growth and inflation still depends on favourable financing conditions~~.~~ for all sectors of the economy. Market interest rates have ~~declined since our last meeting. Financing~~eased over the summer, but reversed recently. Overall, financing conditions for ~~most firms and households~~the economy remain ~~at~~ favourable ~~levels~~.

Bank lending rates for firms and households ~~remain~~are at historically low~~. Firms~~ levels. Lending to households is holding up, especially for house purchases. The somewhat slower growth of lending to firms is mainly due to the fact that firms are still well funded ~~as a result of their borrowing~~, because they borrowed heavily in the first wave of the pandemic. They have high cash holdings and are increasingly retaining earnings, which ~~in part explains why lending to firms has slowed. By contrast, lending to households is holding up. Our most recent~~ reduces the need for external funding. For larger firms, issuing bonds is an attractive alternative to bank ~~lending survey shows that~~ loans. Solid bank balance sheets continue to ensure that sufficient credit ~~conditions for both firms and households have stabilised. Liquidity remains abundant~~is available.

~~At the same time, the cost for firms of issuing equity is still high. Many~~However, many firms and households have taken on more debt ~~to weather~~during the pandemic. ~~Any worsening of~~ A deterioration in the ~~economy~~economic outlook could ~~therefore~~ threaten their financial health~~, which could trickle through to~~. This, in turn, would worsen the quality of banks' balance sheets. ~~It~~Policy support remains essential to prevent balance sheet strains and tightening financing conditions from reinforcing each other.

1.6. Conclusion

Summing up, the euro area economy is clearly rebounding ~~strongly. But~~. However, the ~~outlook~~ speed of the recovery continues to depend on the course of the pandemic and progress with vaccinations. The current rise in inflation is expected to be largely temporary~~. Underlying~~ and underlying price pressures will ~~likely increase~~build up only gradually~~, although leaving inflation over~~. The slight improvement in the medium-term ~~still well below our target.~~inflation outlook and the current level of financing conditions allow favourable financing conditions to be maintained with a moderately lower pace of net asset purchases under the PEPP. Our policy measures, including our revised forward guidance~~, will help~~ on the key ECB interest rates, are key to helping the economy shift to a ~~solid~~sustained recovery and, ultimately, ~~bring~~to bringing inflation to our two per cent target.

Creating Opportunities

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