Central Banks

ECB stands ground against early lift-off, stresses temporality of inflation

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- **ECB sees inflation pressures lasting longer than anticipated but easing over 2022**
- **It delves on the disconnect between ECB's forward guidance on rates and market expectations of the lift-off timeframe**
- **PEPP is expected to end next March, with recalibration of the instruments to be in place at the December meeting**

Today's ECB policy adhered to broader expectations of a status quo on policy rates, forward guidance as well as QE while deliberating substantially on two key topical issues concerning markets - 1) the central bank's view on the drivers and durability of ongoing inflation pressures and 2) the disconnect between ECB's forward guidance on rates and the market's timeframe for a lift-off.

The central bank struck a sanguine tone on the state of economic recovery, which it judged as being still strong but acknowledged that growth momentum had moderated off-late as the support from policy stimulus, economic reopening, pent up demand and large scale vaccination was being partly offset by the adverse-effects of rising inflation pressures on consumer purchasing power and the impact of supply shortages on the manufacturing sector. The ECB highlighted **three key drivers of inflation**, namely 1) decompressed demand outpacing disrupted supply with the latter caused by shortages of materials, equipment and labor, 2) higher energy prices and 3) base effects, including those related to the German VAT changes. Notably, the ECB sounded **cautiously optimistic on the inflation outlook.** While **it expects inflation to gain further traction this year, it sees price pressures easing over the course of 2022.** Lagarde echoed other central bankers, insisting on the temporality of inflation even though she admitted that **bottleneck problems would persist longer than expected, in turn taking *a good chunk of 2022 to be sorted out.* In this regard,** the ECB is talking to large firms and they confirm this delay, reporting that bottlenecks will gradually disappear, but not "in the first quarter of 2022".

Meanwhile, **the ECB expects energy prices to at least stabilize** if not decline in 2022. Against this backdrop, the ECB "**continues to foresee inflation in the medium term to remain below the two per cent target**". On **inflation expectations**, Lagarde stated that while they have moved up they remain well anchored. She also **stressed the need to monitor wages for risks of second round effects** of higher inflation, although she added that the ECB does not see any indication of this yet.

The other key focus this time was to what extent **Mrs Lagarde will push back against market expectations of interest rate increases** (which foresee a high probability of a first hike in September 2022). During the Q&A, she stressed a couple of times that there is a **disconnection between ECB's forward guidance on rates, their analysis of inflation and the market expectations.** In her own words: "the conditions for forward guidance are not satisfied neither at the time when markets expect a liftoff or anytime thereafter soon". Moreover, she stressed that the **ECB will be bound by its forward guidance (FG), as to when ECB will lift rates and its forward guidance has to do with inflation. And she remarked that these conditions do not seem to be satisfied in the near future:** 1) Inflation reaches 2% well ahead of ECB's projection horizon. ECB has more certainty about its forecast.

2) Inflation remains at 2% durably for 3 years. 3) There is sufficient progress in underlying inflation for headline inflation to stabilise at the 2% level.

Regarding monetary policy instruments in place, which are expected to be recalibrated at the December meeting when new staff projections are released, Lagarde gave very few clues. She stated that the **PEPP is expected to end in March;** this suggests that the expected measures to avoid a sharp reduction of QE in March will not be an extension of PEPP, but rather other types of measures. On **TLTROS, she stressed that the ECB should do everything possible to avoid a cliff edge effect** (strong repayments are expected in June 2022 when the special period expires) and confirmed that it will be discussed during the December meeting.

Overall, the ECB's diagnosis of growth, inflation and current markets expectations of the first liftoff coincide very much with our view. The key issue is to what extent this majority view within the ECB is maintained if the persistence of inflation lasts longer than projected or there are signs to inflation expectations rising quickly.

The market reaction was more sensitive to the ECB's remarks on the prolongation of bottlenecks and longer duration of inflation than to Lagarde's warning that markets are out of line with their forward guidance. On rates, 2Y and 10Y German Bund's rate hiked 3bp and 4bp respectively, while 10Y Italy and Spain's spreads rose further, 11bps and 5bps respectively, while the EURUSD appreciated by 0.7% to 1.168.

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, ~~9 September~~28 October 2021

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

~~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~~ The euro area economy continues to recover strongly, although momentum has moderated to some extent. Consumers continue to be confident and their spending remains strong. But shortages of materials, equipment and labour are holding back production in some sectors. Inflation is rising, primarily because of the surge in energy prices but also as the recovery in demand is outpacing constrained supply. We foresee inflation rising further in the near term, but then declining in the course of next year.

Market interest rates have increased since our last meeting in early September. However, overall financing conditions currently remain favourable for firms, households and the public sector ~~have remained favourable since our previous quarterly assessment in June.~~. Favourable financing conditions are essential for the economy to continue its recovery and to ~~offset~~counter the negative impact of the pandemic on the inflation path.

~~Based on a joint assessment of financing conditions and the inflation outlook, the Governing Council judges~~We continue to judge that favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) than in the ~~previous two~~second and third quarters of this year.

We also confirmed our other measures, 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 will 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, which was more than expected. It is on track for strong growth~~continued to grow strongly in the third quarter~~.~~, even though momentum moderated to some extent. We still expect output to exceed its pre-pandemic level by the end of the year.

The ~~recovery builds on the success~~grip of the ~~vaccination campaigns in Europe, which have allowed a significant reopening of~~ pandemic on the economy has visibly weakened, with restrictions being lifted as a result of successful health measures and large numbers of people now vaccinated. This is supporting consumer spending, especially on entertainment, dining, travel and transportation. But higher energy prices may reduce purchasing power in the months to come.

~~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 production continues to be held back by shortages of materials and equipment. The spread of the Delta variant has so far not required lockdown measures to be reimposed. But it could slow the recovery in global trade and the full reopening of the economy.~~

~~Consumer spending is increasing, although consumers remain somewhat cautious in the light of the pandemic developments.~~ The recovery in domestic and global demand is also supporting production and business investment. That said, shortages of materials, equipment and labour are holding back the manufacturing sector. Delivery times have lengthened considerably, and transport costs and energy prices have surged. These constraints are clouding the outlook for the coming quarters.

The labour market ~~is also improving rapidly, which holds out the prospect of higher incomes and greater spending.~~ continues to improve. Unemployment ~~is declining~~has fallen 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 firms, which is supporting business investment~~is down significantly from the peak last year. This supports the prospect of higher incomes and increased spending. But, both the number of people in the labour force and the hours worked in the economy remain below their pre-pandemic levels.

~~At the same time, there remains some way to go before the damage to the economy caused by the pandemic is 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.~~

To ~~support~~sustain the recovery~~, ambitious~~, targeted and coordinated fiscal ~~policy~~support should continue to complement monetary policy. ~~In particular,~~ This support will also help the economy adjust to the structural changes that are under way. An effective implementation of the Next Generation EU programme ~~will help ensure~~and the “Fit for 55” package will contribute to a stronger, greener and ~~uniform~~more even recovery across euro area countries. ~~It will also accelerate the green and digital transitions, support structural reforms 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 increased to 3.~~0~~4 per cent in ~~August~~September. We expect ~~inflation~~it to rise further this ~~autumn but~~ year. But while the current phase of higher inflation will last longer than originally expected, we expect inflation to decline in the course of next year. ~~This temporary~~

The upswing in inflation ~~mainly~~largely reflects ~~the strong increase in oil~~ a combination of three factors. First, energy prices ~~since around the middle of last year,~~ – especially for oil, gas and electricity – have risen sharply. In September, energy inflation accounted for about half of overall inflation. Second, prices are also going up because recovering demand related to the ~~reversal~~reopening of the ~~temporary~~ economy is outpacing supply. These dynamics are especially visible in the prices of consumer services, as well as the prices of goods affected most strongly by supply shortages. And finally, base effects related to the end of the VAT ~~reduction~~cut in Germany~~, delayed summer sales in 2020 and cost pressures that stem from temporary shortages of materials and equipment. In~~ are still contributing to higher inflation.

We expect the influence of all three factors to ease in the course of 2022 ~~these factors should ease~~ or ~~will~~to fall out of the year-on-year inflation calculation. As the recovery continues, the gradual return of the economy to full capacity will underpin a rise in wages over time. Market and survey-based measures of longer-term inflation expectations have moved closer to two per cent. These factors will support underlying inflation and the return of inflation to our target over the medium term.

~~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. 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 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~~The recovery continues to depend on the course of the pandemic and further progress with vaccinations. We see the risks to the economic outlook as broadly balanced. In the near term, supply bottlenecks and rising energy prices are the main risks to the pace of recovery and the outlook for inflation. If supply shortages and higher energy prices last longer, these could slow down the recovery. At the same time, if persistent bottlenecks feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, price pressures could become stronger. However, economic activity could outperform our expectations if consumers become more confident and save less than currently expected. ~~A faster improvement in the pandemic situation could also lead to a stronger expansion than currently~~

~~envisaged. If supply bottlenecks last longer and feed through into higher than anticipated wage rises, price pressures could be more persistent. At the same time, the economic outlook could deteriorate if the pandemic 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~~Growth and medium-term inflation dynamics still ~~depends~~depend on favourable financing conditions for all sectors of the economy. Market interest rates have ~~eased over the summer, but reversed recently. Overall~~increased. Nevertheless, financing conditions for the economy remain favourable~~.~~

~~Bank~~ , not least because bank lending rates for firms and households ~~are~~remain at historically low levels. ~~Lending to households is holding~~ While there was a pick-up~~, especially for house purchases. The somewhat slower growth of~~ in September, lending to firms ~~is mainly due to~~remains moderate. This continues to reflect the fact that firms ~~are still well funded, because they borrowed heavily in the first wave of the pandemic. They~~generally need less external funding, since these have high cash holdings and are increasingly retaining their earnings~~, which reduces the need for external funding. For larger firms, issuing bonds is an attractive alternative to bank loans. Solid~~. Lending to households remains strong, driven by demand for mortgages. Our most recent bank lending survey shows that credit conditions for firms stabilised and were supported – for the first time since 2018 – by a reduction in banks' risk perceptions. By contrast, banks are taking a slightly more cautious approach to housing loans and have tightened their lending standards for these loans accordingly. Bank balance sheets continue to ~~ensure that sufficient credit is available.~~

~~However, many firms and households have taken on more debt during the pandemic. A deterioration in the economic outlook could threaten their financial health. This, in turn, would worsen the quality of banks' balance sheets. Policy support remains essential to prevent balance sheet strains and tightening financing conditions from reinforcing each other~~be supported by favourable funding conditions and remain solid.

1.6. Conclusion

Summing up, the euro area economy ~~is clearly rebounding. However, the speed of the recovery~~ continues to ~~depend on the course of the pandemic and progress with vaccinations. The current rise in~~ recover strongly, although at a more moderate pace. Rising energy prices, the recovery in demand and supply bottlenecks are currently pushing up inflation ~~is expected to be largely temporary and underlying price pressures will build up only gradually. The slight improvement in the medium-term~~ . While inflation ~~outlook and the current level of financing conditions allow favourable financing conditions~~will take longer to decline than previously expected, we expect these factors to ~~be maintained with a moderately lower pace of net asset purchases under the PEPP.~~ease in the course of next year. We continue to foresee inflation in the medium term remaining below our two per cent target. Our policy measures, including our revised forward guidance on the key ECB interest rates, are ~~key~~crucial to helping the economy shift to a sustained recovery and, ultimately, to bringing inflation over the medium term to our ~~two per cent~~ target.

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