Central Banks

Readying to act but not overreact on inflation risks

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- **The ECB warned that risks to the inflation outlook are tilted to the upside**
- **The ECB seems much more open now to accelerate policy normalization in the coming meetings**

The ECB left all its key monetary policy settings unchanged today, in turn **confirming the decisions taken at the previous meeting, but clearly sounded more concerned about rising upside risks to the inflation outlook.** Any immediate policy reaction to these risks was, however, discounted by President Lagarde, who preferred not to rock the boat at least until March, when the ECB would revise its growth and inflation projections and greater data availability would enable a more thorough analysis of the situation. The June meeting was also stressed as being critical in the context of more decisive policy changes.

The ECB struck a cautious tone on near term growth prospects in the wake of new virus variants and related containment measures, high energy costs and shortages of labor, equipment and material, which, together, is holding back the services recovery. This notwithstanding, the central bank expects an activity rebound over the course of this year as domestic demand remains robust underpinned by policy support, favorable financing conditions and a global recovery. Overall, **risks to the economic outlook remain broadly balanced.**

On inflation, **the ECB acknowledged recent surprises and flagged clear upside risks, especially in the short term, and an uncertain medium-term outlook**. Against this background, the ECB for the first time since 2014 reintroduced the phrase that "**risks to the inflation outlook are tilted to the upside**". Mrs. Lagarde said that there was unanimous concern within the Governing Council about inflation figures: while the increase is mainly due to energy, a more broad based increase of prices across components has been seen and inflation is now expected to remain elevated for longer than previously expected but to decline over the course of the year. However, Mrs Lagarde said that despite the fact that the labor market is back to levels where it was pre-covid, there has not seen significant movement in terms of wage increases either in terms of wage negotiations.

Any further adjustments to monetary policy or forward guidance would have to wait at least until the next meeting in March, when the ECB has additional data and will be able to make a thorough assessment again. **Mrs. Lagarde refused to confirm that rate hikes are "very unlikely this year",** as she did several times before. Having said that, she emphasized that **they are going to proceed in a gradual manner - the ECB will not rush -, step by step, and confirmed the sequence already defined**, i.e. firstly ending the PEPP, then deciding on the APP (speed/path of asset purchases reduction, opening the door to a faster tapering) and shortly after on rates. Meanwhile, the conditions underlying the TLTROs and the tiering multiplier for ECB deposits were not a topic of discussion at today's governing council meeting.

The hawkish tone dominating President Lagarde's post policy press conference had clear spillovers on markets today as Eurozone yields rose significantly across the board, mainly those in the periphery, while the EURUSD appreciated by 1% to 1.14.

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, ~~16 December 2021~~3 February 2022

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

The euro area economy ~~continues~~is continuing to recover and the labour market is improving further, helped by ample policy support. ~~Growth is moderating but we expect activity~~ But growth is likely to remain subdued in the first quarter, as the current pandemic wave is still weighing on economic activity. Shortages of materials, equipment and labour continue to hold back output in some industries. High energy costs are hurting incomes and are likely to dampen spending. However, the economy is affected less and less by each wave of the pandemic and the factors restraining production and consumption should gradually ease, allowing the economy to pick up again strongly in the course of ~~next~~the year. ~~The latest pandemic wave and the Omicron variant have prompted some countries to re-introduce tighter restrictions. Energy prices have gone up significantly. And in some industries, there are shortages of materials, equipment and labour. These factors are restraining economic activity and are a headwind for the near-term outlook. However, although the public health crisis is still ongoing, many people have been vaccinated and booster campaigns have accelerated. Overall, society has become better at coping with the pandemic waves and resulting constraints. This has lessened the pandemic impact on the economy.~~

Inflation has risen sharply ~~owing to the surge in energy prices, and also because demand is outpacing constrained supply in some~~ in recent months and it has further surprised to the upside in January. This is primarily driven by higher energy costs that are pushing up prices across many sectors~~.~~, as well as higher food prices. Inflation is ~~expected~~likely to remain elevated ~~in the near term, but should ease~~for longer than previously expected, but to decline in the course of ~~next year. The inflation outlook has been revised up, but inflation is still projected to settle below our two per cent target over the projection horizon~~this year.

~~We judge that the progress on economic recovery and towards our medium-term inflation target permits a step-by-step reduction~~The Governing Council therefore confirmed the decisions taken at its monetary policy meeting last December, as detailed in the press release published at 13:45 today. Accordingly, we will continue reducing the pace of our asset purchases step by step over the coming quarters~~. But monetary accommodation is still needed for inflation to stabilise at our two per cent inflation target over the medium term.~~, and will end net purchases under the pandemic emergency purchase programme (PEPP) at the end of March. In view of the current uncertainty, we need more than ever to maintain flexibility and optionality in the conduct of monetary policy. ~~With this is mind, the Governing Council took the following decisions:~~

~~First, in the first quarter of 2022, we expect to conduct net asset purchases under the pandemic emergency purchase programme (PEPP) at a lower pace than in the previous quarter. We will discontinue net asset purchases under the PEPP at the end of March 2022.~~
~~Second, the Governing Council decided to extend the reinvestment horizon for the PEPP. It now intends to reinvest the principal payments from maturing securities purchased under the PEPP until at least the end of 2024. In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance.~~

~~Third, the pandemic has shown that, under stressed conditions, flexibility in the design and conduct of asset purchases has helped to counter the impaired transmission of our monetary policy and made our efforts to achieve our goal more effective. Within our mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability. In particular, in the event of renewed market fragmentation related to the pandemic, PEPP reinvestments can be adjusted flexibly across time, asset classes and jurisdictions at any time. This could include purchasing bonds issued by the Hellenic Republic over and above rollovers of redemptions in order to avoid an interruption of purchases in that jurisdiction, which could impair the transmission of monetary policy to the Greek economy while it is still recovering from the fallout of the pandemic. Net purchases under the PEPP could also be resumed, if necessary, to counter negative shocks related to the pandemic.~~

~~Fourth, in line with a step-by-step reduction in asset purchases and to ensure that the monetary policy stance remains consistent with inflation stabilising at our target over the medium term, we decided on a monthly net purchase pace of €40 billion in the second quarter and €30 billion in the third quarter under the asset purchase programme (APP). From October 2022 onwards, we will maintain net asset purchases under the APP at a monthly pace of €20 billion for as long as necessary to reinforce the accommodative impact of our policy rates. We expect net purchases to end shortly before we start raising the key ECB interest rates.~~

~~We also confirmed the level of the key ECB interest rates and our forward guidance on the future path of policy rates. This is crucial for maintaining the appropriate degree of accommodation to stabilise inflation at our two per cent inflation target over the medium term.~~

~~We will continue to monitor bank funding conditions and ensure that the maturing of TLTRO III operations does not hamper the smooth transmission of our monetary policy. We will also regularly assess how targeted lending operations are contributing to our monetary policy stance. As announced, we expect the special conditions applicable under TLTRO III to end in June next year. We will also assess the appropriate calibration of our two-tier system for reserve remuneration so that the negative interest rate policy does not limit banks' intermediation capacity in an environment of ample excess liquidity.~~

The Governing Council stands ready to adjust all of its instruments, as appropriate~~ and in either direction~~, to ensure that inflation stabilises at its two per cent target over the medium term.
I will now outline in more detail how we see ~~developments in~~ the economy and inflation~~. I~~ developing, and will then ~~outline~~talk about our assessment of financial and monetary conditions.

1.2. Economic activity

~~We expect the economic recovery to continue, driven by robust domestic demand. The labour market is improving, with more people having jobs and fewer in job retention schemes. This supports the prospect of rising household income and consumption. The savings built up during the pandemic will also support consumption. The current fiscal and monetary policy support, together with a continued global recovery, should support~~ Economic growth~~.~~

~~Economic activity has been moderating over the~~ weakened to 0.3 per cent in the final quarter of ~~the~~last year~~ and this slower growth is likely to extend into the early part of next year. We now expect~~. Nevertheless, output ~~to exceed~~reached its pre-pandemic level at the end of 2021. Economic activity and demand will likely remain muted in the ~~first quarter of 2022.~~

~~To cope with the current pandemic wave, some euro area countries have reintroduced tighter~~early part of this year for several reasons. First, containment measures~~. This could delay the recovery~~ are affecting consumer services, especially ~~in~~ travel, tourism, hospitality and entertainment. ~~The~~Although infection rates are still very high, the impact of the pandemic ~~is weighing~~ on ~~consumer and business confidence and the spread of new virus variants is creating extra uncertainty. In addition, rising~~economic life is now proving less damaging. Second, high energy costs are ~~a headwind for consumption.~~

~~Shortages~~reducing the purchasing power of households and the earnings of businesses, which constrains consumption and investment. And third, shortages of equipment, materials and labour in some sectors ~~are hampering~~ continue to hamper the production of manufactured goods, ~~causing delays in~~ delay construction and ~~slowing down~~hold back the recovery in ~~some~~ parts of the ~~service~~services sector. ~~These~~There are signs that these bottlenecks ~~will still~~may be ~~with us~~starting to ease, but they will still persist for some time~~, but they should ease during 2022~~.
Looking ~~ahead, we expect~~beyond the near term, growth ~~to~~should rebound strongly over the course of 2022~~. Our new Eurosystem staff projections foresee annual real GDP growth at 5.1 per cent in 2021, 4.2 per cent in 2022, 2.9 per cent in 2023 and 1.6 per cent in 2024. Compared with our September staff projections, the outlook has been revised down for 2022 and up for 2023.~~

~~Targeted and growth-friendly~~, driven by robust domestic demand. As the labour market is improving further, with more people having jobs and fewer in job retention schemes, households should enjoy higher income and spend more. The global recovery and the ongoing fiscal and monetary policy support also contribute to this positive outlook. Targeted and productivity-enhancing fiscal measures ~~should continue~~and structural reforms, attuned to the conditions in different euro area countries, remain key to complement our monetary policy~~. 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 and the "Fit for 55" package will contribute to a stronger, greener and more even recovery across euro area countries~~ effectively.

1.3. Inflation

Inflation increased ~~further~~ to ~~4.9~~5.1 per cent in ~~November. It will remain above two~~January, from 5.0 per cent ~~for most of 2022. Inflation~~ in December 2021. It is ~~expected~~likely to remain ~~elevated~~high in the near term~~, but we expect it~~. Energy prices continue to ~~decline in~~be the ~~course~~main reason for the elevated rate of ~~next year.~~

~~The upswing in~~ inflation~~ primarily reflects a sharp rise in prices for fuel, gas and electricity. In November, energy inflation~~. Their direct impact accounted for ~~more than~~over half of headline inflation~~. Demand~~ in January and energy costs are also ~~continues to outpace constrained supply in certain~~pushing up prices across many sectors. ~~The consequences are especially visible in~~Food prices have also increased, owing to seasonal factors, elevated transportation costs and the higher price of fertilisers. In addition, price rises have become more widespread, with the prices of ~~durable~~ a large number of goods and ~~those consumer~~ services ~~that have recently reopened. Base effects related to the end of the VAT cut in Germany are still contributing to higher inflation, but only until~~having increased markedly. Most measures of underlying inflation have risen over recent months, although the ~~end of~~ role of temporary pandemic factors means that the ~~year.~~

~~There is uncertainty as to how long it will take for~~ persistence of these ~~issues to resolve. But,~~increases remains uncertain. Market-based indicators suggest a moderation in energy price dynamics in the course of 2022~~, we expect energy prices to stabilise, consumption patterns to normalise,~~ and price pressures stemming from global supply bottlenecks ~~to~~should also subside.

Labour market conditions are improving further, although wage growth remains muted overall. Over time, the ~~gradual~~ return of the economy to full capacity ~~and further improvements in the labour market~~ should support faster growth in wages. Market~~ and survey~~-based measures of longer-term inflation expectations have remained broadly stable at rates just below two per cent since our last monetary policy meeting~~ in October. But overall, these have moved closer to~~. The latest survey-based measures stand at around two per cent~~ in recent months~~. These factors will also contribute further to underlying inflation and will help ~~underlying inflation to move up and bring~~ headline inflation ~~up to~~to settle durably at our ~~target over the medium term.~~

~~Our new staff projections foresee annual inflation at 2.6 per cent in 2021, 3.2~~two per cent ~~in 2022, 1.8 per cent in 2023, and 1.8 per cent in 2024 – significantly higher than in the previous projections in September. Inflation excluding food and energy is projected to average 1.4 per cent in 2021, 1.9 per cent in 2022, 1.7 per cent in 2023, and 1.8 per cent in 2024, also higher than in the September projections~~target.

1.4. Risk assessment

We continue to see the risks to the economic outlook as broadly balanced~~. Economic activity~~ over the medium term. The economy could ~~outperform our expectations~~ perform more strongly than expected if ~~consumers~~households become more confident and save less than expected. By contrast, ~~the recent worsening of~~although uncertainties related to the pandemic~~, including the spread of new variants,~~ have abated somewhat, geopolitical tensions have increased. Furthermore, persistently high costs of energy could ~~be~~exert a ~~more persistent~~stronger than expected drag on ~~growth. The future path of energy prices~~consumption and ~~the~~investment. The pace at which supply bottlenecks are resolved ~~are~~ is a further risk to the outlook for growth and inflation. Compared with our expectations in December, risks to the ~~recovery and to the outlook for inflation.~~inflation outlook are tilted to the upside, particularly in the near term. If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher.

1.5. Financial and monetary conditions

Market interest rates have ~~remained broadly stable~~increased since ~~the October Governing Council~~our December meeting. However, bank funding costs have so far remained contained. Bank lending rates for firms and households ~~remain~~continue to stand at historically low levels~~. Overall,~~ and financing conditions for the economy remain favourable. Lending to firms ~~is partly driven~~has picked up, supported by both short and longer-term ~~funding needs stemming from supply bottlenecks that increase their expenses for inventory and working capital. At the same time, corporate demand for~~ loans~~ remains moderate because of retained earnings and generous cash holdings, as well as high debt. Lending to households remains robust – driven by~~. Robust demand for mortgages~~.~~

~~Euro area banks have further strengthened their balance sheets thanks to higher capital ratios and fewer non-performing loans.~~ is sustaining lending to households. Banks are now as profitable as they were before the pandemic~~. Bank funding conditions~~ and their balance sheets remain ~~favourable overall~~solid.

~~In line with our new monetary policy strategy, twice a year the Governing Council assesses in-depth the interrelation between monetary policy and financial stability. An accommodative monetary policy underpins growth, which supports the balance sheets of companies and financial institutions, as well as preventing risks of market fragmentation. At the same time, the impact of accommodative monetary policy on property markets and financial markets warrants close monitoring as a number of medium-~~

~~term vulnerabilities have intensified. Still, macroprudential policy remains the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.~~

According to our latest Bank Lending Survey, loan demand by firms increased strongly in the last quarter of 2021. This was driven by both higher working capital needs, stemming from supply bottlenecks, and increased financing of longer-term investment. In addition, banks continue to hold an overall benign view of credit risks, mainly because of their positive assessment of the economic outlook.

1.6. Conclusion

Summing up, the euro area economy continues to recover, ~~despite a slowdown~~but growth is expected to remain subdued in the ~~near term. The sharp increase in energy prices and demand outpacing constrained supply in some sectors are pushing up~~ first quarter. While the outlook for inflation~~. Inflation will remain above our target for most of 2022, but~~ is uncertain, inflation is likely to ~~ease~~remain elevated for longer than previously expected, but to decline in the course of ~~next~~this year. ~~At the same time, given~~We will remain attentive to the ~~progress on economic recovery and towards our~~ incoming data and carefully assess the implications for the medium-term inflation ~~target, we can discontinue net purchases under the PEPP in March. But monetary accommodation is still needed – including net purchases under the APP and our forward guidance on interest rates – for inflation to stabilise at our~~outlook. We stand ready to adjust all of our instruments, as appropriate, to ensure that inflation stabilises at its two per cent ~~inflation~~ target over the medium term.

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