Central Banks

Being predictable during uncertain times

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- **The ECB plans to end asset purchases in 3Q22 going ahead on its monetary policy normalization**
- **At the same time it delinks the end of APP from the rate hike decision, keeping the maximum optionality and flexibility under a very uncertain environment**
- **Limited economic forecast revision on growth, while medium term inflation forecasts remain in line with target**

Today's ECB policy meeting was crucial in its assessment of the extent to which the ongoing Russian invasion and its implications on financial markets, activity, and inflation persuade the Central Bank to alter its disclosed monetary policy normalization plans and change its outlook on growth and inflation for the Euro Area**. The ECB opted for a balanced approach with a focus on delivering its primary mandate of price stability**, albeit after an intense and long debate, in turn sticking to the path of monetary policy normalization, concluding the Pandemic Emergency Purchase Programme (PEPP) as programmed and tapering the asset purchases under the APP, as preannounced in February.

Wisely enough**, the ECB decided to delink the decision to end QE purchases from interest rate hikes, stressing on the need to be data dependent rather than time dependent in a backdrop of high uncertainty**, exacerbated significantly by the ongoing Russian invasion. **The move accords more flexibility and added optionality to the ECB towards calibrating its monetary policy response in the face of maximum uncertainty.** In the words of President Lagarde, the ECB delivered a predictable course while being very cautious.

On the pace of policy normalization, while the PEPP would conclude by March end, as expected, the tapering process of their Asset Purchase Programme **(APP) has now been expedited, with a notable reduction of monthly asset purchases over the course of 2Q22 (**to EUR 40 bn in April, EUR 30 bn in May and EUR 20 bn in June), **heading towards an eventual ending in the 3Q22 if incoming data support ECB's medium term inflation outlook.**

While the latest taper plans seem to open up the central bank's options for a possible rate hike later this year, the ECB has temper any such market expectations. The central bank stated, and President Lagarde emphasized, that **any adjustment in interest rates will take place "sometime after" the end of asset purchases, a conscious change in wordings from past policy statements, which noted that the ECB expects APP to end shortly before it starts raising the key ECB interest rates.** Moreover, the downward bias to policy rates has been dropped, as the ECB no longer suggests that rates could go "lower".

On **staff forecasts, the revision to the baseline scenario was limited on growth but significant on inflation,** although the assumptions on commodity price levels used may seem soft after the recent developments derived from the Russia-Ukraine conflict. However, they also published two alternative, more negative scenarios. GDP growth was revised down only modestly for 2022 (-0.5pp to 3.7%) while inflation significant upwards (+1.9pp to 5.1%), but there were minor changes over the forecast horizon and inflation stands in the medium term below the ECB target (GDP at 2.8% and 1.6% and inflation at 2.1% and 1.9% in 2023 and 2024, respectively). **Risks on the**

inflation outlook are tilted to the upside, especially in the short term, although it would remain still below the ECB's target in 2024 according to more negative scenarios presented today.

Overall, **the relatively modest downward revision in growth projections and the delinking of the tapering from the rate rise scenarios allows the ECB to convey a hawkish message while freeing itself to make the decision on rates more data dependent** (given the highly uncertain outlook and the dilemma they will face with pressures towards lower growth and high inflation at the same time). The three scenarios envisaged by the ECB accords more flexibility and optionality to the central bank in adjusting its reaction function during uncertain times in its endeavor towards fulfilling its price stability mandate and ensuring financial stability.

The hawkish tone dominating the monetary policy meeting had clear spillovers on markets today as Eurozone yields rose significantly across the board, mainly those in the periphery, while the EURUSD fluctuated (the USD strengthened further after the release of a strong February CPI inflation (7.9% YoY)). As per money markets, expectations for interest rate hikes in 2022 have increased from 30bps to 40bps.

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, ~~3 February~~10 March 2022

~~**Jump to the transcript of the questions and answers**~~

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

The Russian invasion of Ukraine is a watershed for Europe. The Governing Council expresses its full support to the people of Ukraine. We will ensure smooth liquidity conditions and implement the sanctions decided by the European Union and European governments. We will take whatever action is needed to fulfil the ECB's mandate to pursue price stability and to safeguard financial stability.

The Russia-Ukraine war will have a material impact on economic activity and inflation through higher energy and commodity prices, the disruption of international commerce and weaker confidence. The extent of these effects will depend on how the conflict evolves, on the impact of current sanctions and on possible further measures. In recognition of the highly uncertain environment, the Governing Council considered a range of scenarios in today's meeting.

The impact of the Russia-Ukraine war has to be assessed in the context of solid underlying conditions for the euro area economy ~~is continuing to recover~~, helped by ample policy support. The recovery of the economy is boosted by the fading impact of the Omicron coronavirus variant. Supply bottlenecks have been showing some signs of easing and the labour market ~~is~~has been improving further~~, helped by ample policy support. But~~. In the baseline of the new staff projections, which incorporate a first assessment of the implications of the war, GDP growth ~~is~~has been revised downwards for the near term, owing to the war in Ukraine. The projections foresee the economy growing at 3.7 per cent in 2022, 2.8 per cent in 2023 and 1.6 per cent in 2024.

Inflation has continued to surprise on the upside because of unexpectedly high energy costs. Price rises have also become more broadly based. The baseline for inflation in the new staff projections has been revised upwards significantly, with annual inflation at 5.1 per cent in 2022, 2.1 per cent in 2023 and 1.9 per cent in 2024. Inflation excluding food and energy is projected to average 2.6 per cent in 2022, 1.8 per cent in 2023 and 1.9 per cent in 2024, also higher than in the December projections. Longer-term inflation expectations across a range of measures have re-anchored at our inflation target. The Governing Council sees it as increasingly likely ~~to remain subdued in the first quarter, as the current pandemic wave~~that inflation will stabilise at its two per cent target over the medium term.

In alternative scenarios for the economic and financial impact of the war, which will be published together with the staff projections on our website, economic activity could be dampened significantly by a steeper rise in energy and commodity prices and a more severe drag on trade and sentiment. Inflation could be considerably higher in the near term. However, in all scenarios, inflation is still ~~weighing on economic activity. Shortages of materials, equipment and labour~~expected to decrease progressively and settle at levels around our two per cent inflation target in 2024.

Based on our updated assessment and taking into account the uncertain environment, the Governing Council today revised the purchase schedule for its asset purchase programme (APP) for the coming months. Monthly net purchases under the APP will amount to €40 billion in April, €30 billion in May and €20 billion in June. The calibration of net purchases for the third quarter will be data-dependent and reflect our evolving assessment of the outlook. If the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases, the Governing Council will conclude net purchases under the APP in the third quarter. If the medium-term inflation outlook changes and if financing conditions become inconsistent with further progress towards our two per cent target, we stand ready to revise our schedule for net asset purchases in terms of size and/or duration.

Any adjustments to the key ECB interest rates will take place some time after the end of our net purchases under the APP and will be gradual. The path for the key ECB interest rates will 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 the year~~be determined by the Governing Council's forward guidance and by its strategic commitment to stabilise inflation at two per cent over the medium term. Accordingly, the Governing Council expects the key ECB interest rates to remain at their present levels until it sees inflation reaching two per cent well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term.

~~Inflation has risen sharply 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 likely to remain elevated for longer than previously expected, but to decline in the course of this year.~~

~~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, 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. The Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation stabilises at its two per cent target over the medium term.~~

We also confirmed our other policy measures, as detailed in the press release published at 13:45 today.

I will now outline in more detail how we see the economy and inflation developing, and will then ~~talk about~~explain our assessment of financial and monetary conditions.

1.2. Economic activity

~~Economic growth weakened to 0.3 per cent in the final quarter of last year. Nevertheless, output reached its pre-pandemic level at the end of 2021. Economic activity and demand will likely remain muted in the early part of this year for several reasons. First, containment measures are affecting consumer services, especially travel, tourism, hospitality and entertainment. Although infection rates are still very high, the impact of the pandemic on economic life is now proving less damaging. Second, high energy costs are 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 continue to hamper the production of manufactured goods, delay construction and hold back the recovery in parts of the services sector. There are signs that these bottlenecks may be starting to ease, but they will still persist for some time.~~

~~Looking beyond the near term,~~ The economy grew by 5.3 per cent in 2021, with GDP returning to its pre-pandemic level at the end of the year. However, growth slowed to 0.3 per cent in the final quarter of 2021 and is expected to remain weak during the first quarter of 2022.

The prospects for the economy will depend on the course of the Russia-Ukraine war and on the impact of economic and financial sanctions and other measures. At the same time, other headwinds to growth ~~should rebound strongly over~~are now waning. In the baseline of the staff projections, the ~~course of 2022,~~euro area economy should still grow robustly in 2022 but the pace will be slower than was expected before the outbreak of the war. Measures to contain the spread of the Omicron coronavirus variant have had a milder impact than during previous waves and are now being lifted. The supply disruptions caused by the pandemic also show some signs of easing. The impact of the massive energy price shock on people and businesses may be partly cushioned by drawing on savings accumulated during the pandemic and by compensatory fiscal measures.

Over the medium term, according to the baseline of the staff projections, growth will be driven by robust domestic demand~~. As the~~, supported by a stronger labour market ~~is improving further, with~~. With more people ~~having~~in jobs ~~and fewer in job retention schemes~~, households should ~~enjoy~~earn higher ~~income~~incomes and spend more. The global recovery and the ongoing fiscal and monetary policy support are also ~~contribute~~contributing to this ~~positive~~growth outlook. ~~Targeted~~Fiscal and ~~productivity-enhancing fiscal measures and structural reforms, attuned to the conditions in different euro area countries, remain key to complement our~~ monetary ~~policy effectively~~support remains critical, especially in this difficult geopolitical situation.

1.3. Inflation

Inflation increased to 5.8 per cent in February, from 5.1 per cent in January~~, from 5.0 per cent in December 2021. It is likely~~. We expect it to ~~remain high~~rise further in the near term. Energy prices~~-~~, which surged by 31.7 per cent in February, continue to be the main reason for ~~the elevated~~this high rate of inflation~~. Their direct impact accounted for over half of headline inflation in January~~ and ~~energy costs~~ are also pushing up prices across many other sectors. Food prices have also increased, owing to seasonal factors, elevated transportation costs and the higher price of fertilisers. ~~In addition, price~~Energy costs have risen further in recent weeks and there will be further pressure on some food and commodity prices owing to the war in Ukraine.
Price rises have become more widespread~~, with the prices of a large number of goods and services having increased markedly.~~. Most measures of underlying inflation have risen over recent months~~, although~~ to levels above two per cent. However, it is uncertain how persistent the rise in these indicators will be, given the role of temporary pandemic-related factors ~~means that~~and the ~~persistence~~indirect effects of ~~these increases remains uncertain~~higher energy prices. Market-based indicators suggest ~~a moderation in energy price dynamics in~~ that energy prices will stay high for longer than previously expected but will moderate over the course of ~~2022 and price~~the projection horizon. Price pressures stemming from global supply bottlenecks should also subside.

Labour market conditions ~~are improving further, although~~have continued to improve, with unemployment falling to 6.8 per cent in January. Even though labour shortages are affecting more and more sectors, wage growth remains muted overall. Over time, the return of the economy to full capacity should support somewhat faster growth in wages. ~~Market-based~~Various measures of longer-term inflation expectations ~~have remained broadly stable at rates just below two per cent since our last monetary policy meeting. The latest survey-based measures~~derived from financial markets and from surveys stand at around two per cent. These factors will also contribute further to underlying inflation and will help headline inflation to settle durably at our two per cent target.

1.4. Risk assessment

~~We continue to see the~~ The risks to the economic outlook ~~as broadly balanced over the medium term. The economy could perform more strongly than expected if households become more confident and save less than expected. By contrast, although uncertainties related to the pandemic have abated somewhat, geopolitical tensions~~ have increased~~. Furthermore, persistently high costs of energy could exert a stronger than expected drag on~~ substantially with the Russian invasion of Ukraine and are tilted to the downside. While risks relating to the pandemic have declined, the war in Ukraine may have a stronger effect on economic sentiment and could worsen supply-side constraints again. Persistently high energy costs, together with a loss of confidence, could drag down demand more than expected and constrain consumption and investment.

The ~~pace at which supply bottlenecks~~same factors are ~~resolved is a further risk~~risks to the outlook for ~~growth and~~ inflation~~. Compared with our expectations in December, risks to the inflation outlook are tilted to the~~, which are on the upside~~, particularly~~ in the near term. The war in Ukraine is a substantial upside risk, especially to energy prices. If price pressures feed through into higher than anticipated wage rises or ~~the economy returns more quickly to full~~

~~capacity~~if there are adverse persistent supply-side implications, inflation could also turn out to be higher over the medium term. However, if demand were to weaken over the medium term, this could also lower pressures on prices.

1.5. Financial and monetary conditions

~~Market~~The Russian invasion of Ukraine has caused substantial volatility in financial markets. Following the outbreak of the war, risk-free market interest rates have ~~increased~~ partially reversed the increase observed since our ~~December~~February meeting~~. However, bank funding costs~~ and equity prices have fallen.

The financial sanctions against Russia, including the exclusion of some Russian banks from SWIFT, have so far ~~remained contained.~~not caused severe strains in money markets or liquidity shortages in the euro area banking system. Bank balance sheets remain healthy overall, owing to robust capital positions and fewer non-performing loans. Banks are now as profitable as they were before the pandemic.

Bank lending rates for firms ~~and households continue to stand~~have increased somewhat, while lending rates for household mortgages remain steady at historically low levels~~ and financing conditions for the economy remain favourable.~~. Lending flows to firms ~~has picked up, supported by both short and longer-term loans. Robust demand for mortgages is sustaining lending to households. Banks are now as profitable as they were before the pandemic and their balance sheets remain solid~~have declined after increasing strongly in the last quarter of 2021. Lending to households is holding up, especially for house purchases.

~~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 Russian invasion of Ukraine will negatively affect the euro area economy ~~continues~~and has significantly increased uncertainty. If the baseline of the staff projections materialises, the economy should continue to ~~recover, but growth is expected~~rebound thanks to ~~remain subdued in the first quarter. While the outlook for~~ the declining impact of the pandemic and the prospect of solid domestic demand and strong labour markets. Fiscal measures, including at the European Union level, would also help to shield the economy. Based on our updated assessment of the inflation ~~is~~outlook and taking into account the uncertain~~, inflation is likely to remain elevated for longer than previously expected, but to decline in the course of this year.~~ environment, we revised our schedule for net asset purchases over the coming months and confirmed all our other policy measures. We ~~will remain~~are very attentive to the ~~incoming~~ prevailing uncertainties. The calibration of our policies will remain data~~ and carefully assess the implications for the medium-term inflation~~-dependent and reflect our evolving assessment of the outlook. We stand ready to adjust all of our instruments~~, as appropriate,~~ to ensure that inflation stabilises at ~~its~~our two per cent target over the medium term.

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