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Central Banks

The ECB confirms a series of hikes

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- **The ECB announces back-to-back rate hikes in July and September after almost eleven years**
- **APP net asset purchases will end as of 1 July**
- **Strong upward revision of staff inflation forecasts**

Faced with undesirably high and persistent inflation, **the ECB took a decisive step in its monetary policy normalization journey today as it pre-announced a series of interest rate hikes,** starting next month. The Bank confirmed that in accordance with its promise of policy sequencing, upcoming rate moves would closely follow a widely expected end to the Asset Purchase Program. **The unanimous decision was accompanied by a notable upward revision to Euro Area's inflation projections and a downgrade on the growth outlook**.

The **ECB set the stage for rate hikes after almost eleven years**, as it concluded that according to its forward guidance, conditions for hiking rates have been satisfied. Hence, it **pre-committed to a 25 bps rate hike in July and another one in September. The later one will be of 50 bps if the medium term inflation outlook remains unchanged or worsens.** Lagarde confirmed that rates hikes will apply to all three key interest rates, i.e. there will not be a narrowing of the corridor of interest rates. **Beyond September, the central bank did not want to give such a specific roadmap**, although it anticipates that a "gradual but sustained path of further increases in interest rates will be appropriate."

On the asset purchase program (APP), as expected, the ECB decided to **end the net asset purchases under the APP as of 1 July 2022**, in order to be consistent with its forward guidance and be able to hike rates at the 21st July meeting. Reinvestments under this program will remain as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance.

The **new staff projections imply a significant upward revision to the inflation outlook**, and a downward revision of GDP growth (2.8% for 2022, -0.9pp; and 2.1% for 2023 and 2024, -0.7pp and +0.5pp, respectively). Given recent surprises and all well-known problems of persistence of bottlenecks and high commodity prices due to the war, besides a recent pick up in wages, the ECB is projecting that both headline and core inflation will be, on average, above 2% during the period 2022-2024. At the same time, risks are on the downside for growth and on the upside for inflation. If the war escalates, economic sentiment could worsen, supply side costs would increase and energy and food costs would remain elevated for longer.

On **fragmentation**, there was no clear response by Mrs. Lagarde to the many questions she faced about the ECB's preparedness to manage such risks, which had been amply rumored in the weeks before the meeting. While she emphasized its commitment to proper transmission of their monetary policy to avoid fragmentation, **for the time being, the flexibility offered by the PEPP reinvestment program is the only tool at ECB's disposal for fighting fragmentation risk**. That said, Mrs. Lagarde stressed, without details, that the central bank will also deploy new instruments if necessary. In response, the 10 Year sovereign bond yield spreads in the periphery broadened by 11 bps (Italy) and by 5 bps (Spain) to 212 and 117 respectively.

All in all, the ECB starts its tightening of monetary policy with no specifics on its tools to face fragmentation beyond reinvestment margins of PEPP, and with a new communication strategy on rates. Given this, the baseline scenario now is a certain 25 bps hike in July, at least a 25 bps and possibly 50 bps hike in September (unless there is a change in conditions that justify a downward revision in the inflation outlook) and one or two more in the rest of the year.

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, 14 April~~Amsterdam, 9 June 2022

Good afternoon, the Vice-President and I welcome you to our press conference. I would like to thank President Knot for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.

High inflation is a major challenge for all of us. The Governing Council will make sure that inflation returns to our two per cent target over the medium term.

In May inflation again rose significantly, mainly because of surging energy and food prices, including due to the impact of the war. But inflation pressures have broadened and intensified, with prices for many goods and services increasing strongly. Eurosystem staff have revised their baseline inflation projections up significantly. These projections indicate that inflation will remain undesirably elevated for some time. However, moderating energy costs, the easing of supply disruptions related to the pandemic and the normalisation of monetary policy are expected to lead to a decline in inflation. The new staff projections foresee annual inflation at 6.8 per cent in 2022, before it is projected to decline to 3.5 per cent in 2023 and 2.1 per cent in 2024 – higher than in the March projections. This means that headline inflation at the end of the projection horizon is projected to be slightly above our target. Inflation excluding energy and food is projected to average 3.3 per cent in 2022, 2.8 per cent in 2023 and 2.3 per cent in 2024 – also above the March projections.

Russia's unjustified aggression towards Ukraine ~~is causing enormous suffering. It is also affecting the~~ continues to weigh on the economy~~,~~ in Europe and beyond. ~~The conflict and the associated uncertainty are weighing heavily on the confidence of businesses and consumers. Trade disruptions are~~ It is disrupting trade, is leading to ~~new~~ shortages of materials and ~~inputs. Surging~~is contributing to high energy and commodity prices ~~are reducing demand and holding back production. How~~. These factors will continue to weigh on confidence and dampen growth, especially in the near term. However, the conditions are in place for the economy ~~develops will crucially depend on how the conflict evolves,~~ to continue to grow on ~~the impact of~~ account of the ongoing reopening of the economy, a strong labour market, fiscal support and savings built up during the pandemic. Once current ~~sanctions and on possible further measures. At the same time~~headwinds abate, economic activity is ~~still being supported by the reopening of the economy after the crisis phase of the pandemic. Inflation has increased significantly and will remain high over the coming months, mainly because of the sharp rise in energy costs.~~ expected to pick up again. This outlook is broadly reflected in the Eurosystem staff projections, which foresee annual real GDP growth at 2.8 per cent in 2022, 2.1 per cent in 2023 and 2.1 per cent in 2024. Compared with the March projections, the outlook has been revised down significantly for 2022 and 2023, while for 2024 it has been revised up~~Inflation pressures have intensified across many sectors~~.

~~At today’s meeting we judged that the incoming~~ On the basis of our updated assessment, we decided to take further steps in normalising our monetary policy. Throughout this process, the Governing Council will maintain optionality, data~~ since our last meeting reinforce our expectation that~~-dependence, gradualism and flexibility in the conduct of monetary policy.

First, we decided to end net asset purchases under our asset purchase programme (APP) as of 1 July 2022. The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance.

Second, we undertook a careful review of the conditions which, according to our forward guidance, should be satisfied before we start raising the key ECB interest rates. As a result of this assessment, the Governing Council concluded ~~in the third quarter. Looking ahead,~~ that those conditions have been satisfied. Accordingly, and in line with our policy sequencing, we intend to raise the key ECB interest rates by 25 basis points at our July monetary policy meeting.

Looking further ahead, we expect to raise the key ECB interest rates again in September. The calibration of this rate increase will depend on the updated medium-term inflation outlook. If the medium-term inflation outlook persists or deteriorates, a larger increment will be appropriate at our September meeting.

Third, beyond September, based on our current assessment, we anticipate that a gradual but sustained path of further increases in interest rates will be appropriate. In line with our commitment to our two per cent medium-term target, the pace at which we adjust our monetary policy will depend on the incoming data and ~~our evolving assessment of the outlook. In the current conditions of high uncertainty, we will maintain optionality, gradualism and flexibility in the conduct of monetary policy. The Governing Council will take whatever action is needed to fulfil the ECB’s~~how we assess inflation to develop in the medium term.

Within the Governing Council’s mandate~~ to pursue~~, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability~~ and to contribute to safeguarding financial stability~~.

The decisions taken today are set out in full in a press release available on our website.
I will now outline in more detail how we see the economy and inflation developing, and will then explain our assessment of financial and monetary conditions.

1.2. Economic activity

~~The euro area economy grew by 0.3 per cent in the final quarter of 2021. It is estimated that growth remained weak during the first quarter of 2022, largely owing to pandemic-related restrictions.~~

~~Several factors point to slow growth also in the period ahead. The war is already weighing on the confidence of businesses and consumers, including through the~~ In the near term, we expect activity to be dampened by high energy costs,

the deterioration in the terms of trade, greater uncertainty ~~it brings. With energy and commodity prices rising sharply, households are facing a higher cost of living and firms are confronted with higher production costs. The war has created new bottlenecks, while a new set of pandemic measures in Asia is contributing to supply chain difficulties. Some sectors face growing difficulties in sourcing their inputs, which is disrupting production.~~ and the adverse impact of high inflation on disposable income. The war in Ukraine and renewed pandemic restrictions in China have made supply bottlenecks worse again. As a result, firms face higher costs and disruptions in their supply chains, and their outlook for future output has deteriorated.

However, there are also ~~offsetting factors underpinning the ongoing recovery, such as compensatory fiscal measures and the possibility for households to draw on savings they accumulated during the pandemic. Moreover, the~~factors supporting economic activity and these are expected to strengthen over the months to come. The reopening of those sectors most affected by the pandemic and a strong labour market, with more people in jobs, will continue to support incomes and ~~spending.~~

~~Fiscal and monetary policy support remains critical, especially in this difficult geopolitical situation.~~consumption. In addition, ~~the successful~~savings accumulated during the pandemic are a buffer.

Fiscal policy is helping to cushion the impact of the war. Targeted and temporary budgetary measures protect those people bearing the brunt of higher energy prices while limiting the risk of adding to inflationary pressures. The swift implementation of the investment and structural reform plans under the Next Generation EU programme ~~will accelerate~~, the ~~energy and green transitions. This should help enhance long-term growth~~"Fit for 55" package and ~~resilience in~~ the ~~euro area.~~

~~1.3. Inflation~~

~~Inflation increased to 7.5 per cent in March, from 5.9 per cent in February. Energy prices were driven higher after~~ REPowerEU plan would also help the ~~outbreak of the war~~euro area economy to grow faster in a sustainable manner and become more resilient to global shocks.

1.3. Inflation~~now~~

Inflation rose further to 8.1 per cent in May. Although governments have intervened and have helped slow energy inflation, energy prices stand ~~45~~39.2 per cent above their ~~level~~levels one year ago. ~~They continue to be the main reason for the high rate of inflation.~~ Market-based indicators suggest that global energy prices will stay high in the near term but will then moderate to some extent. Food prices rose 7.5 per cent in May, in part reflecting the importance of Ukraine and Russia among the main global producers of agricultural goods.

Prices have also ~~increased sharply. This is due to elevated transportation and production costs, notably the higher price~~gone up more strongly because of ~~fertilisers, which are in part related to the war in Ukraine.~~

~~Price rises have become more widespread. Energy costs are pushing up prices across many sectors. Supply~~renewed supply bottlenecks and ~~the normalisation~~because of recovering domestic demand~~ as the~~, especially in the services sector, as our economy reopens~~ also continue to put upward pressure on prices. Measures ~~. Price rises are becoming more widespread across sectors. Accordingly, measures of underlying inflation have ~~risen to levels above two per cent in recent months. It is uncertain how persistent the rise in these indicators will be, given the role of temporary pandemic-related factors and the indirect effects of higher energy prices~~been rising further.

The labour market continues to improve, with unemployment ~~having fallen to a~~remaining at its historical low of 6.8 per cent in ~~February.~~ April. Job ~~postings~~vacancies across many sectors ~~still signal~~ show that there is robust demand for labour~~, yet wage growth remains muted overall.~~. Wage growth, including in forward-looking indicators, has started to pick up. Over time, the ~~return~~strengthening of the economy ~~to full capacity~~ and some catch-up effects should support faster growth in wages. While ~~various~~most measures of longer-term inflation expectations derived from financial markets and from expert surveys ~~largely~~ stand at around two per cent, initial signs of above-target revisions in those measures warrant close monitoring.

1.4. Risk assessment

~~The downside risks to the growth outlook have increased substantially as a result of the war in Ukraine. While risks~~Risks relating to the pandemic have declined~~,~~ but the war continues to be a significant downside risk to growth. In particular, a major risk would be a further disruption in the energy supply to the euro area, as reflected in the downside scenario included in the staff projections. Furthermore, if the war ~~may have an even stronger effect on~~ were to escalate, economic sentiment ~~and~~ could ~~further~~ worsen, supply-side constraints~~. Persistently high energy costs, together with a loss of confidence,~~ could ~~drag down demand~~increase, and energy and ~~restrain consumption and investment more than~~ food costs could remain persistently higher than expected.

The ~~upside~~ risks surrounding ~~the~~ inflation ~~outlook have also intensified, especially in the near term.~~are primarily on the upside. The risks to the medium-term inflation outlook include ~~above-target moves in~~a durable worsening of the production capacity of our economy, persistently high energy and food prices, inflation expectations~~,~~ rising above our target and higher than anticipated wage rises~~ and a durable worsening of supply-side conditions.~~ . However, if demand were to weaken over the medium term, it would lower ~~pressure~~pressures on prices.

1.5. Financial and monetary conditions

~~Financial markets have been highly volatile since the war began and financial sanctions were imposed.~~ Market interest rates have increased in response to the changing outlook for inflation and monetary policy~~, the macroeconomic environment and inflation dynamics. Bank~~. With benchmark interest rates rising, bank funding costs have ~~continued to increase. At the same time, so far there have been no severe strains in money markets, nor liquidity shortages in the euro area banking system.~~

~~Although remaining at low levels,~~increased, and this has fed into higher bank lending rates in particular for ~~firms and~~ households ~~have started to reflect the increase in market interest rates.~~. Nevertheless, lending to firms picked up in March. This was because of the continued need to finance investment and working capital, against the backdrop of increasing production costs, persisting supply bottlenecks and lower reliance on market funding. Lending to households ~~is holding up, especially for house purchases. Lending flows to firms have stabilised~~also increased, reflecting continued robust demand for mortgages.

~~Our most recent bank lending survey reports that credit standards for loans to firms and for housing loans tightened overall in the first quarter of the year, as lenders are becoming more concerned about the risks facing their customers in an uncertain environment. Credit standards are expected to tighten further in the coming months, as banks factor in the adverse economic impact of Russia's aggression towards Ukraine and higher energy prices.~~

In line with our monetary policy strategy, the Governing Council has undertaken its biannual in-depth assessment of the interrelation between monetary policy and financial stability. The environment for financial stability has worsened since our last review in December 2021, especially over the short term. In particular, lower growth and increasing cost pressures, as well as rising risk-free rates and sovereign bond yields, could lead to a further deterioration in the financing conditions faced by borrowers. At the same time, tighter financing conditions could reduce some existing financial stability vulnerabilities over the medium term. Banks, which started the year with solid capital positions and improving asset quality, are now facing greater credit risk. We will watch these factors closely. In any case, macroprudential policy remains the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

1.6. Conclusion

Summing up, ~~the war in~~Russia's unjustified aggression towards Ukraine is severely affecting the euro area economy and ~~has significantly increased~~ the outlook is still surrounded by high uncertainty. ~~The impact of~~But the ~~war on~~conditions are in place for the economy ~~will depend on how the conflict evolves, on the effect of current sanctions~~to continue to grow and ~~on possible~~to recover further ~~measures.~~ over the medium term.

Inflation ~~has increased significantly~~is undesirably high and ~~will~~is expected to remain ~~high over the coming months, mainly because of the sharp rise in energy costs. We are very attentive to the current uncertainties and are closely monitoring the incoming data in relation to their implications for the medium-term~~above our target for some time. We will make sure that inflation ~~outlook~~returns to our two per cent target over the medium term. Accordingly, we decided to take further steps in normalising our monetary policy. The calibration of our policies will remain data-dependent and reflect our evolving assessment of the outlook. We stand ready to adjust all of our instruments within our mandate, incorporating flexibility if warranted, to ensure that inflation stabilises at our two per cent target over the medium term.

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