Central Banks

Front loading and more hikes to come

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- **The ECB raised its three key interest rates by 75 bps each**
- **More hikes in store through a meeting-by-meeting and data dependent approach**
- **Inflation revised significantly up and growth to the downside**

In the face of recent very high inflation out-turns and risks skewed to the upside, the ECB unanimously hiked each of its three key interest rates by 75 bps. Today's front loaded policy action was accompanied by explicit commitment to hike further going forward and a significant revision of the Central Bank's growth and inflation projections. The decision wasn't a total surprise given the Council's recent hawkish rhetoric although expectations were largely pinned at 50 bps hike following the July meeting. Thus, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will be increased to 1.25%, 1.50% and 0.75% respectively. Lagarde emphasized that today's hike was not an isolated case, and that the ECB has a 'journey to cover' in terms of further rate hikes through a meeting-by-meeting and data dependent approach until it ensures that the medium term 2% inflation target is reached.

On the question of whether the central bank is considering to embark in a Quantitative Tightening journey like the Fed, Mrs Lagarde said it is still premature right now to look at other monetary policy instruments other than the policy rate. Accordingly, the forward guidance on APP reinvestments is to continue, in effect, "the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it started raising the key ECB interest rates and, in any case, for as long as necessary". Nonetheless she made clear that a re-evaluation of the APP could happen later if it is decided as being necessary.

The meeting's hawkish undertone was underscored mainly by the significant upward revision to ECB's inflation projections, which moved upwards from 3.5% to 5.5% in 2023, far above consensus, and from 2.1% to 2.3% in 2024. This revision seems to be mainly motivated by energy and food inflation, driven by the huge increase in the gas price assumption since the June outlook. It is also noteworthy that they still forecast energy and food inflation to keep increasing in 2024, despite the easing in oil and gas prices and the expected large base effects associated with them. The upward revision of core inflation was more contained, about 0.6pp in 2023, coupled with a moderate revision to wage growth. In terms of activity, GDP growth has been revised downwards, but not as much as expected: the staff forecasts 3.1% real GDP growth in 2022 (from 2.8%, thanks to a better-than-expected first half of the year), while cutting the 2023 and 2024 projected growth to 0.9% (from 2.1%) and 1.9% (2.1%), respectively. Strictly speaking, the ECB is not projecting a recession around the end of 2022 as it incorporates only one quarter of very mild negative growth. Besides the baseline scenario, the downside scenario incorporates some rationing of gas and continues to contemplate lower growth but similar or even higher inflation.

Regarding other monetary policy measures, the ECB announced that the two-tier reserve remuneration system has ended, as deposit facility is above zero. Mrs Lagarde did not discard the possibility of any modification in the future and she stated ECB will conduct an overview of TLTRO conditions and reserve remuneration "in due course". Nonetheless, today the central bank decided to temporarily remove the 0% interest rate ceiling for remunerating government deposits (the ceiling will temporarily remain at the lower of either the deposit rate or the €STR) in order to prevent an abrupt outflow of deposits into the market.

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, ~~21 July~~8 September 2022

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

~~Today, in line with our strong commitment to our price stability mandate, the Governing Council took further key steps to make sure inflation returns to our two per cent target over the medium term. We~~ The Governing Council today decided to raise the three key ECB interest rates by ~~50~~75 basis points ~~and approved the Transmission Protection Instrument (TPI).~~
~~The Governing Council judged that it is appropriate to take a larger first step on its policy rate normalisation path than signalled at its previous meeting.~~. This ~~decision is based on our updated assessment of inflation risks and the reinforced support provided by the TPI for the effective transmission of monetary policy. It will support the~~ major step frontloads the transition from the prevailing highly accommodative level of policy rates towards levels that will ensure the timely return of inflation to our ~~medium-term target by strengthening the anchoring of inflation expectations and by ensuring that demand conditions adjust to deliver our inflation target in the medium term.~~

~~At our upcoming~~two per cent medium-term target. Based on our current assessment, over the next several meetings~~, further normalisation of interest rates will be appropriate. The frontloading today of the exit from negative~~ we expect to raise interest rates ~~allows us to make a transition to a meeting-by-meeting approach to our interest rate decisions.~~further to dampen demand and guard against the risk of a persistent upward shift in inflation expectations. We will regularly re-evaluate our policy path in light of incoming information and the evolving inflation outlook. Our future policy rate ~~path~~decisions will continue to be data-dependent and ~~will help us deliver on our two per cent inflation target over the medium term. In the context of our policy normalisation, we will evaluate options for remunerating excess liquidity holdings~~follow a meeting-by-meeting approach.

~~We assessed that the establishment of the TPI is necessary to support the effective transmission of monetary policy. In particular, as we continue normalising monetary policy, the TPI will ensure that our monetary policy stance is transmitted smoothly across all euro area countries. The singleness of our monetary policy is a precondition for the ECB to be able to deliver on its price stability mandate.~~

~~The TPI will be an addition to our toolkit and can be activated to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. The scale of TPI purchases depends on the severity of the risks facing policy transmission. Purchases are not restricted ex ante. By safeguarding the transmission mechanism, the TPI will allow the Governing Council to more effectively deliver on its price stability mandate.~~

~~In any event, the~~We took today's decision, and expect to raise interest rates further, because inflation remains far too high and is likely to stay above our target for an extended period. According to Eurostat's flash estimate, inflation reached 9.1 per cent in August. Soaring energy and food prices, demand pressures in some sectors owing to the reopening of the economy, and supply bottlenecks are still driving up inflation. Price pressures have continued to strengthen and broaden across the economy and inflation may rise further in the near term. As the current drivers of inflation fade over time and the normalisation of our monetary policy works its way through to the economy and price-setting, inflation will come down. Looking ahead, ECB staff have significantly revised up their inflation projections and inflation is now expected to average 8.1 per cent in 2022, 5.5 per cent in 2023 and 2.3 per cent in 2024.

After a rebound in the first half of 2022, recent data point to a substantial slowdown in euro area economic growth, with the economy expected to stagnate later in the year and in the first quarter of 2023. Very high energy prices are reducing the purchasing power of people's incomes and, although supply bottlenecks are easing, they are still constraining economic activity. In addition, the adverse geopolitical situation, especially Russia's unjustified aggression towards Ukraine, is weighing on the confidence of businesses and consumers. This outlook is reflected in the latest staff projections for economic growth, which have been revised down markedly for the remainder of the current year and throughout 2023. Staff now expect the economy to grow by 3.1 per cent in 2022, 0.9 per cent in 2023 and 1.9 per cent in 2024.

The lasting vulnerabilities caused by the pandemic still pose a risk to the smooth transmission of our monetary policy. The Governing Council will therefore continue applying flexibility in ~~reinvestments of~~reinvesting redemptions coming due in the pandemic emergency purchase programme ~~(PEPP)~~ portfolio ~~remains the first line of defence to counter~~, with a view to countering risks to the transmission mechanism related to the pandemic.

The decisions taken today are set out in a ~~press release~~press release available on our website. ~~The details of the TPI are described in a~~ A separate technical press release ~~to~~on the remuneration of government deposits will be published at 15:45 CET.
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

~~Economic activity is slowing. Russia's unjustified aggression towards Ukraine is an ongoing drag on growth. The impact of high inflation on purchasing power, continuous supply constraints and higher uncertainty are having a dampening effect on the economy. Firms continue to face higher costs and disruptions in their supply chains, although there are tentative signs that some of the supply bottlenecks are easing. Taken together, these factors are significantly clouding the outlook for the second half of 2022 and beyond.~~

~~At the same time, economic activity continues to benefit from the reopening of the economy, a strong labour market and fiscal policy support. In particular, the full reopening of the economy is supporting spending in the services sector. As people start to travel again, tourism is expected to help the economy in the third quarter of this year. Consumption is being supported by the savings that households built up during the pandemic and by a strong labour market.~~

The euro area economy grew by 0.8 per cent in the second quarter of 2022, mainly owing to strong consumer spending on contact-intensive services, as a result of the lifting of pandemic-related restrictions. Over the summer, as people travelled more, countries with large tourism sectors benefited especially. At the same time, businesses suffered from high energy costs and continued supply bottlenecks, although the latter have been gradually easing.

While buoyant tourism has been supporting economic growth during the third quarter, we expect the economy to slow down substantially over the remainder of this year. There are four main reasons behind this. First, high inflation is dampening spending and production throughout the economy, and these headwinds are reinforced by gas supply disruptions. Second, the strong rebound in demand for services that came with the reopening of the economy will lose steam in the coming months. Third, the weakening in global demand, also in the context of tighter monetary policy in many major economies, and the worsening terms of trade will mean less support for the euro area economy. Fourth, uncertainty remains high and confidence is falling sharply.

At the same time, the labour market has remained robust, supporting economic activity. Employment increased by more than 600,000 people in the second quarter of 2022 and the unemployment rate stood at a historical low of 6.6 per cent in July. Total hours worked increased further, by 0.6 per cent, in the second quarter of 2022 and have surpassed their pre-pandemic levels. Looking ahead, the slowing economy is likely to lead to some increase in the unemployment rate.

Fiscal ~~policy is helping~~ support measures to cushion the impact of ~~the war in Ukraine for those bearing the brunt of~~ higher energy prices~~. Temporary~~ should be temporary and targeted ~~measures should be tailored so as~~at the most vulnerable households and firms to limit the risk of fuelling inflationary pressures~~. Fiscal~~, to enhance the efficiency of public spending and to preserve debt sustainability. Structural policies ~~in all countries~~ should aim at ~~preserving debt sustainability, as well as~~ raising the euro area's growth potential ~~in a sustainable manner to enhance the recovery~~and supporting its resilience.

1.3. Inflation

Inflation ~~increased~~rose further to ~~8.6~~9.1 per cent in ~~June. Surging energy prices were~~August. Energy price inflation remained extremely elevated, at 38.3 per cent, and it was again the ~~most important~~dominant component of overall inflation. Market-based indicators suggest that ~~global energy~~, in the near term, oil prices will moderate, while wholesale gas prices will stay extraordinarily high ~~in the near term.~~. Food price inflation also rose ~~further, standing at 8.9 per cent~~ in ~~June, in part~~August, to 10.6 per cent, partly reflecting ~~the importance~~higher input costs related to energy, disruptions of ~~Ukraine and Russia as producers of agricultural goods~~trade in food commodities and adverse weather conditions.

~~Persistent~~While supply bottlenecks ~~for industrial goods and~~ have been easing, these continue to gradually feed through to consumer prices and are putting upward pressure on inflation, as is recovering demand~~, especially~~ in the services sector~~, are~~. The depreciation of the euro has also ~~contributing~~added to the ~~current high rates~~ build-up of ~~inflation.~~ inflationary pressures.

Price pressures are spreading across more and more sectors, in part owing to the ~~indirect~~ impact of high energy costs across the whole economy. Accordingly, ~~most~~ measures of underlying inflation ~~have risen further~~remain at elevated levels and the latest staff projections see inflation excluding food and energy reaching 3.9 per cent in 2022, 3.4 per cent in 2023 and 2.3 per cent in 2024.

~~We expect inflation to remain undesirably high for some time, owing to continued pressures from energy and food prices and pipeline pressures in the pricing chain. Higher inflationary pressures are also stemming from the depreciation of the euro exchange~~

~~rate. But looking further ahead, in the absence of new disruptions, energy costs should stabilise and supply bottlenecks should ease, which, together with the ongoing policy normalisation, should support the return of inflation to our target.~~

~~The labour market remains strong. Unemployment fell to a historical low of 6.6 per cent in May. Job vacancies across many sectors show that there is robust demand for labour. Wage growth, also according to forward-looking indicators, has continued to increase gradually over the last few months, but still remains contained overall. Over time, the strengthening of the economy and some catch-up effects should support faster growth in wages.~~Resilient labour markets and some catch-up to compensate for higher inflation are likely to support growth in wages. At the same time, incoming data and recent wage agreements indicate that wage dynamics remain contained overall. Most measures of longer-term inflation expectations currently stand at around two per cent, although recent above-target revisions to some indicators warrant continued monitoring.

1.4. Risk assessment

~~A prolongation~~In the context of the slowing global economy, risks to growth are primarily on the downside, in particular in the near term. As reflected in the downside scenario in the staff projections, a long-lasting war in Ukraine remains a ~~source of~~ significant ~~downside~~ risk to growth, especially if firms and households faced rationing of energy supplies~~ from Russia were to be disrupted to~~. In such ~~an extent that it led to rationing for firms and households. The war may also further dampen~~a situation, confidence could deteriorate further and ~~aggravate~~ supply-side constraints~~, while energy~~ could worsen again. Energy and food costs could also remain persistently higher than expected. A ~~faster deceleration~~further deterioration in the global ~~growth would also pose a risk to the~~economic outlook could be an additional drag on euro area ~~outlook~~external demand.

The risks to the inflation outlook ~~continue to be~~ are primarily on the upside~~ and have intensified, particularly~~. In the same way as for growth, the major risk in the short term~~. The risks to~~ is a further disruption of energy supplies. Over the medium~~-~~ term, inflation ~~outlook include a durable~~may turn out to be higher than expected because of a persistent worsening of the production capacity of ~~our~~the euro area economy, ~~persistently high~~further increases in energy and food prices, a rise in inflation expectations ~~rising~~ above our target~~ and~~, or higher than anticipated wage rises. However, if energy costs were to decline or demand were to weaken over the medium term, it would lower pressures on prices.

1.5. Financial and monetary conditions

Market interest rates have ~~been volatile as a result~~increased in anticipation of further monetary policy normalisation in response to the ~~pronounced economic and geopolitical uncertainty. Bank funding costs have risen in~~ inflation outlook. Credit to firms has become more expensive over recent months, ~~which has increasingly fed into higher~~ and bank lending rates~~, in particular~~ for households~~. While the volume~~ now stand at their highest levels in more than five years. In terms of volumes, bank lending to ~~households remains~~firms has so far remained strong, ~~it is expected to decline in view of lower demand. Lending to firms has also been robust as~~ in part reflecting the need to finance high production costs~~,~~ and inventory building~~ and lower reliance on market funding have created a continued need for credit from banks. At the same time, demand for loans to finance investment has declined. Money growth has continued to moderate owing to lower liquid savings and lower Eurosystem asset purchases.~~

~~Our most recent bank~~. Mortgage lending ~~survey reports that~~to households is moderating because of tightening credit standards ~~tightened for all loan categories in the second quarter of the year, as banks are becoming more concerned about the risks faced~~

~~by their customers in the current uncertain environment. Banks expect to continue tightening their credit standards in the third quarter~~, rising borrowing costs and weak consumer confidence.

1.6. Conclusion

Summing up, we raised the three key ECB interest rates by 75 basis points today, and expect to raise interest rates further, because inflation ~~continues to be undesirably~~remains far too high and is ~~expected~~likely to ~~remain~~stay above our target for ~~some time. The latest data indicate a slowdown in growth, clouding the outlook for~~an extended period. This major step frontloads the ~~second half of 2022 and beyond. At~~transition from the ~~same time, this slowdown is being cushioned by a number~~prevailing highly accommodative level of policy rates towards levels that will support a timely return of ~~supportive factors~~inflation to our two per cent medium-term target.

~~The Governing Council has today decided to raise the key ECB interest rates and approved the TPI. At our upcoming meetings, further normalisation of interest rates will be appropriate.~~ Our future policy rate ~~path~~decisions will continue to be data-dependent and ~~will help us deliver on our two per cent inflation target over the medium term.~~

follow a meeting-by-meeting approach. We stand ready to adjust all of our instruments within our mandate to ensure that inflation ~~stabilises at our two per cent target over the~~ returns to our medium~~-~~-term~~. Our new TPI will safeguard the smooth transmission of our monetary policy stance throughout the euro area as we keep adjusting the stance to address high~~ inflation target.

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