Central Banks

ECB ups the ante, delivers another hike and broader measures to fight inflation

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- **The ECB raised its three key interest rates by 75 bps each. Further rate hikes expected; we expect rates to reach 2.75%**
- **The ECB tightened TLTRO conditions in order to provide incentives for earlier repayments and help normalize monetary policy**
- **Guidance of the reduction of the APP monetary portfolio will probably be unveiled in December**

The ECB today raised further the ante in its fight against inflation by delivering its **third straight significant interest rate hikes** and signaled further monetary policy tightening going forward. **The ECB has hiked by 200 bps all its three key interest rates so far in this cycle** (including today's 75bps). Today's largely anticipated rate decision was accompanied by **other measures to facilitate monetary policy transmission and aid ongoing policy tightening stance, namely the recalibration** of repayment and interest rate terms and conditions under targeted longer-term refinancing operations **(TLTRO-III) as well as remuneration of minimum reserves held by credit institutions.** Somewhat de-emphasising current inflation rates, Lagarde insisted that the pace of tightening and the terminal rate will be decided meeting by meeting and hinged on three key factors: 1) the inflation outlook, 2) the measures taken so far and 3) the transmission lags of monetary policy. Furthermore, the key principles on APP reduction would be discussed at the next policy meeting in December, which would precede the central bank's decision to implement and roll out any such quantitative tightening measures.

On the state and prospects of the Euro Area economy, **the ECB warned that growth would further weaken in the remainder of this year and next**, exacerbated by high inflation, tightening financial conditions, rising bank funding costs, tighter credit lending standards and a slowing global economy. To this end, a supportive labor market, and fiscal policy were positive, although well targeted structural reforms and swift implementation of NGEU plans were imperative. **Inflation outlook remained worrisome** with high energy costs feeding through the economy and rising input costs pushing up food inflation. Meanwhile, supply bottlenecks were easing, but were still high and pent up demand and Euro depreciation added to the buildup of price pressures. The ECB warned that risks to growth were clearly on the downside and those for inflation on the upside, especially in the near term. In this regard, Lagarde highlighted that the likelihood of recession was looming in the horizon and the probability of it has increased. She indicated that the ECB would, in December, downgrade its baseline scenario for 2023 even though its downside scenario for 2023, which factored -0.9% growth contraction wasn't likely to play out as many adverse risk assumptions have not materialized. These include complete shortage of Russian gas (still receiving some Russian gas), no substitution of Russian gas (but there is some substitution), and also commodity prices have been declining, some significantly, contrary to assumption. On **financial risks,** Mr. De Guindos signaled that banks are more resilient than in the past, but there are some concerns in the non-banking sector and private and public balance sheets warrant monitoring, given the aggressive tightening.

Regarding **TLTRO-III changes**, the ECB has **recalibrated conditions in order to provide incentives for earlier repayments that would reduce the Eurosystem balance sheet and, with that, "contribute to the overall monetary policy normalization".** New, higher interest rates applicable to TLTRO III from 23 November 2022 and the ECB will offer banks additional voluntary early repayment dates (23-Nov-22; 25-Jan-23 and 22-Feb-23). The first additional voluntary repayment opportunity will coincide with the start of the new interest rate calculation method on 23 November 2022. Mrs Lagarde made clear that this decision has been made for monetary policy reasons as the central wants: i) to make sure that there is no obstacle to monetary policy transmission, ii) to reduce the size of overall Euro system balance sheet and also iii) to increase the pool of collateral that will be available going forward.

Overall, today's meeting does not point to any particular bias to our view that the ECB will hike rates by 50bp in December and 25bp more in February, to reach 2.75% as a terminal rate, although probably will interpret it as slightly dovish. The macro view seems also to coincide with an outlook of a relatively shallow recession. The decisions on TLTRO's recalibration to ensure the transmission of monetary policy go also in line with expectations of making smoother monetary policy normalization (balance sheet reduction starting this year and paving the way to stop APP full reinvestments next 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, ~~8 September~~27 October 2022

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

The Governing Council today decided to raise the three key ECB interest rates by 75 basis points. ~~This~~With this third major ~~step frontloads the transition from the prevailing highly accommodative level of policy rates towards levels that will~~policy rate increase in a row, we have made substantial progress in withdrawing monetary policy accommodation. We took today's decision, and expect to raise interest rates further, to ensure the timely return of inflation to our two per cent medium-term ~~target. Based on our current assessment, over the next several meetings we expect to raise interest rates further to dampen demand and guard against the risk of a persistent upward shift in~~ inflation ~~expectations.~~ target. We will ~~regularly re-evaluate our~~base the future policy rate path ~~in light of incoming information and the~~ on the evolving outlook for inflation ~~outlook. Our future policy rate decisions will continue to be data dependent and follow a~~and the economy, following our meeting-by-meeting approach.

~~We took today's decision, and expect to raise interest rates further, because inflation~~Inflation remains far too high and ~~is likely to~~will stay above our target for an extended period. ~~According to Eurostat's flash estimate,~~ In September, euro area inflation reached 9.~~1~~9 per cent ~~in August. Soaring~~. In recent months, 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~~and the post-pandemic recovery in demand have led to a broadening of price pressures and an increase in inflation. 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~~ is aimed at 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~~support 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~~ demand and guarding against the risk ~~to the smooth transmission of our monetary policy. The Governing Council will therefore continue applying flexibility in reinvesting redemptions coming due in the pandemic emergency purchase programme portfolio, with a view to countering risks to the transmission mechanism related to the pandemic~~of a persistent upward shift in inflation expectations.

The Governing Council also decided to change the terms and conditions of the third series of targeted longer-term refinancing operations (TLTRO III). During the acute phase of the pandemic, this instrument played a key role in countering downside risks to price stability. Today, in view of the unexpected and extraordinary rise in inflation, it needs to be recalibrated to ensure that it is consistent with the broader monetary policy normalisation process and to reinforce the transmission of our policy rate increases to bank lending conditions. We therefore decided to adjust the interest rates applicable to TLTRO III from 23 November 2022 and to offer banks additional voluntary early repayment dates.

Finally, in order to align the remuneration of minimum reserves held by credit institutions with the Eurosystem more closely with money market conditions, we decided to set the remuneration of minimum reserves at the ECB's deposit facility rate.

The decisions taken today are set out in a ~~press release~~press release available on our website. ~~A~~ The details of the changes to the TLTRO III terms and conditions are described in a separate press release to be published at 15:45 CET. Another technical press release ~~on~~, detailing the change to the remuneration of ~~government deposits~~minimum reserves, will also 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

~~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~~ Economic activity in the euro area is likely to have slowed significantly in the third quarter of the year, and we expect a further weakening in the remainder of this year and the beginning of next year. By reducing people's real incomes and pushing up costs for firms, high inflation continues to dampen spending and production. Severe disruptions in the supply of gas have worsened the situation further, and both consumer and business confidence have fallen rapidly, which is also weighing on the economy. Demand for services is slowing, after a strong performance in previous quarters when those sectors most affected by the pandemic-related restrictions reopened, and survey-based indicators for new orders in the manufacturing sector are falling. Moreover, global economic activity is growing more slowly, in a context of persistent geopolitical uncertainty, especially owing to Russia's unjustified war against Ukraine, and tighter financing conditions. Worsening terms of trade, as the prices paid for imports rise faster than those received for exports, are weighing on incomes in the euro area.
The labour market ~~has remained robust, supporting economic activity. Employment increased by more than 600,000 people in the second quarter of 2022~~ continued to perform well in the third quarter, and the unemployment rate ~~stood~~remained at ~~a historical~~the historically low level of 6.6 per cent in ~~July. Total hours worked increased further, by 0.6 per cent,~~August. While short-term indicators suggest that jobs were still being created in the ~~second~~third quarter ~~of 2022 and have surpassed their pre-pandemic levels. Looking ahead~~, the ~~slowing~~weakening of the economy ~~is likely to~~could lead to ~~some increase in the~~ somewhat higher unemployment ~~rate~~in the future.

~~Fiscal~~To limit the risk of fuelling inflation, fiscal support measures to ~~cushion~~shield the economy from the impact of ~~higher~~high energy prices should be temporary and targeted at the most vulnerable ~~households and firms to limit the risk of fuelling inflationary pressures,~~. Policymakers should provide incentives to ~~enhance the efficiency of~~ lower energy consumption and bolster energy supply. At the same time, governments should pursue fiscal policies that show they are committed to gradually bringing down high public ~~spending and to preserve~~ debt ~~sustainability.~~ratios. Structural policies should ~~aim at raising~~ be designed to increase the euro area's growth potential and ~~supporting~~supply capacity and to boost its resilience, thereby contributing to a reduction in medium-term price pressures. The swift implementation of the investment and structural reform plans under the Next Generation EU programme will make an important contribution to these objectives.

1.3. Inflation

Inflation rose ~~further~~ to 9.~~1~~9 per cent in ~~August~~September, reflecting further increases in all components. Energy price inflation ~~remained extremely elevated~~, at ~~38.3~~40.7 per cent, ~~and it was again~~ remained the ~~dominant component~~main driver of overall inflation~~. Market-based indicators suggest that, in the near term, oil~~, with an increasing contribution from gas and electricity prices ~~will moderate, while wholesale gas prices will stay extraordinarily high.~~. Food price inflation also rose ~~in August~~further, to ~~10.6~~11.8 per cent, ~~partly reflecting higher~~ as high input costs ~~related to energy, disruptions of trade in~~made food ~~commodities and adverse weather conditions~~production more expensive.

~~While supply~~Supply bottlenecks ~~have been easing, these continue to~~ are gradually ~~feed through to consumer prices and are putting upward pressure on~~ easing, though their lagged impact is still contributing to inflation~~, as is recovering~~. The impact of pent-up demand, while weakening, is still driving up prices in the services sector. The depreciation of the euro has ~~also~~ added to the build-up of inflationary pressures.

Price pressures are ~~spreading across~~evident in more and more sectors, in part owing to the impact of high energy costs ~~across~~ feeding through to the whole economy.~~ Accordingly, measures~~ Measures of underlying inflation ~~remain~~have thus remained at elevated levels~~ and the latest staff projections see~~. Among those measures, inflation excluding energy and food ~~and energy reaching 3.9 per cent in 2022, 3.~~rose further to 4.8 per cent in ~~2023 and 2.3 per cent in 2024~~September.

~~Resilient~~Strong labour markets ~~and~~are likely to support higher wages, as is some catch-up in wages to compensate for higher inflation~~ are likely to support growth in wages. At the same time, incoming~~. Incoming wage data and recent wage agreements indicate that ~~wage dynamics remain contained overall~~the growth of wages may be picking up. Most measures of longer-term inflation expectations currently stand at around two per cent, although ~~recent~~further above-target revisions to some indicators warrant continued monitoring.

1.4. Risk assessment

~~In the context of the slowing global economy,~~The incoming data confirm that risks to the economic growth outlook are ~~primarily~~clearly on the downside, ~~in particular~~ especially in the near term. ~~As reflected in the downside scenario in the staff projections, a~~A long-lasting war in Ukraine remains a significant risk~~ to growth, especially if firms and households faced rationing of energy supplies. In such a situation, confidence~~. Confidence could deteriorate further and supply-side constraints could worsen again. Energy and food costs could also remain persistently higher than expected. A ~~further deterioration in the global economic outlook~~weakening world economy could be an additional drag on growth in the euro area~~ external demand~~.

The risks to the inflation outlook are primarily on the upside. ~~In the same way as for growth, the~~The major risk in the short term is a further ~~disruption of~~rise in retail energy ~~supplies~~prices. Over the medium term, inflation may turn out to be higher than expected ~~because of~~if there are increases in the prices of energy and food commodities and a stronger pass-through to consumer prices, a persistent worsening of the production capacity of the euro area economy, ~~further increases in energy and food prices, a~~ a persistent rise in inflation expectations above our target, or higher than anticipated wage rises. ~~However, if~~By contrast, a decline in energy costs ~~were to decline or~~ and a further weakening of demand ~~were to weaken over the medium term, it~~ would lower price pressures~~ on prices~~.

1.5. Financial and monetary conditions

~~Market interest rates have increased in anticipation of further monetary policy normalisation~~Bank funding costs are increasing in response to the ~~inflation outlook. Credit to firms~~ rise in market interest rates. Borrowing has also become more expensive ~~over recent months,~~ for firms and ~~bank lending rates for~~ households~~ now stand at their highest levels in more than five years. In terms of volumes, bank~~. Bank lending to firms ~~has so far remained strong, in part reflecting the~~ remains robust, as they need to finance high production costs and ~~inventory building. Mortgage lending~~build up inventories. At the same time, demand for loans to finance investment has continued to decline. Lending to households is moderating~~ because of tightening~~, as credit standards~~,~~ have tightened and demand for loans has decreased in a context of rising ~~borrowing costs~~interest rates and ~~weak~~low consumer confidence.

Our most recent bank lending survey reports that credit standards tightened for all loan categories in the third quarter of the year, as banks are becoming more concerned about the deteriorating outlook for the economy and the risks faced by their customers in the current environment. Banks expect to continue tightening their credit standards in the fourth quarter.

1.6. Conclusion

Summing up, today we have raised the three key ECB interest rates by 75 basis points ~~today~~, 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. This major step frontloads~~to ensure the ~~transition from the prevailing highly accommodative level of policy rates towards levels that will support a~~ timely return of inflation to our ~~two per cent~~ medium-term target. With this third major policy rate increase in a row, we have made substantial progress in withdrawing monetary policy accommodation. The changes to the terms and conditions of our targeted longer-term refinancing operations will also contribute to the ongoing policy normalisation process.

Our future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach. We stand ready to adjust all of our instruments within our mandate to ensure that inflation returns to our medium-term inflation target.

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