Central Banks

A hawkish ECB offsets softer hike with ‘no pivot’ warning and launches QT

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- **ECB opted for a smaller 50 bps hike, but judged rates to be raised significantly at a steady pace of 50bp going forward until they reach their terminal rate, which will be decided on a meeting-by-meeting basis.**
- **ECB made clear it has more ground to cover on restrictive monetary policy, and that rates will remain at their terminal rates for quite some time.**
- **Launched quantitative tightening (QT), starting in March 2023, halving APP reinvestments to € 15 billion per month on average until the end of Q2 2023.**
- **Strong upward revision on the inflation projections, well above the 2% target, which helped the ECB to adopt today’s hawkish tone**

The ECB today raised all its key interest rates by 50 bps, a smaller increase compared to the 75 bps hike in each of the past two meetings, in turn taking the deposit facility rate, main refinancing operations rate and marginal lending facility rate to 2%, 2.5% and 2.75% respectively. Today’s widely expected rate action was accompanied by the launch of quantitative tightening starting in March 2023, and was based on the 'substantial upward revision' to the inflation outlook. That said, the accompanying policy statement, as well as President Lagarde's post policy conference, and the nature of revisions to inflation projections, reflected a visibly hawkish tone and forward guidance by the ECB. The central bank judged that it will have to raise interest rates significantly and at a steady pace going forward, at least at the current 50 bps pace for a period of time, to levels that are sufficiently restrictive, and thereafter sustain the restrictive course to ensure timely return of inflation to its 2% target. Lagarde stressed that the ECB was not pivoting to a softer stance and that the terminal rate would be decided through a data dependent meeting by meeting basis.

On QT, the ECB announced that from March 2023 the stock of APP bonds will decline at a measured and predictable pace, in line with ECB’s forward guidance principle. The decline will amount to €15 billion per month on average until the end of 2Q23 and its subsequent pace will be determined over the time. We think that it is likely that by that date the ECB will stop reinvestments fully, i.e. €30 billion per month. Detailed parameters on this APP reduction will be announced in February while the ECB will regularly reassess the pace of the APP portfolio reduction.

ECB Staff’s updated forecasts support today’s hawkish tone, as both headline inflation (+0.8pp to 6.3% in 2023; +1.1pp to 3.4% in 2024, and 2.3% in 2025) and the core rate (+0.8pp to 4.2% in 2023, +0.5pp to 2.8% in 2024, and 2.4% in 2025) were significantly revised upwards over the forecast horizon, while they still expect a short-lived recession and a clear recovery afterwards (-0.4pp to 0.5% in 2023, 1.9% in 2024 and 1.8% in 2025). Risks to growth remain on the downside due to war-related factors and a weaker global economy. On the contrary, risks to inflation were seen to be on the upside, especially in the short-term as retail energy and food items may reprice higher at the turn of the year. A persistent rise in inflation expectations or higher than anticipated wage rises were also highlighted as key risks.

All in all, today’s meeting made clear ECB’s intentions to achieve a sufficiently restrictive monetary policy by decisively hiking interest rates further by 50 bps again in February 2023 and, possibly, March. Meanwhile, the details of the QT program, to be revealed in the February meeting, would shed more light on how well it aligns with ECB's key monetary policy tool, i.e. interest rates, and its broader implications for Euro Area financing conditions.

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, ~~27 October~~15 December 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~~50 basis points~~. With this third major policy rate increase in a row, we have made~~ and, based on the substantial ~~progress in withdrawing monetary policy accommodation. We took today's decision, and~~ upward revision to the inflation outlook, we expect to raise them further. In particular, we judge that interest rates ~~further,~~ will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure ~~the~~a timely return of inflation to our two per cent medium-term ~~inflation~~ target. ~~We will base the~~ Keeping interest rates at restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift in inflation expectations. Our future policy rate ~~path on the evolving outlook for inflation and the economy, following our~~ decisions will continue to be data-dependent and follow a meeting-by-meeting approach. ~~Inflation remains far too high and will stay above our target for an extended period. In September, euro area inflation reached 9.9 per cent. In recent months, soaring energy and food prices, supply bottlenecks and the post-pandemic recovery in demand have led to a broadening of price pressures and an increase in inflation. Our monetary policy is aimed at reducing support for demand and guarding against the risk 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 key ECB interest rates are our primary tool for setting the monetary policy stance. The Governing Council today also discussed principles for normalising the Eurosystem's monetary policy securities holdings. From the beginning of March 2023 onwards, the asset purchase programme (APP) portfolio will decline at a measured and predictable pace, as the Eurosystem will not reinvest all of the principal payments from maturing securities. The decline will amount to €15 billion per month on average until the end of the second quarter of 2023 and its subsequent pace will be determined over time.

At its February meeting the Governing Council will announce the detailed parameters for reducing the APP holdings. The Governing Council will regularly reassess the pace of the APP portfolio reduction to ensure it remains consistent with the overall monetary policy strategy and stance, to preserve market functioning, and to maintain firm control over short-term money market conditions. By the end of 2023, we will also review our operational framework for steering short-term interest rates, which will provide information regarding the endpoint of the balance sheet normalisation process.

We decided to raise interest rates today, and expect to raise them significantly further, because inflation remains far too high and is projected to stay above our target for too long. According to Eurostat's flash estimate, inflation was 10.0 per cent in November, slightly lower than the 10.6 per cent recorded in October. The decline resulted mainly from lower energy price inflation. Food price inflation and underlying price pressures across the economy have strengthened and will persist for some time. Amid exceptional uncertainty, Eurosystem staff have significantly revised up their inflation projections. They now see average inflation reaching 8.4 per cent in 2022 before decreasing to 6.3 per cent in 2023, with inflation expected to decline markedly over the course of the year. Inflation is then projected to average 3.4 per cent in 2024 and 2.3 per cent in 2025. Inflation excluding energy and food is projected to be 3.9 per cent on average in 2022 and to rise to 4.2 per cent in 2023, before falling to 2.8 per cent in 2024 and 2.4 per cent in 2025.

The euro area economy may contract in the current quarter and the next quarter, owing to the energy crisis, high uncertainty, weakening global economic activity and tighter financing conditions. According to the latest Eurosystem staff projections, a recession would be relatively short-lived and shallow. Growth is nonetheless expected to be subdued next year and has been revised down significantly compared with the previous projections. Beyond the near term, growth is projected to recover as the current headwinds fade. Overall, the Eurosystem staff projections now see the economy growing by 3.4 per cent in 2022, 0.5 per cent in 2023, 1.9 per cent in 2024 and 1.8 per cent in 2025.

The decisions taken today are set out in a ~~press release~~press release available on our website. ~~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, detailing the change to the remuneration of 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

Economic ~~activity~~growth in the euro area ~~is likely to have~~ slowed ~~significantly~~to 0.3 per cent 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~~ . High inflation and tighter financing conditions are dampening spending and production by reducing ~~people's~~ real household 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~~.

The world economy~~. Demand for services~~ is also 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~~continued geopolitical uncertainty, especially owing to Russia's unjustified war against Ukraine and its people, and tighter financing conditions~~. Worsening~~ worldwide. The past deterioration in the terms of trade, ~~as~~reflecting the faster rise in import prices ~~paid for imports rise faster~~ than ~~those received for exports, are weighing~~in export prices, continues to weigh on ~~incomes~~purchasing power in the euro area.

~~The labour market continued to perform well in~~On the positive side, employment increased by 0.3 per cent in the third quarter, and ~~the~~ unemployment ~~rate remained at the historically~~hit a new historical low ~~level~~ of 6.~~6 per cent in August. While short-term indicators suggest that jobs were still being created in the third quarter, the weakening of~~5 per cent in October. Rising wages are set to restore some lost purchasing power, supporting consumption. As the economy ~~could lead~~weakens, however, job creation is likely to ~~somewhat higher~~slow, and unemployment ~~in~~could rise over the ~~future~~coming quarters.

~~To limit the risk of fuelling inflation, fiscal~~Fiscal support measures to shield the economy from the impact of high energy prices should be temporary~~ and targeted at the most vulnerable. Policymakers should provide incentives to lower energy consumption and bolster energy supply. At the same time, governments should pursue fiscal policies that show they are committed to~~ , targeted and tailored to preserving incentives to consume less energy. Fiscal measures falling short of these principles are likely to exacerbate inflationary pressures, which would necessitate a stronger monetary policy response. Moreover, in line with the EU's economic governance framework, fiscal policies should be oriented towards making our economy more productive and gradually bringing down high public debt~~ ratios. Structural policies should be designed~~. Policies to ~~increase~~enhance the euro area's ~~growth potential and~~ supply capacity~~ and to boost its resilience, thereby contributing to a reduction~~, especially in ~~medium-term~~the energy sector, can help reduce price pressures~~. The swift implementation of the~~ in the medium term. To that end, governments should swiftly implement their investment and structural reform plans under the Next Generation EU programme~~ will make an important contribution to these objectives~~. The reform of the EU's economic governance framework should be concluded rapidly.

1.3. Inflation

~~1.3.~~1.1. ~~Inflation~~

Inflation ~~rose~~declined to ~~9.9~~10.0 per cent in ~~September, reflecting further increases in all components. Energy~~November, mainly on the back of lower energy price inflation, ~~at 40.7 per cent, remained the main driver of overall inflation, with an increasing contribution from gas and electricity prices.~~while services inflation also edged down. Food price inflation ~~also~~ rose further~~,~~ to ~~11.8~~13.6 per cent, however, as high input costs ~~made~~in food production ~~more expensive~~were passed through to consumer prices.

Price pressures remain strong across sectors, partly as a result of the impact of high energy costs throughout the economy. Inflation excluding energy and food was unchanged in November, at 5.0 per cent, and other measures of underlying inflation are

also high. Fiscal measures to compensate households for high energy prices and inflation are set to dampen inflation over next year but will raise it once they are withdrawn.

Supply bottlenecks are gradually easing, ~~though~~although their ~~lagged impact is~~effects are still contributing to inflation~~.~~, pushing up goods prices in particular. The ~~impact~~same holds true for the lifting of pandemic-related restrictions: while weakening, the effect of pent-up demand~~, while weakening,~~ is still driving up prices, especially in the services sector. The depreciation of the euro ~~has added to the build-up of inflationary pressures.~~

~~Price pressures are evident in more and more sectors, in part owing~~this year is also continuing to ~~the impact of high energy costs feeding~~feed through to ~~the whole economy. Measures of underlying inflation have thus remained at elevated levels. Among those measures, inflation excluding energy and food rose further to 4.8 per cent in September~~consumer prices.

~~Strong~~Wage growth is strengthening, supported by robust labour markets ~~are likely to support higher wages, as is some~~ and some catch-up in wages to compensate workers for ~~higher~~high inflation. ~~Incoming wage data and recent wage agreements indicate that~~As these factors are set to remain in place, the ~~growth of~~Eurosystem staff projections see wages ~~may be picking~~growing at rates well above historical averages and pushing up inflation throughout the projection period. Most measures of longer-term inflation expectations currently stand at around two per cent, although further above-target revisions to some indicators warrant continued monitoring.

1.4. Risk assessment

~~The incoming data confirm that risks~~Risks to the economic growth outlook are ~~clearly~~ on the downside, especially in the near term. ~~A long-lasting~~ The war ~~in~~against Ukraine remains a significant downside risk~~. Confidence could deteriorate further and supply-side constraints could worsen again.~~ to the economy. Energy and food costs could also remain persistently higher than expected. ~~A weakening world economy~~ There could be an additional drag on growth in the euro area if the world economy were to weaken more sharply than we expect.

The risks to the inflation outlook are primarily on the upside. ~~The major risk in~~In the ~~short~~near term ~~is a further rise~~, existing pipeline pressures could lead to stronger than expected rises in retail ~~energy~~ prices~~.~~ for energy and food. Over the medium term, ~~inflation may turn out to be higher than expected 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,~~risks stem primarily from domestic factors such as a persistent rise in inflation expectations above our target~~,~~ or higher than anticipated wage rises. By contrast, a decline in energy costs ~~and~~or a further weakening of demand would lower price pressures.

1.5. Financial and monetary conditions

~~Bank funding costs are increasing in response to the rise in market interest rates. Borrowing has also become more~~ As we tighten monetary policy, borrowing is becoming more expensive for firms and households. Bank lending to firms remains robust, as ~~they need to~~ firms replace bonds with bank loans and use credit to finance ~~high~~ the higher costs of production ~~costs and build up inventories. At the same time, demand for loans to finance~~ and investment ~~has continued to decline. Lending to households is moderating, as~~. Households are borrowing less, because of tighter credit standards ~~have tightened and demand for loans has decreased in a context of~~ , rising interest rates~~,~~ , worsening prospects for the housing market and ~~low~~lower 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.~~

In line with our monetary policy strategy, twice a year the Governing Council assesses in depth the interrelation between monetary policy and financial stability. The financial stability environment has deteriorated since our last review in June 2022 owing to a weaker economy and rising credit risk. In addition, sovereign vulnerabilities have risen amid the weaker economic outlook and weaker fiscal positions. Tighter financing conditions would mitigate the build-up of financial vulnerabilities and lower tail risks to inflation over the medium term, at the cost of a higher risk of systemic stress and greater downside risks to growth in the short term. In addition, the liquidity needs of non-bank financial institutions may amplify market volatility. At the same time, euro area banks have comfortable levels of capital, which helps to reduce the side effects of tighter monetary policy on financial stability. Macroprudential policy remains the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

1.6. Conclusion

Summing up, ~~today~~ we have today raised the three key ECB interest rates by ~~75~~50 basis points~~,~~ and~~,~~ , based on the substantial upward revision to our inflation outlook, we expect to raise them further. In particular, we judge that interest rates ~~further,~~ will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure ~~the~~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~~Keeping interest rates at restrictive levels will over time reduce inflation by dampening demand and ~~conditions of our targeted longer-term refinancing operations~~ will also ~~contribute to~~guard against the risk of a persistent upward shift in inflation expectations. Moreover, from the ~~ongoing policy normalisation process~~beginning of March 2023 onwards, the APP portfolio will decline at a measured and predictable pace, as the Eurosystem will not reinvest all of the principal payments from maturing securities.
Our future policy rate decisions will continue to be data-dependent and ~~follow a~~determined 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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