Central Banks

The ECB stays on course and promises another similar hike next month

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- **The ECB raised by 50bps key interest rates and signaled another 50bps hike by March. By then, it will evaluate the subsequent path of its monetary policy.**
- **Inflation risks became more balanced, but underlying price pressures are still alive**
- **On the details of the APP bond portfolio reduction, corporate bond reinvestments will be tilted more strongly towards issuers with a better "green" performance**

The ECB today raised all its key interest rates by 50 bps, in line with the increase in the December meeting when it reduced the pace of the monetary tightening, in turn taking the deposit facility rate, main refinancing operations rate and marginal lending facility rate to 2.5%, 3.0% and 3.25% respectively. The decision was widely expected, since at the December meeting Ms. Lagarde judged that rates to be raised significantly at a steady pace of 50bp going forward until they reach their terminal rate. Nonetheless, this time the ECB has been more explicit and says that it intends to implement another similar hike next month, emphasizing there is ground to cover. Mrs Lagarde said that "intended" is a pretty strong word, but it does not imply absolute commitment. After that, the central bank will evaluate the subsequent path of its monetary policy, deciding on a meeting-by-meeting basis, looking at data, and making clear that a level of 3.50% (refi) is not necessarily the peak. Mrs. Lagarde highlighted that they want to take rates to restrictive territory and leave them there for a prolonged period of time.

On the state and prospects of the Euro Area economy, the ECB considers that underlying price pressures are alive since wages are growing and the reopening of China could increase commodity prices. It welcomed the quicker than expected moderation in the headline inflation, but highlighted that this was driven by the energy component. On economic activity, growth was positive in 22Q4 and, despite the slowdown and all the negatives, it seems more sound. Risks both for economic growth and, more importantly, inflation have become more balanced, but not still completely balanced as Mrs. Lagarde clarified.

On Quantitative Tightening, the ECB announced the details of the APP portfolio reduction. It will start in March and the decline will amount to EUR 15bn per month on average until the end of June, and its subsequent pace will be determined over the time. The reduction in its securities holdings will be proportional to the redemptions across the various asset classes (public sector bonds, covered bonds, corporate bonds and ABS). Regarding corporate bond purchases (CSPP), the remaining reinvestments will be tilted more strongly towards issuers with a better climate performance (this is the first monetary policy climate-action taken to support decarbonisation, in line with the new ECB strategy review).

Overall, today's meeting does not point to any particular bias to our view that the ECB will hike rates by 50bp in March and 25bp more in May, to reach 3.75% -refi rate- as a terminal rate. Market reaction was dovish, in line with yesterday's movements on US rates as central banks´ - Fed, BoE and ECB- are seen to be near the peak.

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, ~~15 December 2022~~2 February 2023

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

We would like to begin by congratulating Croatia on joining the euro area on 1 January 2023. We also warmly welcome Boris Vujčić, the Governor of Hrvatska narodna banka, to the Governing Council. We will now report on the outcome of today's meeting.

The Governing Council ~~today decided to raise the three key ECB interest rates by 50 basis points and, based on the substantial upward revision to the inflation outlook, we expect to raise them further. In particular, we judge that interest rates will still have to rise~~ will stay the course in raising interest rates significantly at a steady pace ~~to reach~~and in keeping them at levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target. Accordingly, the Governing Council today decided to raise the three key ECB interest rates by 50 basis points and we expect to raise them further. In view of the underlying inflation pressures, we intend to raise interest rates by another 50 basis points at our next monetary policy meeting in March and we will then evaluate the subsequent path of our monetary policy. 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~~ In any event, our future policy rate decisions will continue to be data-dependent and follow a meeting-by-meeting approach.

~~The key ECB interest rates are our primary tool for setting the monetary policy stance.~~ The Governing Council today also ~~discussed principles~~decided on the modalities for ~~normalising~~reducing the Eurosystem's ~~monetary policy~~ holdings of securities ~~holdings. From the beginning of March 2023 onwards, the~~ under the asset purchase programme (APP~~)~~). As communicated in December, 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. The decline will amount to~~ by €15 billion per month on average from the beginning of March until the end of ~~the second quarter of~~June 2023, and ~~its~~the subsequent pace of portfolio reduction 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~~ Partial reinvestments will be conducted broadly in line 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~~current practice. In particular, the remaining reinvestment amounts will be allocated proportionally to the share of redemptions 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~~each constituent programme of the APP and, under the public sector purchase programme (PSPP), to the share of redemptions 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~~ each jurisdiction and across national and supranational issuers. For our corporate bond purchases, the remaining reinvestments will be ~~subdued next year and has been revised down significantly compared~~tilted more strongly towards issuers with a better climate performance. Without prejudice to our price stability objective, this approach will support the gradual decarbonisation of the Eurosystem's corporate bond holdings, in line 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~~goals of the Paris Agreement.

The decisions taken today are set out in a ~~press release~~press release available on our website. The detailed modalities for reducing the APP holdings are described in a separate press release to 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 growth in~~According to Eurostat's preliminary flash estimate, the euro area ~~slowed to~~economy grew by 0.~~3~~1 per cent in the ~~third~~fourth quarter of 2022. While above the ~~year. High inflation~~December Eurosystem staff projections, this outcome means that economic activity has slowed markedly since mid-2022 and ~~tighter financing conditions are dampening spending~~we expect it to stay weak in the near term. Subdued global activity and ~~production by reducing real household incomes and pushing up costs for firms.~~

~~The world economy is also slowing, in a context of continued~~high geopolitical uncertainty, especially owing to Russia's unjustified war against Ukraine and its people, continue to act as headwinds to euro area growth. Together with high inflation and tighter financing conditions ~~worldwide. The past deterioration~~, these headwinds dampen spending and production, especially in the ~~terms of trade, reflecting the faster rise in import prices than in export prices, continues to weigh on purchasing power in the euro area~~manufacturing sector.

~~On~~However, supply bottlenecks are gradually easing, the ~~positive side, employment increased by 0.3 per cent in the third quarter,~~supply of gas has become more secure, firms are still working off large order backlogs and ~~unemployment hit a new historical low of 6.5 per cent in October.~~confidence is improving. Moreover, output in the services sector has been holding up, supported by continuing reopening effects and stronger demand for leisure activities. Rising wages ~~are~~ and the recent decline in energy price inflation are also set to ~~restore some lost~~ease the loss of purchasing power~~, supporting~~ that many people have

experienced owing to high inflation. This, in turn, will support consumption. ~~As~~Overall, the economy ~~weakens, however, job creation is likely to~~ has proved more resilient than expected and should recover over the coming quarters.

The unemployment rate remained at its historical low of 6.6 per cent in December 2022. However, the rate at which jobs are being created may slow~~,~~ and unemployment could rise over the coming quarters.

~~Fiscal~~Government support measures to shield the economy from the impact of high energy prices should be temporary, targeted and tailored to preserving incentives to consume less energy. ~~Fiscal~~ In particular, as the energy crisis becomes less acute, it is important to now start rolling these measures back promptly in line with the fall in energy prices and in a concerted manner. Any such measures falling short of these principles are likely to ~~exacerbate~~drive up medium-term inflationary pressures, which would ~~necessitate~~call for 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. Policies to enhance the euro area's supply capacity, especially in the energy sector, can help reduce price pressures in the medium term. To that end, governments should swiftly implement their investment and structural reform plans under the Next Generation EU programme. The reform of the EU's economic governance framework should be concluded rapidly.

1.3. Inflation

~~Inflation declined~~According to ~~10.0~~Eurostat's flash estimate, which has been calculated using Eurostat estimates for Germany, inflation was 8.5 per cent in ~~November,~~January. This would be 0.7 percentage points lower than the December figure, with the decline owing mainly ~~on the back of lower~~ to a renewed sharp drop in energy ~~price inflation, while services inflation also edged down.~~prices. Market-based indicators suggest that energy prices over the coming years will be significantly lower than expected at the time of our last meeting. Food price inflation ~~rose further~~edged higher to ~~13.6~~14.1 per cent, ~~however,~~ as ~~high input costs in~~ the past surge in the cost of energy and of other inputs for food production ~~were passed~~is still feeding through to consumer prices.

Price pressures remain strong ~~across sectors~~, partly ~~as a result of the impact of~~because high energy costs are spreading throughout the economy. Inflation excluding energy and food ~~was unchanged in November, at 5.0 per cent, and other measures~~remained at 5.2 per cent in January, with inflation for non-energy industrial goods rising to 6.9 per cent and services inflation declining to 4.2 per cent. Other indicators of underlying inflation are also still high. ~~Fiscal~~Government measures to compensate households for high energy prices ~~and inflation are set to~~ will dampen inflation ~~over next year~~in 2023 but ~~will~~ are expected to raise ~~it~~inflation once they ~~are withdrawn~~expire. At the same time, the scale of some of these measures depends on the evolution of energy prices and their expected contribution to inflation is particularly uncertain.

~~Supply~~Although supply bottlenecks are gradually easing, ~~although~~ their delayed effects are still ~~contributing to inflation,~~ pushing up goods ~~prices in particular~~price inflation. The same holds true for the lifting of pandemic-related restrictions: while weakening, the effect of pent-up demand is still driving up prices, especially in the services sector. ~~The depreciation of the euro this year is also continuing to feed through to consumer prices.~~

~~Wage growth is strengthening~~Wages are growing faster, supported by robust labour markets ~~and~~, with some catch-up ~~in wages~~ to ~~compensate workers for~~ high inflation~~. As these factors are set to remain in place,~~ becoming the main theme in wage negotiations. At the same time, recent data on wage dynamics have been in line with the December Eurosystem staff projections ~~see wages 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~~ but these warrant continued monitoring.

1.4. Risk assessment

~~Risks~~The risks to the outlook for economic growth ~~outlook are on the downside, especially in the near term. The~~have become more balanced. Russia's unjustified war against Ukraine ~~remains~~and its people continues to be a significant downside risk to the economy~~. Energy~~ and ~~food costs~~ could ~~also remain persistently higher than expected.~~ again push up the costs of energy and food. There could also be an additional drag on ~~growth in the~~ euro area growth if the world economy ~~were to weaken~~weakened more sharply than we expect. Moreover, the recovery would face obstacles if the pandemic were to re-intensify and cause renewed supply disruptions. However, the energy shock could fade away faster than anticipated and euro area companies could adapt more quickly to the challenging international environment. This would support higher growth than currently expected.

The risks to the inflation outlook ~~are primarily on~~have also become more balanced, especially in the near term. On the upside~~. In the near term~~, existing pipeline pressures could ~~lead to~~ still send retail prices higher in the near term. Moreover, a stronger than expected ~~rises~~economic rebound in ~~retail prices for energy and food. Over the medium term, risks stem primarily from domestic~~China could give a fresh boost to commodity prices and foreign demand. Domestic factors such as a persistent rise in inflation expectations above our target or higher than anticipated wage rises~~. By contrast, a decline~~ could drive inflation higher, also over the medium term. On the downside, the recent fall in energy ~~costs or a~~prices, if it persists, may slow inflation more rapidly than expected. This downward pressure in the energy component could then also translate into weaker dynamics for underlying inflation. A further weakening of demand would also contribute to lower price pressures than currently anticipated, especially over the medium term.

1.5. Financial and monetary conditions

~~As we tighten monetary policy, borrowing is becoming more expensive for firms and households. Bank lending to firms remains robust, as firms replace bonds with bank loans and use credit to finance the higher costs of production and investment. Households are borrowing less, because of tighter credit standards, rising interest rates, worsening prospects for the housing market and lower consumer confidence.~~

~~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.~~

As we tighten monetary policy, market interest rates are rising further and credit to the private sector is becoming more expensive. Bank lending to firms has decelerated sharply over recent months. This partly stems from lower financing needs for inventories. But it also reflects weakening demand for loans to finance business investment, in the context of a steep upward move in bank lending rates and a considerable tightening in credit standards, which is also visible in our most recent bank lending survey. Household borrowing has continued to weaken as well, reflecting rising lending rates, tighter credit standards and a sharp fall in the demand for mortgages. As loan creation decelerates, money growth is also slowing rapidly, with a marked decline in its most liquid components, including overnight deposits, only partially compensated by a shift to term deposits.

1.6. Conclusion

Summing up, ~~we have today raised the three key ECB interest rates by 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~~the Governing Council will ~~still have to rise~~ stay the course in raising interest rates significantly at a steady pace ~~to reach~~and in keeping them at levels that are sufficiently restrictive~~-~~ to ensure a timely return of inflation to our two per cent medium-term target. Accordingly, we today decided to raise the three key ECB interest rates by 50 basis points and we expect to raise them further. In view of the underlying inflation pressures, we intend to raise interest rates by another 50 basis points at our next monetary policy meeting in March and we will then evaluate the subsequent path of our monetary policy. 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. Moreover, from the 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 determined meeting by meeting. 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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