Central Banks

Roadmap to fight inflation on track despite financial turmoil

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- **The ECB raised key interest rates by 50 bps as already preannounced**
- **No guidance on rates for further meetings, future decisions will be data dependent in the wake of elevated uncertainty**
- **The ECB pledged its commitment to provide liquidity support to banks if needed**

The ECB was steadfast today in its commitment to fight inflation despite recent shifts in financial stability concerns led by adverse developments in the US and Euro Area banking sector. Underscoring that 'inflation was projected to remain too high for too long', the central bank stuck to its preannounced 50 bps hike across all key interest rates (main refinancing operations, marginal lending facility and the deposit facility increased to 3.50%, 3.75% and 3.00% respectively), albeit in a decision that was not unanimous. Meanwhile, ECB's reaction to the financial market turmoil affecting the banking sector was one of assurance of readiness to act, and an emphasis on the resilience of the European banking system. Furthermore, ECB avoided any commitment on future rate projections citing amplified uncertainty in the wake of recent events. After this week's financial market woes, the ECB had the option to partially retreat from its call made in the February meeting and raise only by 25 bps under the principle of caution, mindful of the "mistake" of 2008 when they raised rates just ahead of the great financial crisis to curb inflation only to reverse course within months. Instead, the central bank today chose a more transparent line of addressing the still high inflation outlook with more rate action, while devoting other instruments, if needed, to address liquidity problems of the banking system, and underpin financial stability. In parallel, they have reassured that the outlook of the European banking system is sound. The communication of this strategy has been effective so far, with markets not overreacting to the ECB decision.

A challenging backdrop of accelerating core inflation and shifts in financial stability concerns brought to the fore questions over the trade-off between price stability and financial stability. Ms. Lagarde emphasized that for the ECB there is no such trade-off, reiterating the bank's commitment to its mandate of price stability, of which, financial stability, Lagarde mentioned, was an integral part. Mrs Lagarde remarked that the central bank will continue to address price pressures through interest rates (if the baseline scenario persists and uncertainty diminishes, "we have more ground to cover"), and financial stability, if needed, through liquidity facilities (or the tools needed).

In particular, regarding financial stability, the ECB said they are monitoring it closely, but they emphasized that the Euro Area banking sector is resilient, with strong capital and liquidity positions and with limited exposure to institutions in the US. At the same time, the ECB highlighted that its policy toolkit is fully equipped to provide liquidity support to banks if needed. Specifically, Lagarde underscored the staff's "creativity" and agility to deploy new instruments or adapt existing ones in very short order in case it is needed (i.e. changing the collateral pool, haircuts, new liquidity operations, etc.). Meanwhile, Mrs. Lagarde noted that there was no discussion on adjusting the pace of Quantitative Tightening, which would unfold in a regular fashion.

On the updated macroeconomic projections, while the ECB remarks that inflation is projected to remain too high for too long, its projections show that headline inflation would moderate thanks to lower energy prices: 2023, 5.3% (-1pp); 2024, 2.9% (-0.5pp); 2025, 2.1% (-0.2pp). Core inflation is projected to be higher this year (4.6%, +0.4pp) after recent upward surprises, but lower for 2024 (2.5%, -0.3pp) and 2025 (2.2%, -0.2pp). Similarly, growth has been revised up in 2023 (1.0%, +0.5pp) but down for 2024 (1.6%, -0.3pp) and for 2025 (1.6%, -0.2pp). Mrs Lagarde stressed the increasing uncertainty on the outlook while the updated forecasts do not consider recent financial stress that could result in tighter financing conditions.

All in all, while the ECB delivered its promised rate hike today, its emphasis on data dependence, and the removal of forward guidance on rates suggests that it would act more cautiously going forward in the wake of recent adverse financial sector events. Amplified uncertainty reinforces the need to be data dependent for next meetings based on the inflation outlook, the dynamics of underlying inflation and the strength of monetary transmission. In its own words, the ECB still ‘has a lot of ground to cover’ to bring inflation within target. The big question is, however, whether the nature of uncertainty going forward permits the ECB to act in line with its baseline assessments or be more cautious by internalizing financial risks.

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, ~~2 February~~16 March 2023

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

~~We would like~~Inflation is projected 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 will stay the course in raising interest rates significantly at a steady pace 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~~remain too high for too long. Therefore, the Governing Council today decided to ~~raise~~increase 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. In any event, our future policy rate decisions will continue to be~~ , in line with our determination to ensure the timely return of inflation to our two per cent medium-term target. The elevated level of uncertainty reinforces the importance of a data-dependent ~~and follow a meeting-by-meeting~~ approach~~.~~

~~The Governing Council today also decided on the modalities for reducing the Eurosystem's holdings of securities under the asset purchase programme (APP). As communicated in December, the APP portfolio will decline by €15 billion per month on average from the beginning of March until the end of June 2023, and the subsequent pace of portfolio reduction~~ to our policy rate decisions, which will be determined ~~over time. Partial reinvestments will be conducted broadly in line with current practice. In particular, the remaining reinvestment amounts will be allocated proportionally to the share of redemptions across each constituent programme of the APP and, under the public sector purchase programme (PSPP), to the share of redemptions of each jurisdiction and across national and supranational issuers. For our corporate bond purchases, the remaining reinvestments will be 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 goals of the Paris Agreement~~by our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.

We are monitoring current market tensions closely and stand ready to respond as necessary to preserve price stability and financial stability in the euro area. The euro area banking sector is resilient, with strong capital and liquidity positions. In any case, our policy toolkit is fully equipped to provide liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy.

The new ECB staff macroeconomic projections were finalised in early March before the recent emergence of financial market tensions. As such, these tensions imply additional uncertainty around the baseline assessments of inflation and growth. Prior to these latest developments, the baseline path for headline inflation had already been revised down, mainly owing to a smaller contribution from energy prices than previously expected. ECB staff now see inflation averaging 5.3 per cent in 2023, 2.9 per cent in 2024 and 2.1 per cent in 2025. At the same time, underlying price pressures remain strong. Inflation excluding energy and food continued to increase in February and ECB staff expect it to average 4.6 per cent in 2023, which is higher than foreseen in the December projections. Subsequently, it is projected to come down to 2.5 per cent in 2024 and 2.2 per cent in 2025, as the upward pressures from past supply shocks and the reopening of the economy fade out and as tighter monetary policy increasingly dampens demand.

The baseline projections for growth in 2023 have been revised up to an average of 1.0 per cent as a result of both the decline in energy prices and the economy's greater resilience to the challenging international environment. ECB staff then expect growth to pick up further, to 1.6 per cent, in both 2024 and 2025, underpinned by a robust labour market, improving confidence and a recovery in real incomes. At the same time, the pick-up in growth in 2024 and 2025 is weaker than projected in December, owing to the tightening of monetary policy.

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

~~According to Eurostat's preliminary flash estimate, the~~ The euro area economy ~~grew by 0.1 per cent~~ stagnated in the fourth quarter of 2022~~. While above the December Eurosystem staff projections, this outcome means that economic activity has slowed markedly since mid-2022 and we expect it to stay weak in the near term. Subdued global activity and 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~~, thus avoiding the previously expected contraction. However, private domestic demand fell sharply. High inflation, prevailing uncertainties and tighter financing conditions~~, these headwinds dampen spending and~~ dented private consumption and investment, which fell by 0.9 per cent and 3.6 per cent respectively.

Under the baseline, the economy looks set to recover over the coming quarters. Industrial production~~, especially in the manufacturing sector.~~

~~However,~~ should pick up as supply ~~bottlenecks are gradually easing, the supply of gas has become more secure,~~ conditions improve further, confidence continues to recover, and firms ~~are still working~~work off large order backlogs~~ and 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 and ~~the recent decline in~~falling energy ~~price inflation are also set to ease~~prices will partly offset the loss of purchasing power that many ~~people have experienced owing to~~households are experiencing as a result of high inflation. This, in turn, will support ~~consumption. Overall, the economy has proved more resilient than expected and should recover over the coming quarters~~consumer spending.

~~The~~ Moreover, the labour market remains strong, despite the weakening of economic activity. Employment grew by 0.3 per cent in the fourth quarter of 2022 and the unemployment rate ~~remained~~stayed 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~~January 2023.

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. ~~In particular, as~~As energy prices fall and risks around the energy ~~crisis becomes less acute~~supply recede, it is important to ~~now~~ start rolling back these measures ~~back~~ promptly ~~in line with the fall in energy prices~~ and in a concerted manner. ~~Any such measures~~Measures falling short of these principles are likely to drive up medium-term inflationary pressures, which would call for a stronger monetary policy response. Moreover, in line with the EU's economic governance framework and as stated in the European Commission's guidance of 8 March 2023, 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

~~According to Eurostat's flash estimate, which has been calculated using Eurostat estimates for Germany, inflation was~~ Inflation edged down to 8.5 per cent in ~~January. This would be 0.7 percentage points lower than the December figure, with the~~ February. The decline ~~owing mainly to~~resulted from a renewed sharp drop in energy 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~~ By contrast, food price inflation ~~edged higher~~increased further, to ~~14.1~~15.0 per cent, ~~as~~with the past surge in the cost of energy and of other inputs for food production ~~is~~ still feeding through to consumer prices.

~~Price~~ Moreover, underlying price pressures remain strong~~, partly because high energy costs are spreading throughout the economy.~~. Inflation excluding energy and food ~~remained at~~increased to 5.~~2~~6 per cent in ~~January, with inflation for non~~February and other indicators of underlying inflation have also stayed high. Non-energy industrial goods ~~rising~~ inflation rose to 6.~~9~~8 per cent ~~and services inflation declining to 4.2 per cent. Other indicators of underlying inflation are also still high. Government measures to compensate households for high energy prices will dampen inflation~~ in ~~2023 but are expected to raise inflation once they 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.~~

~~Although~~February, mainly reflecting the delayed effects of past supply bottlenecks ~~are gradually easing, their delayed effects are still pushing up goods price inflation. The same holds true for the lifting of pandemic-related restrictions: while weakening, the effect of~~and high energy prices. Services inflation, which rose to 4.8 per cent in February, is also still being driven by the gradual pass-through of past energy cost increases, pent-up demand ~~is still driving up prices, especially in the services sector~~from the reopening of the economy and rising wages.

~~Wages are growing faster, supported by~~ Wage pressures have strengthened on the back of robust labour markets~~, with~~ and employees aiming to recoup some ~~catch-up~~of the purchasing power lost owing to high inflation~~ becoming the main theme~~. Moreover, many firms were able to raise their profit margins in ~~wage negotiations. At the same time, recent data on wage dynamics have been in line with the December Eurosystem staff projections. Most~~sectors faced with constrained supply and resurgent demand. At the same time, most measures of longer-term inflation expectations currently stand at around two per cent, ~~but these~~ although they warrant continued monitoring, especially in light of recent volatility in market-based inflation expectations.

1.4. Risk assessment

~~The risks~~Risks to the outlook for economic growth ~~have become~~are tilted to the downside. Persistently elevated financial market tensions could tighten broader credit conditions more ~~balanced~~strongly than expected and dampen confidence. Russia's unjustified war against Ukraine and its people continues to be a significant downside risk to the economy and could again push up the costs of energy and food. There could also be an additional drag on euro area growth if the world economy weakened more sharply than ~~we expect. Moreover, the recovery would face obstacles if the pandemic were to re-intensify and cause renewed supply disruptions.~~expected. 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~~ and, together with the fading-out of the energy shock, this could support higher growth than currently expected.

The upside risks to ~~the~~ inflation ~~outlook have also become more balanced, especially in the near term. On the upside,~~include existing pipeline pressures that could still send retail prices even higher than expected in the near term. Domestic factors, such as a persistent rise in ~~the near~~inflation expectations above our target or higher than anticipated increases in wages and profit margins, could drive inflation higher, including over the medium term. Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand. ~~Domestic factors such as a persistent rise in~~The downside risks to inflation ~~expectations above our target or higher than anticipated wage rises~~include persistently elevated financial market tensions that could ~~drive inflation higher, also over the medium term. On the downside, the recent fall in~~accelerate disinflation. In addition, falling energy 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~~reduced pressure from underlying inflation and wages. A ~~further~~ weakening of demand, including owing to a stronger deceleration of bank credit or a stronger than projected transmission of monetary policy, 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, market~~ Market interest rates ~~are rising further and~~ rose considerably in the weeks following our last meeting. But the increase has strongly reversed over recent days in a context of severe financial market tensions. Bank credit to ~~the private sector is becoming~~euro area firms has become more expensive. ~~Bank lending~~Credit to firms has ~~decelerated sharply over recent months. This partly stems from~~ weakened further, owing to 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.~~and tighter credit supply conditions. Household borrowing has ~~continued to weaken as well, reflecting rising lending rates,~~ become more expensive as well, especially owing to higher mortgage rates. This rise in borrowing costs and the resultant decline in demand, along with tighter credit standards~~ and a sharp fall in the demand for mortgages. As~~, have led to a further slowdown in the growth of loans to households. Amid these weaker loan ~~creation decelerates~~dynamics, money growth ~~is also slowing rapidly, with a marked decline in~~ has slowed sharply, driven by its most liquid components~~, including overnight deposits, only partially compensated by a shift to term deposits~~.

1.6. Conclusion

Summing up, inflation is projected to remain too high for too long. Therefore, the Governing Council ~~will stay the course~~today decided to increase the three key ECB interest rates by 50 basis points, in ~~raising interest rates significantly at a steady pace and~~

~~in keeping them at levels that are sufficiently restrictive~~line with our determination to ensure ~~a~~the 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~~ The elevated level of uncertainty reinforces the importance of a data-dependent approach to our policy rate decisions, which will be determined by our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation ~~pressures, we intend to raise interest rates by another 50 basis points at our next~~, and the strength of monetary policy ~~meeting in March~~transmission. We are monitoring current market tensions closely 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~~stand ready to respond as necessary to preserve price stability and ~~will also guard against the risk of a persistent upward shift in inflation expectations. Moreover, from the beginning of March 2023, the APP portfolio will decline at a measured and predictable pace, as~~ financial stability in the ~~Eurosystem will not reinvest all of the principal payments from maturing securities~~euro area.

~~Our future policy rate decisions will continue to be data-dependent and determined meeting by meeting. We~~In any case, we stand ready to adjust all of our instruments within our mandate to ensure that inflation returns to our medium-term target and to preserve the smooth functioning of monetary policy transmission.

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