Christine Lagarde: ECB press conference - introductory statement

Introductory statement by Ms Christine Lagarde, President of the European Central Bank, and Mr Luis de Guindos, Vice-President of the European Central Bank, Frankfurt am Main, 15 June 2023.

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

Inflation has been coming down but is projected to remain too high for too long. We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points.

The rate increase today reflects our updated assessment of the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission. According to the June macroeconomic projections, Eurosystem staff expect headline inflation to average 5.4 per cent in 2023, 3.0 per cent in 2024 and 2.2 per cent in 2025. Indicators of underlying price pressures remain strong, although some show tentative signs of softening. Staff have revised up their projections for inflation excluding energy and food, especially for this year and next year, owing to past upward surprises and the implications of the robust labour market for the speed of disinflation. They now see it reaching 5.1 per cent in 2023, before it declines to 3.0 per cent in 2024 and 2.3 per cent in 2025. Staff have slightly lowered their economic growth projections for this year and next year. They now expect the economy to grow by 0.9 per cent in 2023, 1.5 per cent in 2024 and 1.6 per cent in 2025.

At the same time, our past rate increases are being transmitted forcefully to financing conditions and are gradually having an impact across the economy. Borrowing costs have increased steeply and growth in loans is slowing. Tighter financing conditions are a key reason why inflation is projected to decline further towards our target, as they are expected to increasingly dampen demand.

Our future decisions will ensure that the key ECB interest rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target and will be kept at those levels for as long as necessary. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, our interest rate decisions will continue to be based on 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.

The Governing Council confirms that it will discontinue the reinvestments under the asset purchase programme as of July 2023.

The decisions taken today are set out in a press release available on our website.

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.

Economic activity

The euro area economy has stagnated in recent months. As in the fourth quarter of last year, it shrank by 0.1 per cent in the first quarter of 2023, amid a drop in private and public consumption. Economic growth is likely to remain weak in the short run but strengthen in the course of the year, as inflation comes down and supply disruptions continue to ease. Conditions in different sectors of the economy are uneven: manufacturing continues to weaken, partly owing to lower global demand and tighter euro area financing conditions, while services remain resilient.

The labour market remains a source of strength. Almost a million new jobs were added in the first quarter of the year and the unemployment rate stood at its historical low of 6.5 per cent in April. The average number of hours worked has also increased, although it is still somewhat below its pre-pandemic level.

As the energy crisis fades, governments should roll back the related support measures promptly and in a concerted manner to avoid driving up medium-term inflationary pressures, which would call for a stronger monetary policy response. Fiscal policies should be designed to make our economy more productive and gradually bring down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, can also help reduce price pressures in the medium term. The reform of the EU's economic governance framework should be concluded soon.

Inflation

Inflation fell further to 6.1 per cent in May, according to Eurostat's flash estimate, from 7.0 per cent in April. The decline was broad-based. Energy price inflation, which had risen in April, resumed its downward trend and was negative in May. Food price inflation fell again but remained high at 12.5 per cent.

Inflation excluding energy and food declined in May for the second month in a row, to 5.3 per cent from 5.6 per cent in April. Goods inflation decreased further, to 5.8 per cent from 6.2 per cent in April. Services inflation fell for the first time in several months, from 5.2 per cent to 5.0 per cent. Indicators of underlying price pressures remain strong, although some show tentative signs of softening.

Past increases in energy costs are still pushing up prices across the economy. Pent-up demand from the reopening of the economy also continues to drive up inflation, especially in services. Wage pressures, while partly reflecting one-off payments, are becoming an increasingly important source of inflation. Compensation per employee rose by 5.2 per cent in the first quarter of the year and negotiated wages by 4.3 per cent. Moreover, firms in some sectors have been able to keep profits relatively high, especially where demand has outstripped supply. Although most measures of longer-term inflation expectations currently stand at around 2 per cent, some indicators remain elevated and need to be monitored closely.

Risk assessment

The outlook for economic growth and inflation remains highly uncertain. Downside risks to growth include Russia's unjustified war against Ukraine and an increase in broader

geopolitical tensions, which could fragment global trade and thus weigh on the euro area economy. Growth could also be slower if the effects of monetary policy are more forceful than projected. Renewed financial market tensions could lead to even tighter financing conditions than anticipated and weaken confidence. Also, weaker growth in the world economy could further dampen economic activity in the euro area. However, growth could be higher than projected if the strong labour market and receding uncertainty mean that people and businesses become more confident and spend more.

Upside risks to inflation include potential renewed upward pressures on the costs of energy and food, also related to Russia's war against Ukraine. A lasting rise in inflation expectations above our target, or higher than anticipated increases in wages or profit margins, could also drive inflation higher, including over the medium term. Recent wage agreements in a number of countries have added to the upside risks to inflation. By contrast, renewed financial market tensions could bring inflation down faster than projected. Weaker demand, for example due to a stronger transmission of monetary policy, would also lead to lower price pressures, especially over the medium term. Moreover, inflation would come down faster if declining energy prices and lower food price increases were to pass through to other goods and services more quickly than currently anticipated.

Financial and monetary conditions

Our monetary policy tightening continues to be reflected in risk-free interest rates and broader financing conditions. Funding conditions are tighter for banks and credit is becoming more expensive for firms and households. In April lending rates reached their highest level in more than a decade, standing at 4.4 per cent for business loans and 3.4 per cent for mortgages.

These higher borrowing rates, together with tighter credit supply conditions and lower loan demand, have further weakened credit dynamics. The annual growth of loans to firms declined again in April, to 4.6 per cent. The month-on-month changes have been negative on average since November. Loans to households grew at an annual rate of 2.5 per cent in April and increased only marginally month on month. Weak bank lending and the reduction in the Eurosystem balance sheet led to a continued decline in annual broad money growth to 1.9 per cent in April. Month-on-month changes in broad money have been negative since December.

In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. The financial stability outlook has remained challenging since our last review in December 2022. Tighter financing conditions are raising banks' funding costs and the credit risk of outstanding loans. Together with the recent tensions in the US banking system, these factors could give rise to systemic stress and depress economic growth in the short term. Another factor weighing on the resilience of the financial sector is a downturn in the real estate markets, which could be amplified by higher borrowing costs and a rise in unemployment. At the same time, euro area banks have strong capital and liquidity positions, which mitigate these financial stability risks. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities.

Conclusion

Inflation has been coming down but is projected to remain too high for too long. The Governing Council therefore today decided to raise the three key ECB interest rates by 25 basis points, in view of our determination to ensure that inflation returns to our two per cent medium-term target in a timely manner.

Our future decisions will ensure that the key ECB interest rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to our two per cent medium-term target and will be kept at those levels for as long as necessary. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, our interest rate decisions will continue to be based on 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.

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.

We are now ready to take your questions.

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Six weeks ago you provided a fairly similar guidance in your statement. In the press conference you said there's more ground to cover and the ECB is not pausing. My first question is that, if you have a similar guidance, are you willing to make the same comment in the press conference today? The second is, what lessons do you draw from the Fed's pause? I don't mean that you need to emulate the Fed; clearly, the ECB has its own policy. But I mean the reasons behind the pause, as quite a lot has been done. There needs to be an evaluation of the effects of policy tightening. So, do you see a reason for the ECB to contemplate a similar pause? Is there a risk that focussing on past projection errors could increase the risk of a policy error by the ECB?

On your first question, this meeting was the meeting of a Eurosystem projection exercise. So, we have looked very much at data. We have revised our projection. We essentially did what we said we would do: data dependent and using the three elements of our reaction function to determine what was the right decision today. That is the reason why we increased all three rates by 25 basis points. Are we done? Have we finished the journey? No, we're not at destination. Do we still have ground to cover? Yes, we have ground to cover. I can even go further than that: I can tell you that, barring a material change to our baseline, it is very likely the case that we will continue to increase rates in July, which probably doesn't come as a big surprise to you, but that's what I'm telling you. And this is so because we are determined to reach our target in a timely manner, and to continue to apply the principles that we have applied today: data dependency, the three elements of the reaction function, and moving meeting by meeting. Obviously, we are better informed at each projection meeting which happens, as you know, in June, in September and later.

To your second question: I don't know what difference to make between a pause and a skip. I have not studied enough the press conference of my friend and colleague, Mr

Powell. But as far as the ECB is concerned, I said what I said: we have hiked interest rates. Unless there was a material change to our baseline, we will continue to hike at our next meeting. So, we are not thinking about pausing, as you can tell.

I have two questions. I would like to ask you what do you need to see for core inflation actually coming down so it may give you the possibility to pause or to skip – or whatever you want to call it – in September? So, what needs to happen? Then I have a question on the financial conditions. You are saying that they are forcefully tighter. What would you make rethink that it's enough when it comes to tight financial conditions?

I wish I could give you the very simple answer where I say when we are there and when financing conditions are such, and the tightening has reached that level for corporates, for mortgages. But unfortunately, it doesn't work like that because what we know is the target that we have – which is price stability as defined by the 2% medium term – added to which we want to be confident that it stays at that target of 2%, which is why duration matters as well. But it is going to be a factor of those three elements that we will be looking at. So, it's the inflation outlook, which is every month, and every three months in particular, informed by all the new financial and economic data that we receive. It's the underlying inflation and the dynamics of it. I can assure you that we look at multiple cuts and subsets of inflation to arrive at what is the *corest* of the core. We don't limit our review at core; we go further than that. We look at [HICP] stripped, super stripped, PCCI. There's a whole variety of the prices and the inflation that we look at, and we need to see that. We need to be confident that it is heading down. For the moment, we have some of those measurements declining a bit, some of those sort of stable and others still going strongly.

The third component is the strength of transmission, which we measure at each and every step of the way from the market rates, bond prices, credit by banks, bank funding. And then to the economy, where we refer to the 4.4% and 3.4% [April bank lending rates to] corporate and households, because that's how it is transmitted. And ultimately to inflation. So, that's the path that we want to see delivering so that we head towards our target. That's what we have done, that's what we will do and we will stick to that methodology.

I was wondering: how alarmed are you about the upward revision to the 2025 inflation outlook? Does it mean that the 3.75% terminal rate that was generally expected – at least until recently – isn't going to be enough? Then secondly: you've alluded to the strength of the labour market and the impact that wages are having on inflation. Do you think you can achieve the 2% inflation target with unemployment remaining as low as it is now? Or does it have to go up?

So, your first question referred to the core inflation revision. We revised actually all three. We revised 2023 and 2024 and ultimately to 2.3% [in 2025] which moved by 0.1 from the previous projections [of 2.2%]. I think on the basis of that you can easily conclude that we are not satisfied with the results of that inflation outlook – which is only one of the three components that we look at. That is the reason why we are making the monetary policy decision that we make today, and why we are thinking that, unless there was a material change to the baseline, we would again hike interest rates in July. I don't want to comment about the terminal rate. This is what markets are considering.

The terminal rate is something that we will know when we get there because it is not what is driving our analysis and our deliberations. What is driving it is the ultimate destination, which is the 2% inflation. That's what we want and there are lots of components that come in to help us arrive at the 2% target.

We spent a lot of time on the labour market. We spent a lot of time because it is becoming one of the major components of the drivers of inflation. It was energy for a long time. To oversimplify: energy played a significant role, then food kicked in, and energy is now fading, has moved now in May and is in slightly negative territory. But labour, and wages in particular, is playing a significant role as a driver of inflation. It's quite extraordinary because there have been more people employed, the average hours have been up, wages are increasing – we had 5.2% growth for the first quarter in the compensation per employee –, and the output is where it is: stagnant. So, there is an issue of unit labour cost –in other words, productivity – which clearly has an impact on inflation as well. We will continue to really monitor and dissect as well as we can this entire enigma of the labour market – which is, as I said, playing a critical role.

It's especially important because many services which are playing a large part in our economy are labour-intensive, and wages in that respect play a key role. That is partly, by the way, the reason why we have – I was going to say upgraded, but it's not upgraded–, but why we have increased our projection for core inflation in both 2023 and 2024.

My first question: I was a bit surprised by how strong this revision of the core inflation projection was. Could you elaborate a bit on the reason? Is that all due to wages, wage expectations, or are there other reasons behind that? My second question is about the decision today. Was it unanimous? Could you maybe give us a bit of a flavour about the discussion?

On the first one, our revision to core inflation – I've started answering already in the previous question–, a lot of it is attributable to the unit labour cost. That's a large chunk of the revision. The rest is what you have in the monetary policy statement, which is past upward surprises. So, it's a different starting point, which is informed by data that came in after the last projection that we made in March. The latest data that we had in terms of inflation was from January. Now, things obviously changed between those January data and the May data that we have incorporated because we cut off on the 23 May[1]. I think that's a small part of it. The large part of it is the unit labour cost.

You asked me about the decision and the atmosphere. I have to tell you that it was quite a harmonious discussion and a very good and thorough economic discussion. As I said, we went really deep into the analysis of the labour market and tried to really understand the forces behind inflation to better fight it. It was a very, very broad consensus. By the way, I just want to remind that it was a twofold decision. It was, number one, the 25 basis points but it was also the decision, or the confirmation, that we would stop any reinvestment under the APP.

What does the ECB know about lag effects? What takes longer to transmit into the economy? What are you looking at more closely? The second question, about your targets. According to projections you do not expect to reach the inflation target in the next three years. Some economists suggest that this target

is no longer valid, that 3% will be the new 2%. What do you have to say about that?

We have a target. We have agreed on the target. We are in the middle of that fight against inflation and this is what we know. We're going to get to that 2% and we're going to reduce it to 2%. What happens next is another story, but we want to be at target and we want to be confident that it remains at target. So, the two elements are going to really drive our monetary policy going forward.

On the lag time: we know that there is lag time, that the decisions that we have made in the last soon-to-be-a-year – which are monumental, by all accounts, both in terms of speed, in terms of height, volume of hikes, if you will, and we are seeing some effects. We are seeing it in market rates. We are seeing it in banking, financing. We are seeing it in credit, both in volumes and in rates. There is some lag time – not that much by textbook standards, which will typically say that it's anywhere between 18 and 24 months, maybe a bit more. But because it is so unprecedented and such an exceptional situation, we really have to monitor that very carefully. Whether it is going to be faster, whether it is going to be a bit more slow because there has been variation in the terms of loans, for instance, to both corporates and mortgages and therefore the transmission is not operating as smoothly as it would if everything was at floating rates. All of that we are looking at extremely carefully to measure the transmission and see how fast it moves. Suffice to say that we are seeing it already. Do we see all of it? Obviously, no. We want to see it all the way down to inflation.

Two questions from me. Firstly, the Bank of Canada recently restarted its rate hikes, saying that the reason for this was that it thought the neutral rate had risen from its previous expectations. Do you think similarly? Is that part of the reason that you're continuing to raise rates and signal more rate rises are ahead? The second question is about whether the ECB could consider skipping rate rises, certain meetings, perhaps going to only changing policy when you're issuing forecasts – similarly to the Fed's pause or skip yesterday.

It's difficult to say whether we're in the same position as the Bank of Canada because we did not pause. So, in a way we don't have to ask ourselves whether we are at neutral rate or not. We believe that we have ground to cover. So, we are not where we want to be if we want to reach our target. In terms of having to pause or having to skip: as I said, number one, we have not discussed it at all and we have not begun thinking about it because we have work to do.

I have two questions. The first question is: today you confirmed, repeated, that rates will be kept at the restricted levels for as long as necessary. Because inflation will be above 2% in 2025, we can expect restrictive rates for long. How is the Governing Council concerned that you're going far and you, at the same time, would like to avoid unnecessarily harming economic activity? How far do you look at growth weakening in response to your policies? Then a second question regards this June. That is a historical month for the ECB; the €477 billion repayment of TLTROs is seen as the biggest daily reduction of the ECB balance sheet. On the top this June is also the last month of APP reinvestments. So, what is the impact of these two unprecedented events in the ECB on tightening of financing and monetary conditions?

I thought you were going to say that it's an important month because we are celebrating our 25th anniversary – which was also the date when the ECB was opened first on the ground here in Frankfurt. As I said, the objective that we have is very clear. The destination we know. The journey to get there is not over and we have ground to cover. So, we will be as restrictive as long as needed in order to make sure that we reach that destination. Under the current parameters, 2.2% in 2025 is not satisfactory and it's not timely – which is why we are making the decisions that we are making today, and later on. At the end of June banks will reimburse €477 billion that they had borrowed under TLTRO, which was this very special facility that we had put in place to help the financing of the economy at the time of the pandemic.

Those loans were granted for periods of three years and there were various operations in the course of the pandemic. The repayment which is coming due now, is known and has been known for a long time. Actually it was so well-known that it should have been a lot higher than that but we took measures in order to avoid that we had this sort of cliff effect of a massive reimbursement which would have exceeded €1 trillion. But banks know about it, they have known about it. They have done their funding plans in order to respond to the situation. In any event, we have the normal facilities available, whether it's MRO or LTRO if that was ever needed, just in case.

The APP reinvestment will be completed at the end of June, and we will let run-off take place as of July. We have experienced that partial reinvestment now for a few months because it was decided back in March. It has been well-absorbed by markets. We have not observed any disruption. Given the amounts that we are talking about, we have reasons to believe that it should be absorbed also in a smooth manner. But, of course, we will be very attentive. We will look at this process. We will, as I said, always have the means to take action and to use all the tools that we have available if it was needed.

You've touched on the problem of the wage increases. At your speech at the European Parliament, you touched on the problem of corporate profits. If you take these both together, how confident are you that the relevant parties actually start to be more moderate on this, in particular as both of them start to criticise that interest rates are already too high? The second question: I'm also a bit puzzled about the real severity and persistency of this core inflation. May I ask you as well, please, to elaborate a little bit more where the Governing Council sees the reason for this really strong persistence?

The labour market situation and the employment situation is the good news in Europe, and we have never seen the unemployment rate be so low. Actually in our forecast we see the unemployment rate go from this 6.5% that we have now, to 6.3%. We see the level of unemployment continuing to decline. We also see wages continuing to increase in the future. Now, you really asked me specifically the question of whether corporations and labour – and I'm using that term in a generic, comprehensive way – will find the terms under which they don't contribute to fuelling even more inflation that would call on us to take harder monetary policy measures. This is the assumption that we make. I think economically it is justifiable, it is rational, but of course humans are humans. It's going to be for the parties around the table to actually determine what they do going forward in terms of allocating profits and organising these social relationships. What they can be certain of in their discussion is that the European Central Bank will take all

necessary measures to return inflation to 2%. That, they can count on, and we are confident that we will get there so I hope it helps in their deliberation going forward.

The persistency of inflation, as I said, has a lot to do with this unit labour cost that I have mentioned earlier on. This is really the strong – I don't want to use sticky component, because it is going to be persistent, and we know it. Numbers will continue to be high in the months to come, by the way, because we believe that services are going to continue to grow strongly. Labour-intensive services will. Contact-intensive services will continue to grow strongly. We're heading into the summer: all the summer activities, whether it's transportation, whether it's hospitality, whether it's vacation, all of that is going to go well. So, that persistence is to be expected in the short run. There will be remaining persistency going through into 2024. It declines in 2025 and we have not revised upwards significantly for 2025 because we believe that other elements will kick in, which will reduce inflation numbers – unless risks were to materialise.

But under the baseline, the indirect effect of energy costs will continue to fade. You can still find them in prices, but it is going to gradually fade out. The same goes for food. We expect the persistence of inflation to gradually fade away. As much as it persists, we will persist.

You have delivered quite a strong message about wages, and I'm a little bit scared. Has the risk of an inflation spiral increased since March? The second question about the projections: if 2025 is not acceptable, do we need to see 2% inflation in 2024 for the ECB to consider that the objective will be achieved in a timely manner? Or what is exactly a timely manner?

Well, first of all on wages: we are not seeing second round effects. We're not seeing this wage price spiral. The only thing that I'm trying to say here is that we have to avoid what I have called the tit-for-tat where, in response to inflation, both corporates and labour want to receive full compensation – which obviously would possibly lead to that second-round effect that I was alluding to. Obviously, the sooner the better in terms of when do we bring inflation back to 2%? We have to be also realistic, and we have to be measured in the response that we give, but very determined in the delivery of those measures, and persistent.

You said that wages are having a huge impact on inflation on one side, and on the other side you say that there is no wage price spiral. So, it's not really clear to understand. Can you maybe give us an explanation on how you can come to this conclusion?

We just all wish that everything was clear and simple, wouldn't we? What I said – and thank you very much for your question – is that unit labour cost, which is slightly different from wages, negotiated wages, however you want to measure it– is having an impact, or it is rather causing the revision of core inflation projection. That's what I'm saying. You can certainly have that projection and at the same time acknowledge that today we are not seeing any spiralling of wages and prices that would cause this second-round effect that we would be very concerned about.

You said that the financial markets are not feeling the impact of the balance sheet reduction. Do you expect to, from July onwards, have room to reduce it further?

Well, two things. The TLTRO reimbursement that is falling due at the end of June, which was anticipated, known by all parties involved, is taking place at the end of June. It will, as a result, reduce the balance sheet of the ECB by €477 billion. The second part of the decision that we made today was to stop reinvesting redemptions under APP, and let APP move into a run-off mode. That's all we decided. That means that, for instance, the PEPP continues as it was indicated in the only part of forward guidance that we still have in our monetary policy, which is until 2024 we continue the reinvestment and we apply flexibility if, and where, it is needed. There is no plan to change that.

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[1] The cut-off date for technical assumptions, such as those for oil prices and exchange rates, was 23 May 2023. The projections for the global economy were finalised on 23 May and the macroeconomic projections for the euro area were finalised on 31 May 2023.