MONETARY POLICY STATEMENT

Frankfurt am Main, 14 December 2023

PRESS CONFERENCE

Christine Lagarde, President of the ECB,
Luis de Guindos, Vice-President of the ECB

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

The Governing Council today decided to keep the three key ECB interest rates unchanged. While inflation has dropped in recent months, it is likely to pick up again temporarily in the near term. According to the latest Eurosystem staff projections for the euro area, inflation is expected to decline gradually over the course of next year, before approaching our two per cent target in 2025. Overall, staff expect headline inflation to average 5.4 per cent in 2023, 2.7 per cent in 2024, 2.1 per cent in 2025 and 1.9 per cent in 2026. Compared with the September staff projections, this amounts to a downward revision for 2023 and especially for 2024.

Underlying inflation has eased further. But domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs. Eurosystem staff expect inflation excluding energy and food to average 5.0 per cent in 2023, 2.7 per cent in 2024, 2.3 per cent in 2025 and 2.1 per cent in 2026.

Our past interest rate increases continue to be transmitted forcefully to the economy. Tighter financing conditions are dampening demand, and this is helping to push down inflation. Eurosystem staff expect economic growth to remain subdued in the near term. Beyond that, the economy is expected to recover because of rising real incomes – as people benefit from falling inflation and growing wages – and improving foreign demand. Eurosystem staff therefore see growth picking up from an average of 0.6 per cent for 2023 to 0.8 per cent for 2024, and to 1.5 per cent for both 2025 and 2026.

We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. Based on our current assessment, we consider that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. Our

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future decisions will ensure that our policy rates will be set at sufficiently restrictive 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 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 key ECB interest rates are our primary tool for setting the monetary policy stance. We also decided today to advance the normalisation of the Eurosystem's balance sheet. The Governing Council intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the pandemic emergency purchase programme (PEPP) during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

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 contracted slightly in the third quarter, mostly owing to a decline in inventories. Tighter financing conditions and subdued foreign demand are likely to continue weighing on economic activity in the near term. Prospects are especially weak for construction and manufacturing, the two sectors most affected by higher interest rates. Services activity is also set to soften in the coming months. This is due to spillovers from weaker industrial activity, fading effects from the reopening of the economy and the broadening impact of tighter financing conditions.

The labour market continues to support the economy. The unemployment rate stood at 6.5 per cent in October and employment grew by 0.2 per cent over the third quarter. At the same time, the weaker economy is dampening the demand for workers, with firms advertising fewer vacancies in recent months. Moreover, even though more people are in work, the total number of hours worked edged down by 0.1 per cent in the third quarter.

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As the energy crisis fades, governments should continue to roll back the related support measures. This is essential to avoid driving up medium-term inflationary pressures, which would otherwise call for even tighter monetary policy. Fiscal policies should be designed to make our economy more productive and to gradually bring down high public debt. Structural reforms and investments to enhance the euro area's supply capacity – which would be supported by the full implementation of the Next Generation EU programme – can help reduce price pressures in the medium term, while supporting the green and digital transitions. To that end, it is important to swiftly agree on the reform of the EU's economic governance framework. Moreover, it is imperative that progress towards Capital Markets Union and the completion of Banking Union be accelerated.

Inflation

Inflation dropped over the past two months, falling to an annual rate of 2.4 per cent in November according to Eurostat's flash release. This decline was broad-based. Energy price inflation fell further and food price inflation also came down, despite remaining relatively high overall. This month, inflation is likely to pick up on account of an upward base effect for the cost of energy. In 2024, we expect inflation to decline more slowly because of further upward base effects and the phasing-out of past fiscal measures aimed at limiting the repercussions of the energy price shock.

Inflation excluding energy and food dropped by almost a full percentage point over the past two months, falling to 3.6 per cent in November. This reflects improving supply conditions, the fading effects of the past energy shock and the impact of tighter monetary policy on demand and on the pricing power of firms. The inflation rates for goods and services fell to 2.9 per cent and 4.0 per cent respectively.

All measures of underlying inflation declined in October, but domestic price pressures remained elevated, chiefly because of strong wage growth together with falling productivity. Measures of longer-term inflation expectations mostly stand around 2 per cent, with some market-based indicators of inflation compensation declining from elevated levels.

Risk assessment

The risks to economic growth remain tilted to the downside. Growth could be lower if the effects of monetary policy turn out stronger than expected. A weaker world economy or a further slowdown in

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global trade would also weigh on euro area growth. Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East are key sources of geopolitical risk. This may result in firms and households becoming less confident about the future. Growth could be higher if rising real incomes raise spending by more than anticipated, or the world economy grows more strongly than expected.

Upside risks to inflation include the heightened geopolitical tensions, which could raise energy prices in the near term, and extreme weather events, which could drive up food prices. Inflation could also turn out higher than anticipated if inflation expectations were to move above our target, or if wages or profit margins increased by more than expected. By contrast, inflation may surprise on the downside if monetary policy dampens demand by more than expected or the economic environment in the rest of the world worsens unexpectedly, potentially owing in part to the recent rise in geopolitical risks.

Financial and monetary conditions

Market interest rates have fallen markedly since our last meeting and lie below the rates embedded in the staff projections. Our restrictive monetary policy continues to transmit strongly into broader financing conditions. Lending rates rose again in October, to 5.3 per cent for business loans and 3.9 per cent for mortgages.

Higher borrowing rates, subdued loan demand and tighter loan supply have further weakened credit dynamics. Loans to firms declined at an annual rate of 0.3 per cent in October and loans to households also remained subdued, growing at an annual rate of 0.6 per cent. With weaker lending and the reduction in the Eurosystem balance sheet, broad money – as measured by M3 – has continued to contract. In October it fell at an annual rate of 1.0 per cent.

In line with our monetary policy strategy, the Governing Council thoroughly assessed the links between monetary policy and financial stability. Euro area banks have demonstrated their resilience. They have high capital ratios and have become significantly more profitable over the past year. But the financial stability outlook remains fragile in the current environment of tightening financing conditions, weak growth and geopolitical tensions. In particular, the situation could worsen if banks’ funding costs were to increase by more than expected and if more borrowers were to struggle to repay their loans. At the same time, the overall impact of such a scenario on the economy should be contained if financial markets react in an orderly fashion. Macroprudential policy remains the first line of defence against the build-up of financial vulnerabilities, and the measures in place contribute to preserving the financial system’s resilience.

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Conclusion

The Governing Council today decided to keep the three key ECB interest rates unchanged. We are determined to ensure that inflation returns to our two per cent medium-term target in a timely manner. Based on our current assessment, we consider that rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to our target. Our future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary to ensure such a timely return. We will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

The Governing Council intends to reduce the PEPP portfolio over the second half of 2024 and to discontinue its reinvestments under the PEPP at the end of 2024.

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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