Christine Lagarde: Introductory statement - European Parliament plenary debate on the ECB Annual Report

Introductory statement by Ms Christine Lagarde, President of the European Central Bank, at the plenary session of the European Parliament, Strasbourg, 14 February 2022.

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Today's debate is an important pillar of the ECB's accountability relationship with this Parliament. It is crucial for the ECB to explain its actions to the public, and to you as their elected representatives. But, as I have said before, we need to be equally focused on listening. It is in this spirit that I have read your Report and I look forward to hearing your views during today's debate.

I will first outline our view of the current economic situation in the euro area and explain our monetary policy stance. I had the opportunity to discuss these issues last week in the context of the regular dialogue with the Committee on Economic and Monetary Affairs (ECON). I will then briefly discuss how the ECB's new strategy addresses some of the key points described in your Report, and ensures that our monetary policy strategy is fit for purpose, both today and in the future.

The euro area economy and the ECB's monetary policy

Recent data confirm that quarterly growth slowed to 0.3 per cent in the final quarter of 2021, which still allowed gross domestic product (GDP) to recover to its pre-pandemic level. The moderation in growth momentum has resulted mainly from the rapid spread of the Omicron variant. The associated containment measures have dampened activity, particularly in consumer services such as travel, tourism, hospitality and entertainment.

The current pandemic wave and associated restrictions are likely to continue to have a negative impact on growth at the start of this year. Two other factors, namely supply bottlenecks and high energy costs, are also expected to dampen economic activity in the near term.

However, the economic impact of the current pandemic wave appears to be less damaging to activity than previous ones. Moreover, the aforementioned bottlenecks will still persist for some time, but there are signs that they may be starting to ease. This will allow the economy to pick up strongly again later this year.

Inflation has risen sharply in recent months and it further surprised on the upside in January, with the rate increasing to 5.1 per cent from 5.0 per cent in December. Inflation is likely to remain high in the near term. Energy prices – as you also highlight in your Report – continue to be the main reason for the elevated rate of inflation. Their direct impact accounted for over half of headline inflation in January and energy costs are also pushing up prices across many sectors. Food prices have also increased, owing to seasonal factors, elevated transportation costs and the higher price of fertilisers. In addition, price rises have become more widespread, with the prices of a large number of goods and services having increased markedly.

Financing conditions for the economy have remained favourable. While market interest rates have increased since December, bank funding costs have so far remained contained. Bank lending rates to firms and households continue to stand at historically low levels.

Turning to the risk assessment, we continue to see the risks to the economic outlook as broadly balanced over the medium term. Uncertainties related to the pandemic have abated somewhat. At the same time, geopolitical tensions have increased and persistently high costs of energy could exert a stronger than expected drag on consumption and investment. The pace at which supply bottlenecks are resolved is also a further risk to the outlook for growth and inflation. Compared with our expectations in December, risks to the inflation outlook are tilted to the upside, particularly in the near term. If price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher.

In a few weeks, the March ECB staff projections will provide an updated assessment, taking the most recent data into account. This will help the Governing Council better appraise the implications of the surprisingly high December and January inflation figures for the medium-term outlook.

In particular, we will carefully examine how higher energy prices will transmit through the economy and affect the outlook overall. Two channels could be at play, pulling inflation dynamics in different directions. On the one hand, rising energy costs can drive up prices directly, by increasing the cost of production, as well as indirectly, by having second-round effects on wages. On the other hand, they can have a negative impact on the incomes of households and the earnings of companies, thereby reducing economic activity and dampening the inflation outlook. In the past, the euro area has been particularly vulnerable to the second channel, as surges in energy prices weakened the spending power of households, and reduced inflation over the medium term.

Obviously, in our assessment of the inflation outlook, we have to bear in mind that demand conditions in the euro area do not show the same signs of overheating that can be observed in other major economies. This increases the likelihood that the current price pressures will subside before becoming entrenched, enabling us to deliver on our two per cent target over the medium term.

Indeed, while moving up over recent months, indicators of longer-term inflation expectations are consistent with this expectation. Survey-based measures point to inflation returning to two per cent by 2023 and remaining close to this level thereafter; and market-based indicators stabilise around levels somewhat below two per cent. The solid anchoring of long-term inflation expectations in the euro area – which you also acknowledge in your Report – is a reassuring development, coming after a long period when they were subdued.

To sum up, the euro area economy has continued to recover, although growth is expected to remain subdued in the first quarter. While the outlook for inflation is uncertain, it is likely to remain elevated for longer than previously expected, but to decline in the course of this year.

In the Governing Council meeting earlier this month, we confirmed the decisions we took in December. Accordingly, we will continue reducing the pace of our asset purchases step by step over the coming quarters, and will end net purchases under the pandemic emergency purchase programme at the end of March.

In view of the current uncertainty, we need more than ever to maintain flexibility and optionality in the conduct of monetary policy. Our monetary policy is always data-dependent, and this is all the more important in the situation that we are facing at the moment. We will remain attentive to the incoming data and carefully assess the implications for the medium-term inflation outlook.

Those implications are key parameters in our forward guidance. Our forward guidance has several dimensions. There is a defined sequencing between the end of our net asset purchases and the lift-off date. A rate hike will not occur before our net asset purchases finish. Moreover, there are three conditions that will have to be met before the Governing Council feels sufficiently confident that a tilt in our policy rate is appropriate. All the three conditions are meant as safeguards against a premature increase in interest rates. Finally, any adjustment to our policy will be gradual.

Making our monetary policy strategy fit for purpose, both today and in the future

Let me now turn to the topic of how we are making our monetary policy strategy fit for today, as well as future challenges.

Last year, the ECB and the Eurosystem concluded their first strategy review in almost two decades. I would like to reiterate my gratitude to the ECON Committee for its valuable input, and I am very pleased to read in your Report that you welcome the outcome.

Our new strategy will ensure we have a strong foundation to guide us in the conduct of monetary policy in the years to come. We are now working hard to put it into practice. I will briefly discuss three areas highlighted in your Report in which the review is having an impact on our daily work.

The first area is how we take our monetary policy decisions.

In your Report, you highlight the importance of ensuring the necessity, suitability and proportionality of all our monetary policy measures. Indeed, before taking any decision the Governing Council conducts a careful evaluation of the effectiveness, efficiency and proportionality of its actions, including their potential side effects, based on an integrated assessment of all relevant factors. This assessment builds on a revised analytical framework which brings together the economic analysis and the monetary and financial analysis.

Our new strategy also recognises financial stability as a precondition for price stability and vice versa. In line with this, we undertook our first in-depth assessment of the interrelation between monetary policy and financial stability at our December meeting and we will continue to do so twice a year going forward.

The second area is how we account for the impact of climate change.

I am pleased that your Report welcomes our action plan on how to incorporate climate change considerations in our monetary policy framework. And I am equally pleased to tell you that the implementation of the climate change action plan is on track.

The milestones for 2022 include a detailed plan for disclosure requirements in the collateral framework and asset purchases, a pilot stress test on the Eurosystem balance sheet, and proposals to adapt the framework of our corporate bond purchase programmes.

We are also working together with other central banks across the euro area on new exploratory climate-related statistical indicators and we are adapting our macroeconomic models. Integrating climate-related indicators and risks is essential to better understand how climate change is affecting the economy, the inflation outlook, monetary policy transmission and financial stability.

The third area is how we communicate and engage with the people we serve, and whom you represent.

Good communication is crucial for our policy, for our credibility and for the trust people have in us. But communicating well to different audiences is challenging, in particular in the euro area. I welcome that the Report encourages us to make further progress on this front.

Our aim is to ensure that markets, elected representatives like yourselves, and the wider public better understand how we reach our decisions, the reasons behind these decisions, and how these decisions affect people's daily lives. In other words, we need to be clear about what we call the "three A's".

First, we must be clear about our aim. Our new symmetric inflation target of two per cent over the medium term is simple, clear and easy to convey to the wider public.

Second, we must be clear about our assessment. We need to clearly explain how we process incoming economic and financial data, what we judge to be short-term movements, and what we consider influential factors relevant for our medium-term horizon.

Third, we must be clear about our actions. Our audience should be able to understand what we are trying to achieve with our measures, as well as why they are effective, efficient and remain proportionate to our aim.

Clearly communicating these three A's to different audiences often means being more simple and straightforward. But being more simple does not mean being simplistic. It means being more inclusive when we talk. Following on from our strategy review, we are using clearer, more narrative-driven language, together with visuals people can relate to.

Finally, in all our communication, we need to be open about what we *can* and *cannot* do as a central bank. For example, our monetary policy cannot fill pipelines with gas, clear backlogs at ports or train more lorry drivers.

Conclusion

Let me conclude.

We are very aware that many people across the euro area are concerned about the rising cost of living at the moment – as you also highlight in the Report. And the burden is primarily borne by those with lower incomes, who must face the day-to-day hardship of having to cope with higher prices.

We remain committed to delivering on our price stability mandate – as we have done over the past 20 years. Our target is an inflation rate of 2 per cent over the medium term. To achieve this, we will take action at the right time.

But it is also our task to openly engage with people's concerns with regards to monetary policy. As I said when I first spoke to you here two years ago, the ongoing dialogue between the ECB and the European Parliament is the key channel for this. Independence and accountability are two sides of the same coin for the ECB: one cannot exist without the other.

With that in mind, I look forward to our exchange this afternoon, and to the final resolution on the ECB's Annual Report.