EDITORIAL

ECB: TOUGH TALK AND PUZZLING PROJECTIONS

During the press conference following the latest governing council meeting, Christine Lagarde insisted repeatedly that moving to a 50 bp rate hike versus 75 bp previously did not represent a pivot, adding that rates still have to rise significantly and at a steady pace. Consequently, the likelihood of a terminal rate higher than 3.00% has increased, which explains the jump in bond yields. The large upward revision of the inflation projections is probably another factor behind the hawkish message. Forecasting inflation several years into the future is a difficult task, even more so in the current environment. It will be interesting to see how the governing council will strike a balance between reacting to inflation data, once they have started to decline, and focusing on the ECB's medium-term inflation projections in setting its policy.

The latest press conference following the ECB's governing council meeting brought tough talk. In the word cloud (chart 1), the 'usual suspects' again take a central position -inflation, rates, energy, etc.- but there are some notable others -will, steady, pace- that reflect the determination to send a strong message. 'Significant' or 'significantly' appear 16 times in the comments of Christine Lagarde, who also mentioned 'steady' 13 times. Policy rates will continue to move higher because the monetary stance needs to become sufficiently restrictive to bring inflation back to the two percent medium-term target[1]. The repeated insistence on 'steady pace' of raising the policy rates can be considered as a near-term forward guidance, despite the usual insistence on a data-dependent, meeting-by-meeting approach. Having in mind what was said at last week's press conference, one should expect further 50 basis points rate hikes at the next two meetings -2 February 2023, 16 March 2023-, whereby the latter will be particularly important, considering that new staff projections will be published on that occasion. As mentioned by the ECB president, "*On the issue of interest rates, we will be looking at data. We will be data-dependent, and we will review data, particularly when we have projection meetings that are every three months or so*[2]." Under the assumption that at the March 2023 governing council meeting, the deposit rate would be hiked to 3.00%[3] , this meeting might see a change in language, which would become less hawkish, provided that inflation projections would have been revised downwards. Such a change would be considered by markets as a pivot, a clear change in policy orientation, whereby possible additional moves beyond 3.00% would come in smaller steps and more slowly. At the current juncture, the conditions for such a pivot are not met and on four occasions during the press conference, Christine Lagarde insisted that the ECB was not pivoting. It was a clear effort to avoid that markets would draw the wrong conclusion from moving from 75 bp increases previously to 50 bp. Undoubtedly the hawkish tone -the repeated reference to a sustained pace of tightening- serves the same purpose.

Another factor that has played an important role in the messaging is the large upward revision of the inflation projections, by 0.3 percentage points (pp) in 2022, 0.8 pp in 2023 and 1.1 pp in 2024. At first glance, there is something puzzling about the extent of the upward revision. Compared to the September projections, there are several areas of improvement: lower oil, gas and electricity price assumptions, a faster easing of supply bottlenecks, the recent appreciation of the euro, a weaker growth outlook. The impact of these factors is however dominated by *"recent data surprises, a reassessment of the strength and persistence of pipeline price pressures and their pass-through, stronger wage growth and higher food commodity prices.*[4]"

1. "*In particular, we judge that interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target.*" (Source: ECB, Monetary policy statement and press conference, Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, 15 December 2022.
2. Source: see footnote 1.
3. Following last week's meeting, the current level is 2.00%.

4. Source: ECB, Eurosystem staff macroeconomic projections for the euro area, 15 December

WORD CLOUD OF THE ECB PRESS CONFERENCE OF 15 DECEMBER 2022

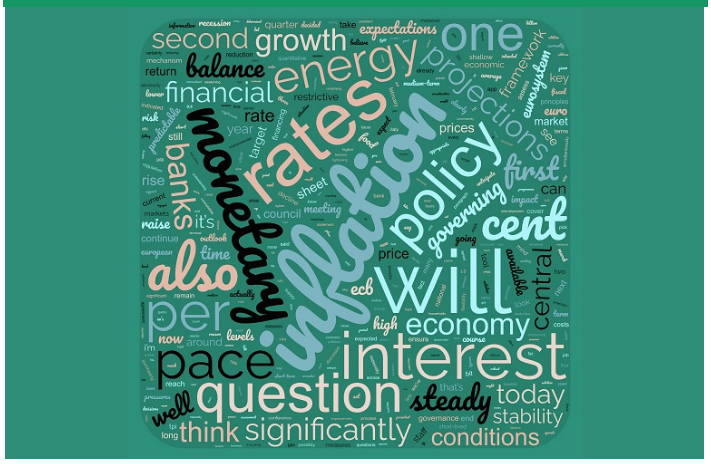

CHART 1 SOURCE: ECB, WORDCLOUDS.COM, BNP PARIBAS

> At a time when forecasting inflation is more difficult than ever, having good forecasts is more important than ever when they are a key input in determining the appropriate level of monetary restraint.

Headline inflation, after dropping in 2023, would stabilise in 2024, but stay above the ECB's target, before declining again in 2025, when it would reach the ECB's 2% inflation target in the second half of that year (chart 2). Core inflation would remain above this target for the entire forecast horizon, which runs until the end of 2025.Forecasting inflation several years into the future is a difficult task. A Bundesbank research paper of 2018[5] has shown that for the euro area, consensus forecasts of inflation are informative up to a horizon of 3 to 5 quarters. The authors nevertheless argue that "*despite what our results say, it can make sense to produce macroeconomic projections for three years ahead, as the Eurosystem does*." However, over longer horizons "*the projections should be regarded less as forecasts and more as scenario analyses which shed light on the interrelationships influencing economic developments*." This point seems very relevant in the current environment, where inflation is the result of multiple supply and demand shocks that make it very challenging to assess the pass-through of these shocks but also to assess how fast it will react to monetary policy tightening and an economic downturn. It will be interesting to see how the governing council will strike a balance between reacting to inflation data, once they have started to decline, or focusing on the ECB's medium-term inflation projections in setting its policy. At a time that forecasting inflation is more difficult than ever, having good forecasts is more important than ever when they are a key input in determining the appropriate level of monetary restraint.

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ECB PROJECTION OF EUROZONE HICP

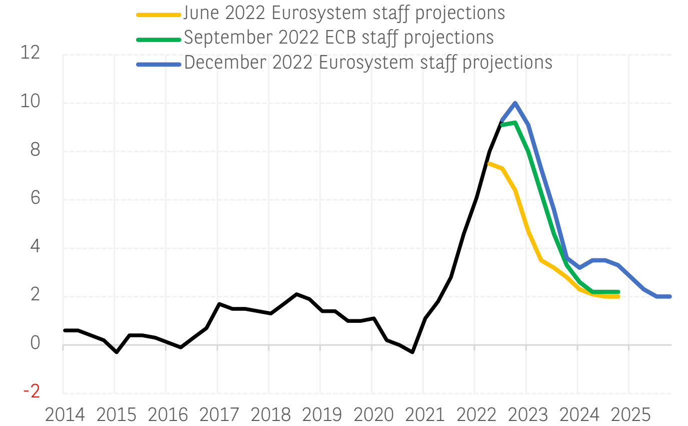

CHART 2

SOURCE: EUROSTAT, ECB, BNP PARIBAS

2022. In addition, "new fiscal measures decided since the September 2022 projections, most of which aim at reducing energy price increases in 2023, dampen the upward revision to inflation in 2023, but contribute significantly to the upward revision in 2024 as many of the measures expire."

5. Jörg Breitung and Malte Knüppel, The trouble with predictions, Deutsche Bundesbank research brief, April 2018.

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