EUROPEAN CENTRAL BANK

EUROSYSTEM

**ECB-PUBLIC**

*COURTESY TRANSLATION*

Christine LAGARDE
President

Mr Marco Zanni
Mr Valentino Grant
Mr Antonio Maria Rinaldi
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 18 April 2023

L/CL/23/91

**Re: Your letter (QZ-003)**

Honourable Members of the European Parliament, dear Mr Zanni, dear Mr Grant, dear Mr Rinaldi,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 1 March 2023.

Regarding your question on the causes of high inflation in the euro area, multiple factors play a role. The surge in inflation that started in 2021 was mainly driven by the large global shock to commodity prices, in particular energy commodities, which was exacerbated by Russia's unjustified war against Ukraine. In addition, imbalances in supply and demand – resulting from global supply bottlenecks and the reopening of our economies after the coronavirus (COVID-19) pandemic – added to inflationary pressure. More recently, headline inflation decreased as energy inflation fell sharply. But underlying price pressures for food and core inflation remain strong because the lagged effects of the past surge in commodity prices, supply bottlenecks and earlier energy cost shocks are still reverberating through the economy. Service prices are also still subject to some upward pressure resulting from pent-up demand linked to the reopening of the economy and rising wages.

Although many of the macroeconomic shocks affecting the euro area are global, the specific impact differs across regions, depending on economic structure, energy dependency, and position in the business cycle. In both the euro area and the United States, the increase in inflation was driven by supply bottlenecks, higher energy prices, and higher wage growth owing to tight labour markets. However, labour market dynamics have been stronger in the United States.

There were also differences between the United States and the euro area in terms of fiscal response to the pandemic and exposure to the energy commodity price shock. In the euro area, fiscal measures to mitigate the economic impact of the pandemic were comparatively small and more targeted, while the economic recovery after the pandemic shock has also been slower and more gradual. At the same time, the euro area is more dependent on energy imports than the United States and, therefore, the surge in commodity prices resulted in a strong terms-of-trade shock, which pushed up inflation.[1]

On inflation developments in both regions in recent months, headline inflation rates in the euro area have surpassed those in the United States, which peaked in the summer of 2022. The higher headline inflation rates in the euro area continue to be driven by high food and energy prices to a greater degree than in the United States, while core inflation stands at comparable levels in both regions. Our March macroeconomic projections anticipate near-term headline inflation remaining higher in the euro area than in the United States, mainly because of higher food and energy inflation. Core inflation is expected to stay at similar levels in both regions. As for the monetary policy response to high inflation, each central bank has followed a monetary policy tightening approach geared towards fulfilling its respective mandate in the light of the economic conditions prevailing in its own currency area. In our case, the policy adjustments made since December 2021 have been calibrated to ensure that inflation in the euro area returns to our 2% medium-term target in a timely manner, in line with our primary objective of maintaining price stability in the euro area.

Regarding your question about the impact that increased interest rates have on the financial conditions of households and businesses, the data show that the first leg of the monetary transmission process – from policy measures to financing and monetary conditions – is already having a substantial impact. The cost of borrowing has increased significantly, and loan dynamics look to be reacting faster than during previous hiking cycles. For the second leg of the transmission process – from tighter financing and monetary conditions to demand – there is currently more uncertainty. We know that the full effect of monetary policy on demand will only reveal itself over time. While more restrictive credit conditions are part of the mechanism by which our tightening ultimately reins in excess price pressures and brings inflation back to target, we will make sure that the process will be orderly throughout.

Yours sincerely,

[signed]

Christine Lagarde

[1] For a full comparison, see the box entitled “Inflation developments in the euro area and the United States”, *Economic Bulletin*, Issue 8, ECB, 2022, available at: https://www.ecb.europa.eu/pub/economic-bulletin/focus/2023/html/ecb.ebbox202208_01~c11d09d5fd.en.html.

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