EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

Christine LAGARDE
President

Mr Rasmus Andresen
Mr Bas Eickhout
Ms Henrike Hahn
Mr Ville Niinistö
Mr Ernest Urtasun
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 17 November 2023

L/CL/23/189

Re: Your letter (QZ-021)

Honourable Members of the European Parliament, dear Mr Andresen, Mr Eickhout, Ms Hahn, Mr Niinistö and Mr Urtasun,

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 26 July 2023.

Regarding our recent monetary policy decisions and their economic implications, inflation in the euro area dropped markedly in October, to 2.9%, from 4.3% in September and from 10.6% in October 2022. Most measures of underlying inflation have continued to ease, supported by improving supply conditions, the pass-through of previous declines in energy prices and the impact of tighter monetary policy on demand and corporate pricing power. Core inflation fell to 4.2% in October, from 4.5% in September. However, latest inflation declines partly owed to so-called base effects (in energy and food inflation) and domestic price pressures remain strong.[1] Inflation is still expected to stay above our 2% target for an extended period.

[1] The base effect can be defined as the contribution to the change in the year-on-year inflation rate in a particular month that stems from a deviation of the month-on-month rate of change in the base month (i.e. the same month one year earlier) from the usual seasonal pattern. For the latest estimations for energy and food inflation base effects, see Chart 5 in the September 2023 ECB staff macroeconomic projections for the euro area, available at: https://www.ecb.europa.eu/pub/projections/html/ecb.projections202309_ecbstaff~4eb3c5960e.en.html.

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As inflation is still expected to remain too high for too long, sufficiently restrictive interest rate levels are required for as long as necessary to achieve a timely return of inflation to our 2% medium-term target. Higher policy rates have increased the cost of funding, notably for banks, and thus the cost of borrowing for households and firms, which is reducing the amount that people and businesses spend and invest. The resulting dampening of aggregate demand puts downward pressure on inflation and ensures that inflation expectations remain anchored at our target.

As regards the impact of the monetary policy stance on climate-related investment, while the higher interest rates have also affected the cost of capital for green energy projects, ensuring price stability over the medium term and anchoring inflation expectations is the best contribution monetary policy can make to sustainable medium-term economic growth and job creation. This, in turn, supports investment dynamics, including the substantial investments in renewable energy and energy efficiency that are needed for the green transition. Leaving inflation unaddressed at too high a level puts a large burden on many households and firms, and risks potentially unanchoring inflation expectations and pushing up risk premia on long-term interest rates as lenders seek protection against higher future inflation. This would have severe consequences for both investment dynamics and the economy more broadly.

Let me also recall that parliaments and governments bear the primary responsibility for addressing climate change, and have much more powerful tools to do so than central banks. Increasing investment in renewable energy is key to keeping the green transition on track, and here governments are making progress. The European Union is already issuing Next Generation EU green bonds worth up to €250 billion and is committed to spending at least 30% of its 2021-27 budget on climate actions through the European Green Deal. Global investment in renewable energy is picking up, with solar energy, for example, now receiving more investment than oil production.[2]

The measures that the ECB is taking to incorporate climate change considerations into its monetary policy are necessary for the Eurosystem to effectively manage the climate-related financial risks to which it is exposed when holding certain assets – in particular corporate bonds – or when lending against collateral. Such measures are fully in line with our primary objective of maintaining price stability.[3] In addition, and without prejudice to that primary objective, the measures also serve our secondary objective as laid down in Article 3 of the Treaty on European Union[4] and support the green transition of the economy in line with the EU's climate-neutrality objectives. As the ECB may only support general economic policies without prejudice to the price stability objective, its secondary objective is hierarchically subordinate to the objective of maintaining price stability. For example, climate-related targets for corporate asset holdings can only be without prejudice to the ECB's primary objective, being conditional on and hence constrained by it.

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[2] See IEA, *World Energy Investment*, May 2023, available at: https://www.iea.org/reports/world-energy-investment-2023.

[3] See Article 127(1) of the Treaty on the Functioning of the European Union, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A12012E%2FTXT.

[4] See, in particular, paragraph 3, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A12008M003.

In line with these general principles, the ECB has taken concrete measures, including tilting our corporate asset holdings, and has committed to further incorporating climate risk considerations into the collateral framework, such as by introducing climate-related disclosure requirements for collateral. These measures will contribute to the greening of the Eurosystem's monetary policy operations and provide incentives to companies and financial institutions to be more transparent about, and reduce, their carbon emissions. The Governing Council is committed to regularly reviewing its climate-related measures to ensure that they are fit for purpose and aligned with the objectives of the Paris Agreement and the EU's climate-neutrality objectives. When deemed necessary and in accordance with our mandate, our measures will be adapted.

Yours sincerely,

[signed]

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