EUROPEAN CENTRAL BANK

EUROSYSTEM

Meeting of 13-14 December 2023

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 13-14 December 2023

18 January 2024

1. Review of financial, economic and monetary developments and policy options

Financial market developments

Ms Schnabel noted that since the Governing Council's previous monetary policy meeting on 25-26 October 2023 the narrative in financial markets had entirely turned around, proving once again its high sensitivity to incoming data and central bank communication. Markets had turned bullish, driven by expectations of quick and "immaculate" disinflation and an early and sharp monetary policy reversal. This repricing had supported risk asset prices, with equity markets soaring and sovereign and corporate credit spreads narrowing amid continued smooth market absorption. Buoyant risk asset markets and a stronger euro exchange rate were consistent with investors pricing in a bottoming-out rather than a deterioration in the euro area's economic growth momentum.

Looking at the key drivers of financial market developments and monetary policy expectations, the first and dominant factor had been the downward surprise in inflation worldwide. Second, other macroeconomic data, excluding inflation, had also come in better than expected in the euro area, alleviating fears of a "hard landing" of the economy. The third factor supporting investor risk appetite had been diminishing impact of geopolitical tensions, accompanied by lower oil prices.

The pronounced swing in market pricing over recent months had resulted in strong movements in financial conditions indices. The tightening in euro area financial conditions seen in September and October on the back of expectations that interest rates would be high for longer, as well as a decompression of term premia, had more than reversed in November and early December when investors had positioned for rapid disinflation. Almost all components of the standard financial conditions indices pointed towards a substantial loosening of financial conditions to levels last seen at the start of the year.

Investors had substantially revised their assessment of both the near-term and longer-term inflation outlook since the Governing Council's previous monetary policy meeting. They now expected inflation to come down much more quickly and to stand close to the ECB's 2% inflation target thereafter. The inflation-linked swap (ILS) forward curve pointed to three features of markets' pricing of annual inflation in the Harmonised Index of Consumer Prices (HICP) beyond 2024. First, market-based measures of compensation for headline inflation in the euro area had moved lower over the entire maturity spectrum. Second, investors did not foresee a scenario in which inflation would return to below-target levels. Third, compared with the period before the global financial crisis, the ILS forward curve was currently more upward-sloping, driven by inflation risk premia that were gradually increasing over the horizon. In other words, in the new global economic and geopolitical landscape, upside risks to longer-term inflation were seen as more prominent than before the global financial crisis.

The disinflation narrative, which had first emerged in the United States, had found fertile ground in the euro area, spilling over into euro area short-term rate markets, especially after the flash estimate of euro area inflation in November had come in lower than expected. Markets were currently pricing in an earlier first rate cut by the ECB and a swifter rate-cutting cycle than they had at the time of the Governing Council's previous monetary policy meeting. A 25 basis point cut in April 2024 had been fully priced in by markets as of 13 December, even prior to the release of the policy rate decision by the US Federal Open Market Committee (FOMC). Expected cumulative rate cuts in the euro area by the end of 2024 had increased to nearly 140 basis points, from around 60 basis points at the time of the Governing Council's previous monetary policy meeting.

One important factor behind the sharp downward adjustment in forward rates had been the pricing-out of further rate hikes. At the time of the October Governing Council meeting, option prices had pointed, under the assumption of risk neutrality, to a 25% probability of a further 25 basis point rate hike. As of 13 December, markets attached only an 8% probability to a further rate hike. By contrast, the most likely outcomes reported by survey respondents were less affected by changes in the tails of the distribution of responses. This could partly explain the substantial divergence between survey-based and market-based expectations, with analysts expecting later and fewer rate cuts than market participants. Participants in the Survey of Monetary Analysts expected a cumulative cut of 75 basis points, starting only in July 2024. Another factor that could explain this divergence was that analysts tended to be more sluggish in revising their expectations, waiting for firmer central bank guidance. Similar developments had been seen at the start of the tightening cycle, when survey results had lagged the forward curves in the euro area and the United States for several months.

As a result of the inflation and monetary policy repricing, real rates at the very short end of the curve had risen measurably as investors reappraised the near-term inflation outlook, while nominal short-term rates had been more "sticky", reflecting the ECB's communication. Looking beyond the short term, however, real forward rates had dropped markedly over the entire maturity spectrum as the decline in nominal interest rates had been greater than the downward revision to the inflation outlook over the medium and longer term. In other words, the previous tightening had been partly reversed.

A decomposition of euro area equity price movements showed that the strong rise in share prices since the Governing Council's previous monetary policy meeting had been driven by the accommodative monetary policy repricing, with a small countervailing effect from earnings expectations. Developments in fixed income markets were consistent with market participants positioning for a bottoming-out rather than a further deterioration in the growth momentum of the euro area economy. The reappraisal of the policy rate outlook, in combination with somewhat better macroeconomic news for the euro area, had reversed the widening of spreads for corporate and sovereign bonds that had been observed in September and October.

Regarding possible adjustments to reinvestments in the pandemic emergency purchase programme (PEPP) portfolio, the December results of the Survey of Monetary Analysts suggested that markets were already expecting a partial run-down of PEPP reinvestments from the middle of 2024 and a full run-off after December 2024. Moreover, the sustained demand for bonds in primary and secondary markets amid the ongoing run-down of the asset purchase programme (APP) portfolio was likely to support the smooth market absorption of an earlier end to full PEPP reinvestments. Private investors had stepped in as the Eurosystem had reduced its footprint in sovereign and corporate bond markets. The smooth absorption had also been supported by debt managers tapping into retail demand and reducing somewhat the maturity of newly issued debt.

Banks' funding conditions had also benefited from the monetary policy repricing and improved risk sentiment. Euro area bank bond spreads had narrowed, most notably for riskier bonds. Investor appetite for bank bonds had led to healthy primary market issuance activity, even in the Additional Tier 1 (AT1) bond segment. The increased recourse to market-based funding by banks amid more favourable funding conditions suggested that banks were able to smoothly absorb repayments of targeted longer-term refinancing operations (TLTROs), as also suggested by notable voluntary repayments. Year-end dynamics in funding markets were expected to be calm. The generally smaller Eurosystem footprint in bond markets and lower excess liquidity should help to reduce distortions in the repo markets on reporting dates.

Turning to exchange rate developments, the euro had initially appreciated markedly against the US dollar after the Governing Council's October monetary policy meeting. This appreciation had been stronger than suggested by movements in interest rate differentials and had been partly the result of improved investor sentiment on the back of the global repricing of monetary policy, which had weighed on the US dollar. Since late November the euro had partly reversed its gains. However, speculative positions pointed to a future appreciation of the euro against the dollar, consistent with expectations of a "soft landing" of the euro area economy.

The global environment and economic and monetary developments in the euro area

Reviewing the global economy, Mr Lane noted that in 2023 world real GDP had been stronger, while global trade had turned out weaker, than had been projected in December 2022. One reason for the drop in the elasticity of trade to global growth was related to the post-pandemic normalisation of the composition of demand from more trade-intensive goods to less trade-intensive services. The most recent data showed that consumption of goods and services was approaching the respective pre-pandemic trends, suggesting that the process of change in the composition of demand was coming to an end. The global inventory cycle was also returning to more normal fluctuations. During the pandemic, trade had been pushed higher by a strong build-up of inventories, much of which were imported inventories, because of global supply chain problems. As the supply chain disruptions unwound and new orders declined, the historically high stock of inventories had been run down. The normalisation of the inventory cycle was expected to contribute to a strengthening in trade growth and a normalisation of trade elasticities in the period ahead.

Turning to the euro area, Mr Lane recalled that the November flash estimate for inflation had been substantially lower than expected, with headline inflation falling to 2.4%, from 2.9% in October. All of the main components of the HICP had contributed to the decline. Core inflation (i.e. excluding the energy and food components) had decreased to 3.6% in November, from 4.2% in October. The decline in non-energy industrial goods inflation to 2.9%, from 3.5%, reflected easing supply chain bottlenecks and slowing demand growth. Services inflation had declined to 4.0% in November, from 4.6% in October. All measures of underlying inflation had fallen in October. While the annual rate of domestic inflation had remained elevated at 5%, the momentum in this indicator had declined markedly over the last three months.

Compared with one year ago, there had been very strong disinflation. Headline inflation had fallen by around 8 percentage points over the last year owing, in particular, to the massive declines in the energy component. When looking back at the inflation projections of December 2022, staff had been correct in foreseeing the major disinflation process a year ahead. This disinflationary process over the course of 2023 was due not only to base effects from the large energy price increases in 2022 but also to lower energy inflation in 2023. Food prices had also contributed to this disinflation – as had core inflation more recently.

Looking ahead, the current assessment was that inflation had reached the end of the strongest phase of the disinflationary cycle. While core inflation and food inflation were expected to continue their gradual decline, upward energy-related base effects and the expiry of the fiscal measures introduced to compensate for the effects of inflation were pushing up headline inflation. In terms of inflation momentum, as measured by the annualised three-month-on-three-month percentage changes in inflation, goods inflation had fallen to below 1% in November. However, momentum in services inflation, while declining, remained strong.

Focusing on the measures of underlying inflation, Mr Lane recalled that these measures were supposed to capture the persistent component of inflation, which was the component of inflation that was expected to persist one or two years ahead. During the past two years all measures of underlying inflation had first increased and then fallen significantly, giving only a blurred signal on the underlying inflationary forces.

Measures that were adjusted for energy and supply bottleneck shocks had seen a less steep increase and decrease. So, while the decline in underlying inflation was also evident in these adjusted measures, they pointed to a smaller improvement from a lower peak level. The decline in the adjusted measures of underlying inflation could be partly attributed to the effects of monetary policy. In other words, without the action of monetary policy, underlying inflation would have stayed higher.

An analysis of price dynamics for individual items in the core inflation basket showed that items accounting for almost half of core inflation were sensitive to monetary policy, and that these were the items that had lately declined more. This helped to explain the decline in underlying inflation and demonstrated that monetary policy was working its way through the economy as envisaged.

Short-term selling price expectations of firms, as reported in the European Commission’s latest business survey, pointed to a normalisation in manufacturing, as the share of firms expecting to charge higher prices three months ahead was close to its long-term average.

The latest Eurostat release showed that the rate of increase in compensation per employee had declined by 0.3 percentage points to stand at 5.2% in the third quarter, with the contribution of unit profits to the GDP deflator also falling substantially. This suggested that, as expected, moderating growth in profits was beginning to absorb some of the inflationary effects of wage increases. However, wage growth remained strong. Negotiated wage growth including one-off payments had increased to 4.7% in the third quarter, from 4.4% in the second quarter. Forward-looking wage trackers continued to signal high pressures, although there had been some deceleration in the Indeed wage tracker.

As regards inflation expectations, the October round of the ECB’s Consumer Expectations Survey showed that consumers had still not adjusted their perception of past inflation downwards, which was a risk factor for upcoming wage negotiations. On the side of professional forecasters, by contrast, the latest Survey of Monetary Analysts showed a sizeable drop in inflation expectations for 2024. Longer-term inflation expectations reported in the survey remained stable at 2%.

In the near term, headline inflation was set to pick up again, owing to energy-related base effects and the expiry of fiscal measures aimed at limiting the repercussions of the energy price shock. For 2024, the staff projections saw inflation declining only gradually – as a result of upward base effects and the phasing-out of past compensatory fiscal measures – before approaching the Governing Council's target in 2025. Nonetheless, the strength of the ongoing disinflation process was reflected in the December projections: staff had revised down their projections for headline inflation by 0.2 percentage points to 5.4% for 2023 and by 0.5 percentage points to 2.7% for 2024. The 2025 projection was unchanged at 2.1%, while for 2026 inflation was projected to be 1.9%. Core inflation was projected to be 5.0% in 2023, 2.7% in 2024, 2.3% in 2025 and 2.1% in 2026.

Mr Lane focused on the fourth-quarter-over-fourth-quarter growth rates, as these were free from carry-over effects. Starting with HICP inflation, the December projections showed a growth rate of 2.8% in the fourth quarter of 2023 over the fourth quarter of 2022, which was expected to slow very gradually to 2.6% in the fourth quarter of 2024. Thus the evolution of inflation during 2024 would be fairly flat. However, the slowdown in core inflation, which was less affected by base effects, was projected to be faster – with the rate falling from 3.8% in the fourth quarter of 2023 to 2.7% in the fourth quarter of 2024.

Upside risks to inflation included 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 the target, or if wages or profit margins increased by more than expected. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly, potentially owing in part to the recent rise in geopolitical risks.

Turning to economic activity in the euro area, in the third quarter real GDP had fallen marginally, as rising domestic demand had been offset by the further run-down of inventories. Survey indicators suggested that activity was set to weaken in the services sector and construction would contract again in the fourth quarter, while there were tentative signs that activity in the manufacturing sector was bottoming out.

Moving to demand components, private consumption had increased by 0.3% in the third quarter, driven by consumption of services and durable goods. While the consumption of services was still being supported by the remaining effects from the post-pandemic reopening of the economy, durable goods consumption was being boosted by the delivery of previously ordered motor vehicles, as supply bottlenecks were being resolved. Thus the upward movement in durable goods consumption observed in the third quarter was a lagging indicator of overall consumption.

As regards near-term expectations, demand for goods that were more sensitive to interest rate changes – chiefly durable goods – was declining, while the consumption of services was still being supported by the remaining reopening effects. The recovery in private consumption embedded in the

December Eurosystem staff projections was predicated on falling inflation and rising wages, which were expected to boost real disposable income.

Housing and business investment were set to remain weak in view of tight lending conditions. Business investment had been stronger than housing investment during 2023, largely owing to the reduction in the outstanding stock of orders. However, this factor would not support business investment in 2024, which would be increasingly affected by the monetary tightening.

Euro area goods export growth had remained negative in September and the growth of import volumes had declined further. Export prospects remained subdued amid increasing competitiveness challenges. According to the European Commission's business survey, European firms perceived themselves to have become less competitive in the global market, owing to both price factors and, increasingly, non-price factors.

Employment had so far been resilient. The unemployment rate had stood at 6.5% in October and employment had increased by 0.2% in the third quarter. However, short-term indicators pointed to a cooling of the labour market and weaker economic activity was dampening the demand for workers, with firms advertising fewer vacancies in recent months. Moreover, the total number of hours worked had edged down by 0.1% in the third quarter.

The sequence of subdued growth followed by the expected recovery based on rising real incomes and improving foreign demand was reflected in the new staff projections. Staff expected annual real GDP growth to be 0.6% in 2023, rising to 0.8% in 2024 and 1.5% in both 2025 and 2026. Compared with the September staff projections, real GDP growth had been revised down by 0.1 percentage points for 2023 and 0.2 percentage points for 2024, while it was unchanged for 2025.

The risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This could result in firms and households becoming less confident about the future. Conversely, growth could be higher if rising real incomes led to spending increasing by more than anticipated or the world economy grew more strongly than expected.

As regards fiscal policies, the December staff projections entailed relatively small revisions to the main fiscal balances compared with the September projections. For 2024, the budget deficit was expected to decline to 2.8% of GDP and the fiscal stance was expected to tighten. It was important to continue monitoring whether governments would stick to their budgetary plans.

Turning to the monetary and financial analysis, market interest rates had fallen markedly since the October Governing Council meeting, more than reversing the significant increases observed earlier in the autumn. Initially, the declines had mainly affected medium to longer maturities, amid spillovers from other major economies. More recently, shorter-term market rates had also declined measurably, mostly in response to inflation falling faster than expected in November. This had resulted in a market forward curve that embedded an earlier and stronger easing of the monetary policy stance than incorporated in the staff projections.

Monetary policy transmission remained exceptionally strong. Bank lending to firms and households continued to be weak. The decline in the annual growth rate of bank lending to firms reflected both weaker credit demand and tighter credit standards. The softening of loan demand was mostly due to higher interest rates and slowing nominal fixed investment. For its part, the slowing pace of lending to households was driven by mortgage loans, consistent with the weakness in the housing market and tighter credit conditions.

Bank composite funding costs had risen further. The deposit base available to banks continued to contract, with the annual growth rates of M3 (the broad monetary aggregate) and M1 (currency in circulation and overnight deposits) in October standing at -1.0% and -10.0% respectively, close to their recent historical lows.

An important question was to what extent pressures from the transmission of monetary policy were still in the pipeline. ECB staff analysis showed that a sizeable increase in policy rates over a short period of time tended to lead to a stronger and faster transmission to credit volumes, and the impact of the tightening cycle on credit growth tended to peak earlier than implied by standard relationships. Such non-linearities seemed to be relevant in the current setting, with a substantial part of the extra interest rate effect attributable to a greater strength of the policy rate adjustments relative to historical regularities. Mr Lane also showed that, from a historical perspective, financing conditions had tightened very strongly over the current hiking cycle.

Monetary policy considerations and policy options

On the basis of the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, Mr Lane proposed keeping the three key ECB interest rates unchanged.

Notwithstanding the recent downside surprises in inflation and the substantial downward revision of projected inflation for 2024, headline inflation was set to return to target only by the second half of 2025. The remaining distance of inflation from the ECB’s target, the waning of disinflationary supply-side tailwinds and, overall, still-high levels of domestic inflation continued to call for maintaining a sufficiently restrictive stance.

The Governing Council should therefore maintain its current strategic orientation, namely that its future decisions should ensure that the key ECB interest rates would be set at sufficiently restrictive levels for as long as necessary, and that it would continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council’s interest rate decisions should continue to be based on its assessment of the inflation outlook in light of incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

It was an appropriate time to review the schedule of PEPP reinvestments. With the fading impact of the pandemic and the reduction in fragmentation risks, Mr Lane proposed advancing the normalisation of the Eurosystem’s balance sheet at a measured and predictable pace. In particular, while full reinvestments should be maintained in the first half of 2024, the PEPP portfolio should be allowed to run off by €7.5 billion per month on average in the second half, with reinvestments fully discontinued at the end of the year. This proposal was broadly in line with market expectations, as reflected in the Survey of Monetary Analysts, and would be in line with the Governing Council's guidance that any “future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance”. For the partial reinvestments until the end of 2024, operational modalities similar to those used during the partial reinvestments of the APP could be applied.

Furthermore, preserving the option to apply flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic, continued to be warranted.

Finally, in line with the ECB’s monetary policy strategy, it was again time for the Governing Council to thoroughly assess the links between monetary policy and financial stability. Euro area banks had demonstrated their resilience. They had high capital ratios and had become significantly more profitable over the past year. However, the outlook for financial stability remained 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 loans. At the same time, the overall impact on the economy of such a scenario should be contained if financial markets reacted in an orderly fashion. Macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities, and the measures in place contributed to preserving the resilience of the financial system.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, members took note of the assessment provided by Mr Lane that euro area foreign demand had generally remained weak in 2023, despite an upward revision in the December staff projections compared with September. One important reason for this was the post-pandemic normalisation of demand away from more trade-intensive goods and towards less trade-intensive services. The fallout from the heightened geopolitical risks had so far remained contained and energy prices had come down from their recent elevated levels. The prices of both oil and gas had declined significantly since the Governing Council's previous monetary policy meeting.

With regard to economic activity in the euro area, members concurred with Mr Lane that tighter financing conditions and subdued foreign demand were likely to continue weighing on economic activity in the near term. Members widely acknowledged the weaker than expected growth in the short term. Survey indicators suggested, however, that the economy might have hit its trough, both globally and in the euro area. The Purchasing Managers' Indices (PMIs) were bottoming out and even showing a small uptick, supporting the prospect of a soft landing. At the same time, it was argued that it would be premature to think that the weakness in activity had run its course. There were several drivers of growth that were unlikely to sustain the euro area economy in the near term. First, there were no clear signals of an upcoming improvement in global trade, while geopolitical risks might be adding to the global weakness, at least in manufacturing. Second, the cash buffers of firms and households had so far delayed the impact of monetary policy on aggregate demand, but as these buffers declined, in tandem with the contraction of the balance sheet of the Eurosystem, the impact of tighter financing conditions was likely to become stronger. As corporate profitability was an important driver of business investment, declining corporate profitability was also seen as a downward risk for investment. Third, a generalised tightening of the fiscal stance was to be expected, possibly in part related to the EU economic governance review, which would put further downward pressure on the economy. Finally, the exceptionally strong monetary policy transmission to lending to firms and households risked having a stronger negative impact on growth and inflation than had been incorporated in the December baseline projection by Eurosystem staff.

On this basis, it was argued that the December staff projections for growth in the near term might be too optimistic overall, also considering that mechanical nowcasting tools continued to point to slower economic activity and the possibility of a technical recession. While it was also recalled that there had recently been a disconnect between hard and soft data – such as PMIs – the Consensus Economics forecast for GDP growth was also significantly lower for 2024 than the equivalent staff projection. Most of the expected growth in 2024 hinged on an increase in consumption, which in turn was dependent on the dynamics of labour income. While productivity growth was currently weak, the strong growth in labour income in the staff projections was seen to be simultaneously driven by continued strength in employment and the catching-up of real wages. Moreover, the removal of fiscal measures implemented to support households in response to increases in energy prices would have a distributional effect and be borne more by low-income households, which had the highest propensity to consume. This would further weigh on consumption. Finally, the recent increase in real interest rates for maturities shorter than one year should also have a negative impact on private consumption.

At the same time, it was underlined that the evidence that monetary policy transmission was working was to be welcomed and remained consistent with a soft landing. The impact of monetary policy tightening was increasingly visible and was broadly proceeding as intended: financing and credit conditions had tightened, lending had been slowing, aggregate demand had been weakening and underlying inflation had been easing. Since inflation was coming down, the euro area economy was set to recover gradually in 2024 owing to rising real incomes, stronger consumption and higher foreign demand. Investment had remained resilient thus far in 2023 and was now projected to stagnate in 2024. However, it could perform better than projected if financial conditions loosened and business confidence improved. Especially in jurisdictions with a high prevalence of adjustable interest rates, mortgage interest rates had already started to decline, which could soon support housing investment again, as this was one of the demand components that had also been the first to react in response to higher interest rates.

More broadly, owing to the variability in the lags and strength of the transmission process, there were several reasons why the transmission of monetary policy remained uncertain and might be less powerful than suggested by historical patterns and models. While the first leg in the transmission of monetary policy, to financing conditions, had been rapid and strong, transmission to the real economy was more uncertain and might be weaker. Several factors played a role here: the strong labour market, the relatively strong balance sheets of firms, households and banks, and the greater weight of less interest-sensitive sectors, such as services, in overall value added. The staff projections therefore remained subject to significant uncertainty with respect to the medium-term outlook for economic activity and prices. This also reflected the lack of clarity about the interplay between cyclical factors and structural changes in the wake of the pandemic and other supply shocks, as well as the possibility of new shocks hitting the economy.

Turning to the labour market, it was noted that employment had remained resilient and had even edged up further, while hours worked was more subdued. At the same time, current levels of indicators should not lead to complacency about the strength of the labour market, which could change abruptly and had to be monitored carefully. Reference was made to potential non-linear changes in macroeconomic conditions if firms were to adjust employment in a synchronised way or if the present high degree of labour hoarding should become more costly, particularly at a time when profits were weakening, albeit from high levels. As the labour market was the main mechanism supporting the projected economic recovery in the period ahead, a potential non-linear response of the labour market posed downside risks to the economic outlook.

A broader question was raised regarding the extent to which the economic slowdown was cyclical or structural in nature. It was highlighted that, on the basis of the regular annual review of the supply side undertaken by staff, potential output had been revised down in the staff projections, albeit moderately, partly reflecting structurally higher energy prices and weaker capital formation. Many euro area corporations found it hard to compete internationally, owing to the high energy costs in Europe. As investment in renewables was running into capacity problems, the energy transition was not going to provide much relief from high energy prices in the near term. The downward revision to potential output also had implications for the implied output gap and for inflationary dynamics. Overall, the outlook for both productivity growth and potential output growth was seen as weak.

Regarding fiscal and structural policies, members reiterated that, as the energy crisis faded, governments should continue to roll back the related support measures. This was 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 the economy more productive and to gradually bring down high public debt. Structural reforms and investments to enhance the euro area's supply capacity could help reduce price pressures in the medium term, while supporting the green and digital transitions.

It was argued that the fiscal stance was likely to become tighter overall in the years ahead, which would imply a drag on economic activity. However, automatic stabilisers working in the opposite direction in a context of lower growth and lower inflation were likely to impede any meaningful improvement in the fiscal balance, thus complicating the fiscal outlook. It was stressed that a well-functioning monetary union with a stability-oriented monetary policy required a set of clear and simple fiscal rules.

Against this background, members assessed the risks to economic growth as remaining tilted to the downside. Growth could be lower if the effects of monetary policy turned out to be stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This could result in firms and households becoming less confident about the future. Conversely, growth could be higher if rising real incomes led to spending increasing by more than anticipated or the world economy grew more strongly than expected.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. They underlined that the recent decline in inflation was good news, as it suggested a faster than anticipated disinflationary process. The decline was not just driven by the fading out of the energy shocks but was broad-based and also reflected developments in core components. In the short run, however, inflation was expected to pick up again in the coming months, mainly owing to energy-related base effects. Inflation numbers also remained affected by the unwinding of past shocks to the food and non-energy industrial goods components, as well as by the reversal of fiscal measures, which made it harder to discern an underlying trend. The latest inflation numbers were therefore to be treated with caution, and it was too early to be fully confident that inflation would return to target. More data were needed to confirm the decline, in particular data on wage growth, which were only expected in the spring of next year. In this context, it was also highlighted that market-based measures of inflation expectations had only started to decline significantly after inflation data had come in lower than expected. This underscored the importance of inflation outturns over the coming months as drivers of inflation expectations, particularly given that household expectations had remained sticky.

At the same time, measures of inflation momentum – namely seasonally adjusted three-month-on-three-month growth rates – suggested that both headline and core inflation had essentially been back at target in November. While such measures were volatile, it was argued that these were often better predictors of future inflation than annual growth rates. However, it was also pointed out that price adjustments were typically more frequent at the start of the year and therefore at the end of the year the signals from such measures on future inflation had to be interpreted with particular caution, in part owing to statistical difficulties with seasonal adjustments in the present conditions.

More broadly, it was pointed out that the envisaged decline in inflation also interacted with the strength of economic activity, which in turn determined the scale and speed at which price-setters were able to pass on their costs to final prices. On the one hand, as the outlook for economic activity in the staff projections seemed too optimistic, it was argued that the strength of disinflation was likely to be underestimated. This concern seemed to be confirmed by recent market expectations, which embodied a notably lower inflation path than the staff projections – for 2024 in particular. On the other hand, scepticism was expressed about whether the recent downward trend in inflation would be confirmed in the coming quarters, particularly as fiscal policy would probably remain loose for some time and a tight labour market would keep pushing up wages and, indirectly, services inflation. Moreover, renewed stronger price increases for energy and food could not be ruled out.

Turning to wage developments, members recalled that the wage outlook was key in understanding medium-term inflation pressures. Labour remained scarce and wage growth was still strong, with compensation per employee growing at an elevated rate and only limited signals of stabilisation coming from negotiated wages and the ECB wage trackers. Coupled with falling productivity growth, unit labour costs had been growing at a record pace of 6.6% in the third quarter, which was contributing to persistence in domestic inflation at levels not consistent with medium-term price stability. This called for remaining vigilant. Moreover, the projected strong pick-up in productivity growth might not materialise if part of its decline proved to be structural or if labour hoarding persisted for longer. It would therefore be important to monitor future rounds of wage negotiations. As negotiations on many wage agreements would only be concluded early next year, members did not expect substantial hard evidence corroborating the projected moderation of wage growth to be available before the middle of the year. While stronger wage growth therefore constituted an upward risk to the staff inflation projections, it was also acknowledged that the recently observed – and projected – further drop in inflation should lead to lower wage demands. If inflation continued to be particularly low, this might also make second-round effects less likely. At the same time, it was pointed out that lower inflation was so far not fully reflected in the perceptions of firms and the general public, so it should not be taken for granted that lower inflation figures would immediately translate into lower wage demands.

One of the reasons why domestic inflation had started to stabilise recently, in spite of the continued rapid increase in wages, might be that firms were moderating their markups. While already embedded in previous staff projections, an important assumption in the December projections had been a declining contribution from unit profits to the GDP deflator measure of inflation. This underpinned the convergence of medium-term inflation trends back towards the target. The significant downward adjustment in the contribution of unit profits seen in the latest national accounts data for the third quarter had lent support to these expectations. It appeared consistent with the return of unit profits to their previous trend, as assumed in the projections. This return to trend was partly of a cyclical nature, but it could well proceed more or less quickly than currently projected, which underlined the particularly high uncertainty surrounding this component of the ongoing and projected disinflation.

As regards longer-term inflation expectations, members took note of the assessments by Ms Schnabel and Mr Lane of the latest developments in market-based measures of inflation compensation and survey-based indicators. Market-based inflation expectations remained broadly anchored at 2% and had come down recently, reflecting the market view that inflation would fall rapidly and stabilise at 2%. At the same time, professional forecasters continued to be more cautious. It was also underlined that the inflation expectations of households and firms remained sticky and well above the ECB's target. More broadly, it was felt that the exceptionally large gap that had formed between the interest rate path derived from financial market prices and the interest rate assumptions embodied in the staff projections pointed to upside risks to the inflation path projected by staff. However, it was hard to establish to what extent the equally substantial fall in the price of energy since the cut-off date for the projections would provide further downward impetus to inflation in the months to come.

Against this background, members highlighted a number of risks to the medium-term inflation outlook, going in both directions. Upside risks to inflation included the heightened geopolitical tensions, which could push energy prices higher 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 the target, or if wages or profit margins increased by more than expected. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly, potentially owing in part to the recent rise in geopolitical risks. Overall, risks were mostly seen as broadly balanced, with some members assessing risks as pointing to the upside and other members judging them as having shifted to the downside, consistent with prevailing downside risks to economic activity.

In this context, members debated the notion of the “last mile” in the disinflation trajectory being the hardest to cover. On the one hand, it was argued that the notion was a useful way to summarise the challenges facing the Governing Council in determining the persistence of inflation pressures and the required duration of monetary policy restriction. From the beginning, it had been understood that bringing inflation all the way down from levels exceeding 10% to 2% would hardly be possible without incurring side effects, such as lower employment and lower output. Surprisingly, so far, progress on the inflation front was advancing at a relatively mild cost in terms of economic activity, with the prospect of a soft landing remaining in place. Therefore, with services inflation still running at 4% and continued strong wage growth, a potentially challenging “last mile” was still looming. In this respect, it was reiterated that the staff projections were predicated on a moderation of wage growth, a buffering of wage growth by lower unit profits and a sustained rebound in productivity growth helping to bring down the growth rate of unit labour costs. Further progress in disinflation thus rested on a number of benign assumptions and on inflation expectations remaining well anchored. In addition, potential rigidities in prices and wages – stemming for example from backward-looking features of wage negotiations – and the impact of structural shocks on the economy and inflation dynamics could well contribute to “last mile”-type delays in disinflation. There was also a risk of new shocks, such as further energy or food price shocks, and effects of climate change on food prices, as well as climate-related measures such as higher carbon taxes, which could render inflation more persistent and more easily unanchor inflation expectations after a long period of above-target inflation.

On the other hand, the view was expressed that the notion of a difficult “last mile” might undermine confidence in the ECB’s inflation target being achieved in a timely manner. More fundamentally, it was not clear why the nature of the disinflationary process would change as the target drew closer. Looking at the annual inflation data for the last few years, it appeared that disinflation to date had actually been faster than the previous surge in inflation, questioning the empirical relevance of the “last mile” narrative. It was argued that inflation depended on the state of the economy and on monetary policy. With a weaker economy, tighter monetary policy and the world economy losing momentum, it should not be surprising to see inflation falling rapidly. Finally, it was argued that the main condition that would make inflation more persistent in the proximity of the inflation target was if inflation expectations became unanchored, which ultimately depended on the credibility of monetary policy.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. The most significant development since the Governing Council's previous monetary policy meeting had been the marked fall in market interest rates, which had intensified following the FOMC's policy decisions and press conference on 13 December, as evident in the update on market developments provided by Ms Schnabel. Market-based measures of inflation expectations had also declined considerably across horizons, to approach 2%, reflecting the view of market participants that inflation would fall rapidly and stabilise at that level. Nevertheless, real interest rates had fallen significantly beyond the near term because nominal interest rates had dropped by more than the corresponding inflation expectations embedded in market prices. Overall, the decline in market interest rates and the rise in risk asset prices had led to looser financial conditions according to most measures. However, the recent appreciation of the euro was going in the opposite direction.

Members generally agreed that this repricing in financial markets could, at least partially, be attributed to recent good news on the broad-based slowdown in inflation in the euro area and other major advanced economies. However, it was widely felt that market expectations reflected significant optimism and were inconsistent with the outlook in the staff projections, with respect to both the inflation outlook and the rate path embodied in the technical assumptions. Reflecting the forward curve at the time of the cut-off date, the projections had incorporated only about 75 basis points of rate cuts for 2024. In addition, it was recalled that analysts, including those participating in the Survey of Monetary Analysts, remained much more cautious. It was also recalled that market expectations were volatile. Market perceptions and narratives had shifted dramatically since the Governing Council's last monetary policy meeting, more than reversing the earlier move which, between September and October, had pushed rates higher on the back of a high-for-longer narrative. This suggested that there might well be another reversal in sentiment over the coming months.

Concern was expressed that the sharp market repricing threatened to loosen financial conditions excessively, which could derail the disinflationary process. Against this background, it was widely regarded as important not to accommodate market expectations in the post-meeting communication.

Overall, some humility was advised with respect to judging market expectations given prevailing uncertainties, including the uncertainty surrounding the outlook for growth and inflation. It was also noted that, if and when inflation fell further, the current level of interest rates would become increasingly tight over time.

Members agreed that, thus far, monetary policy had continued to be transmitted strongly into broader financing conditions. The average interest rates for business loans and mortgages had risen again in October. Higher borrowing rates, subdued loan demand and tighter loan supply had further weakened credit dynamics. With weaker lending and the reduction in the Eurosystem balance sheet, broad money – as measured by annual growth in M3 – had continued to contract for the fourth consecutive month and M1 growth had remained negative for the tenth consecutive month. At the same time, it was noted that the recent financial market repricing had already started to translate into lower interest rates on new mortgage lending and that, in some jurisdictions with a greater prevalence of floating rate mortgages, the average rate on the outstanding stock of housing loans could start to decline within the coming quarter.

The overall transmission of monetary policy to loan growth remained very strong. The annual growth rate of bank loans to non-financial corporations had fallen into negative territory for the first time since July 2015 and growth in loans to households also remained subdued. It was contended that there were signs of "over-tightening" in the banking sector, reflecting the dual effect of higher policy rates and lower deposits amid a declining supply of liquidity, although it was also argued that there was no serious risk in the present environment in which excess liquidity was still abundant. Furthermore, it was recalled that the decline in liquidity in the system had had a limited impact and banks had continued to repay the TLTROs voluntarily.

The Governing Council held its biannual structured exchange on the links between monetary policy and financial stability. Members concurred that euro area banks had demonstrated their resilience, had high capital ratios and had become significantly more profitable over the past year. However, the situation could worsen if banks' funding costs or credit risk were to increase by more than expected, but these risks were assessed to be contained if the market reaction to such scenarios were orderly. It was reiterated that macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities, and that the measures in place contributed to preserving the resilience of the financial system.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members highlighted that, if maintained for a sufficiently long duration, the current monetary policy stance was sufficiently restrictive to bring inflation back to target in a timely manner. Based on the interest rates embedded in the staff projections – which lay above market interest rates – the projections suggested that the rate path was in line with reaching the inflation target in the second half of 2025.

Against this background, members assessed the data that had become available since the last monetary policy meeting in accordance with the three main elements of the “reaction function” that the Governing Council had communicated earlier in 2023. These comprised the implications of the incoming economic and financial data for the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Overall, the view was held that all three elements of the reaction function were moving in the right direction, providing clear evidence that monetary policy was working as intended.

Starting with the inflation outlook, members broadly concurred with the assessment presented by Mr Lane in his introduction. Overall, the process of disinflation seemed to be proceeding well and probably more strongly than had been anticipated, with the November flash estimates coming in significantly lower than expected. The fall in inflation was encouraging and had been broad-based, spanning all main components, including core items. This was indicative of weak demand and reflected the impact of monetary policy as well as diminishing effects from other factors that had been pushing inflation up. It gave grounds for increased confidence that inflation would be brought back to target in a timely manner. But it was highlighted that inflation would likely pick up in the very near term on account of an upward base effect for the cost of energy and would decline only slowly in the course of 2024.

Furthermore, projected inflation for 2025 was largely unchanged in the December projections from the September round and remained slightly above target, especially for core inflation. However, it was noted that services inflation had started to ease and that, more generally, inflationary pressures were receding in all components. This was indicative of weak demand, affected in part by monetary policy. It was underlined that future wage dynamics remained highly uncertain, with many new agreements to be negotiated early in 2024. Convincing evidence of a sustained turnaround in wages had yet to emerge, and this was necessary for sufficient confidence to be gained that inflation would continue to fall back to the ECB’s 2% target. At the same time, it was noted that quarter-on-quarter inflation rates had plunged over the past year and the new Eurosystem staff projections contained a large downward revision in inflation for 2024. Moreover, there were some signs of wage growth stabilising or coming down, and it was argued that wages were a lagging indicator. However, it was stressed that the projection for 2025 had been broadly unchanged in the December round, and core inflation remained above 2% at that horizon. Upside risks to inflation from the outlook for fiscal policy, including higher carbon taxes, and for energy and food prices were also seen as elevated, as were the prevailing geopolitical risks. If such upside risks to inflation materialised or clearer adverse structural changes were to emerge, inflation pressures might become more persistent.

Members agreed that indicators of underlying inflation appeared to have passed their peak and continued to decline. However, the dynamics of underlying inflation remained strong from a historical perspective, including when looking at the measures adjusted for energy shocks and supply bottlenecks. In particular, domestic inflation remained elevated and was edging lower at a slow pace, with sticky wage growth and services inflation in particular reflecting the still strong labour market. It was also pointed out that base effects and fiscal measures made it more challenging to ascertain the true dynamics of underlying inflation.

Turning to the assessment of monetary policy transmission, members generally agreed that transmission was proceeding strongly and helping to dampen inflationary pressures for both goods and services. Moreover, it was argued that a significant part of the interest rate pass-through was still pending, with the overall peak impact on activity seen in early 2024 and the bulk of the impact on inflation still expected over the next two years. The view was expressed that transmission to financing conditions and lending activity was working more strongly than initially expected and non-linearities or financial amplification could be at work. Such effects were typically not included in standard models and the projection baseline and could bolster the strength of transmission to economic activity and prices.

Reference was made to the wide range of estimates for the impact of monetary policy normalisation since December 2021, with large differences as to the extent and persistence of the effects depending on the various models used for policy analysis and in the projections as well as on different underlying assumptions. In this context, the argument was made that the observed disinflation did not validate the notion that the surge in inflation had been transitory but rather supported the view that decisive policy action by the ECB had been instrumental in achieving this outcome.

Looking ahead, it was also emphasised, however, that further transmission was still in the pipeline and that firms' cash buffers and households' excess savings, which had to some extent limited the impact of monetary policy on aggregate demand, could decline alongside the contraction of the Eurosystem balance sheet. This was seen as suggesting that the impact of tight financing conditions might be stronger than expected in the coming quarters. However, it was argued that there was limited evidence of the effects of policy tightening having strengthened, since economic activity was developing broadly according to expectations, the labour market remained tight and downward adjustments in inflation expectations appeared to follow downward inflation surprises more than weakness in the economy.

All in all, on the basis of the December Eurosystem staff projections, members expressed increased confidence that inflation would be brought back towards the 2% target in 2025, although there were different views as to whether there were grounds for sufficient confidence that the target would be reached in a timely manner. Hence a need was seen for continued vigilance and patience, and for the maintenance of a restrictive stance for some time.

It was stressed that there was no room for complacency and that it was not the time for the Governing Council to lower its guard. Caution was warranted, as inflation would probably pick up in the near term and there were continued uncertainties in relation to wages and underlying inflation dynamics. This suggested that it was still too early to be confident that the task had been accomplished.

Monetary policy decisions and communication

Against this background, all members agreed with the proposal by Mr Lane to maintain the three key ECB interest rates at their current level. All three elements of the Governing Council's reaction function were considered to support the case for this decision. Confidence was expressed that the monetary policy stance continued to be sufficiently restrictive, which gave the Governing Council the opportunity to hold rates at current levels and take time to assess the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Restating the Governing Council's data-dependent approach was seen to be important, with a focus on the three elements of the reaction function, which provided a structured approach to monetary policy decision-making and communication. This also was seen as an integral part of the Governing Council's meeting-by-meeting orientation and offered the necessary flexibility.

Turning to the policies affecting the size and composition of the Eurosystem's balance sheet, a very large majority of members agreed with Mr Lane's proposal to advance the normalisation of the balance sheet at a measured and predictable pace.

This was viewed as a proportionate response in view of the initial objectives of the PEPP, which was an instrument designed to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the pandemic. As the pandemic, or at least its emergency dimension, was over, maintaining full reinvestments was no longer appropriate. In addition, markets were currently functioning smoothly and fragmentation concerns were limited. This meant that the risks from ending full reinvestments were contained, especially since moving to partial reinvestments still allowed flexible reinvestments if necessary. Hence it was an opportune time to take this decision, which would be another logical step in the normalisation of the Eurosystem balance sheet.

The proposal was also broadly in line with market expectations, so it would not surprise market participants. Moreover, the approach would allow a smooth adjustment, in particular since redemptions in the PEPP portfolio were very small relative to other sources of balance sheet shrinkage in 2024. At the same time, it was seen as crucial that any decision to end full reinvestments earlier than originally planned should be fully delinked from monetary policy stance decisions relating to level of the policy interest rates. This meant it was important to stress that interest rate decisions were the main instrument of the Governing Council's monetary policy.

While some members favoured an earlier end to full reinvestments than had been proposed, suggesting that tapering could start earlier and be more gradual, other members argued that full reinvestments should continue until the end of 2024. In this context, it was argued that the difference between starting tapering or ending reinvestments a couple of quarters sooner or later would not affect the proportionality assessment.

Members unanimously agreed with Mr Lane's proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

[Monetary policy statement for the press conference of 14 December 2023]

Press release

[Monetary policy decisions]

Meeting of the ECB's Governing Council, 13-14 December 2023

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Cipollone
- Mr Elderson
- Mr Hernández de Cos
- Mr Herodotou
- Mr Holzmann
- Mr Kazāks*

- Mr Kažimír
- Mr Knot
- Mr Lane
- Mr Makhlouf
- Mr Müller
- Mr Nagel
- Mr Panetta*
- Mr Reinesch*
- Ms Schnabel
- Mr Scicluna*
- Mr Šimkus*
- Mr Stournaras
- Mr Välimäki, temporarily replacing Mr Rehn
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch

* Members not holding a voting right in December 2023 under Article 10.2 of the ESCB Statute.

Other attendees

- Mr Dombrovskis, Commission Executive Vice-President**
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

** In accordance with Article 284 of the Treaty on the Functioning of the European Union.

Accompanying persons

- Mr Dabušinskas
- Mr Demarco
- Mr Garnier

- Mr Gavilán
- Mr Gilbert
- Mr Haber
- Mr Horváth
- Mr Kaasik
- Mr Kelly
- Mr Koukoularides
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Pösö
- Mr Rutkaste
- Mr Šošić
- Mr Tavlas
- Mr Ulbrich
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

- Mr Proissl, Director General Communications
- Mr Straub, Counsellor to the President
- Ms Rahmouni-Rousseau, Director General Market Operations
- Mr Arce, Director General Economics
- Mr Sousa, Deputy Director General Economics

Release of the next monetary policy account foreseen on 22 February 2024.