EUROPEAN CENTRAL BANK

EUROSYSTEM

7 July 2022

Meeting of 8-9 June 2022

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Amsterdam on Wednesday and Thursday, 8-9 June 2022

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

Financial market developments

Ms Schnabel reviewed the latest financial market developments. Since the Governing Council's previous monetary policy meeting on 13-14 April 2022, there had been a major shift in monetary policy expectations and actions around the world as inflation had continued to surprise to the upside.

The main developments in financial markets revolved around four main themes. First, volatility in financial markets was high by historical standards, reflecting the longer than expected persistence of high inflation and the associated uncertainty about the extent and pace of monetary policy adjustment required to restore price stability over the medium term. Second, monetary policy normalisation in the euro area was expected to proceed at a significantly faster pace than at the time of the Governing Council's 13-14 April meeting, with a rate lift-off expected in July. Third, expectations of a steeper policy path contributed to halting and partly reversing both the rise in inflation risk premia and the marked depreciation of the euro, thereby offsetting part of the renewed rise in oil prices. Fourth, changes in monetary policy expectations had brought the valuations of riskier assets closer to their long-term averages, in both fixed income and stock markets.

The increase in volatility witnessed globally over the previous few months had been reflected in higher implied volatility across virtually all main asset classes: bonds, equities and foreign exchange. The higher volatility went hand in hand with a deterioration in market liquidity. While such volatility was not surprising at turning points in monetary policy, its magnitude had been amplified by the combination of shocks hitting the world economy: the war in Ukraine, the energy transition, global excess demand and China's zero-COVID policy.

Three sources of policy uncertainty were behind the current volatility: (i) the extent of the required policy adjustment, (ii) the pace of the policy adjustment, and (iii) the transmission of changes in policy rates to market interest rates and bank lending rates.

Regarding the first source of uncertainty, related to the extent of the required policy adjustment in the euro area and other major currency areas, investors had significantly repriced expected terminal rates – the peak interest rates expected by markets at the end of the normalisation or tightening cycle not corrected for term premia. This strong repricing of terminal rates had been a major factor in the recent increase in nominal long-term bond yields. While, in 2021, the rise in nominal ten-year overnight index swap (OIS) rates had been driven by rising inflation compensation, the real ten-year rate had increased markedly in 2022.

Market feedback suggested that the uncertainty about the extent of policy normalisation was driven by two main factors: uncertainty about the level of the neutral rate, and hence the level of the equilibrium real rate of interest, and uncertainty about the need to take policy rates above the neutral rate.

The second source of uncertainty, which related to the pace of policy adjustment, meant markets had not only repriced the terminal rate but were also expecting a significantly swifter policy normalisation than at the time of the Governing Council’s 13-14 April meeting. Surveys continued to lag market prices.

The pace of policy adjustment expected by investors was dependent on the perceived degree of anchoring of longer-term inflation expectations. Survey-based measures of inflation expectations gave different indications regarding the risks of unanchoring, depending on the underlying sample.

Market-based measures of long-term inflation compensation had declined from their decade-high level recorded in April but had started to rise again lately and remained above 2%. These developments reflected markets’ changing views on the likelihood of a recession, in particular market expectations of a resilient growth outlook, as well as the ECB’s communication pointing towards a rate lift-off in July. The ECB’s communication had been an important factor behind the decline in inflation risk premia at longer horizons, as it emphasised the commitment to protect price stability.

The third source of uncertainty in financial markets related to the expected strength of the transmission of changes in the key ECB interest rates to money market and bank lending rates. The weaker the expected transmission, the stronger and swifter the required policy adjustment in the eyes of investors. The strength of policy transmission also depended on the extent and expected pace of a decline in excess liquidity.

Excess liquidity was now expected to decline more slowly than previously assumed. This was because higher expectations of a prospective rise in the key ECB interest rates would lead banks to postpone repayment of the funds from targeted longer-term refinancing operations (TLTROs).

Changes in policy rate expectations had been transmitted to broader financial markets. Equities had sold off as expected, coming down from the elevated levels that had been underpinned by historically low real interest rates. At the same time, since the 13-14 April monetary policy meeting, euro area stock markets had outperformed other indices despite expectations of a steeper policy path.

In euro area fixed income markets, spreads had continued to widen as markets repriced the future path of policy. Despite challenging liquidity conditions and elevated volatility, neither sovereign bond markets nor corporate bond markets had seen excessive moves. However, there had been a marked differentiation across issuers. Spreads had increased the most in Italy and Greece, where debt-to-GDP ratios were highest, and for corporate high-yield issuers, for whom credit risk was the largest. Spreads had increased less in Spain and Portugal and for corporate investment grade issuers.

Although expectations of monetary policy tightening had firmed almost everywhere, the euro had appreciated visibly against the currencies of many advanced economies since the Governing Council’s meeting on 13-14 April. The US dollar was the most notable exception.

The marked and persistent depreciation of the euro against the US dollar, the currency in which oil imports were predominately invoiced, had tangible and immediate effects on inflation, and therefore on inflation expectations. Since May 2021, oil prices had increased by 88% in US dollar terms but by 111% in euro terms. At the same time, the ECB’s communication since the start of the year had provided a counterweight to the downward pressure on the euro that had resulted primarily from the forceful action of the Federal Reserve System.

All in all, the outlook for inflation and hence for monetary policy would remain a key driver of asset prices for the foreseeable future. In this context, higher volatility was a natural reflection of price discovery in an environment in which central banks found it harder to provide clear forward guidance given the uncertainty around the policy outlook.

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

Mr Lane went through the latest economic, monetary and financial developments in the global economy and the euro area. Starting with the international environment, there had been a noticeable slowdown in the global trade of goods in the first quarter of 2022. The most recent data for March pointed to the contraction being largely driven by developments in China. As lockdown measures there had continued into the second quarter, it was likely that the loss of global trade momentum would persist. The war in Ukraine and the lockdown in China had interrupted the easing in global supply pressures in March. In the euro area, Purchasing Managers’ Index (PMI) delivery times had deteriorated in March, but in May there was some improvement.

Looking at exchange rates, the euro was marginally weaker against the US dollar, while it had appreciated slightly in nominal effective terms since the Governing Council’s 13-14 April meeting. Oil prices had increased notably since the April meeting. The June Eurosystem staff macroeconomic projections for the euro area were therefore based on higher oil prices, but the slope of the futures curve remained negative. Other commodity prices had moderated since the meeting, with gas, metals and food prices declining. The June staff projections had seen a significant downward revision of world growth, with the projection for 2022 down from 4.1% to 3.0%. The lower projected growth implied a downward revision of euro area foreign demand, especially in 2023.

Turning to the euro area, real GDP had grown by 0.6% in the first quarter of 2022 according to Eurostat's latest estimate. However, excluding Ireland, euro area GDP was up by only 0.3%. The contribution of domestic demand to euro area growth had been negative, amid the lockdowns at the start of the quarter and the outbreak of the war in Ukraine.

The June staff projections had revised the quarterly GDP profile down but still embodied a significant recovery over the summer and into the fourth quarter. Short-term estimates were subject to high uncertainty for the rest of the year. The projections had generally been within the range of the available short-term forecasting tools, but the range of these estimates was wide on account of the high uncertainty. Indicators of uncertainty had risen sharply following the outbreak of the war, especially for manufacturing and, to a lesser extent, services. The PMI composite indicator was still above 50, but the PMI for manufacturing output had fallen as the indicator of services business activity had risen.

With regard to private consumption, households were increasingly feeling the squeeze on their real incomes from rising energy and food prices. The Consumer Expectations Survey showed that households did not expect to be able to maintain consumption in real terms. The survey also pointed to a reduction in saving flows.

Housing investment was affected by a jump in input costs. Construction used materials that relied on imported commodities. As a result, shortages of materials and equipment continued to accumulate in the construction sector. Rising construction costs were expected to put a break on growth in housing investment. The Consumer Expectations Survey indicated that the perceived attractiveness of housing as an investment was decreasing. The elevated uncertainty was expected to weigh on housing investment over the course of the year.

Data on capital goods production had shown a significant recovery at the end of 2021 with the rebound in car production. Following the outbreak of the war, however, production in the sector had seen little progress.

The euro area goods trade balance had deteriorated owing to the rising cost of imported energy and food. The overall trade balance had deteriorated by about 4 percentage points since the start of 2021, of which about 2.5 percentage points was due to the energy and food balance. This captured the real income cost of having to pay more money to the rest of the world.

A key reason for the good third-quarter prospects was tourism, by far the sector hit hardest by the pandemic. All available indicators were pointing to a very strong recovery, with expectations for demand in the summer months well above their pre-pandemic levels.

For the labour market, the evidence suggested that the very good recovery had continued in the first quarter of 2022. Growth in employment was overall consistent with a return to the pre-pandemic relationship between GDP and employment, after the break caused by the pandemic and the support measures put in place. This also meant that the recovery in economic activity currently explained most of the recovery in employment. The unemployment rate had declined again in April, in particular in countries such as Spain, where the recovery in tourism had helped to create jobs. Survey data continued to signal favourable labour market developments.

Turning to fiscal policies, the June staff projections had incorporated a significant amount of new support measures related to the war and compensation for energy price increases. These new measures amounted to roughly 1% of GDP for the euro area as a whole, with the figure varying across countries. GDP growth was expected to be supported mainly in 2022, as some of the measures were likely to be withdrawn later in the forecast horizon. Their impact on inflation was expected to be on the downside in 2022 and to largely reverse in 2023, owing to the temporary nature of the energy compensation measures. In terms of euro area fiscal balances, a gradual rolling back of the deficit continued to be expected, although the new projections signalled slower progress than foreseen in March. Nonetheless, thanks to the higher nominal GDP, the debt-to-GDP ratio was still expected to decline despite higher interest payments.

Moving on to the latest inflation developments, headline inflation had increased further in May, with the largest contribution again from energy. All categories of energy inflation, not only fuel, were important factors behind the evolution of energy inflation. However, the contributions of all categories of the Harmonised Index of Consumer Prices (HICP) had increased. The May outcomes for both headline HICP inflation and HICP inflation excluding energy and food were above the June staff projections. While forecast errors were made in all components, the largest was in food inflation.

The intensification of pipeline pressures was one reason for the upward revision of the inflation projections for 2023 and, to some extent, for 2024. Pipeline pressures could take a long time to be transmitted to headline inflation, but one of the key uncertainties was that there could currently be a faster pass-through because of the scale of the increases in pipeline pressures. At the same time, a faster pass-through could also mean a shorter adjustment period afterwards, so that the pass-through could lead to a stronger effect on inflation in the near term, but a weaker effect once the price level had adjusted.

Core inflation had clearly risen. Continued analysis was needed of those components of core inflation that were moving up. It was often the case that all components of core inflation rose together, which could be described as a general inflation impulse. By contrast, current core inflation was essentially characterised by a lot of relative price movements as a result of the reopening of certain sectors.

For goods inflation, staff analysis showed that energy prices and bottlenecks accounted for about 0.8 percentage points and 1 percentage point of the increase respectively. However, goods inflation might also have been affected by the green transition. The recovery in domestic demand was also playing a role. Services inflation was not developing in the same way across all sectors. Contact-intensive sectors were contributing the most to the increase in services inflation. The oil-sensitive services sectors were also seeing a large increase in their contributions to services inflation, suggesting that energy was also having significant indirect effects on services inflation. Overall, the reopening of the economy and energy price increases explained much of the dynamics in services inflation.

Moving to wages, growth in negotiated wages had seen a considerable increase in the first quarter, largely owing to one-off payments. When excluding these, the increase was considerably more moderate. The forward-looking wage tracker for the euro area, which was an aggregation of data for four of the euro area's five largest economies, indicated that wage growth obtained on the basis of what had been negotiated this year and covering also next year was around 3% in 2022 and 2.6% in 2023. This represented an increase from the current figure for negotiated wages, but the increase was well below what Eurosystem staff were projecting in terms of aggregate wage dynamics. Wage expectations remained contained according to the Consumer Expectations Survey.

Looking at how firms were coping with the spike in costs, unit profits had weakened significantly in the first quarter of 2022, after increasing steadily during 2021. This seemed to suggest that rising input costs meant that unit profits had to absorb them. The latest Survey on the Access to Finance of Enterprises indicated – based on qualitative replies – that firms in most industries expected to increase their selling prices over the next 12 months. This applied, in particular, to those sectors that had seen the highest cost increases, namely construction, industry and trade, while the share of respondents expecting higher increases in services was smaller.

Turning to the assumptions in the June staff projections, Mr Lane noted that, compared with the December 2021 staff projections, the oil price was almost 40% higher. At the same time, the trade-weighted exchange rate of the euro for 2022 was currently 1.4% weaker, while the exchange rate against the US dollar was four times weaker than the trade-weighted exchange rate. Long-term yields were also 116 basis points higher for 2022 than expected last December, and short-term yields were 44 basis points higher. Developments in oil and exchange rates had played a major role in inflation forecast errors, but the inflation rate would have been even higher without the tightening of assumptions that had taken place in 2022. The June staff projections also contained a wealth of sensitivity analyses and a downside scenario. This was a way to capture non-linearities.

Regarding financial developments, since the 13-14 April Governing Council meeting euro area risk-free rates had increased further as market participants revised their expectations of an earlier tightening of monetary policy. However, correcting the forward curve for risk premia gave indications similar to those in the latest Survey of Monetary Analysis. It was important to note that, in the course of

2022, a significant increase and steepening of real interest rates could be observed. Since the Governing Council meeting on 15-16 December, looking at the term structure of real forward rates, there had been a 1.5-percentage point increase in real forward rates at the very long end for the one-year forward rate nine years ahead contract. From the two-year forward rate contract onwards, there had been an increase in real rates of around 1 percentage point or more.

With regard to inflation expectations, those reflected in the Survey of Monetary Analysts had previously fallen to below 2% for 2024 but were now expected to be at 2% from 2024 onwards and to stay there durably. So this survey was closely aligned with the view that inflation would come down to close to target in 2024 and stay there. Market-based measures of inflation compensation still saw inflation peaking in the very near term and declining across maturities thereafter. Price-level effects were permanent, but it remained the case that market participants envisaged a sizeable reduction in inflation dynamics.

Masked by the recent slight decline, longer-term measures of inflation compensation, such as the five-year forward inflation-linked swap rate five years ahead, had temporarily increased well above target since the last meeting. Estimates of genuine inflation expectations at the five-year horizon five years ahead – obtained by purging plain market data of inflation risk premia – had also increased recently. These estimates, including those from new models with a shifting endpoint, now stood closer to – but still below – 2%, amid high model uncertainty. Allowing for the treatment of risk premia, the expectation that inflation would come back to the target remained the narrative. However, the inflation risk premium was capturing the upside risks.

For consumer inflation expectations three years ahead, the Consumer Expectations Survey for April pointed to a slight decline since March, with the median down from 2.9% to 2.7%. In May, there was a further slight decrease to 2.5%. At the same time, the results indicated heightened uncertainty.

Moving to lending to firms and households, flows remained positive. Credit growth to firms had remained positive, but that was partly a rotation away from bond issuance, which had become more expensive than bank borrowing. The picture for households was mixed, as there had been some recovery in credit for consumption but still not to the pre-pandemic level. It remained the case that, in aggregate, households still had a lot of savings.

On financing costs, so far bank lending rates and credit conditions had, by and large, been insulated from the increase in market rates. This was explained by the fact that deposit rates remained low and deposit funding remained readily available, as people were still holding a lot of money in deposits.

Mortgage rates were picking up more in some countries than in others, displaying some correlation with sovereign yields and with bank deposit rates, although there had not yet been a significant pass-through. There were so far no strong signs of a big slowdown in mortgage lending, but this picture might change rapidly, as in some countries mortgage rates had already moved significantly.

Monetary policy considerations and policy options

In summary, Mr Lane stressed that there had been a further significant increase of 8.1% in HICP inflation in May, up from 7.4% in April. HICP inflation excluding energy and food had increased to 3.8%, from 3.5% in April. The higher rate reflected a rise in both non-energy industrial goods inflation, from 3.8% to 4.2%, and services inflation, from 3.3% to 3.5%. So far, negotiated wage growth in the euro area had remained moderate, especially when excluding one-off payments. The forward-looking wage tracker that incorporated the latest wage settlements showed an uptick in nominal wage increases but still at a moderate pace. Nevertheless, wage formation warranted careful monitoring, particularly in a context in which the labour market had become tighter and some countries were implementing increases in minimum wages.

The future path of headline inflation had been revised up significantly in the June staff projections, especially for the near term. These projections indicated that inflation would remain undesirably elevated for still some time. Over the projection horizon, wage growth was now expected to rise to levels well above the historical average. HICP inflation was projected to stand at 6.8% in 2022 (1.7 percentage points higher than in the March staff projections), before declining to 3.5% in 2023 (1.4 percentage points higher) and further to 2.1% in 2024 (0.2 percentage points higher). This meant that headline inflation in the final year of the projection horizon was projected to be slightly above target. The decline over the projection horizon reflected the moderation in energy and food commodity prices that was embedded in current futures prices, the fading of pandemic effects, a gradual easing of supply bottlenecks and the normalisation of monetary policy.

HICP inflation excluding energy and food had also been revised up over the entire projection horizon. It was now expected to be 3.3% in 2022 (0.7 percentage points higher than in the March staff projections), 2.8% in 2023 (1.0 percentage point higher) and 2.3% in 2024 (0.4 percentage points higher). The upward revision reflected the ongoing reopening of the economy, especially in some services, the re-emergence of some supply disruptions, tightening labour markets and a pick-up in wage increases. At the same time, core inflation was expected to decline over the projection horizon owing to the fading impact of the pandemic, the easing of bottlenecks and the indirect contribution of the current surge in energy prices falling away. The assumption that longer-term inflation expectations remained well anchored and the rising level of market interest rates throughout the projection horizon also contributed to a sustained decline in headline inflation towards the ECB’s target by the end of 2024.

Most measures of longer-term inflation expectations derived from financial markets and from expert surveys stood at around 2%. At the same time, initial signs of above-target revisions in those measures warranted close monitoring.

Risks to inflation projections were primarily on the upside, especially in relation to 2022 and 2023. The risks to the medium-term inflation outlook included a durable worsening of the production capacity of the economy, higher energy and food prices, longer-term inflation expectations rising above the ECB's target and higher than anticipated wage rises. However, if demand were to weaken over the medium term, it would lower pressures on prices.

Turning to the growth forecast in the June staff projections, countervailing forces had resulted in a marked downward revision to real GDP growth for 2022 and 2023. Real GDP growth was now expected to be 2.8% in 2022 (0.9 percentage points lower than in the March staff projections) and 2.1% in 2023 (0.7 percentage points lower). However, stronger growth, at 2.1%, was expected in 2024 owing to catch-up effects (0.5 percentage points higher than in the March staff projections). Taken together, the revisions implied a lower level of GDP throughout the projection horizon.

Risks relating to the pandemic had declined but the war continued to be a significant downside risk to growth. In particular, a major risk would be a further disruption in the energy supply to the euro area, as reflected in the downside scenario included in the staff projections. Furthermore, if the war were to escalate, economic sentiment could worsen, supply-side constraints could increase, and energy and food costs could remain persistently higher than expected.

Markets had priced in a sequence of ECB rate hikes. Increases in risk-free rates had been amplified in euro area sovereign bond yields and corporate bond yields, while bank lending rates were also starting to rise. Lower equity prices had also contributed to a tightening in financial conditions.

On the basis of this updated assessment, it was appropriate to take further steps in normalising monetary policy:

First, the Governing Council should announce that net asset purchases under the asset purchase programme (APP) would end as of 1 July. This would be consistent with communication after the March and April meetings and in line with the stated sequencing, i.e. the prior action opening the door to a first rate hike at the July meeting. Furthermore, the Governing Council should reiterate and update its forward guidance on the length of the horizon for full reinvestment under the APP. Rather than referring to the need to maintain "favourable liquidity conditions and an ample degree of monetary accommodation", which up to now had been the Governing Council's language on the reinvestment period, it should state the need to ensure "ample liquidity conditions and an appropriate monetary policy stance".

Second, the Governing Council should communicate that it saw the conditions of its forward guidance on raising the ECB's policy rates as satisfied. The first condition of the forward guidance stated that inflation should be seen reaching the target of 2% well ahead of the end of the projection horizon. The second condition required inflation to be stabilising at that level durably for the rest of the projection horizon. In fact, the June staff projections saw inflation exceeding the target by a wide margin in 2023 and, more moderately, for a substantial part of 2024. The third condition stipulated that the realised progress in underlying inflation needed to be judged as sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. The most recent data confirmed that underlying inflation dynamics were strengthening and broadening. First, core inflation was expected to stand above target over the entire projection horizon – albeit on a declining path. Second, a wide range of statistical filters, used to extract the underlying common factor and time trend explaining price changes cross-sectionally and over time, suggested that inflation dynamics were not likely to return to the pre-pandemic below-target configuration. Third, the latest wage settlements were also in line with a stronger trend consistent with inflation stabilising at the target in the medium term.

Accordingly, and in line with the ECB's policy sequencing, the Governing Council should express its intention to increase the key ECB interest rates by 25 basis points at its monetary policy meeting in July. The Governing Council should also state that it expected to raise the key ECB interest rates again in September and signal that the scale of the rate increase in September would depend on the updated medium-term inflation outlook.

There were several factors justifying the signal that the intended first increment in July should be 25 basis points. First, a moderate initial increase was most likely to foster a continuing orderly market adjustment amid high uncertainty. Second, longer-term inflation expectations remained anchored at the ECB's target. Third, based on a yield curve that reflected underlying expectations of a gradual but sustained sequence of rate increases over 2022 and 2023, inflation was projected to return close to target in 2024. Fourth, the most effective way to manage the upside risks to medium-term inflation was to be clear about the ECB's reaction function. This meant communicating that larger increments or a faster sequence of moderate rate increases would be appropriate if such risks intensified or materialised. Given the current projections and the high degree of uncertainty, a larger, pre-emptive initial increment ran the risk of triggering excessive adjustments in market interest rates. That could be counterproductive, especially if the upside risks failed to materialise. Moreover, in terms of inflation dynamics, which in any event would only be affected with a considerable lag, deferring a larger increment to a subsequent meeting would not make a material difference.

These considerations suggested that a 25-basis point increment was a proportionate first step. In addition, opening the door to a larger increment in September would also allow the Governing Council to benefit from an updated set of projections and from observing the impact of the first rate hike on financial conditions over the summer. This step-by-step approach to interest rate adjustment during the third quarter would signal determination to exit the negative rate policy expeditiously, while also reasserting the value of optionality in a context fraught with multiple sources of risk. More generally, the Governing Council should be clear that the future path of policy interest rates would be data-dependent and determined by its commitment to stabilise inflation at 2% over the medium term.

Looking beyond the third quarter, the Governing Council should signal that, based on its current assessment, it anticipated that a gradual but sustained path of further increases in interest rates would be appropriate. The pace at which the Governing Council adjusted its monetary policy would depend on the incoming data and how the Governing Council assessed inflation to develop in the medium term. If the medium-term inflation outlook were to deteriorate, the pace of rate increases would accelerate. Likewise, if the medium-term inflation outlook were to moderate, the pace would be slower. Throughout this process, gradualism, flexibility, optionality and data-dependence would be important considerations in setting out the path for interest rates. The likelihoods of the different scenarios would depend – among other factors – on how quickly current price pressures abated, the evolution of excess capacity and the degree to which inflation expectations continued to remain anchored at the ECB’s target.

Finally, the Governing Council should confirm that, as announced previously, the special conditions applicable under TLTRO III would end on 23 June 2022.

The sequential plan had several attractive elements.

First, ending net asset purchases before raising rates would avoid the ECB’s monetary policy instruments working in opposite directions, thereby mitigating volatility and minimising financial stability risks. Moving sequentially would allow the Governing Council to observe how the market adjusted to the end of the net asset purchases and to this pivot in the process of policy normalisation.

Second, what mattered most for the monetary policy stance was not so much the level of the overnight interest rate at present but the path that the rate was expected to follow over the coming months and years. A moderate hike at lift-off had the additional benefit that it would foster an orderly adjustment in financing conditions, reducing volatility.

Finally, flexibility would help the Governing Council to ensure the smooth and even transmission of the ECB’s monetary policy across the entire euro area during the process of policy normalisation.

In line with its monetary policy strategy, the Governing Council should also use the present meeting to consider its biannual assessment of the interrelation between monetary policy and financial stability. On the evidence available, from a financial stability perspective, the environment had worsened since December 2021 – the most recent review period – especially in the short term. In particular, lower growth and increasing cost pressures, as well as rising risk-free rates and sovereign bond yields, could lead to a further deterioration in the financing conditions faced by borrowers, especially in some countries. At the same time, tighter financing conditions could reduce some existing financial stability vulnerabilities over the medium term. Banks, which had started the year with solid capital positions and improving asset quality, were now facing greater credit risk. The Governing Council would watch these factors closely. In any case, macroprudential policy remained the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

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 global trade had seen an important loss of momentum in the first quarter of 2022, mainly as a result of developments in China. The war in Ukraine and the lockdown in China had halted the gradual easing of global supply pressures that had started at the end of 2021. In this respect, it was important to monitor the latest data for signs that easing could have resumed. At the same time, concern was expressed that surges in inflation were being observed across many economic areas. Members saw important differences, however, with price pressures in the United States more related to overheating domestic demand and those in the euro area reflecting, to a larger extent, imported inflation.

Turning to euro area developments, activity was expected to be dampened by high energy costs, the deterioration in the terms of trade, greater uncertainty and the adverse impact of high inflation on disposable income. Firms faced higher costs and renewed disruptions in their supply chains, and their outlook for future output had deteriorated. However, there were also factors supporting economic activity and these were expected to strengthen over the months to come. The reopening of those sectors most affected by the pandemic and a strong labour market, with more people in jobs, would continue to support incomes and consumption. Unemployment remained at its historical low of 6.8% in April and job vacancies across many sectors showed that there was robust demand for labour. In addition, savings accumulated during the pandemic were a buffer. Members noted that economic growth and employment had remained surprisingly robust given the size of the supply shocks. It was cautioned that the stronger than expected quarter-on-quarter growth in euro area real GDP in the first quarter of the year had been driven, to a large extent, by a higher contribution from inventory changes that was likely to unwind. Domestic demand excluding inventory changes had contracted in the first quarter.

Looking at the June staff projections, the question was raised whether the assumptions behind the baseline were too benign in terms of the impact of the sanctions and the war. Doubts were also expressed concerning the assumption, in these same projections, that the saving ratio would unwind less and no longer implied a reduction in previously accumulated savings. The question was also raised whether consumers would start tapping their savings more heavily to cope with the loss of purchasing power or they would reallocate their savings into real assets.

Members widely acknowledged the resilience of the labour market. This implied that the unemployment gap would close much earlier than the output gap, which was puzzling given that the labour market was typically a lagging indicator. It was observed that the size of the output gap had been revised down significantly, while there had been hardly any revision to potential output despite the additional supply shocks, and it was thus suspected that the output gap could also be smaller and close faster. At the same time, it was argued that the current resilience of the labour market reflected a number of factors that made it unlikely to be permanent, such as public employment, temporary jobs and job retention schemes. This implied the risk that there would eventually be a deterioration in employment.

Members broadly agreed with the downside risks to economic activity that the staff projections anticipated in the near term. Risks relating to the pandemic had declined but the war continued to be a significant downside risk to growth. In particular, a further disruption in the energy supply to the euro area would be a major risk, as reflected in the downside scenario included in the staff projections. Furthermore, if the war were to escalate, economic sentiment could worsen, supply-side constraints could increase, and energy and food costs could remain persistently higher than expected. In this context, it was emphasised that the downside risks were not only related to the negative cost shocks but also to the impact of uncertainty on demand. Moreover, there was still a risk that the pandemic could restart. While the medium-term outlook for growth looked balanced in terms of risks, the next few quarters would be weak and the risk of a technical recession needed to be borne in mind. However, it was generally considered that stagflation was an unlikely outcome.

Members agreed that fiscal policies were helping to cushion the impact of the war. Targeted and temporary budgetary measures protected those people bearing the brunt of higher energy prices while limiting the risk of adding to inflationary pressures. The swift implementation of the investment and structural reform plans under the Next Generation EU programme, the “Fit for 55” package and the REPowerEU plan would also help the euro area economy to grow faster in a sustainable manner and become more resilient to global shocks. It was suggested that fiscal measures compensating for high energy prices would likely continue if energy prices remained high. At the same time, further fiscal support would, in any case, have negative implications for public debt. In this respect, it was warned that not all fiscal measures were well targeted and temporary.

On price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. Inflation had risen further to 8.1% in May. Although governments had intervened and had helped to slow energy inflation, energy prices stood 39.2% above their 2021 levels. Market-based indicators suggested that global energy prices would stay high in the near term but then moderate to some extent. Year-on-year food prices had risen by 7.5% in May, in part reflecting the importance of Ukraine and Russia among the main global producers of agricultural goods. Prices had generally also gone up more strongly because of renewed supply bottlenecks and a recovery in domestic demand as the economy reopened, especially in the services sector. Price rises were becoming more widespread across sectors and, accordingly, measures of underlying inflation had been rising further. Wage growth, including in forward-looking indicators, had started to pick up. Over time, the strengthening of the economy and some catch-up effects should lead to faster growth in wages.

It was noted that May was the tenth month in a row in which the inflation figure had been underestimated. Reference was made to the fact that a mechanical update of the June staff projections with the May numbers would imply a level of inflation 0.3 percentage points higher for 2022 as a whole. At the same time, it was observed that most of the recent inflation projection errors could be explained by the direct and indirect effects of under-predictions of energy and food price rises, rather than by an underlying change in agents' behaviour. Such errors could be explained by the difficulty in forecasting supply shocks. At the same time, it was argued that energy and food shocks appeared to be more persistent than previously thought and that this was not just a consequence of the war in Ukraine, because inflation had gained momentum before the outbreak of conflict. Moreover, it was pointed out that the inflation rates for services and non-energy industrial goods had also surprised on the upside and that none of the increases in core inflation every month so far this year had been anticipated. Inflationary pressures from re-opening in the tourism sector, which had been prominent in the May figures, were likely to continue in the coming months as tourism opened up more widely.

Core inflation had reached almost 4% in May and indicators of underlying inflation continued to increase markedly, standing between 3% and 6%. This indicated that price pressures were broadening and becoming more persistent. In terms of absolute deviations, currently the upside deviation of core inflation from the inflation target was much larger than it had been on the downside at any time during the period when monetary policy had focused on deflation risks. It was also emphasised that core inflation was projected to remain above 2% over the entire horizon in the June staff projections. At the same time, it was argued that measures of underlying inflation had to be interpreted carefully, as they were also affected by unusual transitory forces such as the indirect effects of the energy shocks, the re-opening and supply bottlenecks. For example, taking the indirect effects of energy prices out of the core inflation projection would result in a 2.0% projection for core inflation in 2024.

Members broadly agreed that wage developments played a central role in the current inflation outlook. Reference was made to the usefulness of the so-called wage tracker, which afforded a more forward-looking perspective on negotiated wage growth. That measure confirmed that negotiated wages were increasing by around 3-4%. However, it was argued that one-off payments, which had been behind the latest pick-up in negotiated wages, should not be seen as a sign of second-round effects and incipient wage-price spirals. At the same time, the wage tracker was suggesting that increasingly tight labour markets were starting to translate into higher wage demands. Mention was also made of greater recourse to wage indexation in some countries, also in the context of European legislation for a minimum wage. This was seen as a particular concern for the potential emergence of wage-price spirals. It was also noted that the wage tracker did not account for those negotiations that would only take place at the end of the year and could then change the forward-looking picture.

The point was made that, ultimately, it was necessary to look beyond negotiated wage growth and consider all elements affecting actual wage growth. Caution was also expressed about looking only at nominal wage growth, as growth in unit labour costs was ultimately the more relevant indicator for inflation trends and showed only modest dynamics. In this regard, it was remarked that wage growth, while currently contained, was projected to run slightly higher than the sum of productivity growth and the inflation target over the coming years. It was also stressed that the current reduction in real wages could lead to upward pressures on nominal wages going forward.

In their discussion of the June staff projections members highlighted the further large upward revisions to the inflation outlook, particularly in 2022 and 2023, and raised a number of questions about the future path of inflation. It was observed that the inflation path in the current baseline resembled that of the adverse scenario in the March staff projections. It was also underlined that the last time headline inflation had been above 2% in the final year of the projection horizon was 2007, while core inflation had never been above 2% at that horizon. Reference was made to the latest OECD forecast, which showed a higher level of core inflation in the euro area that persisted for longer and stood at 4%, on average, for both 2022 and 2023.

Given the steeply downward-sloping future path of both headline and core inflation, the view was once again expressed that this was likely the result of the assumption that shocks were transitory combined with model dynamics being mean-reverting. Such “built-in” convergence neglected the issue of successive adverse shocks and the possibility of greater persistence and/or non-linear behaviour, which were currently the main challenges to the inflation outlook.

With the tendency of the projections to strongly converge to target in the last year of the horizon, the projection for that year was seen as having limited information content. Moreover, as core inflation was also higher than headline inflation in 2024, this was seen as a signal of upside risks to headline inflation for 2024 and beyond, as core inflation typically captured more persistent components of inflation relevant for medium-term trends. It was also recalled that, if owner-occupied housing was fully taken into account, core inflation would likely be even higher. Moreover, the remark was made that a normalisation of monetary policy according to the rate path currently priced by markets, which was already included in the technical assumptions, would not be sufficient to bring inflation back to 2% over the medium term according to the baseline projection.

At the same time, it was argued that a succession of supply shocks suggested a lengthening, rather than a shortening of the relevant policy horizon, when aiming to maintain price stability over the medium term. It was also recalled that the ECB’s strategy review in 2021 had confirmed that it targeted headline, rather than core inflation, as the relevant yardstick for monetary policy. It was underlined that the future path of inflation in the June staff projections was not so different from that foreseen by many other forecasters in the private sector and by international institutions.

Overall, it was widely acknowledged that uncertainty was high and that the transmission of the current inflation shock and its potential persistence into 2023 and 2024 needed to be better understood. The baseline in the staff projections was seen as potentially too benign, despite substantial upward revisions to the inflation outlook. The historically high level of core inflation pointed to increasing risks of higher inflation becoming more entrenched and persistent. Pipeline pressures were also seen to be continuing to build up, with the odds of a stronger and quicker pass-through to consumer prices increasing. At the same time, it was stressed that risks existed in both directions and, in any case, when considering the inflation outlook, the Governing Council would take both the baseline and the configuration of risks into account.

Regarding the assumptions underlying the projections, it was noted that energy and commodity prices themselves might be seen as likely to rise further, or at least stay higher for longer, in contrast to the downward-sloping path of the futures curve embedded in the projections. This technical assumption had been one of the main reasons for forecast errors in the past. Moreover, structural shifts such as climate change might exert more lasting upward pressure on energy and food prices. This could lead to headline inflation exceeding core inflation by a much larger margin than observed historically, casting further doubt on the plausibility of headline inflation falling below core inflation in 2024, as embedded in the projections. On the fiscal side, it was argued that government support measures could reinforce inflation pressures if they turned out to be less targeted and less temporary than envisaged, at a time of generally high pressures on resources and mismatches between supply and demand. Additionally, supply bottlenecks might prove more protracted than assumed in the baseline scenario. Attention was drawn to the ongoing rotation between bottlenecks in goods, which were expected to ease, and those in services, which had just been emerging and would gain more prominence as households rebalanced their consumption from goods to services.

Medium-term inflation pressures could also be higher than assumed in the projections if potential economic growth suffered more lasting damage from successive supply shocks and the war in Ukraine. Questions were raised as to the reliability and stability of the Phillips curve relationship since behavioural economics indicated that collective psychology might change rapidly when there were threshold effects and possible non-linearities. It was remarked that the longer inflation stayed elevated, the greater the risk of second-round effects via higher wages and/or higher profit margins. According to the projections, 2024 would be the fourth consecutive year of inflation above 2%, which suggested rising risks of second-round effects and of higher inflation becoming entrenched over time. The spending power of households might also turn out to be higher than assumed in the projections, where the saving ratio had been revised up on the expectation of higher precautionary saving. The projections foresaw no drawing down of savings in nominal terms – notwithstanding ”forced dissaving” in real terms – to maintain consumption in the face of higher and unanticipated inflation. Accordingly, firms' pricing power could be higher than projected and they could use the current reopening of the economy to restore profit margins and increase the pass-through of costs to consumer prices, instead of absorbing higher costs by accepting lower margins. Reference was also made to the period following the financial crisis, during which profit margins had increased even in a downturn in a number of euro area economies with weak corporate balance sheets.

At the same time it was underlined that, at present, no second-round effects or wage-price spirals could be observed and that there were indications that unions would be cautious with wage claims to preserve employment at a time of renewed uncertainty. This caution would help avoid derailing a strong labour market, which had been a source of income stability in Europe throughout the pandemic.

While there was wide agreement that market-derived indicators of inflation expectations were broadly anchored at around the target level, it was widely felt that there was no room for complacency given the high costs of re-anchoring expectations. The risk of an unanchoring of inflation expectations was seen as particularly high when inflation expectations adapted to recent developments. Such a risk was considered as increasingly likely to materialise since HICP inflation was projected to stand above, and mostly far above, 2% for more than three years. Emphasis was placed on the importance of households' and firms' inflation expectations, which were more directly relevant for wage and pricing decisions. More generally, it was underlined that concerns over a loss of purchasing power were very pronounced among the general public all over Europe.

Against this background members assessed the risks surrounding inflation as primarily on the upside. The risk to the medium-term inflation outlook included a durable reduction in the production capacity of the economy, persistently high energy and food prices, inflation expectations rising above target and higher than anticipated wage rises. However, if demand were to weaken over the medium term, it would lower pressures on prices.

Turning to the monetary and financial analysis, members largely concurred with the assessments provided by Ms Schnabel and Mr Lane in their introductions. Market interest rates had increased further in nominal terms since the Governing Council's 13-14 April meeting in response to the changing outlook for inflation and monetary policy. Near-term real rates largely remained in negative territory close to historical lows, but the real forward curve had, overall, risen substantially over recent months. With benchmark interest rates rising, bank funding costs had increased, and this had fed into higher lending rates, in particular for households. Nevertheless, bank lending to firms had picked up in March, reflecting the continued need to finance investment and working capital, against the backdrop of increasing production costs, persistent supply bottlenecks and lower reliance on market funding. Lending to households had also increased, reflecting continued robust demand for mortgages. Euro area banks had started the year with solid capital positions and improving asset quality. So far, bank-based financing conditions for households and firms had, on the whole, remained relatively resilient to increases in market rates, notwithstanding growing signs of a turning point having been reached in bank borrowing costs for firms, after the historical lows seen in December.

Broader financial conditions had tightened considerably owing to rising bond yields and lower equity valuations, while the euro exchange rate had stabilised. At the same time, risk aversion was rising and investors were becoming more selective, as evidenced by rising risk premia in yields on lower-rated corporate and sovereign bonds. It was remarked that the scale and speed of recent yield spread increases for some countries, without major changes in country economic fundamentals, suggested that other factors might be at play, including non-linearities, multiple equilibria and factors of a political nature.

In line with the monetary policy strategy adopted in July 2021, the Governing Council held its regular biannual structured exchange on the interrelation between monetary policy and financial stability. Members concurred that the environment for financial stability had worsened since the last review in December 2021, especially over the short term. In particular, lower economic growth and increasing cost pressures, as well as rising risk-free rates and sovereign bond yields, could lead to a deterioration in the financing conditions faced by borrowers. In this context, there was agreement that monetary policy normalisation might affect financial stability at different horizons in opposite ways. Tighter financing conditions could reduce some financial stability vulnerabilities over the medium term, for example in residential real estate. At the same time, when interest rates were exiting a prolonged period in negative territory, monetary policy normalisation could be accompanied by short-term financial stress and increased fragmentation of financial conditions. Moreover, banks were facing greater credit risk in an environment of lower growth and heightened uncertainty. Looking ahead, these factors would need to be watched closely. In any case, macroprudential policy remained the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members agreed that the revised medium-term inflation outlook required further steps to be taken in normalising monetary policy. The latest Eurosystem staff projections saw headline and core inflation in the baseline scenario standing above 2% in 2024, and in the staff assessment risks to the inflation projections were tilted to the upside over the entire horizon, especially for 2022 and 2023. In this respect, it also had to be taken into account that the baseline projections were based on the assumption that monetary policy would be adjusted in line with market expectations at the cut-off date for the projections, with those expectations having shifted markedly upwards in recent months. It was underlined that the appropriate monetary policy response for the Governing Council to take depended on its assessment of the inflation outlook, which comprised both the baseline and the risk assessment. In view of the baseline inflation projection exceeding the ECB's target at the relevant horizon, together with the large and persistent upside risks, it was suggested that the ECB needed to respond more strongly than implied by the market expectations for interest rates embedded in the staff projections.

Members agreed that it was imperative for the ECB to preserve its credibility by showing its resolve to make sure that inflation returned to its 2% inflation target over the medium term. On the one hand, credibility was perceived to have been called into question recently in the light of very high inflation, repeated projection errors and a narrative that had insisted on the temporary nature of inflation shocks for too long. Determined action was judged to be needed to protect the anchoring of inflation expectations and to avoid sizeable second-round effects, with inflation and wages feeding into one another. It was also argued that, if the monetary policy stance were normalised too slowly, monetary policy risked adding to demand pressures at a time when the economy was recovering from the pandemic and pressures on resources were already high. On the other hand, it was stressed that the ECB's credibility was not in doubt as long as inflation expectations remained anchored and as long as no evidence of second-round effects could be seen. Moreover, the ECB should take confidence from the reputation it had earned in successfully combatting the risk of deflation in the past. Reference was made to survey evidence from the general public confirming that the ECB was not currently being blamed for the present episode of high energy inflation, given that the shock was seen as mainly related to rising food and energy costs and that the euro area was not experiencing excessive demand. At the same time, however, it was clear that the general public expected the ECB to take action and to live up to its mandate to maintain price stability over the medium term.

Members concurred overall that most measures of longer-term inflation expectations derived from financial markets and expert surveys appeared to be still broadly anchored at the ECB's target, notwithstanding initial signs of above-target revisions. While risks of an unanchoring had been increasing for some time, it was argued that, since April, there had been some reassuring developments in a number of the indicators, including a stabilisation in the euro exchange rate. On the whole, the evidence so far was seen to remain consistent with a successful re-anchoring of inflation expectations around the ECB's target, in line with the new monetary policy strategy announced in 2021. This provided the Governing Council with grounds for a reasonable degree of self-confidence.

At the same time, it was cautioned that there was no room for complacency because, looking ahead, the anchoring of inflation expectations could not be taken for granted. Some measures of longer-term inflation expectations stood at levels above the Governing Council's inflation target. Moreover, the view was held that it would be much more costly to address a broad-based unanchoring of inflation expectations once it had materialised, as opposed to responding pre-emptively. On the one hand, it was argued that the experience gained in the 1970s, when different inflation outcomes across jurisdictions could be traced back to different central bank reaction functions, suggested that central banks that acted earlier achieved better inflation outcomes. On the other hand, it was maintained that the current environment differed from the 1970s in important respects, such as improved central bank transparency, weaker aggregate demand conditions, a lower degree of unionisation and a lower prevalence of wage-indexation clauses.

Monetary policy decisions and communication

Members broadly agreed that the monetary policy normalisation process should continue to be guided by the four principles of optionality, data-dependence, gradualism and flexibility. Different views, however, were expressed on the need for and the interpretation of gradualism, as well as on how in practice to reconcile gradualism with the need for data-dependence and optionality in an uncertain environment. The view was put forward that the notion of gradualism could be misleading if it was interpreted as implying too slow or too rigid a pace of adjustment in the monetary policy stance. Such an interpretation would be inconsistent with the need for optionality and data-dependence. In particular, it was necessary to avoid gradualism being seen as precluding interest rate steps in excess of 25 basis points. Ensuring price stability over the medium term might, depending on changes in the inflation outlook and prevailing risks and circumstances, require more forceful and front-loaded responses to signal the determination to protect price stability. Moreover, it was argued that the principle of gradualism suggested responding early and in a forward-looking manner, which would then reduce the need for larger and more disruptive adjustments later. A remark was made that the merits of gradualism depended on the nature of uncertainty and shocks. In the light of a long sequence of persistent upward inflation surprises and an increasing risk of an unanchoring of inflation expectations, the “Brainard principle”, i.e. that policymakers should act cautiously if there is uncertainty about the effects of monetary policy measures, no longer applied.

There was agreement that gradualism should not necessarily be interpreted as slow action in small steps. Therefore, members felt that the sustained succession of rate increases over the coming quarters – as reflected in the rate path embedded in market expectations and the staff projections – could be characterised as gradual. It was cautioned that dropping the notion of gradualism could be seen as a signal that the ECB intended to take abrupt action, which could undermine predictability and risked triggering disorderly market movements. Gradualism also was considered consistent with the medium-term orientation of the ECB’s monetary policy strategy and with the prevailing uncertainty on the growth outlook. This was deemed especially important in the face of supply shocks such as those faced by the euro area, and also since the euro area was more exposed to movements in energy prices than other currency areas. Overall, members agreed to retain gradualism as one of the four guiding principles for the monetary policy normalisation process, on the understanding that this did not rule out interest rate steps in increments larger than 25 basis points if and when needed to protect price stability over the medium term. The point was also made that the principles of optionality and data-dependence seemed to be essentially equivalent and were especially important in the present circumstances. In any case it was emphasised that the notion of gradualism should not interfere with the Governing Council's duty to do – at all times –what was needed to maintain price stability over the medium term.

A number of members recalled that in their view, the three forward guidance criteria for interest rates established in July 2021 had been satisfied for some time. At the same time, the need to safeguard the coherence and predictability of ECB policy was acknowledged, which suggested sticking to the sequence previously communicated. However, it was suggested that the implied "delay" in raising interest rates should, in principle, be offset by implementing a larger rate hike in July or by indicating more explicitly the possibility of a larger interest rate move later in the third quarter of 2022. At the same time, it was cautioned that in communicating policy intentions for future meetings, the Governing Council should avoid unduly constraining its optionality and data-dependence.

In any case, all members agreed that, at this point, on the basis of the latest staff projections and developments in measures of underlying inflation, the three forward guidance criteria were satisfied. The revised medium-term inflation outlook called for further, decisive steps towards monetary policy normalisation. In line with the agreed sequencing, the present meeting would be the appropriate moment to announce that net asset purchases under the APP would end as of 1 July 2022. This was the action opening the door to a first rate hike at the July meeting. Looking ahead, members also agreed, overall, that it was appropriate to provide guidance on the Governing Council's expectations regarding the path for the key policy rates to be decided at the July and September 2022 meetings. However, some reservations were expressed about appearing to "lock in" any decisions still to be taken by the Governing Council beyond the very short term. It was underlined that forward guidance always needed to remain conditional on the outlook and prevailing circumstances. However, it was also recalled that the signalling of policy intentions one or two meetings ahead had been a feature of ECB communication in the past, such as through the references to "vigilance" or "strong vigilance", or "(very) close monitoring" of inflation risks.

Most members expressed support for the proposal to signal the Governing Council's intention to increase the key ECB interest rates by 25 basis points at the July meeting. Starting the rate-hiking cycle with a step of this magnitude was seen as a "proportionate first step", as indicated by Mr Lane in his introduction. In this respect, different arguments were brought forward. First, this would be the first rate hike in 11 years, a step that needed to be prepared and explained carefully. Second, the start of the rate-hiking cycle had to be orderly, avoiding unnecessarily surprising the markets and inducing unwarranted volatility. Third, adverse economic surprises in the near term could not be excluded, and it was thus prudent not to start more forcefully.

A number of members expressed an initial preference for keeping the door open for a larger hike at the July meeting. They remarked that the current signal should not be seen as an unconditional commitment, since the Governing Council needed to retain the discretion to adjust the size of the interest rate move in case new information available for the July meeting materially affected the medium-term inflation outlook.

Against this background, it was broadly agreed that the Governing Council should at this point be more specific about its expectations for the September meeting and, in particular, open the door to an increase in the key ECB interest rates by more than 25 basis points. A larger increment would be appropriate at the September meeting if the outlook for medium-term inflation had not improved by that time. A rate hike by a larger increment would signal the Governing Council's intention to move the deposit facility rate into positive territory, ending an eight-year period of negative rates. At the same time, it was generally deemed important to maintain optionality and data-dependence, as it could not be excluded that incoming data in the period to September would materially affect the medium-term inflation outlook in either direction. The point was also made that an acceleration of the monetary policy normalisation process was conditional on market conditions remaining orderly.

Looking beyond September, members widely agreed that, on the basis of the current assessment, a gradual but sustained path of further interest rate increases would be appropriate, with the pace of adjustment depending on incoming data and developments in the medium-term inflation outlook. A comment was made that the neutral rate was unobservable and too vague a concept to guide actual policy measures. It was maintained that the achievement of a neutral stance would be revealed only over time as the Governing Council observed how the economy and the inflation outlook reacted to new shocks and to monetary policy normalisation. It was noted, in this respect, that it might be helpful for the ECB to communicate at some point on the rate path beyond September to avoid markets overshooting. It was remarked there were good reasons to move all three key ECB interest rates in parallel, at least for the initial step in July.

On the basis of the shared assessment and the above considerations, all members accepted the monetary policy proposal presented by Mr Lane in his introduction, subject to more explicit guidance being provided for the September meeting, as appropriate for taking further steps in normalising monetary policy. It was confirmed that the conduct of monetary policy would continue to be guided by optionality, data-dependence, gradualism and flexibility.

All members agreed that the decision on ending net purchases under the APP would pave the way for interest rate increases at the next two meetings, in line with the sequencing of monetary policy action enshrined in the ECB's forward guidance. It was also seen as appropriate at this point in time to confirm that maturing holdings under the APP would continue to be reinvested for an extended period of time past the date when the Governing Council started raising the key ECB interest rates. Reinvestment was considered important for as long as necessary to maintain ample liquidity, thereby ensuring orderly money market conditions, and an appropriate monetary policy stance. It was also agreed to confirm that the special interest rate period under TLTRO III would end on 23 June 2022, as announced previously.

With regard to the path of the key ECB interest rates, members agreed that following the current meeting the Governing Council should communicate that the forward guidance conditions had been satisfied and announce, in line with its policy sequencing, its intention to raise the key ECB interest rates by 25 basis points at the July monetary policy meeting. Looking ahead, it was agreed that the Governing Council should announce that it expected to raise the key ECB interest rates again in September, with the calibration of this rate increase depending on the updated medium-term inflation outlook, indicating that if the medium-term outlook were to persist or deteriorate, a larger increment would be appropriate at the September meeting.

Regarding other elements of communication, members agreed that the Governing Council needed to reiterate its readiness to adjust all of its instruments within its mandate, incorporating flexibility if warranted, to ensure that inflation stabilised at the 2% target over the medium term. Within the ECB's mandate, under stressed conditions, flexibility would remain an element of monetary policy whenever threats to monetary policy transmission jeopardised the attainment of price stability. Attention was drawn to the widening of sovereign spreads over recent months. In this context, the point was made that the establishment of an anti-fragmentation tool was not at odds with the need to contain inflation pressures. Indeed, addressing fragmentation could be regarded as necessary for putting the Governing Council in a better position to accelerate monetary policy normalisation if warranted by the inflation outlook. Reference was made to the "separation principle", which had been introduced by the ECB in the wake of the financial crisis to distinguish between non-standard measures aimed at safeguarding monetary policy transmission and instruments aimed at setting the appropriate policy stance for the euro area as a whole. A call was made for work on a possible new anti-fragmentation tool to be accelerated and completed rapidly since the risk of fragmentation could intensify as the ECB advanced with its monetary policy normalisation.

Members agreed that communication had to emphasise that high inflation was a major challenge and that the Governing Council would make sure that inflation returned to its 2% target over the medium term. The Governing Council would maintain optionality, data-dependence, gradualism and flexibility in the conduct of monetary policy, without hierarchy among these guiding principles.

Taking into account the foregoing discussion among the members, the President ascertained that all members were able to support the policy proposals put forward by Mr Lane, subject to including more explicit guidance with respect to the Governing Council's September monetary policy meeting. Upon a proposal by the President, the Governing Council accordingly decided, on the basis of its updated assessment, to take further steps in normalising its monetary policy, while confirming that earlier decisions would remain in place, as set out in the ECB's 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 to the press conference of 8-9 June 2022

Press release
Monetary policy decisions

Meeting of the ECB's Governing Council, 8-9 June 2022

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- 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 Rehn
- Mr Reinesch*
- Ms Schnabel
- Mr Scicluna*

- Mr Šimkus*
- Mr Stournaras
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Visco
- Mr Wunsch

* Members not holding a voting right in June 2022 under Article 10.2 of the ESCB Statute.

Other attendees

- 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

Accompanying persons

- Ms Buch
- Mr Dabušinskas
- Mr Demarco
- Ms Donnery
- Mr Gavilán
- Mr Gilbert
- Ms Goulard
- Mr Haber
- Mr Horváth
- Mr Kaasik
- Mr Koukoularides
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- Mr Sleijpen

- Mr Tavlas
- Mr Välimäki
- 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 Thursday, 25 August 2022.