EUROPEAN CENTRAL BANK

EUROSYSTEM

25 August 2022

Meeting of 20-21 July 2022

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 20-21 July 2022

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

Financial market developments

Ms Schnabel reviewed the latest financial market developments, noting that the narrative had shifted since the Governing Council's previous monetary policy meeting in early June 2022. Weaker than expected incoming data on the global economy and concerns about disruptions to gas supplies, in combination with further higher than expected inflation outcomes, had turned investors' focus towards a possible "stagflationary" scenario. In this environment, the volatility of short-term interest rate expectations stood at a historical high. The EUR/USD exchange rate remained under pressure. The sell-off of risk assets had continued as investors were still not attracted by cheaper valuations.

Ms Schnabel then turned to the key drivers of the shift in investor sentiment from concerns about inflation to concerns about stagflation. Surprises in economic data releases had recently been negative across the global economy. In the United States, fears of a recession had, at least temporarily, weighed on natural gas prices, and on commodity prices more generally. By contrast, despite the waning growth momentum, gas prices had continued to increase in Europe owing to the domestic gas supply shock.

Daily movements in expectations about short-term interest rates had been at historical highs lately, reflecting the uncertainty that investors were facing regarding the monetary policy implications of incoming information. Looking through this volatility, investors expected the ECB to speed up policy normalisation over the near term, relative to expectations at the time of the June 2022 Governing Council meeting, despite increasing risks of slowing growth momentum. Compared with June 2022, the overnight index swap (OIS) forward curve had steepened at the front end. Survey participants had now, by and large, converged to the market's view regarding a swift tightening of the key ECB policy rates.

Measures of inflation compensation led to three key observations. First, the very front end of the inflation-linked swap forward curve had increased notably since the June monetary policy meeting, reflecting in particular the supply-side-driven sharp increase in European gas prices. Second, medium-term inflation expectations had peaked around the Governing Council's April meeting and had since gradually shifted lower, partly owing to a reappraisal of expectations about the Governing Council's monetary policy intentions. Forward inflation swap rates were now converging towards 2% from above that level in 2024 and fluctuated around 2% over the following years. Third, despite the decline in inflation compensation, tail risks to inflation and the risk of an unanchoring of longer-term compensation had not moderated. The probability that markets assigned to high inflation outcomes of above 4% over a five-year horizon five years ahead had risen steadily since the start of the year. The probability currently stood at 15%, the highest level since 2013. According to the latest Survey of Professional Forecasters, longer-term inflation expectations had been revised upwards to stand on average at 2.2%. This was consistent with stickier long-term inflation compensation in markets.

The repricing of inflation compensation had been the key factor driving the recent decline in nominal long-term sovereign bond yields. The ten-year real rate – i.e. adjusted for inflation – had increased further since the June monetary policy meeting. However, from a historical perspective, both short and long-term euro area real sovereign bond yields remained low.

Against the background of the ECB's monetary policy normalisation path embedded in market expectations, Ms Schnabel noted that a substantial tightening of financial conditions was ongoing in the euro area. However, unlike in some other major currency areas, the rate expectations embedded in financial market prices had yet to be validated by the ECB through actual decisions. The asset price affected most by the divergence between monetary policies across major currency areas was the euro exchange rate. Around half of the 10% depreciation of the euro vis-à-vis the US dollar since the start of the year could be attributed to the divergence in monetary policies. The ad hoc Governing Council meeting on 15 June 2022 might have contributed to mitigating further downward pressures on the euro exchange rate.

As regards sovereign bond spreads, the initial orderly increase since the beginning of the year had accelerated after the June 2022 Governing Council meeting, as concerns about the extent of monetary policy tightening that would be required to restore price stability had intensified. The ECB's announcement after the ad hoc Governing Council meeting that it would accelerate the completion of the design of a new anti-fragmentation instrument had halted or reversed adverse dynamics in some euro area sovereign bond markets.

Market-based funding costs for banks had increased notably since the start of the year on the back of the rise in the risk-free rate and the broad-based increase in risk premia. Yet, in contrast to previous episodes of heightened volatility in sovereign bond markets, there had so far been no visible differentiation between banks across euro area jurisdictions. The same observation could be made for the market-based financing costs of non-financial corporations: in tandem with rates on other risk assets, corporate bond yields had surged over the past few months on the back of rising real yields and, lately, the deterioration in investor sentiment.

Ms Schnabel then noted that the rise in real rates and the weakening in investor sentiment had also had an impact on equity prices. Since the Governing Council's meeting in early June 2022, euro area stock markets had declined further, falling by around 7%, driven by an increase in the equity risk premium, higher discount rates and weakening longer-term earnings growth expectations, while near-term earnings forecasts had remained resilient.

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

Mr Lane then went through the latest economic, monetary and financial developments in the global economy and the euro area. Starting with the global picture, compared with the level in December 2019, global trade was well above its pre-pandemic level, but there had been a decline in the first few months of this year and high-frequency data on global trade, available until mid-July, showed that this decline was accelerating. Purchasing Managers' Index (PMI) data for the manufacturing sector in the second quarter showed a sharp drop in output across advanced economies. The PMI for services showed a levelling-off in May and June, after the strong reading for April.

Comparing the current level of the EUR/USD exchange rate with the level at the end of 2020, when it had reached a peak, there had been a sustained but fairly gentle depreciation of the euro. More recently the bilateral exchange rate had seen a more pronounced drop. Oil prices had declined since the June Governing Council meeting and the futures curve extended this decline until 2024, while the gas price had increased markedly. Other commodity prices had moderated.

Turning to the euro area economy, various indicators for the manufacturing sector showed a sharp slowdown, with the PMI new export orders index falling below the 50 threshold in June. By contrast, services remained on an upward trend thanks to the reopening of the economy, although the latest data pointed to some moderation. Supply bottlenecks, as measured by the PMI indicator of suppliers' delivery times, had seen a visible improvement, having halved compared with their worst level observed last autumn. However, this was largely due to a significant moderation in demand rather than a genuine improvement in supply.

Alongside the deterioration in the short-term GDP outlook, the terms of trade shock continued to severely hit the real income and purchasing power of households. The goods trade balance had stabilised in May compared with April, which was partly due to the fact that energy consumption was moderating in Europe. However, compared with spending about 1% of GDP on energy imports at the start of 2021, the euro area was now spending about 4% of GDP.

Turning to domestic demand, private consumption had moderated significantly since the end of last year. Consumers were buying fewer retail goods and were expecting to make fewer major purchases. At the same time, consumers were increasing their spending on services. For housing investment, concerns related to shortages of materials and labour had declined somewhat in recent months, reflecting lower than expected construction activity. However, concerns related to financing conditions had become more prominent and, overall, the outlook for the housing sector was for a cooling-down. Regarding business investment, capital goods production pointed to continued weakness.

With regard to the labour market, the unemployment rate had declined in May to a record low of 6.6%. As labour force participation was recovering in the euro area, the improvement in the unemployment figure reflected job creation. However, the latest PMI data were indicating a loss of momentum. Changes in the sectoral composition of employment could help explain why the labour market remained strong, driven by the reopening of the recreation sector and other labour-intensive activities, which had seen a big drop during the pandemic.

Turning to the latest inflation developments, inflation in the Harmonised Index of Consumer Prices (HICP) had increased further in June, to stand at 8.6%. Energy inflation, which accounted for about 10% of the HICP basket, had contributed about half of the overall increase and had remained exceptionally high in June at around 42%. This reflected continued high increases in gas, oil and electricity commodity and wholesale prices. A second big contributor continued to be food, which accounted for about 20% of the HICP basket. Non-energy industrial goods prices had also continued to increase in June, with durable goods being strongly affected by supply bottlenecks and most recently by pipeline pressures – i.e. the pass-through of earlier increases in prices in the production chain. Services inflation had seen a small decline in June, which was due to the reduction in public transportation prices in Germany from 1 June to 31 August.

Indicators of underlying inflation continued to rise. A new index constructed by ECB staff provided a measure of domestic inflation, by including prices of all items with a low import content. This measure was currently above 3%, at the bottom of the range of indicators for underlying inflation. The expectation that all the indicators of underlying inflation would revert to 2% was based on the assumption that the energy shock and supply bottlenecks would gradually disappear. The momentum in terms of the month-on-month change in underlying inflation indicators had been roughly stable. However, it was stable at a rate well above levels consistent with 2% inflation. The question remained as to whether this would be a temporary adjustment or more persistent.

Turning to wages, negotiated wages had continued to grow at a modest rate over the last few months. The experimental ECB wage tracker, which included some of the largest euro area countries, indicated that the wage increases agreed in the first quarter of 2022 implied annual wage growth of around 3% this year, before falling back to around 2.5% next year. The most recent wage agreements signed in the second quarter showed a pick-up in wage growth to around 3.5% both this year and next year. This implied that new agreements were consistent with inflation remaining significantly higher for longer, but also that the wage adjustment was far from catching up 100% with inflation.

Regarding profit margins, the latest ECB Corporate Telephone Survey gave a mixed picture between those firms able to increase margins and those with decreasing margins, reflecting differences in their capacity to pass on the large increases in input costs. The pass-through potential was higher for intermediate firms selling to other businesses than for those selling directly to consumers.

With respect to inflation expectations, the latest Survey of Professional Forecasters indicated that the mean longer-term inflation forecast had risen slightly, while the mode, i.e. the most frequent answer given by participants, remained at 2%. There was still a part of the distribution of responses that was below 2%, but in the course of this year there had been an increase in the share of participants who thought inflation would remain above 2.5%, which now amounted to nearly 20% of the respondents. Market-based measures of inflation compensation were consistent with an acute episode of high inflation but implied a return to 2% around mid-2024.

Turning to financial and monetary developments, Mr Lane first noted that the respondents in the July Survey of Monetary Analysts had shifted up and steepened the path for the expected deposit facility rate, relative to the survey round in June, and had changed their assessment of the stance at the end of the interest rate hiking cycle. Mr Lane also reported that banks had seen a big increase in the cost of market funding since the start of the year and their composite funding costs had been creeping up even without any increase in interest rates paid on bank deposits. Firms too had seen a marked increase in the cost of market-based financing and the costs of borrowing from banks had also edged up. Real borrowing rates, while remaining in negative territory, had also crept up in the period to May. The cost of bank borrowing for households for house purchase had continued to increase strongly, reflecting rising long-term market interest rates. When adjusting for inflation, real rates had also started to increase, while remaining in negative territory.

The July 2022 bank lending survey showed that banks had considerably tightened their credit standards for both firms and households in the second quarter of 2022. Behind this tightening was a reduction in risk tolerance and an increase in risk perception, related to the deteriorating economic outlook.

Bank lending to firms remained robust. Since the end of 2021 firms had been tapping the bond market to a lesser extent and instead had mainly been using bank financing. The July bank lending survey indicated that firms’ demand for bank loans was being driven by the need to finance working capital and inventories rather than new investment. Lending flows to households remained strong. However, the July bank lending survey indicated a drop in demand for housing loans in the second quarter and in the following months.

Money growth had moderated significantly from its peak and its short-term dynamics were now below the long-term average. This reflected the fact that the ECB had stopped its net asset purchases, as well as lower firm deposits with banks.

Regarding the role of the monetary policy transmission mechanism in a currency union, Mr Lane recalled that the smooth transmission of the single monetary policy across all euro area jurisdictions was a prerequisite to deliver on the ECB’s price stability mandate. He explained that in a decentralised currency union the smooth transmission of monetary policy did not mean that the level of borrowing costs had to be the same across all jurisdictions in the union. Differences in local financing conditions could legitimately arise owing to, among other things, country-specific economic factors. However, the monetary policy impulses that the Governing Council sent should be transmitted smoothly and not give rise to disproportionate reactions in some jurisdictions that were divorced from fundamental factors in those regions. A fundamentally unjustified reaction of local financing conditions to expected or actual changes in the monetary policy stance would induce distortions that would ultimately undermine the singleness of the ECB’s monetary policy and its ability to deliver on its Treaty mandate.

In particular, a breakdown in the relation between sovereign yields and fundamentals, with bond markets becoming fragmented along national borders, might lead to excessive divergences in financing conditions across the euro area which, if left unchecked, could result in persistent impairments in the transmission mechanism. Episodes of acute and unwarranted divergences in financing conditions across countries could arise in response to a wide range of different shocks and in the face of inflation that was too low or too high.

Mr Lane stressed that the ongoing normalisation of the ECB’s monetary policy stance could be a trigger for fragmentation in bond markets, with adverse consequences for all euro area countries. Volatility and upward shifts in the risk-free yield curve meant that the duration risk for private investors increased, which tested their capacity to hold different types of risk and put upward pressure on sovereign spreads in vulnerable jurisdictions. This could lead to a tightening of financing conditions in these countries – possibly over and above what was appropriate to address excess inflation. A symmetric distortion in the opposite direction could emerge in less vulnerable countries, where capital inflows originating from the vulnerable countries could compress yields below the levels necessary to stabilise inflation at the target over the medium term.

In all these cases, a currency union was particularly susceptible to the risk that fragmentation events might degenerate into self-fulfilling debt crises. While there was typically a maximum level of interest rates at or below which national government debt was sustainable, the interest rates at which euro area countries could refinance debt could spiral upwards in a self-fulfilling manner to levels where debt dynamics became unstable and ultimately unsustainable. Such self-perpetuating mechanisms gave rise to multiple equilibria. In particular, even a fundamentally sound sovereign could be brought to the brink of default owing to a self-fulfilling dynamic involving market participants demanding higher risk premia based on a fear that the market might become illiquid. Announcing that the Governing Council was prepared to intervene in the bond market to lean against market movements not justified by fundamentals could therefore coordinate creditors’ expectations at a stable equilibrium in which a crisis was avoided.

Monetary policy considerations and policy options

Mr Lane therefore proposed that the Governing Council should at the present meeting approve a new Transmission Protection Instrument (TPI), as put forward by the Executive Board, to safeguard monetary policy transmission throughout the euro area and the singleness of monetary policy – a precondition for the ECB to be able to deliver on its mandate. The TPI would be an addition to the ECB’s toolkit and could be activated to counter unwarranted, disorderly market dynamics that posed a serious threat to the smooth transmission of monetary policy across the euro area. By safeguarding the transmission mechanism, the TPI would allow the Governing Council to more effectively deliver on its price stability mandate. Subject to fulfilling established criteria, the Eurosystem would be able to make secondary market purchases of securities issued in jurisdictions experiencing a deterioration in financing conditions not warranted by country-specific fundamentals. This would enable the Eurosystem to counter risks to the transmission mechanism to the extent necessary. The scale of TPI purchases would depend on the severity of the risks facing policy transmission. Purchases would not be restricted ex ante.

The TPI was a monetary policy tool to address a wide variety of shocks that could lead to fragmentation and ultimately to transmission impairments. The TPI’s specific design features, as well as the safeguards for complying with the monetary financing prohibition and the principle of proportionality, would be decided on by the Governing Council in the light of the specific shocks that needed to be addressed in any given situation. At present the TPI was necessary – and specifically designed – to minimise threats to transmission arising from the normalisation of interest rates that was appropriate in the current environment of high inflation and significant upside risks, to ensure that inflation stabilised at the ECB’s target over the medium term.

There were two elements to the effectiveness of the TPI. First, its announcement should act as a stabilising force. Second, if considered necessary by the Governing Council, its activation at any point in time would allow an active response to an emerging threat to the transmission mechanism. To assess whether announcing the TPI at the present meeting was proportionate, three conditions should be met: first, the new tool needed to be effective in pursuing the intermediate objective of protecting the transmission mechanism as a precondition for attaining the ECB’s primary objective; second, it should be efficient in the sense that its intermediate objective could not be achieved with an alternative measure having less intrusive effects on other areas of economic life; and, third, the new tool should be cost-efficient, that is, its benefits in achieving the protection of the transmission mechanism should outweigh its potentially adverse side effects, including any conflict with the maintenance of the monetary policy stance appropriate to achieving the primary objective and any risks that the new tool might unduly interfere with economic policy.

In making this assessment, the Governing Council relied on a thorough exercise that had been carried out by Eurosystem committees and ECB staff over the past few months. The outcome of that exercise demonstrated that, first, in its current design, the TPI was an effective instrument particularly suited to accompanying the announcement of further normalisation steps, as it could prevent impairments in transmission. Second, the announcement of the TPI, which did not imply its immediate activation, was an efficient way to preserve the smooth transmission of the ECB's monetary policy stance to an extent that could not be achieved with other instruments available to the Eurosystem, given their specific design features and purpose. Third, potential side effects as a result of a TPI announcement did not outweigh the benefits of announcing the instrument to mitigate the risk of fragmentation during the normalisation and tightening of monetary policy in the current highly uncertain economic and geopolitical environment. This was particularly true in view of the specific design features and safeguards of the TPI, which also ensured that any potential interference with the monetary policy stance and other policies would be avoided. This included the fact that, being designed to enable a normalisation of the policy rates in view of the current high level of inflation, the TPI would also mitigate the risk of a weakening of the impetus for sound fiscal policies in the euro area.

In accordance with the governance of the TPI, the Governing Council would only activate it after assessing that tangible risks to policy transmission existed at the time of activation; that adequate safeguards were in place at that time to ensure that the obligations and principles contained in EU law were respected; and after conducting a comprehensive proportionality assessment to establish that activation was proportionate to the price stability mandate of the ECB. TPI purchases would be terminated either to reflect a durable improvement in transmission or based on an assessment that persistent tensions were due to country fundamentals.

Summing up the assessment of the economy and the outlook for price stability, Mr Lane remarked that economic activity was slowing but was still benefiting from the reopening of the economy. Risks to the growth outlook remained tilted to the downside. Russia's war in Ukraine remained a source of significant downside risk, especially if energy supplies from Russia were to be disrupted to such an extent that it led to rationing for euro area firms and households. The war could also further dampen confidence and aggravate supply-side constraints, while energy and food prices could remain persistently higher than expected. A faster deceleration in global growth would also pose a risk to the euro area outlook. Purely mechanical updates of the June projections saw high downside risks to GDP growth in the third quarter.

Inflation had increased further, from 8.1% in May to 8.6% in June. Overall, inflationary pressures had broadened and intensified, as signalled by an increase in a range of indicators of underlying inflation. Inflation was expected to remain undesirably high for some time, owing to continued pressures from energy and food prices and pipeline pressures in the pricing chain. The depreciation of the euro was also a source of higher inflation. Looking further ahead, in the absence of new disruptions, energy costs were expected to stabilise and supply bottlenecks to ease. Together with the ongoing policy normalisation, this should support the return of inflation to the ECB's target.

Developments in measures of inflation expectations were mixed. While there had been limited upward revisions in survey-based measures of longer-term inflation expectations, these remained close to 2%. By contrast, market-based measures of inflation compensation had eased appreciably of late: forward inflation-linked swap rates had already priced in a return of inflation to 2% from above that level over the course of 2024. Overall, most measures of longer-term inflation expectations stood at around 2%, although recent above-target revisions to some indicators warranted continued monitoring.

The risks to the inflation outlook continued to be on the upside and had intensified, particularly in the short term. The risks to the medium-term inflation outlook included a durable worsening of the production capacity of the euro area 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 ease pressures on prices.

Market interest rates had been exceptionally volatile as a result of the pronounced economic and geopolitical uncertainty. In addition, the dispersion across sovereign bond yields had remained elevated and global risk asset markets had recorded further declines. Bank funding costs had risen in the past few months, which had increasingly fed into higher bank lending rates, in particular for households. While the volume of bank lending to households remained strong, it was expected to decline in view of lower demand. Lending to firms had also been robust as high production costs, inventory building and lower reliance on market funding created a continued need for credit from banks. At the same time, the demand for loans to finance investment had declined. On balance, financial conditions in the euro area had tightened.

Against this backdrop, Mr Lane proposed to progress further along the path of policy normalisation to make sure that inflation returned to the 2% target over the medium term. In addition to the approval of the TPI, he proposed raising the key ECB interest rates by 50 basis points. While this increment was larger than the step that had been signalled at the June meeting, a bigger first step in the ECB's policy rate normalisation path was appropriate. This was based on the updated assessment of inflation risks and taking into account the reinforced support that would be provided by the TPI for the effective transmission of monetary policy. An increment of this magnitude would support the return of inflation to the ECB's medium-term target by strengthening the anchoring of inflation expectations and by ensuring that demand conditions adjusted to deliver the ECB's inflation target in the medium term.

Mr Lane remarked that further normalisation of interest rates would be appropriate at forthcoming meetings. The frontloading of the exit from negative interest rates at the current meeting would allow the Governing Council to make a transition to a meeting-by-meeting approach to interest rate decisions. The future policy path would be data-dependent and guided by the Governing Council's medium-term inflation target of 2%. In the context of the policy normalisation, the Governing Council should evaluate options for remunerating excess liquidity holdings at one of its forthcoming meetings.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members broadly agreed with the assessment of the current economic situation in the euro area and the risks to the outlook provided by Mr Lane in his introduction. Inflation continued to be undesirably high and was expected to remain above target for some time. The latest data indicated a slowdown in economic growth, clouding the outlook for the second half of 2022 and beyond. At the same time, while risks to growth were on the downside – related in particular to the uncertainty about the consequences of the Russian invasion of Ukraine – the slowdown was being cushioned by a number of supportive factors. Risks to the inflation outlook were on the upside and had intensified, especially for the short term. They were also spreading more broadly.

As regards the external environment, the slowdown in global trade observed in the first quarter of 2022 was worsening, reflecting developments in both advanced and emerging market economies. Concerns were expressed about a deteriorating outlook for the United States and the United Kingdom. It was also observed that China would probably not be able to play its past role as the engine of global growth, as its economy was slowing down.

Members widely noted that the depreciation of the euro constituted an important change in the external environment and implied greater inflationary pressures for the euro area, in particular through higher costs of energy imports invoiced in US dollars. The point was made that the improvements in competitiveness and support for growth that would normally be associated with a depreciation were being impeded by the prevailing global supply constraints and logistics restrictions. At the same time, it was suggested that most of the depreciation against the US dollar was due to divergent monetary policies, which partly reflected the differences in the outlook for the two economies. It was argued that, if the present risks of recession in the US economy were to materialise, the euro would be expected to appreciate. However, a countervailing – and probably dominant – effect could result from worsening global risk sentiment, which typically implied a strengthening of the US dollar.

Turning to euro area developments, economic activity was slowing and Russia's war in Ukraine was an ongoing drag on growth. The adverse impact of high inflation on purchasing power and demand, continuous supply constraints and higher uncertainty were having a dampening effect on the economy. Firms continued to face higher costs and disruptions in their supply chains, although there were tentative signs that some of the supply bottlenecks were easing. Taken together, these factors were significantly clouding the outlook for the second half of 2022 and beyond. At the same time, economic activity continued to benefit from the reopening of the economy, a strong labour market and fiscal policy support. For instance, as people started to travel again, tourism was expected to help the economy in the coming months. Consumption was being supported by the savings that households had built up during the pandemic and by a strong labour market, where unemployment had fallen to a historical low of 6.6% in May and job vacancies across many sectors showed that there was robust demand for labour.

In their discussion, members noted that there were increasing signs of a downturn in euro area economic activity that could extend into 2023. PMI survey data for output in manufacturing and services pointed to a loss of momentum. In the case of manufacturing, the indicator had dropped to contractionary territory for the first time since mid-2020. Survey data on new orders and business expectations suggested that this weakening would continue in the coming months. Moreover, consumer confidence had declined to an all-time low. Inflation was eroding real wealth and savings, as well as real incomes, and the decline in equity prices pointed to negative effects on capital expenditure. Against this background, caution was warranted regarding the prospects for consumption and investment demand. At the same time, it was reiterated that the euro area economy had demonstrated considerable strength and resilience in the face of multiple crises, notably with regard to the pandemic and the war in Ukraine. Additionally, there were no indications of a major recession in the euro area so far. In this context, a good understanding of the current resilience of labour market dynamics was needed.

Members broadly agreed that the risks to economic activity were on the downside. A prolongation of the war in Ukraine remained a source of significant downside risk to growth, especially if energy supplies from Russia were disrupted to such an extent that it led to rationing for firms and households. Indeed, the possibility of Russian gas supply shortages increased the probability of a recession. More generally, the war might further dampen confidence and aggravate supply-side constraints, while a faster deceleration in global growth would also pose a risk to the euro area outlook. The risk of a renewed pandemic wave was seen as still looming, with infection rates remaining high despite favourable weather conditions. Overall, it was acknowledged that developments in energy markets warranted close attention, but it was also stressed that the baseline scenarios of the June staff projections and the European Commission forecasts just published did not foresee a recession.

Members agreed that fiscal policy was helping to cushion the impact of the war in Ukraine for those bearing the brunt of higher energy prices. Temporary and targeted measures should be tailored so as to limit the risk of fuelling inflationary pressures. Fiscal policies in all countries should aim at preserving debt sustainability, as well as raising the growth potential in a sustainable manner to enhance the recovery. It was noted that the dispersion of inflation rates across euro area countries and the role played in this by energy and gas prices required a response that could not be provided by monetary policy alone but needed to be addressed by other policy areas. However, a warning was given that such calls should not be interpreted as recommending continued and untargeted fiscal stimulus.

On price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. Inflation had increased further to 8.6% in June, and surging energy prices had again been the most important component of overall inflation. Price pressures were spreading across more and more sectors, in part owing to the indirect impact of high energy costs across the whole economy. Accordingly, most measures of underlying inflation had risen further. Inflation was expected to remain undesirably high for some time, owing to continued pressures from energy and food prices and pipeline pressures in the pricing chain. Higher inflationary pressures also stemmed from the depreciation of the euro exchange rate. Looking further ahead, in the absence of new disruptions, energy costs should stabilise and supply bottlenecks should ease, which, together with the ongoing policy normalisation, should support the return of inflation to the Governing Council’s target.

It was underlined that the latest inflation developments implied a clear materialisation of upside risks since the previous meeting of the Governing Council. Once more, June had seen an inflation surprise, confirming the underestimation bias observed in the recent past when outturns were compared with earlier projections. Not only had the inflation rate recorded in June increased to well above the projections, but also seasonally adjusted month-on-month rates pointed to continued strong momentum in almost all inflation components. It was also observed that the upward movement of inflation had taken place despite the dampening effect of temporary measures introduced to cope with high energy prices. Actual inflationary pressures were thus even greater than suggested by official readings and, to some extent, reflected government measures.

Against this background, it was argued that upside risks were clearly dominant in the short term. These upside risks were evident when updating the short-term projections by taking explicit account of the recent stronger month-on-month dynamics, the elevated level of oil refining margins, the stronger link between electricity prices and oil and gas futures, and the apparent faster pass-through of energy and producer prices to consumer prices. However, it was noted that such an updated short-term outlook could not easily be converted into an updated medium-term outlook. A key issue in the outlook for 2023 was the extent to which further inflation pressures were still to be observed, as, in the absence of further shocks, the large contribution of energy and food to the rise in inflation should otherwise diminish mechanically. Moreover, it remained to be seen by how much indirect effects would contribute to a further rise in core inflation over time.

In considering the possible persistence of inflationary pressures in the medium term, it was recalled that HICP projections did not as yet fully include costs for owner-occupied housing, while the latest data pointed to quite persistent upward pressures on housing costs despite recent increases in mortgage interest rates. It was also argued that upward shifts in medium-term inflation could emerge from structural changes to the economy. Examples were a possible partial reversal of globalisation and the green transition.

Over the usual projection horizon, it was seen as important to assess whether potential second-round effects or a weak anchoring of expectations would imply higher inflation over the medium term or whether current price pressures were simply one-off inflation bursts owing to the war and would stop once the adjustment was complete. The expected retreat of inflation from its anticipated peak later this year was seen to be predicated on two main factors: first, base effects, and second, a process of convergence with the target in line with Phillips curve predictions. However, it was cautioned that this type of prediction had disappointed more than once in the past. It was thus seen as questionable to keep shifting the short-term outlook upwards while keeping the end point unchanged, as the short-run situation would have an impact on persistence and thus propagate inflation tendencies into the medium term. In this respect, there might be more persistence in the inflation process than embedded in models where parameters were maintained at the values that had been estimated in a low-inflation environment, even though such values were likely to be changing as inflation moved higher. In addition, more persistent price pressures could emerge if the strong supply constraints implied that potential output was lower than initially thought. Such negative effects were all the more likely if there should be a failure to bring more people into the labour market.

Members agreed that the persistence of inflation depended, to a large extent, on the behaviour of wages. Wage growth, also according to forward-looking indicators, had continued to increase gradually over the last few months but still remained contained overall. Over time, the strengthening of the economy and some catch-up effects were likely to support faster growth in wages. It was recalled that steady-state inflation of 2% was consistent with wages growing at 3% per year given typical productivity growth. Reference was made to indications from the ECB's Corporate Telephone Survey, in which three-quarters of the respondents expected higher wage growth in 2023 than in 2022, pointing to an elevated risk of second-round effects. Reference was also made to the forward-looking wage tracker, which suggested a pick-up in wage growth and thus pointed to possible greater persistence of inflation.

Overall, it was maintained that there was no evidence of significant second-round effects as yet, but the repeated upward surprises as regards inflation and indications that inflation had become more persistent had increased the probability of such effects. In this context, reference was made to the Annual Economic Report 2022 from the Bank for International Settlements, which had concluded that transitions from low to high inflation regimes tended to be self-reinforcing, mainly owing to the occurrence of wage-price spirals. While members pointed out that wage formation in the euro area was built on overlapping multi-year wage agreements, this was also seen as implying that there could be long delays in higher inflation being reflected in the negotiation process. The catch-up of nominal wages in response to the current erosion of real wages might thus still take place. The risk was that, once wages started moving, they would keep increasing over the medium term, particularly in view of the higher persistence of inflation than observed in other major currency areas. It was argued that, thus far, the costs of the terms of trade shock had been borne essentially by workers. A rebalancing of the distribution of the implied "tax" between workers and employers would take some time, in part depending on productivity developments, bargaining power and the ability of firms to maintain profit margins. It was argued that there was a need to closely monitor wage developments, as these could transform price-level effects into presistent inflation. However, it was also remarked that a rebalancing between profits and wages would not necessarily represent the start of a wage-price spiral.

At the same time, the point was made that the current high rates of inflation could trigger increased wage indexation and then change the structural features of wage formation. This could reverse the earlier wage growth trend that had taken hold in a low-inflation environment. The current situation raised the question of why the apparent tightness of the labour market had not led to higher wage growth thus far. One explanation put forward was that workers were still hesitant to ask for higher wages, even though stronger pricing power for firms should have increased the scope for granting higher wages. This was corroborated by evidence from the Corporate Telephone Survey, with firms reporting both labour shortages and an easier pass-through of costs into higher selling prices. In this context, it was also pointed out that there was evidence of a higher frequency of repricing in the face of the current significant cost-push shocks.

With regard to longer-term inflation expectations, most measures were currently standing at around 2% and were thus still in line with the medium-term target. However, recent above-target revisions to some indicators warranted continued monitoring. Survey-based measures had edged up. In the case of the Survey of Professional Forecasters, longer-term expectations had risen to a new historical high of 2.2%. The median stood at 2%, but the increasing number of survey respondents at the upper end of the distribution of expectations was seen as an early warning sign of further shifts in the mean. The point was made that expectations had proven relatively slow to adjust upwards after many years of below-target inflation. If the same was now true in the opposite direction, it would be very difficult to re-anchor expectations once these had moved away from the target. Reference was also made to the

ECB's Consumer Expectations Survey and the renewed upshift in inflation expectations three years ahead, after a temporary drop following the outbreak of the war in Ukraine. Such upward shifts might reflect "experience effects", which could be very long-lived and hard to reverse.

The view was expressed that the latest survey data suggested a greater threat to anchoring than was apparent from financial market-based measures of inflation expectations. It was remarked that market-based measures of inflation compensation mattered for monetary policy because financial markets transmitted interest rate changes. So far no extreme movements had been observed in these measures, despite heightened volatility. The measures had actually declined since mid-June, with market participants expecting higher interest rates and lower economic growth. On the one hand, it was argued that their return to just above 2% – a level last seen in January – suggested that expectations were well anchored. This was seen to corroborate the notion that the current high inflation was being driven mainly by supply factors and not by expectations. On the other hand, the question was raised as to whether this could be seen as a stable anchoring when these expectations had first risen substantially to almost 2.5% and then fallen again by the same amount. This cautioned against drawing too much comfort from market-based measures and models that used them as inputs.

Against this background, members assessed that the risks to the inflation outlook continued to be on the upside and had intensified, particularly in the short term. The risks to the medium-term inflation outlook included a durable worsening of the production capacity of the euro area economy, persistently high energy and food prices, inflation expectations rising above the Governing Council's target and higher than anticipated wage rises. However, if demand were to weaken over the medium term in the wake of an economic slowdown, it would lower pressures on prices.

Risks to the medium-term inflation outlook were seen to be clearly tilted to the upside. It was argued that even a recession would not necessarily diminish upside risks, especially if it was related to a gas cut-off or another supply shock implying a further increase in inflation. At the same time, the point was made that this scenario of low growth but high and persistent inflation owing to supply shocks could be contrasted with a scenario where low growth would itself take care of high inflation. This appeared to be the current view of the markets, which were reflecting a combination of lower growth expectations and lower inflation expectations. In this respect the behaviour of the unions in response to a recession was seen as crucial.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. Bank funding costs had risen in recent months, which had increasingly fed into higher bank lending rates, in particular for households. It was remarked, however, that the increase in bank funding costs had remained contained – probably owing to the fact that banks were generally not yet paying interest on customer deposits and continued to have access to favourable Eurosystem funding, including from the targeted longer-term refinancing operations

(TLTROs). Moreover, the transmission of higher funding costs to lending rates was incomplete in some countries – perhaps owing to strong competition among banks or typical lags in the transmission. However, bank lending rates might start to increase more strongly in the coming quarters. While the volume of bank lending to households remained strong, it could be expected to decline in view of lower demand for loans.

Lending to firms had been robust as high production costs, inventory building and lower reliance on market funding had created a continued need for credit from banks. At the same time, demand for loans to finance investment had declined. Money growth had continued to moderate owing to lower liquid savings and lower Eurosystem asset purchases. The most recent bank lending survey had reported that credit standards had tightened for all loan categories in the second quarter of the year, as banks were becoming more concerned about the risks faced by their customers in the current uncertain environment.

Overall, despite the increase in the cost of borrowing and a decline in equity prices, monetary and financial conditions were assessed as having remained favourable, also taking into account the contribution from the exchange rate. Real interest rates for short maturities had declined since the June Governing Council meeting, as expected inflation had been revised upwards, while for longer maturities real rates had increased somewhat. Market interest rates had been volatile as a result of the pronounced economic and geopolitical uncertainty. It was remarked that market expectations for the terminal rate in the interest rate hiking cycle had also displayed significant volatility, increasing until mid-June on the back of higher interest rate expectations and decreasing thereafter when perceived recession risks rose.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members agreed that it was appropriate to take further steps on the path of monetary policy normalisation. In recent months inflation had repeatedly been higher than expected, and some of the upside risks that the Governing Council had anticipated in June had materialised, while further increases in energy prices were dampening the economic growth outlook. Medium-term risks had also increased. It was recalled that monetary policy was not able to provide effective support when the economy was hit by a series of supply shocks. As witnessed during the pandemic, governments were better able to provide support to households and firms, leaving monetary policy to focus on inflation developments and take the necessary action in line with the ECB’s mandate.

Inflationary pressures were judged to have intensified since the Governing Council’s June meeting, especially in the short term. It was highlighted that persistently high inflation posed an increasing risk of longer-term inflation expectations becoming unanchored, even though both market-based measures of inflation compensation and survey-based longer-term inflation expectations were still broadly in line with the Governing Council's medium-term inflation target. It was cautioned that a continued anchoring of inflation expectations was dependent on the Governing Council acting decisively on the worsening inflation outlook.

Against this background it was seen as appropriate to reaffirm the Governing Council's determination to bring inflation back to its 2% target over the medium term, particularly in view of the fact that an instrument was being established to prevent unwarranted, disorderly reactions in financial markets to the ongoing normalisation of monetary policy and to safeguard a smooth monetary policy transmission throughout the euro area.

Members first discussed Mr Lane's proposal to approve the TPI, as put forward by the Executive Board. Members highlighted the importance of the measure, which was seen as a decisive step to ensure the smooth transmission of the monetary policy stance and enable the Governing Council to more effectively deliver on its price stability mandate. The TPI would strengthen the Governing Council's toolkit when fragmentation threatened the transmission of monetary policy, and would complement reinvestment flexibility under the pandemic emergency purchase programme (PEPP) and the Outright Monetary Transactions (OMT) programme. Confidence was expressed that the TPI, with clear eligibility criteria, a well-structured process for its activation and conditions for an exit from its use, would support the stabilising potential of the toolkit and allow an effective response in the event of unwarranted, disorderly market dynamics. In this vein, the TPI would complement the other instruments available to address fragmentation by helping to support a smooth transmission of monetary policy across all the euro area countries while the stance was being normalised. It was argued that a detailed monetary policy case for the TPI and a clear framework for its activation were essential.

The TPI was deemed an important way to increase the resilience of Economic and Monetary Union, which – due to decentralised fiscal policy and the lack of a fully-fledged capital markets and banking union – was still incomplete and exposed to asymmetric shocks. This incompleteness would only disappear with fundamental changes to the euro area's architecture. In this context, monetary policy had to play its role, within the ECB's mandate, in addressing fragmentation to the extent that it impeded a smooth transmission of the monetary policy stance, a precondition for the ECB to be able to deliver on its price stability mandate. Fragmentation risks were considered to be more likely in the current environment, in which monetary policy was being normalised at a time of large supply-side shocks and increasing risks to economic growth. While the ECB was taking action to preserve the efficiency of monetary policy, it was suggested that European governments should, within their own domain of responsibility, advance institutional reforms in order to better address the underlying sources of fragmentation in the euro area.

The design of the TPI was considered to be proportionate and to contain sufficient safeguards and conditions to ensure that the Governing Council acted within its mandate. It was recalled that the European Court of Justice had confirmed in its case law that, in exercising its competence in monetary policy in the pursuit of price stability, the Governing Council had broad discretion but had to carry out a thorough proportionality assessment of any new initiative. The comprehensive work on the TPI carried out over the past three months by the Eurosystem committees and ECB staff clearly documented the fact that the Governing Council was basing its decisions on a thorough analysis along the three dimensions of the proportionality assessment: effectiveness, efficiency and limited side effects. That analysis led to the conclusion that the instrument incorporated sufficient eligibility criteria and activation conditions, and a number of additional safeguards. This made the new instrument a proportionate response to the challenge posed by fragmentation to an effective and efficient conduct of monetary policy. It was also highlighted that the TPI was designed in such a way as to avoid weakening incentives for governments to pursue sound economic policies, particularly in the fiscal domain.

While it was remarked that the success of the TPI ultimately required sufficient commitment by governments to maintain the impetus for sound fiscal and economic policies, it was viewed as essential that the Governing Council underlined its readiness to use the TPI to the extent necessary to address risks to transmission and as appropriate under the stated conditions. Moreover, it was recalled that more persistent and fundamental problems were to be addressed by the OMT programme and that, while monetary policy was able to react to self-fulfilling liquidity crises, solvency problems had to be tackled by other actors. In this respect it was pointed out that, when assessing the sustainability of public debt, the Governing Council would take into account, where available, the debt sustainability analyses by the European Commission, the European Stability Mechanism, the IMF and other institutions, together with the ECB's internal analysis, without establishing a hierarchy between the analyses of the different institutions. Importantly, however, it was stressed that the Governing Council would undertake this assessment with full discretion.

In the light of the foregoing discussion, members unanimously supported the TPI as proposed by Mr Lane in his introduction. The unity and the team spirit in the discussion among the members of the Governing Council were widely praised, and the Eurosystem committees and staff at the ECB and national central banks were thanked for their efficient collaboration during the preparatory phase. A unanimous decision by the Governing Council with forceful and convincing communication was seen to lend strong credibility to the TPI.

Turning to the consideration of the current monetary policy stance, a very large number of members agreed that it was appropriate to raise the ECB's key interest rates by 50 basis points as proposed by Mr Lane. A 50 basis point hike was seen as warranted in view of the worsening of the inflation outlook since the Governing Council's June meeting. The Governing Council thereby took a larger first step on its policy rate normalisation path than signalled at its previous meeting, applying the stated principles of data-dependence and optionality. This was seen as providing a clear signal of its determination to act and to fulfil its mandate.

Some members argued in favour of raising the ECB key interest rates by 25 basis points as this was the intended move communicated at the Governing Council's June meeting and would preserve consistency with the Governing Council's earlier communication. With recession risks looming, an increase of 25 basis points was seen as more in line with a gradual monetary policy normalisation. It was also perceived as compatible with inflation returning to the Governing Council's 2% target over the medium term once transitory shocks had faded. Moreover, the concern was raised that, if the Governing Council deviated from its earlier guidance and surprised markets with a larger than expected increase, this would add to the prevailing market uncertainties.

These considerations notwithstanding, it was maintained that the Governing Council had to demonstrate that it was willing and able to respond if the outlook changed. It was also argued that, despite constituting a larger than expected increase, a 50 basis point interest rate hike provided more clarity for market participants in a highly uncertain environment. Moreover, it was judged that the monetary policy stance remained accommodative even after a 50 basis point rise.

Members widely held the view that the TPI provided reinforced support for the effective transmission of monetary policy, thereby helping the Governing Council to proceed more decisively with the normalisation of monetary policy than envisaged at the June meeting. While the TPI was judged as allowing the Governing Council to address unwarranted, disorderly financial market developments more effectively, it was also perceived as necessary to enable the Governing Council to act more decisively to maintain price stability.

It was underlined that a decision to raise interest rates by 50 basis points at the present meeting should be regarded as frontloading the exit from negative rates and as part of the interest rate adjustment necessary to normalise monetary policy, rather than indicating a change in the rate to be expected as the end-point of the normalisation cycle. Indeed, the Governing Council was not changing its assessment regarding the terminal rate in the hiking cycle, which could only be determined more precisely when interest rates were approaching it more closely. A 50 basis point hike would take the deposit facility rate to zero, ending the period of negative interest rates, which were clearly no longer warranted in view of longer-term inflation expectations standing at or above 2% and the current high inflation numbers. Furthermore, it was argued that frontloading a 50 basis point increase in July would allow the Governing Council more flexibility in reacting to incoming data and proceeding with monetary policy normalisation at its future meetings.

Looking at the September meeting and further ahead, broad support was expressed for Mr Lane's proposal to transition to a meeting-by-meeting approach to interest rate decisions. While providing forward guidance on interest rates was a powerful instrument in times when interest rates were close to the effective lower bound, its usefulness was judged as being significantly diminished in the normalisation phase. In the current circumstances with exceptionally high uncertainty, specific forward guidance on the future interest rate path was seen as excessively constraining the Governing Council's optionality, flexibility and data-dependence, with the risk that the Governing Council would tie itself to decisions that it needed to reverse later when circumstances changed. In this context, attention was drawn to the continued forward guidance on the evolution of the Eurosystem balance sheet.

Different views were expressed as to the need for and the interpretation of the notion of gradualism and how to reconcile it with the need for data-dependence and optionality. On the one hand, it was stressed that in an uncertain environment in which incoming data pointed to increasing risks to price stability, optionality should take precedence over gradualism. On the other hand, it was maintained that gradualism should be interpreted as proceeding step by step with the policy normalisation and not jumping immediately to an end-point rate that was highly uncertain under current conditions. In that sense, a 50 basis point increase was regarded as gradual and compatible with the principles of flexibility, optionality and data-dependence, which would continue to govern the normalisation path.

Members agreed that flexibility in reinvestments of redemptions coming due in the PEPP portfolio remained the first line of defence to counter risks to the transmission mechanism related to the pandemic. In the discussion it was questioned whether the narrowing of spreads observed since mid-June could be attributed to the activation of flexible PEPP reinvestments or whether it was linked to other factors, such as the expectation that the Governing Council would create a new tool to fight fragmentation and whether the activation of PEPP flexibility in June had been necessary.

Monetary policy decisions and communication

Against this background, members expressed readiness to join a consensus on raising the ECB's three key interest rates by 50 basis points. Communication had to acknowledge that upside risks to the inflation outlook had intensified, especially in the short term. It was also emphasised that the Governing Council's decision was based on an updated assessment of the risks to the medium-term inflation outlook. The decision had to be seen as a further step in an ongoing normalisation process that had started in December last year with the phasing-out of the unconventional monetary policy measures. It was seen as important to stress that the 50 basis point hike did not consitute an upward shift in the interest rate path but rather a frontloading of the policy normalisation.

Taking into account the foregoing discussion among the members, and after having ascertained that there were no further comments, on a proposal by the President, the Governing Council approved the TPI with the broad conditions and safeguards set out in the dedicated press release.

The Governing Council also decided to raise the three key ECB interest rates by 50 basis points. Accordingly, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would be increased to 0.50%, 0.75% and 0.00% respectively, with effect from 27 July 2022.

At the Governing Council's upcoming meetings, further normalisation of interest rates would be appropriate. The frontloading of the exit from negative interest rates allowed the Governing Council to make a transition to a meeting-by-meeting approach to interest rate decisions. The Governing Council's future policy rate path would continue to be data-dependent and would help to deliver on its 2% inflation target over the medium term.

The Governing Council intended to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme (APP) for an extended period of time past the date when it started raising the key ECB interest rates and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance.

As concerns the PEPP, the Governing Council intended to reinvest the principal payments from maturing securities purchased under the programme until at least the end of 2024. In any case, the future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate monetary policy stance.

Redemptions coming due in the PEPP portfolio were being reinvested flexibly, with a view to countering risks to the transmission mechanism related to the pandemic.

The Governing Council would continue to monitor bank funding conditions and ensure that the maturing of operations under the third series of targeted longer-term refinancing operations (TLTRO III) did not hamper the smooth transmission of its monetary policy. The Governing Council would also regularly assess how targeted lending operations were contributing to its monetary policy stance.

The Governing Council stood ready to adjust all of its instruments within its mandate to ensure that inflation stabilised at its 2% target over the medium term. The Governing Council's new TPI would safeguard the smooth transmission of its monetary policy stance throughout the euro area.

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 21 July 2022]

Press releases

[Monetary policy decisions]

[The Transmission Protection Instrument]

Meeting of the ECB's Governing Council, 20-21 July 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 July 2022 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

- Ms Buch
- Mr Demarco
- Ms Donnery
- Mr Gavilán
- Ms Goulard
- Mr Haber
- Mr Kaasik
- Mr Koukoularides
- Mr Kuodis
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Rosalino, Alternate to Mr Centeno
- 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 6 October 2022.