EUROPEAN CENTRAL BANK

EUROSYSTEM

Meeting of 26-27 October 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, 26-27 October 2022

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

Financial market developments

Ms Schnabel noted that uncertainty had increased in financial markets since the Governing Council's previous monetary policy meeting on 7-8 September 2022. This had occurred amid persistently high inflation and elevated fears of a recession, with increased attention on potential financial instability. Inflation concerns had remained the dominant driver of financial market developments, as inflation outcomes had continued to surprise to the upside, leading to a renewed adjustment of market expectations for monetary policy globally. Against the background of persistent inflation surprises, investors had sharply revised up their expectations regarding central banks' "terminal policy rate" (the level at which market participants expected the current interest rate cycle to peak) as embedded in risk-free rates, for all major advanced economies, albeit to different degrees.

In the euro area, compared with expectations at the time of the Governing Council's previous monetary policy meeting, market pricing and survey evidence now pointed to expectations of a faster pace of policy rate hikes and a markedly higher terminal rate. Forceful policy action was bringing about a tightening of financial conditions, with medium to longer-term real interest rates moving notably higher and risk assets continuing to be sold off. However, there was still a high degree of uncertainty about the extent of the policy adjustment needed to rein in inflation. At the same time, investors had gradually shifted their attention towards the side effects of the sharp global rate hiking cycle, amid tighter funding conditions for lower-rated entities, low market liquidity and heightened volatility in repo markets.

The heightened concerns about inflation had resulted in euro area risk-free yields being much more sensitive to news about inflation in 2022 than had been the case in 2021. In contrast, the relationship between risk-free yields and news about growth had remained rather weak, suggesting that market participants expected central banks to focus primarily on inflation.

In the United States, the adjustment of near-term rate expectations in financial market prices had been even more pronounced. Unlike in the euro area, the forward rate curve in the United States showed a marked inversion, signalling expectations of a reversal of rate hikes in the course of 2023.

In the euro area, real interest rates had increased across the entire maturity spectrum since the Governing Council’s previous monetary policy meeting. However, they were still deeply negative at short maturities and remained below the levels prevailing in previous tightening cycles, such as in December 2006, when inflationary pressures had been far less intense.

On the back of repeated upward inflation surprises and heightened uncertainty about the path of monetary policy required to tame inflation, market-based measures of longer-term inflation compensation in the euro area had trended upwards in recent weeks. They now stood above the levels observed at the time of the Governing Council’s previous monetary policy meeting, despite the sharp reappraisal of monetary policy expectations. Additional inflationary pressure could emanate from the ongoing depreciation of the euro. So far this year the euro had weakened by 13% vis-à-vis the US dollar. Considering that the bulk of commodities were denominated in US dollars, such currency developments had exacerbated the energy price shock.

The reappraisal of monetary policy expectations had led to a broad-based tightening of financial conditions beyond risk-free rates. The global sell-off in equity markets had continued also in the euro area, even though analysts had lately made only limited downward revisions to euro area firms’ longer-term earnings prospects and earnings expectations remained at a high level overall. Cyclically adjusted price-earnings ratios had come down markedly from the elevated levels prevailing during the extended period of accommodative monetary policy. They were now much closer to, albeit still above, their long-run averages since 2005.

In the euro area corporate bond market, the spreads of both high-yielding and investment-grade bonds had increased. Moreover, bond issuance by euro area non-financial corporations had declined markedly, especially in the high-yield segment. Developments in sovereign bond markets had so far been benign. Despite the sharp rise in risk-free yields, sovereign spreads vis-à-vis the overnight index swap (OIS) rate had remained broadly unchanged and had become less sensitive to changes in risk-free yields than before the announcement of the Transmission Protection Instrument.

While the direct spillovers from the financial market turmoil in the United Kingdom had been limited, euro area financial markets had not been entirely immune. However, two mitigating factors were present. First, the euro area pension fund sector was comparatively small and concentrated, reducing the risk to euro area-wide financial stability. Second, interest rate derivatives were commonly based on the euro interbank offered rate (EURIBOR), limiting the impact of country-specific shocks on margin calls.

Regarding the transmission of policy rate adjustments to money markets, after the September rate hike the functioning of euro area repo markets had been impaired, though only temporarily. This had been triggered predominantly by concerns about additional cash flows into the repo market from the non-monetary policy deposits held with the Eurosystem. The tensions in the repo market also reflected the general scarcity of collateral and the abundance of cash to be deposited in the repo market in an environment of high uncertainty. At the same time, cash bond markets had continued to function smoothly.

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

Mr Lane highlighted that global economic activity had continued to slow in October. Global economic growth had seen a sharp reversal from a strong performance at the beginning of the year to a below-trend performance more recently. While data on goods trade had shown relatively stable growth rates until July, the Purchasing Managers' Index (PMI) for new export orders had in October been significantly below the threshold of 50, indicating a contraction. The filling of the backlog of orders still supported activity, while new orders were declining. However, the latest data showed that manufacturing firms had largely worked through the backlogs accumulated over the last year, suggesting that this channel would provide less support to the economy in the future.

Turning to exchange rate developments, in the past couple of years the euro effective exchange rate and the bilateral exchange rate vis-à-vis the US dollar had recorded a trend depreciation. However, since the Governing Council's last monetary policy meeting little movement had been seen in the effective exchange rate, owing to the fact that the Japanese yen had depreciated. In fact, the trade-weighted exchange rate had appreciated slightly since the September meeting. Looking at the determinants of the euro's depreciation versus the US dollar in 2022, the differences in the expected paths of policy rates had played a big role. However, the deterioration in the euro area terms of trade, as the prices paid for imports rose faster than those received for exports, had also been increasingly important.

Regarding commodities, compared with the situation at the time of the September meeting, the prices of oil, metals and foods had not changed significantly. In contrast, there had been a huge decline in the spot price of gas, although the latest gas futures curve signalled a reversal of some of the drop in early 2023 and a stabilisation afterwards.

Turning to the euro area, GDP growth in the second quarter of 2022 had been boosted by a strong increase in private consumption as a result of the reopening of contact-intensive services. In this period the contribution to inflation in the Harmonised Index of Consumer Prices (HICP) from demand factors had also increased. In particular, the very large increase in private consumption had made a larger contribution to inflation.

The most recent indicators suggested that GDP growth had broadly stagnated in the third quarter of the year. For the next two quarters, the current assessment pointed to a drop in economic activity.

However, this was very different from a scenario in which the euro area entered a prolonged period of negative growth. It was also very different from the downside scenario described in the September 2022 ECB staff macroeconomic projections, as energy prices were currently much lower than had been assumed in the downside scenario. Moreover, the assumption of energy rationing leading to sizeable production cuts had not materialised, nor had there been a major increase in financial stress.

Survey-based sectoral indicators confirmed a continuing downward trend in manufacturing activity, despite the fact that industrial production had been supported by the filling of order backlogs and by the easing of supply bottlenecks. This support was not expected to continue in the future. PMI indicators showed that there had also been a significant slowdown in the services sector in recent months, while retail sales volumes had been on a declining path since June. Both manufacturing and services were experiencing a further increase in uncertainty, which affected the expected dynamics of demand.

Focusing on private consumption, consumer confidence had continued to decline in the period to September, before rising marginally in October. The European Commission's consumer survey showed that households were increasingly postponing major purchases and reducing their savings in order to maintain their consumption of basic necessities.

The investment outlook had darkened significantly. Indicators of housing investment, such as building constructions and the PMI for residential output, had started to signal a contraction in the second quarter of this year and had continued to decline in the third quarter. Indicators of non-construction investment had also moved into contractionary territory in the third quarter.

The goods trade balance had continued to deteriorate, reaching a deficit of around 4% in August. This new record had been driven mainly by the rapidly rising import bill for energy. High energy prices were not only increasing import costs, but were also affecting chemical exports. The production of chemicals, which had a high energy content, had become very expensive in Europe, reducing the competitiveness of these products and their exports. On the services sector side, there had been a strong recovery in tourism indicators. However, the latest data had started to signal a return towards more normal levels.

Turning to the labour market, the unemployment rate had remained at a historical low of 6.6% in August. Employment and total hours worked had increased in the second quarter, by 0.4% and 0.6% respectively. That said, recent indicators were starting to suggest some weakening in the labour market. While the ECB's latest Corporate Telephone Survey showed that employment growth remained in positive territory, firms had become more pessimistic about employment, which was in line with their sentiment about economic activity. A slowdown was also visible in the PMI data, although employment indices remained on the whole above the threshold indicating growth. While the PMI indicators for services and manufacturing were still above the threshold value, the indicator for construction had moved below it.

Looking at the tightness of the labour market, the ratio of job vacancies to unemployed persons had increased significantly in the past two years, which was evident both from Eurostat data and from data obtained from the private digital job search platform Indeed. While both sets of data had suggested an increase in tightness in the period to the second quarter of 2022, the most recent indications from Indeed suggested a stabilisation of the ratio in the third quarter.

Turning to fiscal policies, structural balances were not expected to improve in 2022, as the reduction in pandemic-related spending was being compensated by new energy-related spending measures. These large energy spending programmes had in part been financed by the large revenue windfalls in 2022. As a result, while the overall euro area fiscal deficit was still expected to improve this year, it was unlikely to improve next year. Governments had announced further large packages of fiscal measures in their budgetary plans for 2023, which were likely to prevent any further improvement in their deficit-to-GDP ratios. While so far it appeared that spending on the newly announced measures would be reduced in 2024, it was still too early to assess how temporary and targeted the measures would be. The increase in interest rates was expected to lead to higher financing costs for governments.

Moving to the latest inflation developments, HICP inflation had increased further to 9.9% in September. The forecast error in the September projections amounted to 0.5 percentage points and was primarily related to the energy and food components. The projection for non-energy industrial goods inflation had been slightly higher than the actual outcome, while the projection for services inflation had been lower. Most countries had contributed to the September forecast error.

Since the weight of food prices in the total HICP was double that of energy prices, understanding their dynamics was very important. Consumer prices for food had seen a sharp increase and food producer price indices were rising. At the same time, growth in "upstream" prices at the start of the production chain – such as fertiliser prices and international food commodity prices – had started to decelerate. The fact that food producer prices were still on a rising path implied that more pipeline pressures should be expected for food consumer prices.

For goods prices, the most recent data showed that pipeline pressures on intermediate goods prices had started to ease, although these remained very elevated. However, pressures on consumer goods prices continued to increase, reflecting transmission lags.

Focusing on core inflation, i.e. inflation excluding energy and food, the decomposition into supply and demand factors showed that until July 2022 supply factors had continued to make a significant contribution, suggesting that the core inflation rate would come down significantly if supply factors eased. However, the decomposition also showed a steady increase in the contribution from demand factors.

Mr Lane recalled that core inflation was also affected by indirect effects of high energy prices, which were causing many energy-intensive sectors to raise their prices. ECB staff analysis, which divided goods and services into either energy-intensive or non-energy-intensive items, showed that a disproportionate share of inflation stemmed from the energy-intensive sectors. A stabilisation of energy prices would thus have important implications for core inflation.

Turning to domestic wage pressures, negotiated wages had continued to increase gradually over the last few months, even when the impact of one-off wage payments was excluded. The forward-looking information compiled in the experimental ECB wage tracker for the euro area showed wage agreements concluded in the third quarter of 2022 implying wage growth of 3.7% in 2023. This represented an acceleration compared with 2022 but was still a relatively moderate pace of growth.

Headline inflation in the euro area had exceeded headline inflation in the United States owing to much higher energy and food inflation. In the United States, however, core inflation was stronger than in the euro area, and it was very closely correlated with wage inflation. In the euro area, core inflation remained well ahead of wage inflation because the sectors with the highest price increases were not particularly labour-intensive but were relatively energy-intensive. Inflation in wage-sensitive HICP items had continued to increase in line with negotiated wage growth, which, however, remained relatively contained overall. These sectors had generally seen less inflation pressure than sectors more exposed to supply-chain problems.

Moving to price pressures related to housing, rental price growth had remained below 2% in September. It was thus exerting a dampening effect on services prices and on the overall inflation rate. However, other prices related to housing had increased strongly. The growth of owner-occupied housing costs had reached 10.1% in the second quarter of 2022. Looking ahead, the September projections suggested a significant deceleration in residential property price growth.

Longer-term inflation expectations (for 2027) reported in the October ECB Survey of Professional Forecasters had remained basically constant at 2.2% for headline inflation and had decreased from 2.2% to 2.1% for core inflation. However, respondents had significantly revised up their inflation expectations for 2024 to 2.4%. Most of the responses continued to lie between 2% and 2.4%. But the average was affected by movements in the tails of the distribution, with an increase in the number of respondents who expected inflation to exceed 3% in 2024 and a marked decline in the numbers who expected inflation to be below 2%.

The September data from the ECB's Consumer Expectations Survey showed that there had been no significant change since the increase in expected inflation that had occurred in March 2022. Market-based measures of inflation compensation continued to point to a sharp decline in inflation rates next year, from very high levels to significantly lower rates.

Turning to monetary and financial developments, bank funding costs had been gradually increasing, which reflected the changes in risk-free rates. Since early 2022 bank bond yields had risen by more than 300 basis points. Deposit rates for households and firms had also seen a significant increase and were expected to rise further in the coming months in the context of monetary policy normalisation.

Rates on lending to firms and households had also increased and credit standards had tightened markedly.

The latest monetary data for September showed large shifts from overnight to time deposits, mainly on the part of firms and other financial intermediaries (OFIs). Households had also recorded their largest inflow into time deposits for ten years, but still continued to increase their holdings of overnight deposits. This deposit reconfiguration was in line with the increase in opportunity costs of holding overnight deposits since the beginning of monetary policy normalisation. The September monetary data also confirmed a drop in loan flows to non-financial corporations and, in particular, to households, providing further evidence that the tightening of financial conditions was being transmitted to the real economy.

Finally, Mr Lane reported the results of the October ECB Survey of Monetary Analysts. Compared with the September survey, respondents now expected the path of the key ECB interest rates to steepen and shift upwards by about 100 basis points.

Summing up, Mr Lane stressed that inflation remained far too high and would stay above the ECB's target of 2% for an extended period. Inflation had increased again in September, to 9.9%. Energy price inflation had exceeded 40%, which was due to one-off effects but also reflected the ongoing pass-through of wholesale prices to retail prices. Food price inflation had also risen further, to 11.8%, owing to developments in both the unprocessed and processed food components. Measures of underlying inflation were at elevated levels. Among those measures, inflation excluding energy and food had risen to 4.8% in September, from 4.3% in August, reflecting the impact of high utility prices on the cost structures of many sectors, the ongoing impact of supply bottlenecks and the post-pandemic recovery in demand. Wage growth had continued to increase gradually.

At the same time, there were no clear signs of widespread second-round effects, and longer-term inflation expectations remained broadly aligned with the 2% target. Still, the increases in wage growth signalled by the ECB wage tracker were moderately above the levels embedded in the September staff projections, and wage pressures in the public sector could add a further impulse.

Overall, risks to the inflation outlook were primarily on the upside. The major risk in the short term was a further rise in retail energy prices. Over the medium term inflation could turn out to be higher than expected if there were increases in the prices of energy and food commodities and a stronger pass-through to consumer prices; a persistent worsening of the production capacity of the euro area economy; a persistent rise in inflation expectations above the ECB's target; or higher than anticipated wage rises. By contrast, a decline in energy costs and a further weakening of demand would lower price pressures.

Economic activity was likely to have slowed significantly in the third quarter of the year and was expected to weaken further in the remainder of 2022 and the beginning of 2023. Higher inflation, lingering uncertainty and further cuts in the supply of gas from Russia had dampened consumer and business confidence and were expected to curb aggregate demand in the second half of 2022. The effects of the reopening of the economy that had boosted services over the spring and summer were expected to fade in the autumn and winter months. Households were concerned about inflation eroding real disposable incomes, with those on low incomes being especially affected. While supply-chain bottlenecks were gradually easing, the energy supply shock would continue to weigh on manufacturing activity and trade. In addition, global economic prospects remained clouded.

In line with these developments, available indicators and short-term estimates pointed to marginal downside risks for the third quarter of 2022 and to clear downside risks for both the fourth quarter of the year and the first quarter of 2023, compared with the September 2022 projections. A long-lasting war in Ukraine was still a significant risk. Confidence could deteriorate further and supply-side constraints could worsen again. Energy and food costs could also remain persistently higher than expected. A weakening world economy could be an additional drag on growth in the euro area.

So far, the labour market had continued to be a source of resilience for the economy but, since it generally reacted with a delay to economic activity, it was likely to lose momentum. Accordingly, the weakening of the economy could lead to somewhat higher unemployment in the future.

Market interest rates had risen and broader financial conditions had tightened significantly amid expectations of faster and more substantial monetary policy tightening, both in the euro area and globally. Government bond yields had risen in tandem with risk-free interest rates, with spreads narrowing slightly, probably continuing to reflect support from the Transmission Protection Instrument and communication on flexible reinvestments under the pandemic emergency purchase programme (PEPP). Bank funding costs were increasing in response to rising market interest rates. This was making borrowing more expensive for firms and households. While bank lending to firms had remained robust, as they needed to finance high production costs and build up inventories, demand for loans to finance investment had continued to decline. Household borrowing for house purchase had reached a turning point in the summer. The latest bank lending survey indicated that credit standards had tightened, with banks becoming more concerned about the deteriorating outlook for the economy and the risks faced by their customers in the current environment. Banks expected to continue tightening their credit standards in the fourth quarter.

Monetary policy considerations and policy options

In view of the protracted period of excessively high inflation and the risk that this may add to medium-term price pressures, Mr Lane proposed that the three key ECB interest rates be raised again by 75 basis points at the present meeting. With this third major policy rate increase in a row, substantial progress would be made in withdrawing monetary policy accommodation. Since the ECB’s policy rates were still accommodative, a large increase would underscore the Governing Council’s commitment to taming inflation by reducing support for demand and ensuring inflation expectations remained anchored at the medium-term target. As a further tangible sign of this commitment, it should be communicated that the Governing Council expected to raise rates further. The future rate path should be based on the evolving outlook for inflation and the economy, following a meeting-by-meeting approach.

In addition to further rate normalisation, Mr Lane proposed changing the terms and conditions of the third series of targeted longer-term refinancing operations (TLTRO III). During the acute phase of the pandemic, the TLTROs had played a key role in countering downside risks to price stability. In that period the ECB had granted exceptionally favourable conditions to credit institutions that borrowed via these operations, with the aim of sustaining the supply of bank loans to the real economy at a time when banks were likely to pull back and disengage from credit intermediation. At present, in view of the unexpected and extraordinary rise in inflation, the instrument needed to be recalibrated to ensure that it was consistent with the broader monetary policy normalisation process and to reinforce the transmission of policy rate increases to bank lending conditions. It was therefore necessary to adjust the interest rates applicable to TLTRO III from 23 November 2022 and to offer banks additional voluntary early repayment dates.

The proposed recalibration was proportionate. First, it would contribute to the normalisation of bank funding costs. The ensuing normalisation of financing conditions would, in turn, exert downward pressure on inflation over the medium term. Moreover, the recalibration removed disincentives for voluntary early repayment of outstanding TLTRO III funds, which would reduce the Eurosystem's balance sheet. It was also expected to facilitate the release of securities currently being used as collateral with the Eurosystem, thereby alleviating collateral scarcity and improving the money market intermediation capacity of banks by reducing their balance sheets. This, in turn, supported a smoother and more efficient pass-through of the Governing Council's policy rate increases to secured money market rates. Second, the proposed recalibration was more efficient than seeking to achieve the same objective through a shorter full-reinvestment period for the Eurosystem's bond holdings or through more aggressive interest rate hikes. While amending the TLTRO III conditions might have side effects, the abrupt and unforeseeable change in circumstances justified a change in the policy stance if this was in the service of the ECB's primary objective.

Moreover, Mr Lane proposed adjusting the remuneration of the minimum reserves held by credit institutions with the Eurosystem, to align it more closely with money market conditions. Given the high levels of excess liquidity, the marginal cost of reserves was currently anchored at the interest rate on the deposit facility, not the rate on the main refinancing operations. Changing the remuneration from the main refinancing operations rate to the deposit facility rate would thus restore the neutrality of the minimum reserves system.

Finally, Mr Lane proposed continuing to apply flexibility in reinvesting redemptions falling due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

Regarding 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 remained far too high and would stay above target for an extended period. In September euro area inflation had reached 9.9%, with soaring energy and food prices, supply bottlenecks and the post-pandemic recovery in demand having led to a broadening of price pressures and an increase in inflation in recent months.

As regards the external environment, the latest data confirmed signals of slowing economic growth across countries and sectors and implied a substantial reversal of the pick-up in global activity recorded earlier in the year. It was observed that an increasing number of economies were expected to enter a recession. The concern was expressed that the cumulative impact of the slowdown, also including spillovers from synchronised monetary policy tightening, could even result in a "technical recession" at the global level. At the same time, reference was also made to easing global supply bottlenecks. Uncertainty surrounded China and the United States, with global activity being negatively affected by China's closure of its economy and by the global fallout from restrictive monetary policy in the United States. At the same time, it was argued that lockdowns in China had led to declines in the country's imports of liquified natural gas, with dampening effects on gas prices. In this regard, it was noted that spot prices for natural gas had seen an unexpected sharp fall in recent days and that the recent movements in global commodity markets had almost reversed the price increases posted since the beginning of the year. Some further alleviation of global energy price pressures was anticipated for 2023. However, it was argued that futures prices suggested some reversal of this trend and that, even after their recent decline, gas prices had been very volatile and were still many times higher than in the past.

Turning to euro area developments, economic activity in the euro area was likely to have slowed significantly in the third quarter of 2022, with the weakening expected to continue during the remainder of the year and into early 2023. By reducing real incomes and pushing up costs for firms, high inflation continued to dampen spending and production. Severe disruptions in the supply of gas had further worsened the situation, and consumer and business confidence had fallen rapidly, also weighing on the economy. Demand for services was slowing after performing strongly in previous quarters, when those sectors most affected by the pandemic-related restrictions had reopened, and survey-based indicators for new orders in the manufacturing sector were lower. Moreover, global economic activity was growing more slowly, in a context of persistent geopolitical uncertainty – especially owing to Russia's unjustified war against Ukraine – and tighter financing conditions. Worsening terms of trade were weighing on incomes in the euro area. At the same time, the labour market had continued to perform well in the third quarter, with the unemployment rate remaining at the historically low level of 6.6% in August. While short-term indicators suggested that jobs were still being created in the third quarter of the year, the weakening of the economy could lead to somewhat higher unemployment in the future.

Members widely agreed that the outlook for euro area economic activity had deteriorated since the September monetary policy meeting. It was noted that all components of demand, including consumption, investment and exports, showed signs of weakening. Reference was made to the latest forward-looking survey indicators for economic activity, which had posted strong declines and were signalling a contraction. It was argued that a technical recession was becoming the baseline scenario and the most likely outcome. The view was expressed that, while real GDP for the quarter ahead had repeatedly been underestimated in previous staff projections, it was currently likely that the projection error would have the opposite sign. At the same time, it was cautioned that, so far, the hard evidence was consistent with a mild recession rather than suggesting a hard landing for the economy or a protracted downturn.

This distinction was widely seen as a key issue for the current economic picture and for the medium-term inflation outlook. A question was raised on the propagation mechanisms that could turn a shallow and short-lived recession into a deep and prolonged slump. Weakness in the banking sector had been a factor in past episodes but was likely not a key factor now, while the housing market – at least in some countries – might play a role. Another issue was what a recession would imply for the resilience of the labour market. In this regard, it was noted that the latest data for the forward-looking PMI survey indicators for manufacturing were down for activity but up for employment. At the same time, it was observed that the ratio of job vacancies to unemployed persons had remained much lower in the euro area than in the United States, pointing to a lesser degree of labour market tightness in the euro area.

It was argued that uncertainty and losses in purchasing power were the main factors behind the deterioration in the outlook, reflecting lower real wages but also lower real financial wealth, given that many households held their savings in low-remunerated deposits and debt securities. In this context, reference was made to analysis that pointed to substantially higher inflation rates for lower income households, since energy and food items made up a greater proportion of their consumption. This was seen as a reminder that inflation had substantial distributional consequences. It was argued that consumer confidence was likely to stay weak as long as inflation stayed high, as consumers had now lost a large part of previous gains in purchasing power. At the same time, it was recalled that there were still substantial excess savings accumulated during the pandemic crisis that could – together with fiscal support and a strong labour market – bolster consumption. In this context, it was noted that the findings of the Consumer Expectations Survey suggested that some households were keeping up their spending either by saving less or by liquidating part of their stock of savings.

Regarding fiscal policy, it was reiterated that fiscal support measures to shield the economy from the impact of high energy prices should be temporary and targeted at the most vulnerable, in order to limit the risk of fuelling inflation. Policy measures should provide incentives to lower energy consumption and bolster energy supply. At the same time, governments should pursue fiscal policies that showed they were committed to gradually bringing down high public debt ratios. Structural policies should be designed to increase the euro area's growth potential and supply capacity and to boost its resilience, thereby contributing to a reduction in medium-term price pressures. The swift implementation of the investment and structural reform plans under the Next Generation EU programme would make an important contribution to these objectives. The solution to the energy problem was seen as mainly of a structural nature.

The point was made that the planned fiscal support appeared to differ across countries. Concern was expressed that, in the face of high energy costs, there was growing pressure on governments to support demand via transfers, which would then fuel inflation, instead of fostering potential growth through targeted public investment. While there was a risk that fiscal compensation packages would turn out to be bigger than warranted, also from a price stability perspective, it was also argued that the planned and expected additional fiscal measures were needed in view of the expected recession. When assessing the fiscal stance, it was considered important to include the EU funds. It was recalled that a recession would activate automatic stabilisers, which would increase spending at the same time as tax revenues declined. Moreover, as tax revenues had been bolstered by the "inflation tax", the expected decline in inflation would have a dampening impact on revenues at a time when funding costs were rising as a result of higher interest rates, leading to a deterioration in nominal deficits.

Against this background, the incoming data confirmed that risks to the economic growth outlook were clearly on the downside, especially in the near term. A long-lasting war in Ukraine remained a significant risk. Confidence could deteriorate further and supply-side constraints could worsen again. Energy and food costs could also remain persistently higher than expected. A weakening world economy could be an additional drag on growth in the euro area. The concern was expressed that, with the changes in the economic outlook, the economy was now closer to the downside scenario than to the baseline scenario depicted in the September ECB staff projections. However, a note of caution was voiced against equating the current outlook to the downside scenario. This was because the mechanisms were different, as regards both gas price developments and potential gas-supply rationing affecting production. It was argued that, in many respects, the outlook was more benign than the September downside scenario. However, in the meantime, other downside risks had materialised.

With regard to price developments, members generally agreed with the assessment presented by Mr Lane in his introduction. Inflation had risen to 9.9% in September, reflecting further increases in all components. Energy price inflation had remained the main driver of overall inflation, with an increasing contribution from gas and electricity prices. Food price inflation had also risen further, as high input costs had made food production more expensive. Supply bottlenecks were gradually easing, although their lagged impact was still contributing to inflation. The impact of pent-up demand, while weakening, was still driving up prices in the services sector. The depreciation of the euro had added to the build-up of inflationary pressures. Price pressures were evident in an increasing number of sectors, in part owing to the impact of high energy costs feeding through to the whole economy. Measures of underlying inflation had thus remained at elevated levels. Among those measures, inflation excluding energy and food had risen further to 4.8% in September.

Members underlined that the latest inflation outcomes were not at all reassuring. Data continued to come in above expectations. Concerns were expressed especially with regard to core inflation and the broader array of measures of underlying inflation, which appeared to be gradually increasing further and – with few exceptions – did not point to the stabilisation that had been hoped for and that had been embedded in the September staff projections. The continued strong short-run momentum was also confirmed by the upward trend in month-on-month increases in core inflation.

At the same time, it was pointed out that prices for natural gas had fallen. There were doubts as to whether, in view of the high volatility in the market, these lower gas prices would be sustained and should form the basis of a revised outlook. But it was also noted that the latest developments cautioned against simply extrapolating the very large impact that had been included in the September projections. The point was made that a correction in wholesale energy prices did not automatically imply a corresponding pass-through to HICP inflation. The earlier surges in energy prices had led to ever-faster impacts on inflation, and it remained to be seen how this would evolve when the commodity price surges were reversed. Changes and non-linearities in the speed and strength of the pass-through, depending on the size and persistence of the energy price shock, were typically not embedded in the models used for forecasting. It was recalled that what ultimately mattered was not wholesale but consumer energy prices, and that it was thus important to understand the pass-through mechanisms between the two and the corresponding time lags. The observation was made that long-term contracts could imply long delays, with significant upward pipeline pressures still working their way through.

References were made to various decompositions of inflation into underlying factors. First, it was noted that the rise in both headline and core inflation had come with an increase in demand-driven factors. Inflation could thus decline as a result of both supply and demand factors. Doubts were expressed as to whether, at the current juncture, relaxations on the supply side would be sufficient, and it was argued that a reduction in inflation would need to be driven mostly by a lower contribution from the demand component. Second, the decomposition of non-energy industrial goods inflation and services inflation showed that the non-energy-intensive components of inflation were also increasing. It was thus cautioned that any alleviation of inflationary pressures on the energy side could be offset by countervailing forces. One such force was exchange rate depreciation, which was negatively affecting the inflation outlook on a broad basis. More generally, the pass-through from producer to consumer prices was taking time and was still accounting for further upward pressure in the pipeline. It was recalled that the pass-through had recently been faster and stronger than expected and embedded in standard models. However, it was also argued that the quicker and stronger the pass-through, the faster the overall price adjustment would be completed and the earlier inflation rates could normalise. In this context it was seen as useful to also look at quarter-on-quarter inflation rates to get a better picture of inflation dynamics, given that annual rates were affected by base effects and carry-over.

With regard to wages, continued strong labour markets were likely to support higher wages, and some catch-up in wages to compensate for higher inflation was likely. Incoming wage data and recent wage agreements indicated that wage growth might be picking up. This could also be inferred from the statements of union representatives, employers and politicians. The tight labour market and the prolonged period of high inflation were seen as beginning to have an impact on wage growth. In the Corporate Telephone Survey, a large majority of respondents had expected wage increases to be above 4% in 2023. At the same time, it was argued that, even though growth in negotiated wages and in compensation per employee might be more dynamic, their levels were still moderate compared with inflation and there were no clear signs of a wage-price spiral. However, it was recalled that wages were a lagging indicator, and some doubts were expressed as to whether the still comforting picture provided by the experimental ECB wage tracker would hold up. It was considered unwise to assume that workers would simply accept the hit to real wages without a stronger response of nominal wages. There was a risk that future wage growth was being underestimated, as also suggested by more timely information on wages from job postings on private digital platforms, which were increasing faster than data on negotiated wages.

While it was argued that the euro area labour market was clearly a source of strength and resilience, it was cautioned that labour markets were still undergoing normalisation in the wake of the pandemic-related crisis, also with respect to the associated swings in productivity and sectoral reallocations. Hence, concern was expressed that this strength could be undermined if wages were overstretched in such a delicate adjustment period. Attention was also drawn to the unusual resilience of profits and profit margins in the light of deteriorating cyclical conditions, which was as important as wage developments when it came to factors driving inflation and inflation persistence.

As regards longer-term inflation expectations, most measures were currently standing at around 2%, although further above-target revisions to some indicators warranted continued monitoring. It was argued that survey-based measures had been trending upwards for some time and that market-based measures were pointing in the same direction, with no sign of a turning point. At the same time, it was recalled that market-based inflation measures contained an inflation risk premium, which had turned positive. A note of caution was added, to not only look at the upper tail of the distribution when assessing risks to longer-term inflation expectations but to include the lower tail. In the Survey of Monetary Analysts, the distribution appeared to have become more symmetric. Moreover, survey expectations had likely been measured at a cut-off date prior to the recent fall in gas prices and, if this fall were to persist, these expectations might see some downward adjustment. It was argued that, with actual HICP inflation standing at around 10%, longer-term inflation expectations had remained relatively well anchored.

At the same time, it was warned that the formation of inflation expectations was becoming more and more backward-looking. If actual inflation was not brought down in a timely manner, expectations would increasingly react to actual inflation and would, in turn, push it higher. In this context, reference was made to the substantial upward shifts in the expectations for headline and core inflation in 2024 as reflected in the Survey of Professional Forecasters, which pointed to an increased risk of unanchoring. An upward shift in medium-term inflation expectations had also been seen in the Consumer Expectations Survey.

Against this background, members agreed that the risks to the inflation outlook were primarily on the upside. The major risk in the short term was a further rise in retail energy prices. Over the medium term, inflation could turn out to be higher than expected if there were increases in the prices of energy and food commodities and a stronger pass-through to consumer prices; a persistent worsening of the production capacity of the euro area economy; a persistent rise in inflation expectations above the ECB's target; or higher than anticipated wage rises. By contrast, a decline in energy costs and a further weakening of demand would lower price pressures. It was pointed out that risks and their direction needed to be reassessed in the December Eurosystem staff projections.

One key issue was the extent to which a possible recession would limit upside risks to inflation in the medium term. It was argued that a shallow or technical recession was unlikely to keep inflation in check given its recent momentum and the risk that price increases would be difficult to reverse. However, reference was made to the downside scenario in the September projections, in which there would be a deeper recession in 2023 than in the baseline scenario and a higher inflation rate in 2024. It was commented that any dampening effect from a recession could be counterbalanced by an increased likelihood of second-round effects as a result of higher inflation in the short term, leading to greater inflation persistence and constituting an upside risk to the medium-term inflation outlook. It was argued that there was an increasing risk of a vicious circle in which higher inflation expectations would feed into both higher prices and higher wages, and the concern was raised that such effects could be highly non-linear given the size of the shock. It was also argued that potential economic output might be lower than currently estimated. Lower potential output would imply higher inflationary pressures and could reconcile the difference between estimates of the unemployment and output gaps.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. Bank funding costs were increasing in response to the rise in market interest rates, translating into higher borrowing costs for firms and households. Bank lending to firms had remained robust, whereas household borrowing for house purchase had reached a turning point in the summer. The latest bank lending survey indicated that banks had tightened their credit standards in the third quarter of the year and expected to continue tightening them in the fourth quarter. It was pointed out that the transmission of the increase in bank lending rates to households was highly dependent on the fixation period for interest rates in mortgage contracts, which differed significantly across euro area economies.

Members agreed that financial conditions across markets and financing conditions for different types of borrowers had tightened significantly in anticipation of a faster and more substantial monetary policy tightening, both in the euro area and globally. Euro area government bond yields had risen in lockstep with risk-free interest rates, with their spreads relative to the OIS rate having remained broadly unchanged since the Governing Council’s September monetary policy meeting. The spreads had been relatively insensitive to shifts in monetary policy expectations, which probably reflected support from the Transmission Protection Instrument and communication on flexible reinvestments under the PEPP.

In this context, it was highlighted that the Governing Council’s interest rate hike in September had not been transmitted smoothly to all segments of the repo markets. Use of the Eurosystem facility for securities lending against cash had reached its second highest level ever after the September interest rate decision took effect. Tensions in the repo market had also been reflected in the behaviour of the swap spread, i.e. the spread between OIS rates and sovereign bond yields of the same maturity, which had widened in some jurisdictions, partly owing to the scarcity of collateral.

It was remarked that financial market volatility had increased since the September Governing Council meeting, as evidenced by the bond market turbulence that was triggered by the announcement of the initial UK budget plans for 2023. The view was expressed that, for a long period, central bank policy measures had suppressed volatility to a significant extent and that some reversal of this situation could be considered a healthy return to more normal market conditions. It was considered noteworthy that volatility had been especially pronounced in markets that were traditionally considered low-risk, such as the money markets and the sovereign bond markets, with higher volatility in these markets since the beginning of the year than in the equity market. However, measures such as liquidity or bid-ask spreads indicated that euro area markets had continued to function well.

Monetary policy stance and policy considerations

Turning to the monetary policy proposals, the view was widely shared that the inflation outlook continued to worsen, with inflation far too high and repeatedly above the projected figures. In addition, price pressures had become more broad-based, with a rising trend in core inflation and other measures of underlying inflation. These developments indicated an increasing risk that inflation might become entrenched and that second-round effects and a wage-price spiral could emerge. A return of inflation to the ECB's 2% target was deemed unlikely without further decisive monetary policy action. Such action would also underscore the Governing Council's commitment to bringing inflation under control and keeping inflation expectations anchored.

At the same time, it was underlined that, although wage growth was accelerating, it could still be considered moderate and there were no indications of a wage-price spiral at present. Moreover, price pressures originating from international commodity markets had weakened recently, and the expected economic downturn, together with higher interest rates and tighter financial conditions, would dampen inflation in the medium term.

Although the economic outlook had deteriorated considerably, it was widely judged that the expected weakening in economic activity would not suffice to curb inflation to a significant extent and would not in itself bring projected inflation back to the target. It was argued that, in the event of a shallow recession, the Governing Council should continue normalising and tightening monetary policy, whereas it might want to pause if there was a prolonged and deep recession, which would be likely to curb inflation to a larger extent. In this context, attention was also drawn to the divergence between monetary policy, which was removing accommodation, and fiscal policy, which was becoming more expansionary.

It was reiterated that the Governing Council had to focus squarely on its primary objective and on bringing inflation back to target in a timely manner. Reference was made to the outcome of the ECB's strategy review, which had underscored its commitment to act forcefully, using all available instruments, to address prolonged downward deviations from the target. The ECB now needed to show equal determination when inflation was above the target, countering far too high inflation and preventing it from becoming entrenched, irrespective of a deteriorating outlook for economic activity.

Monetary policy decisions and communication

Against this background, all members agreed that, in view of the current inflation outlook, it was appropriate to continue normalising monetary policy by withdrawing accommodation to ensure that demand was no longer sustained. While the Governing Council's monetary policy actions were having the desired effect on financial and financing conditions, the current setting of the ECB's key policy rates was judged to be still accommodative, which implied that they should be increased further. The view was widely shared that monetary policy normalisation had to continue in order to counter the risk of long-term inflation expectations becoming unanchored and of a possible wage-price spiral. Successive inflation figures above the projections, heightened uncertainty and the prevailing upside risks to the inflation outlook were seen as warranting further action.

Turning to the size of the rate increase, Mr Lane's proposal to raise the key ECB interest rates by 75 basis points was supported by a very large majority of members. A 75 basis point increase was judged to be an appropriate response in view of the protracted period of excessively high inflation and the risk that this might add to medium-term price pressures. It was recalled that the monetary policy stance was still accommodative and argued that a 75 basis point increase constituted a necessary step toward a more neutral level. It would also amount to a further frontloading of interest rate increases, allowing a neutral level to be reached swiftly. Moreover, it was noted that market participants were pricing in an increase of this size. It was argued that falling short of these market expectations would imply an unwelcome loosening impulse, potentially undermining confidence in the Governing Council's commitment to price stability. The view was held that feeding uncertainty as regards the way the Governing Council would react to the inflation outlook could further increase the volatility of risk-free interest rates in the present environment. It was also argued that, when the persistence of high inflation was uncertain, optimal policy called for a forceful response to reduce the risk of inflation remaining high for too long.

A few members expressed a preference for increasing the key ECB interest rates by 50 basis points, taking into account that the rate hike would be accompanied by a signal on the need for further future rate hikes, by a change in the remuneration of minimum reserves, and by the adjustment of the terms and conditions of TLTRO III, all of which would imply some additional monetary policy tightening. While the direction of monetary policy was clear, prudence was necessary as regards the pace of the adjustment. A 50 basis point hike was deemed sufficient to adjust the monetary policy stance in a gradual and measured way given that market sentiment was fragile, the risk of a significant slowdown in economic activity was increasing and financing conditions had already tightened significantly since the start of the normalisation process. Moreover, it was argued that an overly aggressive pace of tightening could have repercussions for financial stability, economic activity and ultimately inflation.

While it was widely felt that, with a 75 basis point increase, the Governing Council would make substantial progress in withdrawing monetary policy accommodation, it was also clear that rates would need to be raised further to reach a level that would deliver on the ECB's 2% medium-term target, although decisions would need to be based on incoming data and the evolving outlook for inflation and the economy. Overall, in the light of prevailing uncertainties, there was broad support for a meeting-by-meeting, data-dependent approach to taking monetary policy decisions.

A discussion took place on the use of concepts such as the "neutral rate" or the "terminal rate" consistent with inflation returning to target over the medium term, with different views expressed on the link between these measures and projection scenarios or on their steady state properties. At the same time, while the difficulty of relying on precise values of these rates was acknowledged, there was agreement that, looking ahead, the Governing Council needed to continue removing accommodation with further interest rate hikes. Moreover, the view was expressed that monetary tightening would probably need to continue after the monetary policy stance had been normalised and moved into broadly neutral territory. With respect to the December monetary policy meeting, it was noted that the Governing Council would have more information available, which was seen as especially valuable in the light of the high market volatility and uncertainty that characterised the current environment. Moreover, the December staff projections would provide more information over a horizon extending up to 2025, including an assessment of how the increased recession risks, the development of commodity prices and the tightening of financial conditions since the September meeting would affect the medium-term inflation outlook.

Turning to the ECB's outstanding lending operations, members unanimously agreed with Mr Lane's proposal to change the terms and conditions of TLTRO III. The adjustment was seen as an essential part of the ongoing monetary policy normalisation process and the recalibration of the Governing Council's toolkit to ensure consistency across all monetary policy instruments. Moreover, it was in line with the Governing Council's communication that it stood ready to adjust all of its instruments within its mandate to ensure that inflation returned to its medium-term target. Since the last recalibration of TLTRO III in December 2020 the inflation outlook had changed fundamentally, in part owing to the war against Ukraine, which had led to an energy crisis that could not have been foreseen at the time. Accordingly, the Governing Council had to recalibrate its monetary policy stance, including the terms and conditions of TLTRO III, in order to pursue its price stability mandate. In the light of the worsening inflation outlook and the still negative short-term real interest rates, monetary policy transmission had to be accelerated.

The view was widely held that a change in the TLTRO III conditions would reinforce the transmission of changes in the policy rates to bank funding costs and bank lending conditions for households and firms, which to date did not fully reflect the intended monetary policy tightening. Moreover, it was argued that maintaining the average TLTRO III rate for the remaining lifetime of the operations at a rate below the deposit facility rate risked blurring the intended policy signal, which could call into question the Governing Council's determination to bring inflation back to its medium-term target of 2% in a timely manner.

It was noted that with the adjustment of the TLTRO III conditions banks would have the incentive and the opportunity for early repayment of their borrowing, which would also contribute to the normalisation of the Eurosystem's balance sheet. Such a decrease in the size of the balance sheet was judged to be necessary and a helpful first step before considering a reduction of the asset purchase programme (APP) portfolio. Finally, it was noted that a repayment of TLTRO III funds would reduce banks' need for collateral, which could flow back to the market and thereby help to alleviate the collateral scarcity that had led to repo market tensions.

Overall, members agreed that the monetary policy case for adjusting the TLTRO III conditions was strong and that the resulting effects could not be achieved through other measures, as indicated by Mr Lane in his proposal. Although side effects were acknowledged, these were seen not to outweigh the benefits from the TLTRO III adjustment, which was required in order to maintain the effectiveness of monetary policy and thereby the Governing Council's ability to attain its medium-term inflation target in a timely manner. In consideration of all these arguments, the adjustment was therefore judged to be proportionate in the service of the Governing Council's mandate.

Members further agreed with Mr Lane's proposal to lower the remuneration of the minimum reserves held by euro area credit institutions with the Eurosystem, from the rate on the main refinancing operations to the deposit facility rate, in order to align it more closely with money market conditions.

Members also agreed with the proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio. Retaining the existing flexibility in PEPP reinvestments was seen as a prudent approach to countering risks to the monetary policy transmission mechanism related to the pandemic, which still persisted in the current market environment.

Looking beyond the configuration of the key ECB interest rates, it was underlined that the Eurosystem's large bond portfolios were continuing to provide further significant monetary policy accommodation by compressing term premia. Allowing the downward pressure on term premia to decline would facilitate more efficient setting of monetary policy, thereby helping to contain inflation. In this respect, it was seen as necessary, following an assessment of the repayments resulting from the adjustment of TLTRO III and their impact on financial conditions, to discuss the reinvestment strategy for the APP portfolio at the Governing Council's December monetary policy meeting.

Members widely concurred with Mr Lane that monetary policy should continue to be data-dependent and not follow a pre-set path, in accordance with a meeting-by-meeting approach to setting interest rates. To stress the Governing Council's commitment to achieving its medium-term inflation target, it was seen as important to indicate that interest rates were expected to be raised further in order to guard against the risk of inflation expectations becoming unanchored. Forward guidance on interest rates was widely seen as being of little value in view of the high uncertainty currently prevailing. In the same vein, indicating the size of future interest rate adjustments was seen as implying renewed forward guidance on interest rates, which the Governing Council had deemed no longer warranted.

The Governing Council stressed the importance of authorities addressing supply-side issues with appropriate structural and macroprudential policies, which would support monetary policy in ensuring price stability. Finally, it was seen as appropriate to reiterate that the Governing Council stood ready to adjust all of its instruments within its mandate to ensure that inflation returned to its medium-term target of 2%.

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 27 October 2022

Press releases
Monetary policy decisions

ECB recalibrates targeted lending operations to help restore price stability over the medium term

ECB adjusts remuneration of minimum reserves

Meeting of the ECB’s Governing Council, 26-27 October 2022

Members

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

- Mr Kažimír*
- Mr Knot*
- Mr Lane
- 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 Vujčić**
- Mr Wunsch

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

** As observer.

Other attendees

- Mr Dombrovskis, Commission Executive Vice-President***
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy

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

Accompanying persons

- Mr Cassidy — Alternate to Mr Makhlouf

- Mr Demarco
- Mr Gavilán
- Ms Goulard
- Mr Haber
- Mr Kelly
- Mr Koukoularides
- Mr Kuodis
- Mr Luikmel
- Mr Lünnemann
- Mr Madouros
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Sleijpen
- Mr Tavlas
- Mr Ulbrich
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 19 January 2023.