EUROPEAN CENTRAL BANK
EUROSYSTEM

Meeting of 24-25 January 2024

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 24-25 January 2024

22 February 2024

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

Financial market developments

Ms Schnabel noted that, since the Governing Council's previous monetary policy meeting on 13-14 December 2023, the rapid easing of financial conditions observed after the 25-26 October meeting had levelled off and been pared back slightly.

Financial conditions had eased sharply in November and December, as the narrative in financial markets had shifted from "high for longer" to swift disinflation and imminent monetary policy easing. After the Governing Council's 13-14 December meeting, financial conditions had continued to ease until late December but had tightened slightly thereafter. This followed ECB communication that had countered the aggressive market pricing of a rate-cutting cycle starting as early as March 2024.

While the probability of a 25 basis point cut in April still stood at around 60%, a first cut was now fully priced in only for June. Expected cumulative rate cuts by the end of the year had declined slightly since the December meeting, to around 130 basis points. Policy rate expectations in US forward markets had also been scaled back, although to a slightly lesser extent. US interest rate markets were positioned for an initial 25 basis point cut in May, with a 40% probability of a March cut. Moreover, investors expected almost the same magnitude of cumulative cuts as in the euro area in the course of 2024, anticipating a globally synchronised normalisation cycle.

However, the uncertainty around this policy path was high, as reflected in the persistent volatility in bond markets. The easing of global financial conditions in November and December 2023 had gone hand-in-hand with lower volatility in risk asset markets. Implied volatility in euro area equity markets had dropped to its lowest level since the onset of the coronavirus pandemic in February 2020, despite significant geopolitical tensions and risks of protracted economic weakness. Yet, lower implied volatility in risk asset markets was not accompanied by meaningfully lower implied volatility in bond markets, which had decoupled from equity market volatility.

There were two potential sources of heightened monetary policy uncertainty. The first was the timing and pace of the policy adjustment, while the second was the extent of the required policy adjustment. Respondents to the January 2024 ECB Survey of Monetary Analysts (SMA) had raised their expectations for the pace of rate cuts over the year but remained more cautious than financial market pricing. While markets foresaw a cumulative easing of around 130 basis points, SMA respondents expected total cuts of 100 basis points by the end of the year. Differences in the outlook for inflation could explain the discrepancy between market pricing and analysts' expectations for the future path of monetary policy. Investors trading in financial markets were discernibly more optimistic about the inflation outlook than the median SMA respondent. Another explanation could be different speeds in adjusting to new information. During the interest rate tightening cycle in 2022 and 2023, rate markets had consistently led survey expectations, often by several months.

The second source of uncertainty about the medium-term policy rate path concerned the extent of adjustment required to return to a neutral policy rate and the uncertainty surrounding estimates of such a rate. SMA participants had raised, noticeably, their median longer-run expectations for policy rates compared with levels during the period before the start of the ECB's hiking path.

The expected reversal of the 2023 tightening was also visible in longer tenors of the yield curve. The euro area ten-year real overnight index swap (OIS) rate remained close to early 2023 levels and slightly below its September 2023 level, when the ECB had last hiked interest rates. The corresponding nominal OIS interest rate had even fallen below early 2023 levels. In the United States, the ten-year real OIS interest rate had fallen to a similar degree since late October but remained above early 2023 levels. The reappraisal of the monetary policy outlook had been the dominant driver of the decline in bond yields since the Governing Council's October monetary policy meeting, along with news on the growth outlook and fiscal developments.

The rescaling of the earlier aggressive market pricing had also affected risk asset markets. Yet, euro area equity markets remained broadly unchanged since the December meeting. A longer perspective, since the start of 2023, revealed that developments in equity markets, as in other risk asset markets, had been robust, providing an easing impulse to financial conditions. The somewhat stronger repricing of monetary policy expectations in the euro area than in the United States had been reflected in a slight appreciation of the euro, with the US dollar moving lower against a broad set of currencies.

Intra-euro area sovereign bond spreads had declined further, as the announcement regarding the phasing-out of reinvestment under the pandemic emergency purchase programme (PEPP) had been well absorbed by the market and some government bonds had seen record demand. The announcement on the PEPP and the ongoing gradual and predictable unwinding of the Eurosystem's bond portfolios under the asset purchase programme (APP) had not amplified the sensitivity of spreads to changes in risk-free rates, suggesting that fragmentation risks remained muted.

Absorption in euro area government bond markets had been supported by benign liquidity conditions, underpinned by the return of foreign investors and investment funds. The prospects for smooth and healthy market absorption remained largely in place for 2024. Benign market conditions had also been evident in 2023 year-end trading and repo market functioning. Repo rate declines in general collateral and non-general collateral markets had been substantially more contained than at the 2021 and 2022 year-ends.

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

Reviewing the global environment, Mr Lane noted that global economic activity had moderated in the fourth quarter of 2023. At the same time, global trade growth was improving as post-pandemic patterns normalised. However, the recent tensions in the Red Sea and Gulf of Aden were a downside risk to trade, since these could adversely affect delivery times and maritime shipping costs, especially on routes between China and Europe. Since the end of December, there had been a big drop in transit volumes, with some shipping re-routing around Africa. So far, the rental price for container vessels was relatively unaffected, likely owing to spare capacity, while shipping prices had already increased.

Oil production was not expected to be affected by the developments in the Red Sea area. The latest projections from the International Energy Agency estimated that oil supply and demand would remain broadly in balance in the first quarter of 2024 and that the market would move into surplus in the remainder of the year. However, there had been notable movements in energy prices. Oil futures prices were significantly above levels at the time of the Governing Council's December meeting but gas futures prices were significantly lower. Mr Lane noted that, when analysing energy prices, it was also important to look at the EU Emissions Trading System (EU ETS) market. Emissions allowance prices had fallen 22% within the first three weeks of January, reflecting weak demand from the industry and power sectors. In the case of the power sector, this was due to the increased use of renewables.

Concerning global commodities, there had been little movement in food and metal prices since the last Governing Council meeting. Also since then, there had been limited change in the euro's exchange rates, both against the US dollar and in nominal effective terms.

Turning to the euro area, Mr Lane recalled that inflation had risen to 2.9% in December, from 2.4% in November, owing to energy-related base effects. However, the increase was less than expected.

While services inflation had remained steady at 4.0%, food and non-energy industrial goods inflation had continued to decline. Looking ahead, headline inflation and core inflation – as measured, respectively, by the Harmonised Index of Consumer Prices (HICP) and the HICP excluding energy and food – were expected to continue their downward trajectory.

Domestic inflation remained high at 4.5%, owing to the elevated pace of wage increases and falling labour productivity, but it too had started to ease. Indicators of momentum in headline inflation and all of its components had eased further. The annualised three-month-on-three-month growth rate of seasonally adjusted core inflation had fallen below 1.5%, with momentum in goods inflation at zero and momentum in services and food inflation close to 2%. A broad range of underlying inflation measures had also fallen in December. This reflected the fading impact of past shocks, as well as weaker demand that was, in part, the result of the ongoing strong transmission of tighter monetary policy. Among the different measures, the Persistent and Common Component of Inflation, which was the best predictor of inflation one and two years ahead, had eased to 2% in December.

Overall, the December inflation data provided further evidence that the disinflationary process was well on track and in fact might be running faster than previously expected. However, several headwinds were expected to increase inflation momentum again, as embedded in the December Eurosystem staff macroeconomic projections. This was largely due to the increasing role of wage pressures in explaining the dynamics of core inflation and also to the fading out of some of the energy price falls and the disinflationary pressures coming from the removal of supply bottlenecks.

Historically, the Purchasing Managers' Indices (PMIs) for prices had not been able to capture developments in goods and services inflation very well. Since 2020, however, the correlation had improved, with the PMIs showing a six-month leading property for goods and a nine-month leading property for services. On this basis, the PMIs suggested that downward pressures on goods and services inflation were likely to continue in the near term. However, the latest readings showed a small reversal, suggesting that these pressures were set to weaken.

Looking ahead, the expected slowdown in the disinflationary process was also evident from a decomposition of services inflation into "wage-intensive" and "not wage-intensive" components. So far, the declines in services inflation observed earlier had been driven by the not wage-intensive component, while the contribution from the wage-intensive component had declined only very gradually.

The pace of wage growth remained elevated but there were some initial signs of a deceleration. Unit labour costs had grown by 6.7% and compensation per employee by 5.3% in the third quarter of 2023. Negotiated wage growth had decreased from 4.8% in September to 4.6% in October. The forward-looking wage trackers signalled wage dynamics that were broadly in line with the December staff projections. Mr Lane also recalled that the wage tracker contained both old and new contracts, renegotiated at different points in time. New agreements signed at the end of 2023, if one-off payments were included, showed increases still above 5%. Moreover, many negotiations taking place in the first quarter of 2024 were expected to be concluded in February or March.

Survey-based measures of wage expectations showed that firms and professional forecasters expected a decline in wage growth in 2024. According to the January Corporate Telephone Survey, wage growth was expected to fall from 5.3% in 2023 to 4.4% in 2024. These expectations were a bit lower than in previous rounds. Similarly, in the latest Survey of Professional Forecasters, expectations for the annual growth in compensation per employee pointed to easing wage growth from 2024 onwards and had been revised down for the longer-term horizon. In particular, as of 2026, expected wage growth was below 3%, which was generally seen as the trend increase consistent with the ECB’s 2% medium-term inflation target.

The contribution of unit profits to domestic price pressures had continued to decrease in the third quarter of 2023, suggesting that – as expected – profit margins were absorbing some of the price pressures coming from wage increases. The January Corporate Telephone Survey suggested that firms had adjusted their profit margins during 2023. Although reported profit margins had edged up somewhat at the end of the year, they remained below the long-term average after being above it from early 2021 to mid-2023. This further confirmed that profits had started to mitigate the inflationary effects of wage increases.

Looking ahead, inflation was expected to ease further over the course of 2024, as the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy faded and tighter monetary policy constrained demand.

Measures of shorter-term inflation expectations had come down markedly, while longer-term inflation expectations mostly stood around 2%. Market-based measures of inflation compensation implied by fixings contracts – measures extracted from swap contracts linked to very near-term euro area inflation releases – indicated that investors were expecting inflation to fall to 2% as early as April and to stay at or below 2% for most of the remainder of 2024. The Consumer Expectations Survey showed that perceptions about inflation had finally declined in recent months. Households’ expectations one year ahead had declined considerably between October and December, whereas three-year ahead expectations had moved sideways since October. As regards professional forecasters, their inflation expectations had shifted down over the entire horizon, with longer-term expectations now standing at 2%.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and hamper global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins remained resilient. By contrast, inflation might surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly. Moreover, inflation could decline more quickly in the near term if energy prices evolved in line with the recent downward shift in market expectations for the future path of oil and gas prices.

The euro area economy had likely stagnated in the final quarter of 2023, following a mild contraction in real GDP in the third quarter. The latest statistical releases for services and industrial production indicated a drop relative to the third quarter, and survey indicators including the PMIs remained at levels consistent with falling activity. However, in January, forward-looking indicators signalled some pick-up in growth further ahead.

Turning to the components of demand, private consumption was estimated to have remained subdued at the end of 2023. Mr Lane recalled that the December staff projections entailed a significant recovery in private consumption during 2024. Indicators were not yet available for the first quarter. However, firms' expectations had remained contained for retail trade, while they continued to be above historical averages for contact-intensive services.

Moving on to housing investment, this was the GDP demand component most visibly affected by monetary policy transmission. Housing investment had been contracting over the past two years and was estimated to have also declined in the final quarter of 2023. The December projections entailed a slower rate of decline. At the same time, the PMI for housing output remained in deeply negative territory but with some signs of bottoming out.

Regarding business investment, the picture was mixed. Business investment had still been growing in 2023, but the expectation in the December projections was that it would decline in the fourth quarter. There had been an accumulation of stocks of finished capital goods that might have cushioned the decline in investment in the recent past. Additionally, the existing order books for capital goods were helping to keep investment growth in positive territory. However, new orders were still falling sharply, which suggested a period of weak investment ahead.

On the trade side, in spite of the recovery in global trade, euro area exports had remained subdued as 2023 drew to a close. Imports also continued to be weak, owing to an unfavourable composition of demand and to the inventory destocking cycle, both at the global level and in the euro area.

The labour market continued to be robust. The unemployment rate had fallen back to 6.4% in November, even as more workers entered the labour force. Labour market conditions had benefited from the 2022 surge in profit margins, which enabled firms to hoard labour despite demand tailing off. At the same time, momentum in demand for labour was decelerating, with fewer vacancies being advertised.

Turning to fiscal policies, news on fiscal measures had been limited. The few measures taken were cancelling each other out at the euro area aggregate level, as some countries had implemented new measures and others were rolling back their previous plans.

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

Turning to the monetary and financial analysis, market interest rates had moved broadly sideways since the previous Governing Council meeting. Similarly, at the longer end of the yield curve, risk-free rates and sovereign bond yields were little changed overall, despite some fluctuations in the intervening period.

Monetary aggregates had continued to decline in annual terms and remained close to historical lows. M3 – the broad monetary aggregate – had declined by 0.9%, year on year, in November 2023. This decline was consistent with the lack of aggregate growth in bank lending and, if measured in real terms, the decline was much larger. M1 – the narrow monetary aggregate of currency in circulation and overnight deposits – had continued to fall very sharply in November, against a background of portfolio shifts.

The transmission of the restrictive monetary policy stance to broader financing conditions remained exceptionally strong. Lending rates on business loans had declined slightly to 5.2% in November but remained close to their historical highs. Mortgage rates had increased further to 4.0%. The January bank lending survey suggested that higher borrowing rates, with the associated cutbacks in investment plans and house purchases, had led to a further drop in credit demand in the fourth quarter. Against this background, credit dynamics had improved somewhat but, overall, remained weak in November, despite an increase in short-term loans to firms likely associated with their greater working capital needs. At the same time, the further tightening in credit standards for loans to companies reported in January was quite moderate, in a sign that the trend towards ever more restrictive credit conditions observed over the last two years might be flattening out.

Monetary policy considerations and policy options

Overall, the incoming information had broadly confirmed the Governing Council's previous assessment of the medium-term inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Inflation was heading towards the 2% target, possibly at a faster pace than previously expected. The current levels of the policy interest rates would make a substantial contribution to reaching that goal if maintained for a sufficiently long duration. In terms of an overall evaluation of the policy rate trajectory, the disinflationary process needed to be further along for the Governing Council to be sufficiently confident that inflation would hit the target in a timely manner and settle sustainably at that level. Therefore, Mr Lane proposed keeping the three key ECB interest rates unchanged.

The three elements of the Governing Council's reaction function gave a robust framework for assessing the data and guiding decisions over the upcoming policy meetings. The Governing Council should continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions should remain based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

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

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, members took note of the assessment provided by Mr Lane that, while global GDP growth was seen to have decelerated in the fourth quarter of 2023, incoming trade data suggested that goods trade momentum was turning positive again. This was in line with the assessment that a normalisation of the inventory cycle and consumption patterns between goods and services should support trade. Moreover, the impact on global trade from recent developments in the Red Sea area was seen as contained so far. Looking at key global economies, the United States was on course for a soft landing, while in China GDP growth had slowed in the last quarter of 2023. In the context of weaker Chinese domestic demand, it was argued that Chinese exports would put additional negative pressure on international prices. The weakness in China had also been negatively affecting euro area exports, increasing uncertainty around the economic outlook.

Turning to energy commodities, oil prices had increased since the December Governing Council meeting, while European gas prices had declined further as demand remained subdued and gas storage facilities were relatively full. The euro area economy was seen as particularly exposed to geopolitical risk, which was likely to remain elevated for years to come. First, the war in Ukraine remained an important risk factor. Second, the conflict in the Middle East had resulted in rising freight costs and a lengthening of delivery times owing to the recent attacks on freight ships in the Red Sea and the Gulf of Aden. So far there had been no major disruption of trade and the main impact had come from ships taking longer routes around Africa, resulting in higher shipping rates and longer delivery times. However, this had, anecdotally, already led to some euro area companies halting production because of a lack of components. In this context of heightened global uncertainty, it was seen as puzzling that international energy price developments had remained overall very benign.

With regard to economic activity, members concurred with Mr Lane that the euro area economy was likely to have stagnated in the final quarter of 2023. The incoming data continued to signal weakness in the near term. However, some forward-looking survey indicators pointed to a pick-up in growth further ahead. The labour market had remained robust. The unemployment rate, at 6.4% in November, had fallen back to its lowest level since the start of the euro and more workers had entered the labour force. At the same time, demand for labour was slowing, with fewer job vacancies being advertised. Governments should continue to roll back energy-related support measures to avoid driving up medium-term inflationary pressures. Fiscal and structural policies should be designed to make the euro area economy more productive and competitive, as well as to gradually bring down high public debt ratios. Structural reforms and investments to enhance the euro area's supply capacity – which would be supported by the full implementation of the Next Generation EU programme – could help reduce price pressures in the medium term, while supporting the green and digital transitions. Following the recent ECOFIN Council agreement on the reform of the EU's economic governance framework, the legislative process should be concluded swiftly so that the new rules could be implemented without delay. Moreover, it was imperative that progress towards capital markets union and the completion of banking union be accelerated.

Members widely acknowledged that growth would likely be weaker than expected in the short term. So far, however, the decline in inflation was coming at a relatively mild cost in terms of economic activity. On the one hand, survey indicators suggested that the economy might have bottomed out. PMI indicators had plateaued and were even showing an uptick, feeding into the view that there would be a soft landing. Looking at the flash PMIs for January, manufacturing activity, although still firmly in negative territory, was on an upward path. The forward-looking PMIs for services had increased notably and employment expectations had also edged up moderately. On the other hand, it was pointed out that the economy was now likely to have stagnated for the fifth quarter in a row and the next staff projections would most likely shift the start of the recovery by one or two quarters again. Consumer confidence remained low and the PMI indicator for services had come in below analysts' expectations in January. The ECB's contacts with non-financial corporations showed that the business environment was perceived as not worsening, but also not improving. The Governing Council therefore still needed to see clearer signs that the recovery was on track.

Looking ahead, the main factor behind the expected recovery – according to the December 2023 staff projections – was consumption, which was seen picking up as real household income gradually improved. Investment was seen as another potential driver. Housing investment had been quite weak for almost two years, but it might gradually recover with mortgage rates coming off their peak. Reference was made to the bank lending survey, which foresaw an increase in households' demand for loans for house purchase in the first quarter of 2024. Business investment had held up better than anticipated, and it might continue to do so given the still high stock of orders for capital goods and profits remaining above pre-pandemic trends, especially if financial conditions loosened further. This was seen as posing an upward risk to the economic outlook, notably in the short term, in view of the weak investment trajectory that the December projections anticipated. At the same time, it was stressed that monetary transmission remained very strong, particularly in the housing sector, as reflected in weak developments for housing loans.

Turning to the labour market, conditions there were seen as persistently very tight. Unemployment was still at an all-time low, so it could be argued that the "sacrifice ratio" of bringing down inflation had been virtually zero. Given the very tight labour market, it was prudent for the Governing Council to exercise caution on wage prospects and to await evidence that wage growth was actually moderating as projected for 2024. It was argued that the Governing Council would need to see some hard data confirming that wages had turned the corner. At the same time, it was highlighted that the labour market was clearly showing signs of cooling, and that was likely to have a dampening effect on future wage growth. Given significant labour hoarding, either economic activity would have to recover soon or employment and wage growth had to fall. Some softening of labour market conditions was already visible in a decline in job vacancies, which was typically the first variable that started to adjust.

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

In this context, the view was expressed that the risks surrounding growth and inflation in the December staff projections were, overall, increasingly on the downside. It was remarked that a lower figure for activity in the fourth quarter, with the economy stagnating or even contracting, would mechanically imply substantially lower growth for 2024 owing to a carry-over effect. Moreover, the growth rate in both 2023 and 2024 would remain far below potential, mainly as a result of tighter financial conditions, weak sentiment, the withdrawal of fiscal support and the lagged effect of monetary policy tightening.

As euro area growth remained disappointing, also from a medium-term perspective, it was regarded as important to stress the need for structural reforms to address low productivity and impediments on the supply side. Low potential growth in Europe highlighted the importance of making progress towards capital markets union, as well as improving the functioning of the Single Market and other factor and product markets. In this context, it was pointed out that national governments were faced with several structural challenges, including an ageing population and the green and digital transitions, all to be tackled against a backdrop of heightened geopolitical risks. Even if activity and sentiment in the manufacturing sector were slowly improving, firms continued to face structural headwinds that were unrelated to the ECB's monetary policy and needed to be tackled first and foremost by governments via structural reforms.

On the reform of the EU's fiscal governance framework, it was stressed that the European Commission and the European Council should implement the new rules as transparently and as efficiently as possible, and in a way that permitted further progress towards fiscal consolidation and could simultaneously create headroom for investment. It was also recalled that governments needed to bring down high public debt ratios while being ready to contribute to closing the investment gap for the green transition and adaptation to climate change. This implied that they also had to adjust not only the path of "headline" fiscal policies but also the composition of budgets, to be able to pursue truly sustainable levels of economic activity that were resilient to the increasingly plausible scenario that the world would fall short of the objectives of the Paris Agreement.

With regard to price developments, members concurred with the assessment presented by Mr Lane in his introduction. Inflation had risen to 2.9% in December as some of the past fiscal measures to cushion the impact of high energy prices dropped out of the annual inflation rate, although the rebound was weaker than expected. Aside from this base effect, the overall trend of declining inflation had continued. Food price inflation had eased to 6.1% in December. HICP inflation excluding energy and food had also declined again, to 3.4%, owing to goods inflation falling to 2.5%. Services inflation was stable at 4.0%. Inflation was expected to ease further over the course of 2024 as the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy faded, and tighter monetary policy continued to weigh on demand. Almost all measures of underlying inflation had declined further in December. The elevated rate of wage increases and falling labour productivity were keeping domestic price pressures high, although these too had started to ease. At the same time, lower unit profits had started to moderate the inflationary effect of rising unit labour costs. Measures of shorter-term inflation expectations had come down markedly, while measures of longer-term inflation expectations mostly stood around 2%.

Members stressed that the recent decline in inflation was good news. Headline and underlying inflation figures had recently been continuously below the predicted levels, suggesting a faster than anticipated disinflationary process. It was therefore likely that in March, with the new projections, there would be a downward revision to inflation for 2024. In this context, it was highlighted that the staff projections tended to underestimate changes in inflation momentum in both directions. Moreover, downside inflation surprises were currently occurring in parallel with downside growth surprises and repeated signs of a stronger than expected transmission of monetary policy. Additionally, market participants were expecting a lower inflation profile, notably for 2024. The view was expressed that this suggested the risks to the inflation projections might be moving to the downside, especially for the short term.

However, it was emphasised that the outlook for inflation remained particularly clouded over the short term. Seasonality could play a disproportionate role, with many firms posting new prices at the start of the year. This was likely to complicate the interpretation of incoming inflation numbers. Moreover, it was underlined that extracting a signal from the month-by-month data on how inflation would evolve over the medium term was subject to considerable uncertainty. In this regard, the medium-term component of wage dynamics and the evolution of inflation expectations remained crucial. It also remained an open issue as to how the pandemic-related changes in the prices of services would unwind relative to goods prices. There could be either more protracted deflation in goods prices or an extended period of services inflation above normal levels, with services prices typically stickier and more heavily determined by wages.

While headline inflation was generally seen as being on track towards the ECB's 2% inflation target, this path remained surrounded by considerable uncertainty, especially with respect to the medium term. The prospect of inflation returning to target in a timely and sustained manner therefore remained fragile and depended on a number of benign assumptions materialising. In particular, emphasis was placed on the projected decline of record high unit labour cost growth, which was predicated on a rebound in productivity alongside a moderation in wage growth in 2024. Moreover, it was assumed that higher labour costs would continue to be absorbed by profits, as indicated by a projected smaller contribution from unit profits to domestic inflation. Reference was again made to the "last mile" difficulties, with the final stretch to the inflation target seen as more challenging than earlier phases. This was seen as a risk because the swift disinflation following the reversal of supply shocks and the forceful monetary tightening would soon start to wane, and the domestic components of inflation might prove more persistent or new shocks might derail progress. For example, although the momentum of services inflation had slowed, the annual growth rate had remained high, at 4% in December.

Similarly, domestic inflation had come down but remained above other measures of underlying inflation. Moreover, the absorption of higher input costs by lower profit margins was not assured, as was suggested by the increase in selling price expectations over three successive months.

Turning to wage developments in more detail, members recalled that wage pressures were key to the medium-term inflation outlook. So far, wage growth had remained strong and, together with negative productivity growth, had led to a historically large increase of 6.7% in unit labour costs in the third quarter of 2023. The distance between current wage growth of around 5% and a trend increase of 3% or 2½% that was compatible with the 2% inflation target, assuming 1% or ½% trend productivity growth, was regarded as quite significant and likely to diminish only gradually over time. It remained to be seen whether unit labour cost growth would decline sharply in 2024 as assumed in the December staff projections, which relied partly on a rather strong recovery in productivity growth combined with a moderation in wage growth.

Despite stagnation, it was underlined that the economy continued to add jobs. The unemployment rate was clearly below all available estimates of the non-accelerating inflation rate of unemployment (NAIRU) for the euro area. Hence trade unions would probably still see themselves as being in quite a powerful negotiating position. It should also be kept in mind that the backloading of wage increases in some countries implied more persistent pressure on wage growth, stretching well into 2025. At the same time, the reason why unit labour costs were expected to improve significantly this year was because the economy was expected to recover strongly according to the December projections. So, under the baseline scenario, firms could increase output this year without necessarily adding to employment, and an improvement in productivity ensured that unit labour costs would decline more quickly than wages. If the economy were to grow by less, unit labour costs might not retrench and inflation pressure might persist. However, it was also argued that this was unlikely to happen, as firms would face weaker demand and pricing power and would thus eventually respond with layoffs, which would pre-empt a further decline in labour productivity.

Moreover, it was pointed out that nominal wage growth of around 5% – according to the latest available data for compensation per employee (for the third quarter of 2023) – was not necessarily an excessive number during a “catching-up” phase, taking into account that real wages had declined by about 7% since the beginning of the inflation surge. A recovery in real wages, as also embodied in the December projections, could be regarded as necessary for the euro area economy to recover from its current period of stagnation. In a context of weak demand, this should not be expected to put upward pressure on inflation. Conversely, if employment and wages were to weaken too much, there was a risk that the economy could quickly find itself back in a situation of low growth and low inflation. Moreover, in a context of rapid disinflation, it also seemed likely that trade unions would accept lower nominal wage increases to achieve the same real wage increases. Finally, caution was expressed against overinterpreting the signal from current wage growth, as the labour market typically lagged output dynamics and the impact of monetary policy tightening should therefore also become visible in wage growth with a lag.

Against this background, it was widely felt that the signal from wage growth in the first quarter of this year would be important, as many wage contracts were scheduled to be settled in the coming months. At the moment it was an open question as to how workers would react to the new environment of falling inflation, with the level of prices still high compared with wage levels. The incoming information from the wage trackers was broadly in line with the baseline in the December staff projections. Hence the question was raised as to whether new wage agreements would corroborate recent first signs of moderation in line with the projections, and whether firms would continue to compress margins. These were two elements which would be consistent with inflation returning to target in the medium term. Finally, it was also recalled that, while negotiated wages were typically a lagging indicator of economic growth, the wage drift – the other component of total wage growth – was more immediately responsive to the overall business cycle. In the context of an economy that had been stagnating for nearly one and a half years, it was thus likely that this component of wage growth would turn out to be weaker than suggested by the information in the wage tracker for negotiated wages.

Attention was drawn to another reason why inflation could be falling in spite of increasing wages. Since wages amounted to only around 40% of firms' total costs and most indicators of intermediate costs were currently falling, when wages and intermediate costs were taken together, pressure on inflation from total costs was declining. As changes in producer prices typically led changes in consumer prices by a few quarters, this decline in cost pressure could be expected to be transmitted to consumer prices in the next couple of quarters. Now that intermediate costs were moving in the opposite direction to wages, wage growth was not a sufficient indicator to capture overall cost pressures in the economy, given that prices were typically set as a mark-up over total costs, not just wage costs.

The question was also raised as to whether, in the near future, profit margins would have enough scope to continue absorbing the rise in unit labour costs. If not, businesses might increasingly pass high unit labour costs through to prices. Firms' profits were far from the exceptional levels of 2022, a time when firms purportedly took advantage of high inflation to increase profit margins. In fact, profit margins had already come down to the point where anecdotal evidence suggested that some firms were now starting to cut back on investment because they felt constrained by a lack of profitability. The performance of the manufacturing sector was weaker and the sector was also exposed to global competition, so profits might continue to buffer unit labour costs. By contrast, the services sector was largely shielded from global competition and demand was still robust. Therefore, the high unit labour costs in this sector were likely to be passed through to prices more easily. In this context, it was also noted that stock returns suggested that corporate profitability was, overall, still high. Moreover, there was significant uncertainty surrounding the link between wages and price-setting, and it was underlined that the Governing Council needed to monitor a broad set of variables to understand how the current state of the labour market would ultimately affect inflation, rather than relying on only a few indicators.

As regards longer-term inflation expectations, market-based measures had come down notably and remained broadly anchored at 2%, reflecting the market's view that inflation would fall rapidly and stabilise around 2%. In this context, reference was made to risks of a downward unanchoring of inflation expectations, as a result of the weakness in economic activity and of a faster and broader disinflation than anticipated. At the same time, the view was expressed that there were no indications that expectations would become unanchored to the downside, with the inflation expectations of households and firms instead being skewed to the upside. Overall, developments were widely seen as going in the right direction.

Against this background, upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and hamper global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected, or if the economic environment in the rest of the world worsened unexpectedly. Moreover, inflation could decline more quickly in the near term if energy prices evolved in line with the recent downward shift in market expectations for the future path of oil and gas prices.

Turning to the monetary and financial analysis, market interest rates were broadly unchanged compared with the levels at the time of the Governing Council's previous meeting but had shown substantial volatility. The rapid fall in market interest rates until around the turn of the year had subsequently reversed on the back of communication by Governing Council members that had curbed expectations of imminent policy rate cuts. This had led markets to price in a lower probability of policy rate cuts at the upcoming meetings of the Governing Council. Nevertheless, expected cumulative rate cuts for 2024 were currently nearly double the 75 basis points that had been embedded in the December staff projections. In addition, it was argued that the markets were expecting lower interest rates because they were expecting lower growth and inflation than projected, especially in 2024.

In this respect, it was widely felt that the current market pricing of future interest rates was not a sign that markets did not understand the ECB's reaction function. Instead, it appeared that markets simply expected inflation to be lower than foreseen in the December staff projections, notably for 2024. Given that market expectations for inflation and for the future path of nominal interest rates had moved lower in tandem, the profile of expected real interest rates had remained broadly unchanged. It was important not to dismiss the markets' assessment, and it was advisable to exercise humility when judging market expectations for inflation and rates. However, this did not mean that the Governing Council had to follow or validate these expectations. Market pricing would likely respond both to incoming data and to the Governing Council's communication of its own assessment.

Euro area equity markets were assessed to have been quite buoyant in 2023 and also to have remained robust into 2024, despite the weaker outlook for economic growth. It was argued that this could, in part, reflect the repricing of the outlook for interest rates by financial markets, which might be underpricing the risk of a shallower monetary policy easing cycle. An alternative interpretation of the strength in equity markets was that financial market participants might be expecting profits to remain resilient, which could justify current stock market valuations, notably of globally active firms.

Members also pointed out that euro area financial markets had continued to function well, with sovereign and corporate bond spreads generally contained and mostly narrowing. There was no evidence of market fragmentation amid the normalisation of the Eurosystem balance sheet, which was a welcome development. Overall, there had been a significant loosening of financial conditions since the October monetary policy meeting, when the Governing Council had first paused the hiking cycle after the series of interest rate increases implemented since July 2022. Financial conditions were broadly unchanged from the time of the December meeting and had tightened only slightly since the trough around the end of 2023.

Members agreed that the ECB's restrictive monetary policy had been strongly transmitted to financing conditions for firms and households, while some evidence had recently emerged that borrowing costs might have reached a peak. Bank lending rates for firms had fallen in November 2023 for the first time in a long period and, although mortgage rates had increased further, the bank lending survey suggested some flattening-out in the tightening of credit standards and an easing in the terms and conditions for housing loans. However, it was recalled that, even if rates on new lending might be reaching a turning point, much of the repricing of the existing stock of loans at higher rates remained in the pipeline.

Credit dynamics had improved somewhat but remained weak overall. This weakness reflected the impact of past monetary policy tightening, which, as reported in the latest bank lending survey, had also contributed to a further drop in credit demand in the fourth quarter of 2023. On the credit supply side, it was argued that weak incentives for bank lending might also have played a role. Banks had attractive alternative ways of putting their liquidity to work, including by investing in bond markets and placing funds in the ECB's deposit facility. Anecdotal evidence nevertheless suggested that loan supply was not seen as a major problem by firms, who cited other issues, such as regulation and the lack of qualified labour, as being more important. Overall, it was assessed that the monetary policy transmission to credit volumes had remained strong, especially for mortgages. At the same time, credit dynamics appeared to be in line with the narrative of a soft landing for the economy. Moreover, the fact that monthly lending flows to firms had reached their highest level in more than a year and loans to households had picked up could be an indication that credit dynamics might be close to a turning point, and that the peak of monetary transmission to bank lending volumes might have been reached.

Finally, it was remarked that, in response to changes in the monetary policy stance, banks' funding strategies were gradually normalising in terms of both the configuration of bank interest rates and their recourse to the Eurosystem balance sheet. Banks had benefited from being able to draw on well-functioning funding markets with stable and sustainable spreads. While more diversified funding strategies might imply an increase in aggregate bank funding costs, they contributed to robust bank balance sheets and therefore increased the resilience of banks to shocks in the prevailing uncertain macro-financial environment. This would also support an orderly and smooth transmission of monetary policy if shocks were to materialise.

Monetary policy stance and policy considerations

Turning to the monetary policy stance, members assessed the incoming data since the last Governing Council meeting in accordance with the three main elements that the Governing Council had communicated in 2023 to be important in shaping its reaction function. These elements were (i) the implications of the incoming economic and financial data for the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission. Overall, members saw the latest developments in economic activity and inflation as being consistent with the current monetary policy stance. There had been further progress on all three elements of the reaction function, which gave grounds to be confident that monetary policy was working.

Starting with the inflation outlook, data releases issued since the previous meeting suggested that disinflation was broadly proceeding as envisaged, or even at a slightly faster pace than previously expected. It was argued that, on the basis of current information and updated assumptions, and in particular lower energy prices, the new staff projections due in March were likely to show a downward revision to inflation for 2024. However, it was underlined that the important question from a policy perspective was the extent to which the news on near-term inflation would be translated into changes in the medium-term inflation outlook. While the incoming information had broadly confirmed the previous assessment of the medium-term inflation outlook, it would be premature to draw any firm conclusions in this regard, as a more complete evaluation was needed when the March projections were available. While inflation had been decreasing faster than expected, this could partly be attributed to one-off factors and energy price developments that might easily reverse. For an assessment of the medium-term inflation outlook, a wide range of variables needed to be considered, in particular the extent to which disinflation would lead to lower wage claims.

For the new staff projections, the prevailing market expectations regarding interest rates were also important as conditioning assumptions. Market expectations were currently significantly lower than those underlying the December projections. Since the lower path for interest rates currently expected by markets was in part an endogenous reaction to lower inflation, the extent to which lower nominal rates would translate into higher growth and inflation in the future needed to be carefully assessed. This should include looking at how the expected path of real rates would change in the projections with new assumptions.

Members noted that measures of underlying inflation had passed their peak, having fallen since the summer, and HICP inflation excluding energy and food had been weaker than predicted in recent data releases. Momentum had also come down in those measures of underlying inflation that remained relatively high, including services inflation and domestic inflation. Yet, wage growth had remained strong, with only limited indications of a turnaround thus far. Moreover, unit labour costs had risen sharply, in part reflecting weak productivity growth, and it remained to be seen whether they would grow as slowly as foreseen in the projections, which were predicated on a recovery in productivity growth together with moderating wage growth. Further uncertainty pertained to how much the contribution of unit profits to domestic inflation would continue to decline as projected, with firms absorbing higher labour costs rather than passing them on to consumers.

Turning to the assessment of monetary policy transmission, members noted that there was solid evidence that monetary policy was being transmitted to financial markets, financing conditions and credit conditions, with the impact most likely having been stronger than expected. However, uncertainty remained about the timing of the peak impact, as well as the ultimate overall effect of monetary policy tightening on the real economy and inflation.

All in all, members signalled that continuity, caution and patience were still needed, since the disinflationary process remained fragile and letting up too early could undo some of the progress made. While the initial inflation shock had largely reversed, the task that lay ahead was the reversal of second-round effects, which might prove to be more stubborn. At the same time, members expressed increased confidence that inflation would be brought back towards the 2% inflation target in a timely manner. The point was made that, for the first time in many meetings, the risks to reaching the inflation target were seen as broadly balanced or at least becoming more even. At the same time, the view was also expressed that, after several years of significantly overshooting the inflation target, the costs of another overshooting were likely higher than the costs of undershooting.

In this context, members underlined the fact that the ECB’s inflation target was symmetric, implying the need to avoid both an undershooting and an overshooting, unless policy rates were close to the effective lower bound. At the same time, there was likely to be some volatility in inflation on the path to achieving the 2% target, and new shocks could materialise. Even if the projections foresaw a temporary period of inflation below 2%, as long as such a deviation was neither large nor persistent, the policy conclusion, in keeping with the ECB's medium-term orientation, was that the Governing Council did not necessarily have to act. However, it was recalled that, since the ECB's monetary policy strategy did not prescribe an average inflation target, the Governing Council should not aim at any such undershooting and all persistent deviations from the inflation target in either direction required a policy response.

Monetary policy decisions and communication

Against this background, all members agreed with the proposal by Mr Lane to maintain the three key ECB interest rates at their current levels. It was affirmed that further progress needed to be made in the disinflationary process before the Governing Council could be sufficiently confident that inflation was set to hit the ECB's target in a timely manner and in a sustainable way. At the present juncture it was regarded as important for monetary policy to stay the course and for the Governing Council to proceed with a steady hand. At the same time, members underlined the fact that monetary policy remained data-dependent. It was reiterated that, based on its current assessment, the Governing Council considered the key ECB interest rates to be at levels that, if maintained for a sufficiently long duration, would make a substantial contribution to returning inflation to the medium-term target in a timely manner. Future decisions would ensure that policy rates would be set at sufficiently restrictive levels for as long as necessary.

There was broad consensus among members that it was premature to discuss rate cuts at the present meeting and members widely referred to risk management considerations to support this view. The risk of cutting policy rates too early was still seen as outweighing that of cutting rates too late. Having to reverse course, in the event that economic activity picked up more strongly than expected, wage growth accelerated or renewed inflationary pressures emerged, could entail high reputational costs. The point was also made that the risk of an inadvertent overtightening of monetary policy was mitigated by the fact that financial markets were already pricing in a number of rate cuts in 2024, contributing to a loosening of both financial and financing conditions. However, it was also argued that such a loosening might be premature and could possibly derail or delay a timely return of inflation to target. In any case, members agreed that following a data-dependent rather than a calendar-based approach was important, in line with the elements of the reaction function that the Governing Council had communicated in 2023.

Members also agreed with the Executive Board proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio.

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

Monetary policy statement

Monetary policy statement for the press conference of 25 January 2024

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 24-25 January 2024

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno*
- Mr Cipollone
- Mr Elderson
- Mr Hernández de Cos
- Mr Herodotou
- Mr Holzmann*
- Mr Kazāks
- Mr Kažimír
- Mr Knot*
- Mr Lane
- Mr Makhlouf
- Mr Müller
- Mr Nagel

- Mr Panetta
- Mr Reinesch*
- Ms Schnabel
- Mr Scicluna*
- Mr Šimkus
- Mr Stournaras
- Mr Välimäki, temporarily replacing Mr Rehn
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch

* Members not holding a voting right in January 2024 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 Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Kaasik
- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros

- Mr Martin
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Pösö
- Mr Rutkaste
- Mr Sleijpen
- Mr Šošić
- 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 4 April 2024.