EUROPEAN CENTRAL BANK

EUROSYSTEM

Meeting of 1-2 February 2023

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 1-2 February 2023

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

Financial market developments

Ms Schnabel noted that the Governing Council’s previous monetary policy meeting on 14-15 December 2022 had left a visible footprint in euro area financial markets, with a welcome increase in real interest rates to levels that were more consistent with a timely return of inflation to the 2% target.

However, while the “terminal rate” priced in the euro area real overnight index swap (OIS) forward curve had edged up initially, a sharp decline in expected inflation, on the back of lower gas prices and inflation surprises to the downside, had later contributed to market participants revising down their rate expectations. Expectations of rapid disinflation had also induced markets to price in material rate cuts as of 2024, suggesting that they judged the period of restrictive monetary policy needed to rein in high inflation to be relatively short.

These developments, alongside further signs of a more resilient euro area economy and the reopening of China’s economy, had boosted risk sentiment. Risk premia had declined measurably across market segments, compressing bond spreads and boosting equity prices, while the euro had appreciated further across the board as sentiment towards the euro area improved. However, the compression in risk premia was predicated on the markets’ firm conviction that inflation dynamics were on a steep and sustained downward trajectory towards 2%. A stronger persistence of underlying price pressures could lead to a reappraisal of the monetary policy outlook and a correction in asset prices, as suggested by the strong market reaction, during the week, to some higher than expected inflation prints.

Documenting the substantial changes in real interest rates that had occurred since the Governing Council’s previous monetary policy meeting, it was noted that the euro area real OIS forward curve had shifted upwards, with the real two-year OIS rate having turned positive for the first time since the 2008-09 global financial crisis. The upward shift reflected the impact of the ECB's December communication, as well as a decline in expected inflation that had been most pronounced over the near term. While the rise in real rates did not necessarily imply that rates were now restrictive, especially considering the uncertainty about the level of the neutral rate, it could, if persistent, mark the end of a long era of negative real interest rates.

Model-based analysis suggested that the decline in the market-based inflation outlook had two broad origins. First, after a long phase of upside surprises to inflation, some misses to the downside relative to expectations for euro area headline inflation had been observed since November. Second, there had been a substantial decline in gas prices, which had, at present, a much larger impact on inflation swap rates than in the past, at both the short and the long end of the inflation swap curve. This increased sensitivity to changes in gas prices may have contributed to an increasing disconnect between the market-implied inflation path and that of professional forecasters. Two factors raised doubt about the markets' benign view of inflation. First, the growing signs that a technical recession in the euro area had become less likely. And second, the reopening of China's economy.

As markets were seemingly discounting these risks to the inflation outlook, they also questioned whether the ECB would keep rates in restrictive territory for a sustained period. While the market-implied path for future short-term interest rates foresaw a further tightening over the short run, in line with the ECB's December communication, it also envisaged a reversal as of 2024. The expected terminal rate in the euro area had initially shifted notably upwards in response to the Governing Council's previous monetary policy meeting. However, it had gradually fallen back as investors reappraised the inflation outlook. Furthermore, markets currently expected a significant number of rate cuts over the course of 2024. In other words, given that investors expected a fast and sustained return of inflation to 2%, they expected policy rates to remain at a restrictive level for only a short period of time.

Investors had also become more certain about the revised expected interest rate path. Implied volatility over a horizon of up to one year was now at its lowest since spring 2022, although it remained high from a historical perspective. The decline in interest rate volatility, however, masked important differences in the drivers of uncertainty, with model-based analysis suggesting that uncertainty about the ECB's "reaction function" had increased, while inflation uncertainty had declined.

These developments were not confined to the euro area. Investors, globally, expected major central banks to cut their key policy rates this year or next, as headline inflation was expected to ease rapidly from high spot levels. In response to some first signs of a turning point in headline inflation, investors were signalling that they believed rate cuts would soon be needed. This was despite warnings from central bank officials around the world that interest rates would probably stay higher for longer than markets expected, since core inflation – as measured by excluding energy and food from the overall index – remained elevated. Overall, therefore, markets had taken a view that the global economy, including the euro area, was at an inflection point, with stronger growth and lower inflation than previously expected. Such positioning was putting market pricing at a considerable risk of correction should inflation prove more persistent.

This was also visible when looking at the significant impact of the global reappraisal of the inflation and interest rate outlook on broader financial markets. In fixed income markets, there had been a broad-based compression of risk premia. In euro area sovereign bond markets, spreads had fallen across jurisdictions, despite the ECB's December announcement that the asset purchase programme (APP) portfolio would start to decline as of March 2023 and expectations of a faster run-off as of the third quarter. In euro area corporate bond markets, spreads for non-financial corporate bonds were around 25% lower than late-October levels. The rally in financial markets, spurred by the prevailing disinflation narrative, had been especially pronounced in stock markets, with euro area equities, in particular, having made significant gains.

Fading risks of recession, amid lower gas prices, had also been a key driver behind the euro's continued appreciation since the 14-15 December meeting. This appreciation had been broad-based against most major currencies, with the Japanese yen being a notable exception.

In this environment of a more positive risk sentiment, market functioning had also improved notably, as reflected in lower volatility and improved liquidity in euro area sovereign bond markets. This made a further positive contribution to investors' risk absorption capacity. At the same time, the increase in public sector issuance had contributed to reducing collateral scarcity. German repo rates for non-general collateral had moved closer to the euro short-term rate (€STR) again, reducing the collateral premium.

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

Mr Lane observed that the world economy had further decelerated in the fourth quarter of 2022, with the global Purchasing Managers' Index (PMI) for both manufacturing and services output falling below the threshold of 50 at the end of 2022. Consistent with low activity, international trade had also slowed in the final quarter of 2022. Despite the deceleration, global growth projections had improved for 2023, owing partly to the relaxation of pandemic restrictions in China. The euro had continued to appreciate since the 14-15 December Governing Council meeting. In trade-weighted terms, the exchange rate had returned to the level observed at the beginning of 2022.

The slowdown in global demand, together with the unusually warm winter and effective gas saving measures, had led to a sharp decline in energy prices. European gas prices had fallen by around 50% since the December monetary policy meeting. According to the futures curve, they were expected to remain around present levels, easing concerns about storage levels for next winter. Oil prices had ticked up since the December meeting but remained significantly below mid-2022 levels. The sharply lower energy prices and easing of supply bottlenecks could be interpreted as a partial reversal of the large negative supply shock that had been observed since 2021.

The euro area economy had slowed further in the fourth quarter of 2022 but had proved more resilient than expected in December. The PMI composite output indicator had risen above the threshold of 50 in January 2023, after falling well into contractionary territory last autumn. However, unlike services, manufacturing output was still below the threshold. Manufacturing was once again the principal drag on overall output, despite the continued easing in supply bottlenecks that had particularly benefited car production and sales. Strong demand for leisure activities, tourism and hospitality were cushioning the slowdown in services activity.

The latest round of the Commission's household survey suggested that euro area households had revised their expectations on consumer prices 12-months ahead sharply downwards and their expectations on the economic situation upwards. The less pessimistic view on the economic situation also supported the improvement in their expectations on the financial situation and would help private consumption in the period ahead. These survey results supported the interpretation of a reversal of the negative supply shock.

Housing and business investment were clearly weakening, owing partly to tighter financing conditions. The Commission's business survey had shown that supply constraints, rather than demand constraints, had so far been the strongest factor limiting production. In particular, shortages of material and equipment were constraining production in the capital goods sector. While output in this sector had been supported by the easing of supply bottlenecks and firms working through backlogs of orders, especially in the car industry, new orders remained weak. For the construction sector, the PMI for both output and new orders had been on a downward trend since early 2022.

Nonetheless, Mr Lane continued to expect that the economy would recover over the course of the year, on the back of a robust labour market, rising wages and fiscal support measures, as well as current headwinds fading away. If the favourable supply-side developments persisted, these would provide further support to the recovery in activity.

The decline in energy inflation had meant an improvement in the terms of trade. A significant drop in import price inflation had been followed by a less pronounced decline in export price inflation. This asymmetry in the price adjustment had led to a significant improvement in the euro area current account at the end of 2022.

The labour market continued to be resilient. The unemployment rate had stabilised at 6.6% in December, far below the pre-COVID level. The PMI for employment, which had declined from its very high mid-2021 level, was still firmly positive. This suggested that firms were continuing to increase their labour force. In terms of vacancies, the latest Indeed data (from online job matching portals in the five largest euro area countries and Ireland) indicated that there had been a slight decline, but the level remained very high.

Compared with December expectations, risks to the growth outlook had become more balanced. Russia's war against Ukraine continued to be a significant downside risk to the economy and could again push up energy and food costs. There could also be an additional drag on euro area growth if the world economy were to weaken more sharply than expected at present. Moreover, the recovery would face obstacles if the pandemic were to re-intensify and cause renewed supply disruptions. However, the adverse energy shock could fade away faster than anticipated and, while the security of European gas supplies remained vulnerable to global supply risks, higher than usual gas inventories had reduced supply risks for next winter. Moreover, euro area companies could adapt more quickly to the challenging international environment. This would support higher growth than currently expected.

HICP inflation had declined sharply from 10.6% in October to 9.2% in December, and further to 8.5% in January, according to Eurostat's flash estimate. The lower figures largely reflected the sizeable drop in energy price inflation. By contrast, food price inflation had increased to 14.1% (from 13.8% in December). As in December, HICP inflation excluding energy and food stood at 5.2% in January. However, there was some variation across the sub-categories, with the inflation rate for non-energy industrial goods rising to 6.9% (from 6.4%) and services inflation declining to 4.2% (from 4.4%). When measured in terms of "momentum", defined as the annualised three-month-on-three-month percentage change in prices, the deceleration of inflation dynamics between December and January was notably stronger than suggested by the annual rates in these components.

The uncertainty surrounding Eurostat's January flash HICP estimate was greater than usual, as it contained an estimate of the figure for Germany. In January there had also been the usual change in the HICP weights, reflecting changes in expenditures over the previous year. Across items, one of the most important changes was the increased weight of services, as households had returned to a more normal consumption profile.

Measures of underlying inflation continued to stand at high levels. However, those indicators that included an energy component saw a turnaround. In addition, the recent dynamics of core inflation showed that there had been a levelling-off of momentum.

Looking at the determinants of goods inflation, energy-sensitive items had continued to provide a strong contribution until December 2022. Looking ahead, the contribution of energy-sensitive items could be expected to decline. However, it was uncertain whether the pace of the reduction was likely to be symmetric to that of the increase. But the contribution of non-energy-sensitive items was increasing.

To reconcile the still increasing contribution of energy-sensitive items with the fall in energy costs, it was useful to look at pipeline pressures. Those pressures had declined for food inflation, in particular for international food commodity prices and for European farm gate prices. But the producer price index for processed food was still increasing, owing to long transmission lags. Similarly, for goods inflation, there had already been a significant decline in pipeline pressures for intermediate goods, but the producer price index for non-food consumer goods was still increasing. Still, the fast decline observed in pressures upstream in the production chain were expected to lead to lower retail prices, as had been the case in the United States.

Mr Lane reported that, in the latest round of the ECB’s Corporate Telephone Survey, firms had stated that input cost pressures had been easing, reflecting declines in energy costs as well as other input costs, and they were expecting input costs to continue to decline.

Moving to the inflationary pressures stemming from the housing sector, rent inflation had been picking up very gradually in the euro area during 2022. Housing-related expenses had increased strongly during 2022 but the pace had started to decelerate at the end of the year. Moreover, inflation in owner-occupied housing costs had started to ease in the third quarter of 2022, reflecting the acquisition component. Residential property price inflation in the euro area had eased substantially in the third quarter of 2022, falling to 6.8%, from 9.2% in the second quarter.

Measured wage growth was strengthening, as compensation for past high inflation was becoming the main theme in wage negotiations, but wage developments so far were broadly in line with the December 2022 Eurosystem staff macroeconomic projections for the euro area. The ECB wage tracker, which had improved its representativeness with the inclusion of data for France, indicated that new contracts signed during 2022 and coming into effect in 2023 implied ongoing wage increases of around 5%. Similarly, according to the January wage expectations from the Corporate Telephone Survey, firms expected average wage growth of around 5% for 2023, which was similar to the rate expected in the October survey round. The Indeed wage tracker had shown some signs of a turnaround in the last two months of 2022.

Longer-term inflation expectations stood at around 2%. Market-based measures of inflation compensation had edged down, with a more marked correction for 2023 and 2024. In the other direction, the 2023 and 2024 inflation projections from the ECB Survey of Professional Forecasters had increased. However, longer-term expectations had been revised marginally down to 2.1%, whereas those from the ECB Survey of Monetary Analysts were unchanged at 2%. Finally, the ECB's Consumer Expectations Survey for December 2022 indicated a levelling-off of median inflation perceptions and one-year ahead inflation expectations, but continued to point to three-year ahead inflation remaining at around 3%.

Overall, the favourable supply-side developments, if these persisted, should help dampen inflation, including through the impact of lower energy prices on the cost structures of energy-intensive sectors in the goods and services categories and on the real wage gap. At the same time, the improvement in the terms of trade constituted a positive income and wealth shock that would also support demand.

The inflation outlook remained highly uncertain, although compared with the Governing Council's expectations in December, the risks to the inflation outlook had become more balanced, especially in the near term. On the upside, existing pipeline pressures could still send retail prices higher in the near term. Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand. Domestic factors, such as inflation expectations persistently above the ECB's target or higher than anticipated wage rises, could drive inflation higher, also over the medium term. On the downside, the recent fall in energy prices, if it persisted, might slow inflation more rapidly than expected. This downward pressure in the energy component could then also translate into weaker dynamics for underlying inflation. A further weakening of demand would also contribute to lower price pressures than currently anticipated, especially over the medium term. The net impact of the reopening of China's economy on euro area inflation dynamics over the coming months was uncertain. While a strong rebound in Chinese production could further ease supply bottlenecks and increase competition in the global goods market, thus constituting a disinflationary impulse for the world economy, a recovery in Chinese demand could also add to inflationary pressures, especially through higher demand for commodities.

Turning to financial and monetary developments, bank funding costs continued to reflect the transmission of monetary policy. Euro area bank bond yields had increased somewhat further since the December Governing Council meeting, reflecting the movements in the key ECB interest rates and in market rates. Deposit rates had also increased further, rising more strongly for firms than for households since May 2022.

The spread between M3 savings deposits and overnight deposits had continued to widen, broadly in line with past rate hiking periods. Over time, this would likely lead to a considerable downward adjustment to the currently still high share of overnight deposit holdings, as currently there was an incentive to minimise deposit holdings in current accounts. Moreover, as the ECB's targeted longer-term refinancing operations (TLTROs) were being repaid, banks needed some longer-term deposits to meet various regulatory ratios. Thus, there was an expectation that this portfolio switch would continue.

The increase in policy rates continued to be passed through to firms. The cost of debt financing had risen substantially since September 2022 and the strong increase in bank lending rates had led to a considerably narrower spread between the cost of market-based debt financing and the cost of bank borrowing at the end of 2022, compared with its September level.

The current pace of monetary policy tightening was faster than in previous rate hiking cycles, reflecting the greater frequency and size of policy rate hikes. However, as this represented a reversal of previous loosening and was a necessary normalisation to address high inflation, it was not viewed as a severe squeeze by the banks or their customers.

The transmission of monetary policy was also reflected in developments in bank lending conditions, as reported by banks in the latest bank lending survey. Banks continued to report a substantial net tightening of their credit standards on loans to firms and on loans to households for house purchase in the fourth quarter of 2022. Mr Lane noted that, since the survey was meant to assess the change in credit standards and not their level, it was legitimate to ask whether banks were tightening or just reversing a very accommodative set of credit standards. Still, as the tightening continued, at some point the trend would move beyond normalisation.

Demand for bank loans to non-financial corporations had also declined in the final quarter of 2022. This was driven mainly by rising interest rates, in line with the increase in bank lending rates for firms. The bank lending survey revealed that the decline in demand for loans stemmed, in particular, from the commercial real estate, residential real estate and construction sectors – the most interest rate-sensitive sectors. In addition, loan demand was being dampened by lower financing needs for fixed investment and a moderation in firms' financing needs for working capital. The bank lending survey reported a steep drop in demand for housing loans, which was unprecedented in the history of the survey. The main drivers of this fall were rising interest rates, deteriorating prospects for housing markets and low consumer confidence.

Debt financing flows for firms had declined in November and December, owing to net redemptions in bank borrowing. There was therefore evidence of some deleveraging by firms at the end of 2022. Household borrowing dynamics had also weakened, driven mainly by developments in housing loans. The moderating trend in mortgage borrowing reflected tighter credit standards, rising lending rates and decreasing loan demand.

Finally, on monetary developments, Mr Lane reported that the deceleration in loan creation was reflected in a decline in money growth. The moderation in broad money (M3) growth was driven mainly by outflows from narrow money (M1), the growth of which had fallen markedly. Persistently low remuneration of overnight deposits meant that the opportunity costs of holding M1 instruments had risen significantly. Deposit flows continued to reflect the shifts towards time deposits and to M3 instruments offering a remuneration closely linked to market rates.

Monetary policy considerations and policy options

Against this background, Mr Lane proposed raising the three key ECB interest rates by 50 basis points and communicating that the Governing Council expected to raise them further. The Governing Council should stay the course in raising interest rates significantly at a steady pace and in keeping them at levels that were sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. Accordingly, in view of the underlying inflation pressures, Mr Lane proposed communicating the intention to raise interest rates by another 50 basis points at the next monetary policy meeting in March and to then evaluate the subsequent path of monetary policy. Signalling a 50 basis point step for the March meeting acknowledged that, in a very wide range of scenarios, the Governing Council saw that a further step of this size remained necessary to bring the key ECB interest rates to levels that would ensure a return of inflation to target in a timely manner. That said, looking beyond the immediate term, the monetary policy meeting in March would provide a waypoint at which to evaluate the subsequent path of monetary policy, including on the basis of a new set of staff macroeconomic projections that would then be available. The Governing Council would in this way ensure that its future policy rate decisions continued to be data-dependent and followed a meeting-by-meeting approach.

Regarding the parameters that would govern the measured and predictable reduction of the asset purchase programme (APP) portfolio that had been decided in December, it was important that the process remained transparent, simple to understand and as neutral as possible vis-à-vis the pricing of the classes of securities held in the portfolio. To this end, Mr Lane proposed that the partial reinvestments be conducted broadly in line with current practice. Without prejudice to the objective of price stability, the Governing Council should also support the gradual decarbonisation of the Eurosystem's corporate bond holdings, in line with the goals of the Paris Agreement.

As regards the pandemic emergency purchase programme (PEPP), the signalling power of the framework for PEPP reinvestment flexibility was still supporting the monetary policy transmission mechanism. It was therefore proposed, in the spirit of prudence, to continue to allow flexibility in PEPP reinvestments as an effective first line of defence against remaining fragmentation risks.

Ms Schnabel then detailed the proposal for the modalities to be followed in reducing the APP holdings, following the Governing Council's decision at its December monetary policy meeting to reduce the APP portfolio by €15 billion per month on average from the beginning of March until the end of the second quarter of 2023. During the partial reinvestment phase, reinvestment amounts were expected to be relatively small. Any changes to the modalities would therefore have a very limited impact on the composition of the APP portfolio. This argued for keeping the modalities for the period of partial reinvestments simple, reflecting as much as possible the practice applied for full reinvestment. This approach would also preserve consistency with the overall monetary policy stance and market functioning, and should facilitate the Eurosystem's public communication.

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 subdued global economic activity and high levels of geopolitical uncertainty, especially owing to Russia's unjustified war against Ukraine and its people, continued to act as headwinds to euro area growth. Subdued global activity would weigh on global trade and euro area foreign demand, despite improvements in global supply chains. In their discussion, members argued that, on the one hand, the reopening of the Chinese economy should lead to fewer bottlenecks in global supply chains and thus support global activity. This would also imply stronger foreign demand for the euro area. On the other hand, the reopening of its economy would increase China's appetite for commodities, including natural gas, and would make China a strong competitor of Europe for supplies of liquified natural gas. This would put upward pressure on European gas prices and act as a headwind to Europe's recovery. Pressure on prices of other raw materials, such as metals, owing to increased demand from China, was already visible. Which of the various forces at play would eventually prevail was not clear, creating considerable uncertainty for the euro area outlook.

Members highlighted that energy commodity prices had come down significantly, in some cases returning to levels prevailing before the start of Russia's war in Ukraine. This implied that the euro area's import bill for fossil fuels would be reduced considerably. At the same time, it was mentioned that there was still considerable scepticism in energy markets about whether the current lower energy prices would persist. Part of the decline in prices seemed to be driven by the current mild winter weather, which would not necessarily be repeated next winter. It was widely stressed that the euro area continued to be confronted by an exceptionally high degree of global uncertainty, owing to both economic and geopolitical factors.

With regard to economic activity, despite the challenging external environment, members concurred with Mr Lane that the euro area was likely to avoid a recession. Together with high inflation and tighter financing conditions, global headwinds were dampening spending and production, especially in the manufacturing sector. However, in addition to easing supply bottlenecks and more secure gas supplies, firms were still working through large order backlogs and confidence was improving. Moreover, output in the services sector had been holding up, supported by the continuing effects of the reopening of the economy and stronger demand for leisure activities. Rising wages and the recent decline in energy price inflation were also set to ease the loss of purchasing power that many people had experienced owing to high inflation. This, in turn, would support consumption. Overall, the economy had proved more resilient than expected and should recover over the coming quarters. The unemployment rate had remained at a historical low of 6.6% in December 2022. However, the rate at which jobs were being created was seen as potentially slowing, with unemployment rising over the coming quarters.

Members commented on the surprising resilience of economic activity to date. The release of Eurostat's preliminary flash estimate for GDP growth in the fourth quarter of 2022 had surprised on the upside, which was regarded as good news, even if the figure had most likely been pushed up by volatile transactions in Irish intellectual property products. In combination with recent levels of inflation, which had been lower than expected, this stronger activity was seen as indicative of a partial reversal of the negative supply shocks that had shaped developments in the euro area economy over the past year. As a result, the euro area economy was now in a better situation than expected in December, and it was argued that recent developments were in line with a "soft landing" (with the economy slowing but avoiding a recession). In such circumstances, the Governing Council might be able to bring down inflation without overly large sacrifices in terms of economic activity. However, it was also maintained that, despite the better than expected economic news, the underlying economic situation had not fundamentally changed since the December meeting.

Members concurred that government support measures to shield the economy from the impact of high energy prices should be temporary, targeted and tailored to preserving incentives to consume less energy. In particular, as the energy crisis became less acute, it was important to start rolling these measures back promptly in line with the fall in energy prices and in a concerted manner. Any such measures falling short of these principles were likely to drive up medium-term inflationary pressures, which would call for a stronger monetary policy response. Moreover, in line with the EU's economic governance framework, fiscal policies should be oriented towards making the economy more productive and gradually bringing down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, could help reduce price pressures in the medium term. To that end, governments should swiftly implement their investment and structural reform plans under the Next Generation EU programme. The reform of the EU's economic governance framework should be concluded rapidly.

Against this background, members assessed risks to the economic growth outlook as having become more balanced. Russia's war in Ukraine continued to be a significant downside risk to the economy and could again push up the costs of energy and food. There could also be an additional drag on euro area growth if the world economy weakened more sharply than expected. Moreover, the recovery would face obstacles if the pandemic were to re-intensify and cause renewed supply disruptions. However, the energy shock could fade away faster than anticipated and euro area companies could adapt more quickly to the challenging international environment. This would support higher growth than currently expected.

With regard to price developments, members concurred with the assessment presented by Mr Lane in his introduction. Price pressures remained strong, partly because high energy costs were spreading throughout the economy. HICP inflation excluding energy and food, as a measure of core inflation, remained at 5.2% in January. Other indicators of underlying inflation were also still high. Although supply bottlenecks were gradually easing, their delayed effects were still pushing up goods price inflation. The same was true for the lifting of pandemic-related restrictions: while weakening, the effect of pent-up demand was still driving up prices, especially in the services sector.

Government measures to compensate households for high energy prices were, by contrast, dampening inflation in 2023. However, the scale of some of these measures depended on the evolution of energy prices and therefore their overall contribution to inflation was particularly uncertain, since they were expected to raise inflation once they expired. Market-based indicators suggested that energy prices were seen as being significantly lower over the current and coming years than had been expected at the time of the Governing Council's December meeting. At the same time, wages were growing faster, supported by robust labour markets. However, recent data on wage dynamics had been in line with the December Eurosystem staff projections. Most measures of longer-term inflation expectations stood at around 2% but warranted continued monitoring.

Members concurred with the view that, although the rate of headline inflation had slowed since October, inflation was still far too high. While the good news ought to be welcome, it was argued that the December assessment of the inflation outlook had not fundamentally changed. Core inflation was still at levels foreseen in December. Therefore, it was much too early to declare victory.

Attention was drawn to the fact that the inflation figures for the euro area's largest economy had not been available in time to be included in Eurostat's flash release for January. It was suggested that, in all likelihood, the final release would turn out to be somewhat higher for the euro area. In this context, it was underlined that core inflation had surprised slightly on the upside and remained unchanged from

December, which was seen as the reason for the very muted market reaction to the lower than expected headline inflation figure for January. Since core inflation was often regarded as the "attractor" to which headline inflation would revert over the medium term, the latest inflation figures were not necessarily a welcome development overall. However, caution was expressed against focusing too much on measures of core inflation. Indeed, some elements of core inflation could move quite quickly, as seen from the experience in the United States and in line with the latest developments in euro area pipeline pressures. However, that would not necessarily imply that the more persistent elements of inflation, such as those related to wages, would turn around. It was recalled that the ECB monitored a wide array of measures of underlying inflation and undertook a detailed analysis of all components of headline inflation, rather than looking exclusively at particular measures of core inflation excluding several volatile items. Finally, it was mentioned that January inflation developments in Croatia, which had just joined the euro area, had been quite stable overall, compared with December. This suggested that the upward impact on prices from the cash changeover had been rather limited so far, contrary to the expectations of some people.

As regards developments in core inflation, it was stressed that the pass-through of lower energy prices to this measure was a key factor in the assessment of the lag with which the rate of core inflation would show convincing signs of a deceleration. In this context, members debated the extent to which lower energy prices would lead to a moderation in underlying price pressures. This would depend on whether the pass-through from declining energy prices to other components of inflation was symmetric to that observed when energy prices increased.

On the one hand, there were a number of reasons to believe that offsetting factors might lead to a slower pass-through of the disinflationary impulse than had been observed over the recent inflationary phase. In particular, the pass-through of earlier higher wholesale energy prices to retail prices took time and was still ongoing. Demand pressures had increased and wage pressures were rising on the back of wage negotiations that were being increasingly influenced by the high rates of current or past inflation and continued labour scarcity. In addition, the longer duration of wage contracts, rising minimum wages and staggered wage-setting could lead to a longer persistence of wage growth. In this respect, it was underlined that inflation pressures had been broadening for some time, so the driving force behind the inflation process was no longer a pure supply-side inflation shock. While the rise in inflation had started with a supply shock, it had turned into more of a demand-side type of inflation, making inflation more persistent. Moreover, there was evidence that the effect of an increase in energy prices on both GDP and inflation was very different from the effect of a decrease in energy prices, partly owing to downward price and wage rigidities. Recent evidence for the euro area showed that there was significant asymmetry, so the strong and fast pass-through observed as energy prices rose could not be expected to simply reverse swiftly as prices declined.

On the other hand, it was argued that the decline in energy prices could well be transmitted more quickly to items of core inflation, in line with how the inflationary shocks had filtered through to this measure in recent quarters as prices rose. This suggested that core inflation might over time decline faster than envisaged in the December projections. In any case, it was noted that it was too early to observe such a rapid pass-through, as non-energy industrial goods inflation was still increasing, suggesting that the upside pressures from past higher energy prices were still present. Staggered price adjustment implied that households and firms might face higher energy prices only after some time had elapsed, so while energy commodity prices were falling, households and firms would still see some of the pass-through from the previous increase in energy prices. At the same time, it had to be acknowledged that the rate of industrial producer price inflation, excluding energy, had significantly decelerated, which was an important indication that lower energy prices would at some point translate into lower core inflation. In this context, it was also argued that in the three-month-on-three-month changes in the HICP excluding energy and food – the core "momentum" – there were already initial signs that underlying inflation would start to decline in annual growth rates, despite the fact that core inflation naturally responded with a lag to changes in energy prices.

Members considered the implications of the reopening of China's economy for inflation developments in the euro area. In this context, the remark was made that the reopening of a major global net-exporting economy, such as China, should on balance be expected to have a dampening impact on global price pressures, even if Chinese aggregate demand increased. Moreover, Chinese exporters could also be expected to lower their prices so as to regain some of the market share they had lost during the periods of lockdown, thus spurring price competition worldwide. However, upward pressures on inflation could be expected from an increase in Chinese demand, especially for commodities.

There was still considerable uncertainty about the dampening impact of tighter monetary policy on inflation. The current inflation dynamics most likely did not yet reflect recent monetary policy tightening. In fact, it was argued on the basis of recent survey evidence that current financing conditions were hardly restrictive enough to dampen demand sufficiently to bring inflation back to the ECB's target in a timely manner. This suggested that the contribution of monetary policy to disinflation had been limited so far, except indirectly through the appreciation of the euro and through the housing market channel in a number of euro area economies. With regard to exchange rates, it was noted that the recent appreciation of the euro implied lower inflationary pressures for the euro area in the period ahead.

Members recalled that wage pressures were key in understanding the risks of second-round effects on inflation and in determining more persistent developments in underlying price pressures. Until a few months ago wage growth had remained moderate, but now there was a clear acceleration, which had to be taken into account in the outlook for core inflation. It was also highlighted that, despite the slowdown in economic activity, the labour market remained exceptionally tight. This meant that price pressures acting on labour-intensive services were unlikely to abate soon. The wage trackers were showing very strong wage increases under newly concluded contracts, which, in a context of the long durations of wage contracts and centralised wage bargaining, might lead to more persistent wage growth. However, it was also noted that wage growth for the pool of job movers should naturally be expected to be much higher than wage growth for job stayers, as the former were expected to account for the bulk of productivity growth. Following the pandemic, the economy was going through a period of intensified job churning, so it was natural that labour productivity and wage growth were accelerating. But this would not necessarily imply an increase in price pressures. At the same time, it was highlighted that the observed strong increase in minimum wages would add to existing wage pressures. There was evidence that, over time, increases in minimum wages could feed into wage increases further up the wage scale. Therefore, while there was wide agreement that there were no signs of a wage-price spiral, it was argued that current wage growth was clearly not consistent with a 2% inflation target, even when taking into account trend improvements in productivity.

In this context, it was reiterated that wages were a lagging indicator, so only the most recent phase of wage growth should be seen as fully reflecting past price increases. In some sectors and some countries, wages were expected to rise by more than 10%. However, it was also observed that there was a lot of heterogeneity across sectors and countries. Moreover, while wage negotiations were still ongoing, wage claims were hardly reliable early indicators for the final wage agreements, which more often than not tended to be more moderate. It was observed that some catch-up effect from the loss of purchasing power accumulated over the past few years would unavoidably exert upward pressure on wage growth, in line with the December staff projections. At the same time, as energy prices had started to decline again, the loss in real income was now lower than previously expected. This could imply that the push to recover purchasing power via higher wages would also diminish, while leading to stronger than expected aggregate demand. It was underlined that, so far, the association of fast-rising prices with lagging wages had implied a large shift in income from labour to capital. Developments in unit profit growth remained very strong, which suggested that the pass-through of higher costs to higher selling prices remained robust. It was therefore widely stressed that developments in profits and mark-up warranted constant monitoring and further analysis on an equal footing with developments in wages.

Members agreed that fiscal policies continued to play a crucial role in determining the degree of persistence of medium-term inflation. Several members were of the view that fiscal policy was working against monetary policy efforts to restore price stability. At the same time, some upward effects on inflation could be expected from the positive demand impact of fiscal policy – especially through the component of fiscal policy aimed at protecting consumers from a loss of purchasing power. Moreover, governments could be expected to refrain from providing additional support if there was a diminished need for it, because this was costly in budgetary terms.

As regards longer-term inflation expectations, members took note of the assessments by Ms Schnabel and Mr Lane of the latest developments in market-based measures of inflation compensation and in survey-based indicators, concurring that they were broadly in line with longer-term inflation expectations being well anchored. Financial markets continued to see the Governing Council as credible in bringing inflation back to target. At the same time, it was argued that some indicators suggested longer-term inflation expectations remained at risk of becoming unanchored. Market-based expectations for near-term inflation had come down substantially, whereas medium and long-term inflation expectations remained broadly unchanged. Moreover, some survey-based measures had even increased. Median three-year ahead inflation expectations in the Consumer Expectations Survey for December had reversed their previous decline and again stood at 3%. The Survey of Professional Forecasters had reported upward revisions for 2023 and 2024, for both headline and core inflation, while long-term inflation expectations had declined slightly.

Against this background, members assessed that the risks to the inflation outlook had become more balanced, especially in the near term. On the upside, existing pipeline pressures could push retail prices higher in the near term. Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand. Domestic factors, such as a persistent rise in inflation expectations above the ECB's target or higher than anticipated wage rises, could drive inflation higher, including over the medium term. On the downside, the recent fall in energy prices, if it persisted, might slow inflation more rapidly than expected. This downward pressure in the energy component could then translate into weaker dynamics in underlying inflation. A further weakening of demand would also contribute to lower price pressures than currently anticipated, especially over the medium term.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. As monetary policy was tightened, bank lending rates for firms and households were rising. The growth of bank lending to firms had decelerated sharply over recent months. This partly stemmed from lower financing needs for inventories. But it also reflected weakening demand for loans to finance business investment, in the context of a steep upward move in bank lending rates and a considerable tightening in credit standards, as reported in the most recent euro area bank lending survey. Household borrowing had continued to weaken as well, reflecting rising lending rates, tighter credit standards and a sharp fall in the demand for mortgages. As the pace of loan creation was decelerating, money growth was also slowing rapidly, with a marked decline in the growth of its most liquid components, including overnight deposits, which was only partially compensated for by a shift to term deposits.

It was highlighted that the weakening in credit dynamics, with the growth of loans to firms in the euro area coming to a virtual standstill in November and December, was in large part a natural and desired consequence of the ongoing normalisation of the monetary policy stance. However, the size and speed of the recent decline had to be monitored, since it might act as a drag on the recovery. A question was raised as to the extent to which the weakening in lending dynamics was due to lower demand, which could be traced back to monetary policy tightening, or to supply factors. Reference was made in this respect to the results of the latest round of the bank lending survey. This pointed to reduced loan demand being driven mainly by a higher general level of interest rates and lower demand for fixed investment, while the tightening of lending standards was driven mainly by banks' risk perception and risk tolerance, and less by the cost of funds. At the same time, it was remarked that euro area banks' capital positions remained solid amid improving asset quality, despite challenging and quickly evolving macroeconomic and financial circumstances. Moreover, at the current stage of policy normalisation, banks saw their profitability boosted by increasing interest rate margins. Rising bank lending rates and lower lending volumes did not therefore necessarily reflect a reduction in banks' intermediation capacity.

Looking beyond bank-based financing costs, members noted that broader financial conditions had tightened overall after the December meeting, reflecting the Governing Council's policy decisions and communication. Market expectations for the terminal rate had risen to levels that were regarded as more comfortable and more consistent with a timely return of inflation to target. Notwithstanding the uncertainty about the precise level of the terminal rate, these expectations had been remarkably stable since December. Moreover, members welcomed the fact that real forward rates were now positive along the entire yield curve. It was underlined that debt financing conditions had tightened amid a benign situation in the bond market, in conjunction with receding uncertainty. In particular, bond spreads remained generally contained and risk assets, including equities, were performing strongly. In addition, the ECB's announcement in December regarding the plans to reduce the APP portfolio from March 2023 had not resulted in a substantial increase in term premia or government bond spreads. Overall, despite some volatility, it was felt that the market response to the Governing Council's communication following its December meeting could thus be deemed a success.

In view of recent monetary and financial developments, members noted that the transmission of monetary policy to financing conditions seemed to be working as intended and, so far, was broadly in line with previous hiking cycles. Given that transmission lags were long and variable – typically estimated to be around two years – it was argued that only a limited impact could be expected to be visible in demand and inflation at this point, at least if policy normalisation was assumed to have started in July 2022. However, it was suggested that December 2021, when the winding-down of asset purchases had been announced, could be a better starting point. This was when financing conditions had begun to tighten and mortgage rates had started to rise, well ahead of the time when policy rates were first raised. Accordingly, there had already been evidence for some time of a transmission of monetary policy to the housing market – which was welcome in view of the long-standing signs of overheating. Consumer loans and loans to non-financial corporations, by contrast, had seen little impact before the sharp deceleration in lending to firms observed in more recent months. As regards the extent to which financing conditions were constraining demand, reference was made to the ECB's Corporate Telephone Survey. This suggested that larger firms continued to see financing conditions as favourable, with very few considering them a reason for reducing investment. Similarly, in the recent European Commission survey, financial constraints were not seen by firms as a significant factor limiting production. This was somewhat at odds with the results of the ECB's bank lending survey, in which banks pointed to a significant negative contribution of interest rates to demand for loans.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members stressed that inflation remained far too high. However, the latest data implied that risks had become more balanced, with both downside risks to growth and upside risks to inflation having diminished relative to the Governing Council's December assessment. Energy prices had declined rapidly, suggesting a partial reversal of the earlier adverse supply shock. If this development persisted, it should lead to a more rapid fall in headline inflation. It was also reiterated that, given the typically long transmission lags, the decline in headline inflation observed to date was unlikely to be the result of monetary policy tightening. At the same time, it was underlined that core inflation and other measures of underlying inflation were likely to be stickier, with only limited evidence of a stabilisation so far.

Overall, it was widely argued that the latest data and the change in the balance of risks did not fundamentally alter the assessment made by the Governing Council in December, and there was a need to stay the course in raising interest rates significantly at a steady pace and in keeping them at levels that were sufficiently restrictive to ensure a timely return of inflation to the ECB's 2% medium-term target.

While members agreed that there were no signs of a wage-price spiral taking hold, wage pressures were broadening, in line with the December 2022 projections. On the whole, although there were already signs of a stabilisation and turning point in headline inflation, the pass-through to persistent components of inflation was highly uncertain. Underlying price pressures remained strong, inflation in non-energy components of the price index was rising and a tight labour market would continue to exert pressure on core inflation. Moreover, a better than expected growth outlook would contribute to continued inflationary pressures, which were unlikely to abate by themselves without further significant policy tightening.

In any case, it was argued on the basis of standard model elasticities that expected inflation for 2025 would now be closer to 2% than envisaged in the December 2022 projections, when taking into account the most recent data as well as changes in the external assumptions. These included higher market rates, a stronger euro in nominal effective terms and markedly lower energy prices. Beyond the impact of new data, members underlined the role of the change in market interest rate expectations, which had moved higher since the cut-off date for the December projections. At the same time, it was acknowledged that this was a partial analysis, and the strength and persistence of the various factors driving inflation required a full new round of projections to assess the implications for both the baseline outlook and the balance of risks. Uncertainty remained very high in any case, and it was unclear whether low energy prices would persist. Uncertainty surrounding the inflation outlook stemmed particularly from the impact of China's reopening, fiscal measures and the exchange rate on inflation. The next ECB staff projections would help shed more light on these questions and provide a more complete picture. It was remarked that basing the new staff projections on a yield curve that was more in line with members' views should offer a better benchmark than the one provided by the projections available at the Governing Council's December monetary policy meeting.

Attention was drawn to the gap between the inflation trajectory embedded in the December projections and that implied by financial markets. Market participants appeared to be more optimistic and had substantially reassessed their inflation outlook, with inflation-linked swap rates having come down significantly at short horizons. This raised the question of whether markets were giving too much weight to the decline in energy prices. In this context, it was seen as somewhat surprising that markets had hardly reacted to the flash estimate for euro area January headline inflation being lower than projected. At the same time, they had reacted strongly to the upside surprise in January headline inflation in the euro area's fourth largest economy, which had also seen an acceleration in core inflation. This could indicate that markets were now paying more attention to core inflation than to headline inflation to gauge underlying inflationary pressures.

It was underlined that both survey and market-based indicators of inflation expectations at longer-term horizons remained broadly anchored, suggesting that the ECB was expected to be successful in bringing inflation down to 2% over the medium term. However, it was also pointed out that some survey-based measures of inflation expectations had been revised upwards, and that the risk of inflation expectations becoming unanchored had not disappeared.

Monetary policy decisions and communication

Against this background, broad support was expressed for Mr Lane's proposal to raise the key ECB interest rates by 50 basis points and to communicate that the Governing Council expected to raise them further, indicating specifically that it intended to raise rates by another 50 basis points at the next monetary policy meeting in March and would then evaluate the subsequent policy path. Indeed, further increases were required for the Governing Council's policy rates to enter restrictive territory, and it was necessary to keep them at levels that were sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target.

Any assessment of what level of rates could be seen as excessively restrictive was complex and uncertain, although it was generally felt that concerns of "overtightening" were premature at the present high levels of inflation and in view of the likely persistence of underlying price pressures. It was emphasised that policy rates were, at present, barely consistent with the range of estimates for the neutral rate and that the large bond portfolio held by the Eurosystem was also still providing substantial policy accommodation. Moreover, even the benign inflation scenario expected by financial markets was conditional on the significant further rate increases priced into the forward curve.

Overall, it was seen as imperative to stay the course and to show determination in the intention to tighten further. This would reduce unwarranted policy uncertainty and would be fully consistent with the decisions and communication adopted by the Governing Council in December. The view was expressed that, given the still substantial distance to the prospective terminal rate, there continued to be value – from a risk management perspective – in frontloading rate hikes at the present stage. In particular, showing determination now to raise rates significantly further could help to avoid being forced into further rate hikes later on.

In this context, it was remarked that the risk-free forward curve suggested markets were expecting rate cuts not long after the terminal rate had been reached. This was seen to be somewhat at odds with the Governing Council's communication in December that interest rates would need to stay at restrictive levels for inflation to return to the medium-term target. At the same time, this could be interpreted as markets having confidence that the ECB would be successful in stabilising inflation. In other words, once inflation had returned to target, interest rates could come down to a level consistent with the long-run "steady state".

While there was broad agreement that tightening needed to continue, reservations were expressed on the proposed communication of an intention for the March meeting. The point was made that policy rates were coming closer to a level where caution was needed to ensure that monetary policy was not tightened excessively. In view of the high uncertainty, the inflation outlook could change rapidly in either direction. This required a careful assessment of new data and of the effect of previous rate hikes on price dynamics. Not least in view of the ECB's symmetric inflation target, the risk of doing too much deserved as much consideration as the risk of doing too little. It was noted that the short-term momentum in core inflation had also started to decline somewhat and, allowing for transmission lags, core inflation should come down further over time. Moreover, at the start of policy normalisation, large buffers of savings accumulated by households and firms, together with substantial pent-up demand, had ensured that monetary policy could be tightened without causing much harm to the real economy.

Although these buffers remained at high levels, they had diminished. This implied that more caution was required as regards further tightening steps.

The point was made that the proposed communication did not prevent adapting the intended change in the policy stance in March should it be required on the basis of substantial new information: expressing an “intention” was different from giving a “commitment”. It merely reflected the fact that, on the basis of the information available, the probability of a change occurring was seen as insignificant. It conveyed the view that, in the absence of abrupt changes in circumstances, a further 50 basis point interest rate hike at the March meeting was consistent with a very wide range of possible scenarios for the way inflation would develop. An advance indication of such a move would therefore provide clarity about the near-term direction of monetary policy. This reconciled communicating the intention to raise rates in March with a data-dependent approach.

All in all, it was seen as important to provide a firm signal of policy intentions for the March meeting, while stating that the path of monetary policy following that meeting would be evaluated with an open mind, in line with the data-dependent approach.

Turning to the policies affecting the size and composition of the Eurosystem’s balance sheet, members widely agreed with Mr Lane’s proposal on the key parameters for the reduction of the APP portfolio and with the detailed operational modalities as described by Ms Schnabel and as set out in a dedicated ECB press release. In particular, given the relatively small reinvestment amounts expected, broad support was expressed among the members for a simple and neutral approach. This meant that the partial reinvestments over the period between March and the end of June would be conducted broadly in line with current practice. The remaining reinvestment amounts would be allocated proportionally to the share of redemptions across each constituent programme of the APP and, under the public sector purchase programme, proportionally to the share of redemptions of each jurisdiction and across national and supranational issuers. Just as the APP had supported the monetary policy stance when it was introduced, the reduction of the APP portfolio had to be carried out in a way that would support smooth policy normalisation and transmission, keeping the decline in the portfolio measured and predictable.

It was highlighted that tilting reinvestments in the corporate sector purchase programme portfolio more strongly towards issuers with a better climate performance would signal the ECB’s continued commitment – without prejudice to the objective of price stability – to supporting the EU’s policies for achieving the climate goals of the Paris Agreement via a gradual decarbonisation of the Eurosystem’s corporate bond holdings.

Members also agreed with the proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio. Maintaining this existing flexibility was seen as an efficient, preemptive approach to countering a potential re-emergence of risks to the monetary policy transmission mechanism related to the pandemic.

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 relevant press releases. 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 2 February 2023

Press releases
Monetary policy decisions

Detailed modalities for reducing asset purchase programme holdings

Meeting of the ECB's Governing Council, 1-2 February 2023

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 Makhlouf*
- Mr Müller*
- Mr Nagel

- Mr Panetta
- Mr Rehn
- Mr Reinesch
- Ms Schnabel
- Mr Scicluna
- Mr Šimkus
- Mr Stournaras*
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Visco*
- Mr Vujčić*
- Mr Wunsch

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

Other attendees

- Mr Donohoe, President of the Eurogroup***
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

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

Accompanying persons

- Ms Buch
- Mr Demarco
- Mr Garnier
- Mr Gavilán
- Mr Gilbert
- Mr Haber

- Mr Kaasik
- Mr Koukoularides
- Mr Kuodis
- Mr Lünnemann
- Mr Madouros
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Šošić
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 20 April 2023.