EUROPEAN CENTRAL BANK

EUROSYSTEM

Meeting of 15-16 March 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, 15-16 March 2023

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

Financial market developments

Ms Schnabel distinguished two periods when reporting on financial market developments since the Governing Council's previous monetary policy meeting on 1-2 February 2023.

In the first period, stretching until the collapse of Silicon Valley Bank (SVB) in the United States, mounting signs of more persistent pressures on core inflation in the euro area – i.e. inflation in the Harmonised Index of Consumer Prices (HICP) excluding the food and energy components – had led investors to reassess their views on the likely future path of inflation and interest rates, and they were pricing in a higher-for-longer inflation and rate environment. Expectations regarding the level of the "terminal rate" (the peak rate) in the ECB's ongoing rate hiking cycle had reached a level of 4.2% in the week prior to the Governing Council's meeting on 15-16 March, while the expected date of the first rate cut had been pushed out to the third quarter of 2024. Yet, despite this sharp upward revision to the expected policy rate path, market-based indicators of longer-term inflation expectations had continued to point to elevated concerns that inflation would remain above the ECB's target of 2%.

The second period had started when these market developments had been abruptly halted by the collapse of SVB. Interest rate expectations had been revised downwards sharply, but they had partially reversed this decline on 14 March 2023 before dropping again on the morning of 15 March. Financial market indicators at the close of the markets on 14 March 2023 had not shown signs that the US banking sector turbulence would cause a systemic crisis in the United States or the euro area. However, the moves in these indicators had reversed again on the morning of 15 March, in turbulent market conditions. It would not be possible to get a clearer picture of the most recent change in market perceptions until the dust from the market turbulence had settled.

Amid this market volatility, three observations stood out. First, broad stock indices had remained much more resilient than bank stocks, as the share prices of non-financial corporations had been affected only moderately. Second, spillovers from the United States to the euro area had been contained. Third, bank share prices in the euro area remained well in positive territory relative to their lows in mid-2022, owing to the strong and sustained rally since then on the back of improving earnings expectations.

While stock prices of major global banks had fallen sharply across Europe and the United States, spreads on credit default swaps had increased only moderately for euro area banks. Liquidity conditions also remained solid. The FRA-OIS spread – i.e. the difference between the rate charged on interbank unsecured deposits and the overnight index swap (OIS) rate – had increased significantly in the euro area but had remained near its long-term average level. Moreover, the cost of offshore US dollar funding had increased substantially, although this increase had been partially reversed subsequently. As regards volatility, fixed income markets had reacted much more strongly to the SVB event than equity markets. Overall, these developments suggested that, if there was no intensification of the stress in the banking sector, the inflation outlook would soon come to the fore again in the minds of market participants.

Before the banking sector turbulence had started in the United States, global macroeconomic upside surprises had dominated financial market developments across major economies. Positive data on economic activity had been accompanied by upward surprises for headline inflation and, especially, core inflation in the euro area. This growth and inflation mix had led to a repricing by markets of the inflation outlook for the euro area over the medium term, as market participants perceived the factors driving inflation pressures to have shifted from external supply to internal demand or, put differently, from headline to core inflation. Investors were now pricing in a substantially more sluggish return of inflation to 2%, despite lower natural gas prices.

Expectations of more persistent core inflation had led to a significant reappraisal of policy rate expectations in the euro area. The United States had seen a similarly strong repricing of the forward curve, underlining the perceived close synchronicity in the global economic activity and inflation cycle. These developments had been reversed after the unfolding of the events related to SVB. But developments in market-based indicators of longer-term inflation expectations in the euro area were a vivid reminder that investors saw elevated risks of inflation remaining above target in the medium term. Evidence from option prices also pointed to elevated upside risks to inflation.

Three factors had fuelled market concerns about inflation becoming more persistent in the euro area. The first related to the prevailing uncertainty about the ECB's "reaction function". The second factor was related to uncertainty about the extent of policy tightening needed to bring real interest rates into sufficiently restrictive territory to curb inflation. The third factor related to broader financial conditions, which might be insufficiently restrictive, as they had remained broadly unchanged since the Governing Council's October monetary policy meeting despite a notable tightening of monetary policy in this period.

Regarding developments in bond markets, sovereign bond spreads had remained broadly unchanged until the collapse of SVB, when they had started to increase somewhat. Yet this increase in spreads had been moderate and entirely driven by the sharper decline in German Bund yields. Developments in corporate bond markets had also been benign until the onset of the banking sector stress. Since then, there had been a sharp increase in corporate bond spreads of investment-grade financial corporations compared with those of non-financial corporations. Spreads of high-yield non-financial corporate bonds had also increased, but they remained at relatively compressed levels from a historical perspective.

Regarding market functioning, collateral availability concerns had been fading. Since the announcement of the new ceiling for remuneration of non-monetary policy deposits, the spread between short-term government bills and the respective risk-free rates (OIS) had been narrowing. Looking ahead, further progress on the roll-off of the ECB's monetary policy bond portfolios would support the availability of collateral.

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

Mr Lane noted that the ongoing exceptional tensions in the financial markets were a source of significant uncertainty for the economic outlook. These could lead to an undue tightening of credit conditions or significantly dampen confidence, and therefore implied additional uncertainty for the baseline assessments of growth and inflation.

The Governing Council needed to closely monitor current market tensions and stand ready to respond as necessary to preserve price stability and financial stability in the euro area. The euro area banking sector was resilient, with strong capital and liquidity positions. This reflected effective supervision and a rigorous implementation of the global regulatory reform agenda. In any case, the ECB's policy toolkit was fully equipped to provide liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy.

Turning to economic developments in the euro area, a series of favourable supply shocks and increasing evidence of the ECB's monetary policy tightening working its way through the economy had been the dominant developments since the start of the year. The fall in energy prices and the clearing of supply chain bottlenecks were lowering price pressures, while at the same time boosting confidence and supporting real incomes and business activity, especially in the short run. Indeed, most survey indicators pointed to improving business and consumer sentiment, although still at low levels, with the brighter prospects for economic activity reflecting a broad-based improvement in supply conditions. Delivery times for inputs for factories were shortening to a degree not seen since the recovery from the global financial crisis in 2009. However, international markets were becoming a drag on the euro area economy, as evidenced by the substantial fall in order book volumes in February.

Overall, the world economy showed signs of a stabilisation in the first few months of the year and the reopening in China was expected to provide support later on. Nevertheless, the outlook for global activity remained subdued in the near term, reflecting weak domestic demand in key trading partners of the euro area. In addition, the rapid tightening of the ECB's monetary policy stance was increasing the cost of credit for the euro area economy and slowing the provision of bank loans. This sharp tightening of financing conditions was starting to affect the real economy measurably.

Euro area economic activity had stagnated in the last quarter of 2022. Industrial production was virtually flat in the final quarter of 2002 and had recovered only marginally in January 2023. Notable contractions in the production of energy, intermediate goods and durable consumer goods had been offset by still expanding production of non-durable and capital goods, especially motor vehicles, as production in these sectors was recovering with the easing of supply disruptions. At the same time, market services had contracted in the fourth quarter of 2022, mainly because of sharp declines in retail trade, transport, and accommodation and food services in December. While the previously expected economic contraction had been avoided, all private domestic demand components had contracted.

Whereas private consumption had been very strong in the second and third quarters of 2022 as a result of the reopening of the euro area economy, the significant drop in the fourth quarter of 2022 reflected low confidence and the earlier terms-of-trade shock adversely affecting spending decisions. Looking ahead, households had started to be more optimistic in their expectations for their own financial situation, thanks to the decline in inflation. However, this had not yet translated into stronger optimism in their spending plans. In relation to demand for housing, where monetary policy was expected to have a stronger impact, the results of the ECB's Consumer Expectations Survey showed that households' perceptions of housing as a good investment continued to deteriorate.

Turning to investment, investment in residential construction had started to fall in the second quarter of 2022 and this decline had accelerated in the third and fourth quarters of 2022. Survey indicators, such as the Purchasing Managers' Index (PMI) for output and business expectations in the construction sector, had recovered slightly in recent months but still clearly pointed to contracting activity both currently and in the near future. Business investment had seen a small contraction in the last quarter of 2022 if Irish intellectual property products were excluded. Survey indicators showed some improvement in the capital goods sector in recent months, as the output PMI for the sector had moved into slightly positive territory, in line with the expected better outlook for GDP in the short term. But steeply rising financing costs were expected to weigh on business investment in the quarters ahead.

For trade, recent data confirmed a significant drop in imports of goods, while exports had recovered somewhat. Thanks to falling energy prices, the terms of trade had started to improve at the end of last year and this had led to an improvement in the goods trade balance. On the services side, forward-looking indicators for tourism pointed to the expectation of a strong rebound in the first half of 2023, to which the reopening of China might also contribute.

Regarding the labour market, all indicators pointed to resilience. The unemployment rate had stood at 6.6% in January, broadly stable since April 2022. The vacancy rate had also remained stable. Employment growth was expected to remain positive in early 2023, according to the PMI. The labour force had recovered from the impact of the pandemic and remained well above its longer-term trend. This dynamism reflected increased participation rates – in particular for older workers – and an increase in migrant workers. This was an important element to take into account in relation to future wage growth dynamics.

These macroeconomic developments were reflected in the March 2023 ECB staff macroeconomic projections. Provided that the current financial market tensions did not feed into an undue tightening of credit conditions or significantly dampen confidence, the economy looked set to recover over the coming quarters as the adverse supply shocks that had occurred over the past few years had been partly reversed. Industrial production was expected to pick up as supply conditions improved further, confidence continued to recover, and firms worked off large order backlogs. Rising wages and falling energy prices would partly offset the loss of purchasing power that many households were experiencing as a result of high inflation. This, in turn, was projected to support consumer spending. Accordingly, projected growth for 2023 had been revised up by 0.5 percentage points, to 1.0%, in the March staff projections. At the same time, the expected further pick-up in growth to 1.6% in both 2024 and 2025 was weaker than projected in December, as the headwinds from tighter financing conditions and the appreciation of the euro were seen to outweigh the positive effects on real income and confidence of somewhat lower inflation. This combination of factors, together with the gradual withdrawal of fiscal support and lingering concerns about energy supply risks for the winter of 2023-24, was expected to weigh on economic growth in the medium term.

Risks to the outlook for economic growth were tilted to the downside. Persistently elevated financial market tensions could tighten broader credit conditions more strongly than expected and dampen confidence. Russia’s unjustified war against Ukraine and its people 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. However, companies could adapt more quickly to the challenging international environment and, together with the fading-out of the energy shock, this could support higher growth than currently expected.

Inflation had edged down from 8.6% in January to 8.5% in February, while underlying price pressures remained strong. The decline in the overall inflation index had resulted from a renewed sharp drop in energy prices. Conversely, food price inflation had increased further, to 15.0% in February, with the past surge in the cost of energy and of other inputs for food production still feeding through to consumer prices. Inflation excluding energy and food had increased markedly to 5.6% in February, from 5.3% in January, driven by the delayed pass-through of the past surge in energy prices, as well as continued, albeit declining, pipeline pressures and strengthening wage growth pressures. At the sectoral level, inflation in the non-energy industrial goods sector had risen to 6.8% in February, mainly reflecting the delayed effects of past supply bottlenecks and high energy prices. Services inflation – which had risen to 4.8% in February – was also still being driven by the gradual pass-through of past energy cost increases, residual pent-up demand from the reopening of the economy and rising wages.

Other indicators of underlying inflation had also stayed high. As these indicators aimed to capture the most persistent part of inflation, it was interesting to compare them with the surveys of expectations about the persistence of inflation. Survey data on expectations of headline inflation in the near term were aligned with the information coming from the indicators of underlying inflation. In other words, the surveys predicted that inflation would fall but remain high, at above 4%, over the next few months. However, for 2024-25 there was a disconnect, as both survey data and market-based inflation compensation measures indicated that inflation would be well below 4% from the beginning of 2024. This showed that it was not straightforward to extrapolate a signal for medium-term headline inflation from indicators of underlying inflation. Indeed, it was likely that these indicators reflected, to varying degrees, cumulated distortions as a result of extraordinary developments following the pandemic – namely the war in Ukraine and the energy shock.

Focusing on core inflation, there had been a large gap between the inflation developments in energy-sensitive sectors and those in non-energy-sensitive sectors. Those sectors with a high energy dependency had seen a disproportionate increase in the inflation rate compared with non-energy-sensitive sectors. This implied that, as the effect of the energy shock faded, the contribution of this component of core inflation would start to decline. Mr Lane also noted that, while downward pressures could be expected from inflation developments in energy-sensitive sectors, inflation in wage-intensive sectors had started to increase their contribution to core inflation.

Changes in HICP weights in January were expected to have a significant impact on the profile of inflation in 2023. For headline inflation the change implied a negative impact throughout 2023, while for core inflation (and especially services) the impact was estimated to be negative in the first quarter of 2023 and positive in the third quarter of the year, mostly owing to a higher weight of recreational services in 2023.

Mr Lane remarked that it was important to look also at the inflation momentum in order to capture turning points. One indicator for momentum was the three-month-on-three-month annualised inflation rate based on seasonally adjusted data. For headline inflation this measure had fallen from close to 11% in November 2022 to close to 3% in February 2023. This sharp fall in momentum was entirely due to a sharp decline in energy inflation. For other components of the HICP, changes in inflation momentum were much more limited.

Although pipeline pressures were weakening, they remained substantial. Wage pressures had strengthened, supported by robust labour markets and employees aiming to recoup some of the purchasing power lost owing to high inflation. Moreover, many firms had been able to raise their profit margins in sectors faced with constrained supply and resurgent demand. The evolution of profits compared with that of wages suggested that wages had had only a limited influence on inflation over the past two years and that the increase in profits had been significantly more dynamic than that in wages. An important question for the forecasting of inflation was whether firms would continue with the same pricing strategy or would accept lower profit margins in the period ahead.

Market-based measures of inflation compensation had increased substantially across maturities since the Governing Council’s 1-2 February meeting, although they had eased again more recently. More reassuringly, expectations captured in the ECB Survey of Monetary Analysts and the ECB Survey of Professional Forecasters showed that an increasing share of respondents expected inflation to be at target over the long run. Household expectations for inflation three years ahead, as expressed in the ECB’s Consumer Expectations Survey, had declined by 0.5 percentage points in January 2023 compared with the previous month’s survey.

In the March ECB staff projections, the path for inflation had been revised down throughout the projection horizon, owing mainly to a smaller contribution from energy prices than previously expected. This, in turn, implied a smaller role for compensatory fiscal measures and a somewhat stronger impact of monetary policy tightening. Inflation was now projected to average 5.3% in 2023, 2.9% in 2024 and 2.1% in 2025, implying downward revisions of 1.0, 0.5 and 0.2 percentage points respectively.

In contrast, inflation excluding energy and food had been revised up by 0.4 percentage points to 4.6% for 2023, largely on account of recent data surprises and the lagged pass-through of indirect effects from past energy price increases. Overall, these indirect effects would still contribute to inflation until the end of the projection horizon despite the sharp downward corrections in energy prices. Similarly, the past depreciation of the euro had continued to put upward pressure on core inflation, although to a lesser extent than previously assumed owing to the recent appreciation of the euro. So, while most of the projected core inflation was essentially coming from profits and labour costs, the contribution of indirect effects from the past energy shock and depreciation of the euro was still sizeable. However, the fall in energy prices, combined with the recent appreciation of the euro and continued tightening of credit conditions, was expected to gradually dampen core inflation compared with the December projections. This was reflected in the downward revisions to core inflation of 0.3 and 0.2 percentage points for 2024 and 2025 respectively. Over those later years of the projection horizon, core inflation was projected to ease slowly towards 2% by 2025.

Upside risks to inflation included existing pipeline pressures that could still send retail prices even higher in the near term. Domestic factors, such as a persistent rise in inflation expectations above the Governing Council's target or higher than anticipated increases in wages and profit margins, could drive inflation higher, including over the medium term. Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand. On the downside, persistently elevated financial market tensions could accelerate disinflation. In addition, falling energy prices could translate into reduced pressure from underlying inflation and wages. A weakening of demand, including owing to a stronger than expected transmission of monetary policy, would also contribute to lower price pressures than currently anticipated, especially over the medium term.

Financing conditions reflected a strong transmission of tighter monetary policy but had recently been subject to significant volatility. Market interest rates had risen considerably in the weeks following the Governing Council's February monetary policy meeting. But this increase had reversed sharply in the days before the March meeting in the context of severe financial market tensions. Turning to real rates, Mr Lane commented on two measures of the real rate. The first was the short-term version, computed as the policy rate minus the expected inflation rate one quarter ahead. This short-term real rate remained negative, but it was increasing strongly – into positive territory – as expected inflation was declining and the policy rate implied by the yield curve was increasing. The second version was a medium-term cost of finance concept, computed as the expected average policy rate over the next year minus the expected inflation rate over the same period. This second version was solidly positive throughout the horizon.

Mr Lane emphasised that bank credit to firms had become more expensive and, in January, banks' cost of borrowing had risen to levels last seen in late 2011. The biggest increase was in bank bond yields, but deposit rates were also starting to rise noticeably. There was also a composition effect because more people were moving away from overnight deposits to better remunerated types of deposits. Moreover, the move away from targeted longer-term refinancing operations (TLTROs) to market funding was also pushing up the cost of finance for banks. Following a sharp slowdown since mid-2022, credit flows to non-financial firms had lately declined to close to zero as a result of lower demand and considerably tighter credit supply conditions.

The cost of borrowing for households had increased as well, especially owing to higher mortgage rates, which were currently at their highest level since early 2013. This rise in borrowing costs and the resultant decline in demand, along with tighter credit standards, had led to a further slowdown in the growth of loans to households. Amid these weaker loan dynamics, money growth had again slowed sharply, driven by its most liquid components. The decline in the annual growth rate of narrow money

(M1) had been accelerated by a pronounced reshuffling between instruments within broad money (M3), with shifts from overnight deposits into other less liquid but better remunerated instruments, such as time deposits.

Monetary policy considerations and policy options

Since inflation was set to remain above the target for too long, Mr Lane proposed raising the three key ECB interest rates by 50 basis points, in line with the intention communicated after the February Governing Council meeting. The Governing Council should also state that future policy rate decisions would be determined by 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.

Following up on the announcement in February that the Governing Council would evaluate the subsequent path of its monetary policy at the March meeting, this clear statement of the ECB’s policy reaction function would help orient market expectations towards the key factors underlying its decisions. In particular, this would clarify that a careful analysis of underlying price pressures and the state of monetary policy transmission at each point in time would act as a cross-check of the staff projections in times of heightened uncertainty and potential structural change. It also reflected the fact that monetary policy considered financial developments to the extent that these affected price stability, in line with the ECB’s monetary policy strategy statement.

As regards the pandemic emergency purchase programme (PEPP), the signalling power of the PEPP’s reinvestment flexibility framework still contributed to supporting the transmission mechanism. It was therefore proposed that, in the spirit of prudence, the Governing Council should continue to allow flexibility in PEPP reinvestments as an effective first line of defence against remaining fragmentation risks, but that it would only exercise this flexibility in the event market conditions deteriorated.

2. Governing Council’s discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members broadly shared the assessment of the economic situation and outlook of the euro area provided by Mr Lane in his introduction. The March ECB staff projections had a cut-off date in mid-February for the technical assumptions and had been finalised in early March. This was before the release of the flash estimate of euro area inflation for February and the emergence of financial market tensions. There was broad agreement that these tensions implied additional uncertainty around the baseline assessments of economic growth and inflation. The view was expressed that, given the emergence of the tensions and heightened uncertainty, observers might see the economy as being in a different place compared with that pictured in the projections. At the same time, the point was made that despite the uncertainty implied by the tensions, and unless the situation deteriorated drastically in the new situation, inflation would still not simply disappear on its own and underlying inflation, in particular, remained far too high.

As regards the external environment, members took note of the assessment provided by Mr Lane that the upward impact on trade from the unwinding of supply bottlenecks had been fading in the second half of 2022. In the March ECB staff projections, both world real GDP growth and trade growth had been revised upwards for 2023, reflecting higher growth projections for China and the United States. In the exchange of views, it was reiterated that the reopening of the Chinese economy would increase China's appetite for commodities. While currently this applied mostly to China's demand for coal, it was suggested that the prospect of the country restocking gas supplies should be closely monitored, as increased demand for gas might not yet be fully reflected in current gas futures prices and could still have an impact on euro area energy prices. It was pointed out that even slower than expected growth in China would still imply an enormous increase in its energy demand.

Turning to economic activity in the euro area, members took note of Mr Lane's assessment that the dominant developments since the start of the year represented a partial reversal of earlier adverse supply shocks and there was increasing evidence that monetary policy tightening was starting to work its way through the economy. The euro area economy had stagnated in the fourth quarter of 2022, thus avoiding the previously expected contraction. However, private domestic demand had fallen sharply as high inflation, prevailing uncertainties and tighter financing conditions had dented private consumption and investment. These had fallen by 0.9% and 3.6% respectively. According to the March ECB staff projections, the economy looked set to recover over the coming quarters. Industrial production should pick up as supply conditions improved further, confidence continued to recover and firms worked off large order backlogs. Rising wages and falling energy prices would attenuate the loss of purchasing power that many households were experiencing as a result of high inflation. This, in turn, would support consumer spending.

Looking ahead, the ECB staff's baseline projections for economic growth in 2023 had been revised up to an average of 1.0%. This was the result of both the decline in energy prices and the economy's greater resilience to the challenging international environment. The projections then expected growth to pick up further, to 1.6%, in both 2024 and 2025, underpinned by a robust labour market, improving confidence and a recovery in real incomes. At the same time, the pick-up in growth in 2024 and 2025 was seen to be weaker than projected in December, owing to the tightening of monetary policy. Some comfort was drawn from the fact that there had been no contraction at the end of last year, which had previously been expected, but it was cautioned that the observed stagnation still implied a fragile growth outlook for this year.

It was noted that the upward revision to economic growth in 2023 reflected a better than expected outcome for the fourth quarter of 2022 and lower energy prices. At the same time, financing conditions were now substantially tighter compared with the corresponding assumptions underpinning the December 2022 Eurosystem staff projections. It was well understood that the impact of interest rate increases on growth usually came with a lag, but there was still a question as to whether forecasting models sufficiently captured the cumulative impact on growth and inflation of the sequence of rate increases seen so far. It was also argued that the decline in the credit-to-GDP ratio foreseen over the projection horizon could not be driven only by a fall in demand for credit but had to reflect also significant supply-side effects. These were likely to have a strong impact on consumption and investment, which appeared at odds with the only limited credit supply effects on GDP incorporated into the staff projections. At the same time, it was questioned whether, in the absence of hard evidence, quantity restrictions on lending should have come into play at all, at least before the recent turbulence, since the economy had improved and macro risks had receded, while bank profitability had been growing and capital and liquidity positions were solid.

Members widely underlined the continued resilience of the labour market, which had remained strong despite the weakening of economic activity. Employment had grown by 0.3% in the fourth quarter of 2022 and the unemployment rate had stayed at its historical low of 6.6% in January 2023. It was noted that the increase in the unemployment rate that had been expected for the last six months had not materialised and that the projections implied continued labour market tightness over the projection horizon. Strong growth in employment was seen as reflecting the elastic response of the labour force to job opportunities, which differed from the situation in the United Kingdom and the United States, where labour force participation rates had not fully recovered since the pandemic. At the same time, it was cautioned that the upward revisions to real GDP growth and highly resilient labour markets likely reflected the impact of some tailwinds, including accumulated savings and liquidity buffers held by households and firms, as well as generous government support measures, all of which could not be expected to last indefinitely. In this context, it was recalled that labour markets were usually a lagging indicator that sooner or later might reflect the uncertainties in the real economy. However, it was also argued that the tight labour market might reflect potentially persistent matching problems between vacancies and the unemployed, which would also have implications for wages. The point was made that the resilience of the labour market and labour scarcity likely meant that, on the basis of historical regularities, the monetary policy transmission to the economy could well be weaker than was expected.

As regards fiscal policies, members reiterated 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. As energy prices were falling and risks around the energy supply were receding, it was important to start rolling back these measures promptly and in a concerted manner. 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 and as stated in the European Commission’s guidance of 8 March 2023, fiscal policies should be oriented towards making the euro area 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. Risks on the fiscal side were seen as stemming from governments’ energy-related support measures remaining in place for longer than currently expected or budgetary space being redirected towards other expenditures, with uncertainty prevailing about the reform of the EU’s fiscal governance framework and the outlook for medium-term national consolidation paths.

Against this background, members overall assessed risks to the economic growth outlook as tilted to the downside. Persistently elevated financial market tensions could tighten broader credit conditions more strongly than expected and dampen confidence. It was pointed out in this regard that the recent financial market tensions could put the current expectation of a soft landing of the economy at risk. Russia’s war against Ukraine continued to be a significant downside risk to the economy and could again push up the costs of energy and food. There could be an additional drag on euro area growth if the world economy weakened more sharply than expected. However, companies could adapt more quickly to the challenging international environment and, together with the fading-out of the energy shock, this could support higher growth than currently expected. For the medium term, the question was raised as to whether the assessment that the balance of risks was tilted to the downside was justified, given that the baseline projections had already seen a substantial downward adjustment.

With regard to price developments, looking ahead, members noted that the path for headline inflation had been revised down in the March ECB staff projections, mainly owing to a smaller contribution from energy prices than previously expected and a somewhat stronger downward impact from monetary policy tightening. At the same time, underlying price pressures remained strong and ECB staff expected HICP inflation excluding energy and food to average 4.6% in 2023, which was higher than foreseen in the December projections.

In the discussion of the inflation outlook and the projections, the point was made that HICP data for February had surprised on the upside compared with the starting point for the projections. Mechanically incorporating the latest information would imply higher headline and core inflation in 2023. Moreover, even disregarding this upside surprise, the projected outcome of 4.6% for core inflation in 2023 suggested that the projections incorporated an overly optimistic belief in the unwinding of underlying inflation. While core inflation might be close to a turning point, this had not yet been seen in hard data. Reference was made to the calculations of the momentum of core inflation in the short term, based on annualising the rate of price increases over the last three months, which had rebounded for the euro area according to the February inflation data release.

Some comfort was drawn, however, from the observation that the March projection had embodied the first downward revision to the inflation outlook after eight consecutive rounds of upward revisions. It was acknowledged that this was mainly due to lower current and future energy commodity prices and implied that the supply shock that had caused inflation to surge initially was now partly unwinding. Questions were raised as to how strongly and quickly the new situation of energy prices would be reflected in underlying inflation. While it was welcomed that the projections incorporated some staggered effects in the pass-through of past increases in energy prices to core inflation, this begged the question of whether the pass-through would play out symmetrically with respect to the recent declines in energy prices. As evidence for an asymmetric pass-through, it was observed that PMI survey data pointed to a much slower decline in output prices than in input prices, which was in line with recent academic research.

It was remarked that the decomposition of HICP inflation excluding energy and food into energy-sensitive and wage-sensitive items suggested that, while the energy factor was becoming less important, wages were becoming more important. According to this decomposition, wage growth was becoming the main driver of underlying inflation and lately its contribution had been roughly twice as large as in 2019-20. The apparent stickiness of core inflation thus reflected a rotation of the main drivers.

It was also argued that the extent to which the adjustment of core inflation to energy price developments was symmetric over the disinflationary phase would depend on the behaviour of profit margins. It was recalled that profit margins had remained rather resilient and had even expanded during 2022, in the face of the large adverse energy and cost-push shocks. This behaviour might potentially differ when energy prices fell, but it remained to be seen if the widening of profit margins would reverse in 2023.

As regards wage and price-setting, members agreed that wage pressures had strengthened on the back of robust labour markets and employees aiming to recoup some of the purchasing power lost owing to high inflation. Moreover, many firms had been able to raise their profit margins in sectors faced with constrained supply and resurgent demand. Reference was made to the strong growth in compensation per employee and unit labour costs in the fourth quarter of 2022, which was well above levels considered consistent with the 2% inflation target in the medium term. Given the tight labour markets and the ongoing high inflationary pressures, in particular for everyday purchases such as food, wage growth was not expected to ease soon. It was observed that the average for wage agreements in the euro area concealed considerable variation across countries.

There were doubts about whether the projected lower wage growth towards the end of the horizon in the March projections was justified. At the same time, it was argued that it was consistent to revise down nominal wage growth if inflation decelerated at a faster pace than previously expected over the medium term. Nominal wage growth was a little lower because of the fall in the cost of living. In real terms, however, the projections implied an upward revision of wages, and it was noted that this now implied that the terms-of-trade shock would not result in any decline in real wages by the end of the projection horizon compared with early 2022.

Members widely reiterated that developments in profits and mark-ups warranted constant monitoring and further analysis on an equal footing with developments in wages. Frequent references to wages in public communication did not imply that there was no consideration of profit margin developments. It was stressed that the terms-of-trade shock had been operating like a tax and that its absorption in the domestic economy should proceed with some burden-sharing between labour and capital. From a monetary policy perspective, what mattered was that burden-sharing would contribute to preventing second-round effects and wage-price spirals. The question was also raised as to whether the strong profit margin developments implied that the sizeable cost pressures had not immediately affected the competitiveness of European exporters. It was observed that corporate balance sheets and profitability had been very strong, which suggested that pricing power had been significant until the economy had started to soften. In a period of increasing cost pressures, this pricing power and an increased frequency of price changes had kept upward pressure on underlying inflation. However, the point was also made that competitiveness concerns would ultimately kick in and help reduce inflation.

As regards longer-term inflation expectations, members took note that most measures currently stood at around 2%, although they warranted continued monitoring, especially in light of recent volatility in market-based inflation expectations. It was underlined that market-derived inflation expectations had increased substantially across maturities in the period between the Governing Council's last two monetary policy meetings, although they had eased again more recently. While these measures seemed to include significant inflation risk premia, a rise in these premia could be interpreted as reflecting market uncertainty about the ECB's ability to achieve its inflation target on a lasting basis. The fact that the five-year forward inflation-linked swap rate five years ahead had moved up to almost 2.6% was seen as an indication that a fast reduction in underlying inflation was unlikely. Furthermore, market-based inflation expectations had hardly moved down in response to the latest financial market tensions, suggesting that the events were not seen as having a large disinflationary impact.

However, it was also recalled that swap rates did not reflect genuine inflation expectations, as they included significant inflation risk premia. Reference was also made to the recent increase in option price-implied probabilities of longer-term inflation being above 3%. With respect to surveys, it was recalled that medium-term inflation expectations in the ECB's Consumer Expectations Survey had, reassuringly, been coming down.

Against this background, members assessed that there were both upside and downside risks to the inflation outlook and that, in view of the considerable uncertainty associated with the recent financial market tensions, there was no need for the Governing Council to express its own collective balance of risks to price stability from the range of risk factors. The upside risks to inflation included existing pipeline pressures that could still send retail prices even higher than expected in the near term. Domestic factors, such as inflation expectations persistently above target or higher than anticipated increases in wages and profit margins, could drive inflation higher, including over the medium term. Moreover, a stronger than expected economic rebound in China could give a fresh boost to commodity prices and foreign demand. The downside risks to inflation included persistently elevated financial market tensions that could accelerate disinflation. In addition, falling energy prices could translate into reduced pressure from underlying inflation and wages. A weakening of demand, including owing to a sharper deceleration of bank credit or a stronger than projected transmission of monetary policy, would also contribute to lower price pressures than currently anticipated, especially over the medium term. Listing these risk factors did not imply that the risks were balanced but instead highlighted the significant uncertainty that prevailed in the current environment, which called for a data-dependent approach to monetary policymaking.

In their discussion, members expressed a range of views on the risks with respect to the baseline of the staff inflation projections, with a number of members seeing risks as tilted to the upside over the entire horizon. Some members argued that there was only a small probability that inflation would fall back to low levels as quickly as suggested in the March ECB staff projections, which gave the impression of an "immaculate disinflation" (i.e. a return of inflation to target with very low cost in terms of lost output). It was also underlined that the baseline and the balance of risks were not independent of one another: if the downward revision to the baseline reflected greater optimism, this should lead to an upward tilting of the risk balance. It was remarked that such an interpretation appeared to be corroborated by the latest inflation data, which had been higher than expected and challenged the downward revision of the baseline. In addition, it was suggested that the latest strengthening of wage growth was consistent with second-round effects having already started. It was also suggested that the output gap was now narrower than before and that, in any case, it gave different indications compared with the unemployment gap, as had been discussed on previous occasions. The point was made that there was a potential for different risk factors to reinforce rather than neutralise each other, and this would then imply greater persistence, especially of core inflation, than was embedded in the projections. More expansionary fiscal policy was considered to be a further important upside risk factor, although it was surrounded by uncertainty, related not least to adherence to fiscal rules. At the same time, it was argued that the downward impacts incorporated in the baseline from monetary policy tightening and credit constraints were too small, which implied a downside risk.

Turning to the monetary and financial analysis, members widely concurred with the assessment provided by Mr Lane in his introduction. It was noted that bank credit to euro area firms had become more expensive, among other things because collateral values were declining. This was also contributing to a sharp contraction in demand for loans. At the same time, credit supply was also playing a role, with the recent tensions in financial markets likely to reinforce the tightening of credit conditions and banks becoming more sensitive to the risk of deposit outflows and therefore less willing to lend. However, against the background of an economy projected to pick up over the coming quarters and profitable lending opportunities for banks, the existence of credit supply restrictions was called into question. Moreover, the argument was made that credit developments, and specifically bank lending to firms, responded to monetary policy with a time lag. Hence the recent weakening in loan growth could reflect lower credit demand owing to the energy price shock and high investment uncertainty rather than quantitative restrictions on the supply of credit. Reference was also made to the downward trend in lending to non-financial corporations reversing some of the exceptionally strong loan growth seen during the pandemic period. It was cautioned, however, that such a benign assessment might have to be revised if risk premia increased and the tensions in financial markets proved to be longer-lasting.

It was noted that household borrowing had also become more expensive, owing to higher mortgage rates. These had resulted in a decline in loan demand and, along with tighter credit standards, had led to a further slowdown in the growth of loans to households. Concerns were voiced that the sharp slowdown in money growth, which was driven by its most liquid components, could foreshadow further risks to the economic outlook.

At the same time, members expressed confidence that the euro area banking sector was resilient, with strong capital and liquidity positions. The Governing Council's expression of confidence in the euro area banking sector, together with the measures that were being discussed at the international level to ease conditions for banks' foreign currency funding, were expected to alleviate the current market tensions. The view was held that, should it be faced with spillovers to euro area banks, the Governing Council was equipped with a policy toolkit that allowed it to provide sufficient liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy. With these instruments, the Governing Council was seen as being able to calm markets if and when necessary.

The point was made that, in the context of tighter monetary policy, pockets of financial vulnerability had to be expected. It was also to be expected that market participants would scrutinise the soundness of banks, so elevated market volatility was likely to persist. It was argued that, in assessing financial stability risks, it had to be considered that the transmission of monetary policy impulses was likely to be stronger at times of market stress than in calmer times.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members widely agreed that bank credit had become more expensive since the previous monetary policy meeting, reflecting an ongoing transmission of tighter monetary policy. However, bond markets and broader financial conditions had more recently been subject to significant volatility, with increasing risk premia but lower risk-free yields, as market participants had considerably lowered their expectations for the policy rate peak in the current hiking cycle. This was exerting countervailing effects and was likely to mean that more time was needed to fully assess the overall effect of the monetary policy stance on financial conditions.

Against this background, reference was made to the separation principle, which called for the monetary policy stance to be assessed independently of risks related to financial stability. It was recalled that the Governing Council had liquidity instruments at hand to address potential liquidity strains in the banking sector and spillovers from international developments, which allowed it to look through the recent volatility in financial market variables to set interest rates in accordance with its price stability objective. Further analysis on the strength of monetary policy transmission was seen as warranted, so as to better understand the effect of tighter financial conditions on the economic outlook and on trends in underlying inflation. On the one hand, the view was held that in the past the effect of monetary policy had been continually overestimated, which might happen again. On the other hand, it was pointed out that, because of long transmission lags, the effects of the interest rate increases since July 2022 had not yet fully materialised, leading to a risk that the impact of monetary policy tightening was being underestimated.

Turning to the policy proposal for the present meeting, members emphasised that inflation remained far too high and was projected to remain too high for too long. While inflation expectations appeared to remain broadly anchored, developments in market-based measures of inflation compensation had been moving in the wrong direction for much of the period since the February monetary policy meeting, and there was a risk that high inflation could become more persistent, with core inflation still increasing. In this context, monetary policy still had some way to go to bring inflation down, including in the case that the baseline of the March ECB staff projections materialised. The point was made that, in light of the risk of persistent inflation dynamics, the ECB's monetary policy had to be persistent as well.

At the same time, the ongoing exceptional financial market tensions were seen as a source of significant uncertainty for the economic and inflation outlook, as the magnitude, persistence and scope of the shock were not known. Sustained financial stress had the potential to move the economy from the baseline scenario to a different regime, with such a regime shift being difficult to ascertain in real time. All in all, it was felt that the two objectives of price stability and financial stability were complementary and there was no fundamental trade-off, as safeguarding financial stability supported an orderly transmission of monetary policy and the achievement of price stability over the medium term. Moreover, it was judged that, unless the situation deteriorated significantly, the financial market tensions were unlikely to fundamentally change the Governing Council's assessment of the inflation outlook.

Monetary policy decisions and communication

Against this background, a very large majority agreed with Mr Lane's proposal to raise the ECB's key interest rates by 50 basis points, in line with the intention the Governing Council had communicated at its last monetary policy meeting. It was acknowledged that in the current situation of heightened uncertainty a decision had to be taken with imperfect information. In this situation, risks were seen on both sides. However, following the announced intended interest rate path was seen as important to instil confidence and avoid creating further uncertainty in financial markets. In any case, it was highlighted that inflation was far above the Governing Council's target and inflation dynamics were still too strong, which justified a 50 basis point increase in the ECB's key interest rates. Overall, delivering a 50 basis point increase was considered to be proportionate, taking into account possible side effects.

Some members would have preferred not to increase the key rates until the financial market tensions had subsided and to conduct a comprehensive re-evaluation of the stance at the Governing Council's next monetary policy meeting, in May. It was stressed that markets were volatile and the positive opening of the financial markets on the second day of the current meeting could not be taken as evidence that financial stability risks had receded. Moreover, a risk-management approach was seen as calling for the interest rate hike to be put on hold, as the risks from not raising rates, if the tensions turned out to be short-lived, were assessed to be much less severe than the risks associated with raising rates into a persistent crisis. Moreover, a 50 basis point increase would exert a much stronger tightening effect if the economy was already suffering from the fallout of financial stress. Past episodes were recalled in which the Governing Council had increased interest rates and then had to reverse the hike shortly afterwards. It was felt that the Governing Council's data-dependent approach would in the current situation suggest postponing the interest rate hike and waiting until uncertainty had declined.

Looking ahead, members concurred with Mr Lane that the elevated level of uncertainty reinforced the importance of a data-dependent approach to the Governing Council's future policy rate decisions. It was argued that this approach would acknowledge the Governing Council's limited information as to how the ongoing market turbulence was likely to develop. At the same time, it was maintained that the Governing Council's communication would confirm its determination to deliver on its primary objective, underpinned with a sizeable interest rate increase at the present meeting.

Against this background, it was underlined that if the inflation outlook embedded in the March ECB staff projections were confirmed, the Governing Council would have further ground to cover in adjusting the monetary policy stance to ensure a timely return of inflation to target.

At the same time, it was also seen as important for the Governing Council to clarify its reaction function for future monetary policy decisions. In this context, spelling out the main "reaction variables" was critical. In particular, these comprised the implications of the incoming economic and financial data for the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission. By listing the main variables that would be given particular weight in upcoming policy decisions, the Governing Council would provide an anchor that the public could use to form expectations in conditions of heightened uncertainty. A clearer statement of the policy reaction function would allow the public to form their own assessment of the strength of monetary policy transmission, on the basis of newly available information such as from the bank lending survey. In any case, the Governing Council would have time in the period until its monetary policy meeting in May to reassess the effect of the tightening in financing conditions on inflation dynamics. At the same time, it would stand ready to provide liquidity support if needed to ensure a smooth monetary policy transmission.

With these considerations in mind, members generally agreed that the Governing Council should refrain from communicating unconditional expectations for the future interest rate path. However, the concern was voiced that the absence of any such guidance could be interpreted as indicating that the hiking cycle was coming to an end. For this reason, it was suggested to convey the message that, had the recent market turmoil not occurred, the Governing Council would have expressed the expectation that it would increase rates further, given the baseline scenario.

All in all, members widely concurred on the resilience of the euro area banking system and on the importance of reassuring market participants that banks' capital and liquidity positions were strong. The view was held that, while it should be indicated that the Governing Council would monitor financial stability risks, it had to be reiterated that price stability was the primary objective and that the Governing Council remained committed to bringing inflation back to its medium-term target in a timely manner.

Finally, it was seen as important to reiterate that the Governing Council stood ready to adjust all of its instruments within its mandate to ensure that inflation returned to its medium-term target and – in view of the elevated uncertainty – to also highlight the smooth functioning of the monetary policy transmission mechanism.

Members also agreed with the proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio. Maintaining the existing flexibility in PEPP reinvestments was considered an efficient, pre-emptive approach to responding to a potential re-emergence of risks to the 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 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 16 March 2023

Press release
Monetary policy decisions

Meeting of the ECB's Governing Council, 15-16 March 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 March 2023 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
- Ms Buch
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Koukoularides
- Mr Kuodis

- Mr Luikmel
- Mr Lünnemann
- Mr Madouros
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Sleijpen
- Mr Šošić
- Mr Tavlas
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 1 June 2023.