EUROPEAN CENTRAL BANK
EUROSYSTEM

11 July 2023

Meeting of 14-15 June 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, 14-15 June 2023

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

Financial market developments

Ms Schnabel noted that, since the Governing Council's previous monetary policy meeting on 3-4 May 2023, the narrative in financial markets had shifted from global tail risks – emanating from the banking sector tensions and the US debt ceiling debate – towards concerns about a deterioration in the euro area macroeconomic outlook and more persistent core inflation pressures globally.

Global market conditions had further normalised as tail risks to the economy had subsided. Volatility in financial markets had decreased notably across market segments and countries, suggesting that risks of systemic stress were currently contained. Stock market implied volatility in the United States, as measured by the VIX volatility index, had declined to its lowest level since the beginning of 2020.

Market conditions had also normalised across market segments in the euro area. Banks had restarted primary market issuance activity not only for covered bonds and senior bonds, but more recently also for subordinated bonds. Moreover, banks' asset swap spreads of subordinated and senior bonds had decreased substantially, but remained slightly above the levels seen before the collapse of Silicon Valley Bank (SVB). Spreads of non-financial corporate bonds had remained broadly stable and stood below the average levels recorded in 2022.

Developments in sovereign bond markets had been even more benign. Sovereign spreads relative to overnight index swap (OIS) rates had decreased during the market turmoil in March and had continued to narrow since then. Both the start of partial reinvestments and the expected end of reinvestments under the asset purchase programme (APP) had been absorbed smoothly by the market. Nevertheless, sovereign spreads had remained sensitive to fundamentals, as illustrated by the response to recent shifts in rating outlooks.

Negative macroeconomic data surprises had sparked investor concerns about a deterioration in the economic outlook. However, developments in equity markets argued against the hypothesis that markets were pricing in a severe economic downturn. Equity indices for euro area banks and non-financial corporations had seen only small changes. Moreover, defensive equity sectors, i.e. stocks which tend to be more stable during periods of expected economic weakness, had underperformed sectors more sensitive to the business cycle.

Developments in long-term risk-free bond yields had also provided little indication that negative data surprises had left a significant mark on the economic growth outlook. A decomposition of long-term yields into real rates and the inflation component in the euro area showed that real rates were slightly up since the Governing Council's previous monetary policy meeting on 3-4 May 2023, and only marginally down since the collapse of SVB.

In the United States, real interest rates had continued to recover strongly from the banking sector turmoil. Markets were no longer pricing in the banking sector stress driving a significant wedge between the growth outlook in the euro area and the United States. This was also evident in the gap between ten-year real rates, which had widened again and was now as large as in early March. The divergence in risk-free rates in the euro area vis-à-vis the United States had also been reflected in the EUR/USD exchange rate. The euro had depreciated by around 3% since the previous monetary policy meeting, closely tracking movements in interest rate differentials.

Regarding the evolution of interest rate expectations, the front end of the euro short-term rate (€STR) forward curve had remained broadly unchanged. The forward curve was pricing in two more 25 basis point rate hikes – one at the present meeting and another in July – and a 20% probability of an additional 25 basis point hike afterwards, implying a peak deposit facility rate slightly above the level that had been expected at the time of the previous monetary policy meeting. The inversion of the forward curve had moderated. By contrast, the US federal funds futures curve had shifted upwards markedly since the previous monetary policy meeting.

Uncertainty about the future path of monetary policy in the euro area had declined substantially since the collapse of SVB. Volatility in expected euro area short-term interest rates had reached its lowest level since May 2022, before the start of the ECB's rate hiking cycle, reflecting the increasing convergence of monetary policy expectations among market participants.

The reduction in uncertainty about the ECB's medium-term policy rate path seemed somewhat at odds with market participants' inflation expectations. Inflation-linked swap forward rates had continued to gradually increase from their mid-March lows. Remarkably, this repricing had come despite the weaker macroeconomic data as well as softer than expected inflation data releases and falling commodity prices. The increase in inflation-linked swap rates could partly be attributed to rising inflation risk premia, also reflecting the fact that many commodity prices appeared to be subject to pronounced

upside risks for which investors demanded compensation. Such risks also related to food prices, which were exposed to upside risks posed by Russia's war in Ukraine as well as to a rising probability of more frequent extreme weather events occurring this year as a result of El Niño. The second factor driving up inflation compensation was the increase in expected core inflation rates.

Market-based measures of longer-term inflation compensation in the euro area had trended upwards since the summer of 2022, amid some volatility. The persistent upward trend of these measures was unique among major currency areas. Option prices also pointed to rising upside risks to inflation. Such elevated and rising market-based inflation expectations over the medium and long run indicated that investors may have some doubts as to whether the currently priced-in ECB policy rate path was sufficient to rein in inflation in a timely manner. Real one-year OIS rates one year ahead were currently 45 basis points below their level before the SVB collapse and were expected to remain at around 0.25% or lower over the coming years.

Ms Schnabel then turned to the market impact of some of the ECB's recent policy decisions. As announced in February, the ceiling for the remuneration of government deposits held with the Eurosystem and for the rate on deposits of non-euro area residents held under the Eurosystem reserve management services framework had been set at a spread of 20 basis points below the euro short-term rate (€STR) from 1 May 2023. Overall, the new level of remuneration for these deposits had achieved the desired effects. Nevertheless, developments would be closely monitored to assess whether the pricing had been adequately calibrated.

Turning to the implications of the upcoming large repayments due under the targeted longer-term refinancing operation (TLTRO) in June, banks were expected to predominantly draw on their excess liquidity holdings as well as on market funding. Recourse to the ECB's regular refinancing operations – the main refinancing operations and three-month longer-term refinancing operations – would be a natural choice for banks that required other funding sources.

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

Starting with the outlook for the global economy, Mr Lane recalled that, after a rebound in the first quarter of the year, global economic growth had decelerated, especially in advanced economies, and was heavily skewed towards the services sector. The gap between the global output Purchasing Managers' Indices for the services and manufacturing sectors had reached a historical high. The euro had depreciated both against the US dollar and in effective terms since the last monetary policy meeting. Oil futures had remained broadly stable and natural gas futures prices were lower than at the time of the May Governing Council meeting. Non-energy commodity prices had declined, with both food and metal prices falling compared with the last meeting.

The euro area economy had stagnated in recent months: contracting public and private consumption and a negative contribution from inventories had only partly been offset by expanding net trade and investment. Business investment had held up in the first quarter of 2023, thanks to the easing of supply bottlenecks, as car production in particular had resumed. At the same time, survey data pointed to only a modest recovery in the second quarter of the year.

Developments had diverged sharply across sectors also in the euro area. Hard data and surveys indicated very weak activity in the manufacturing sector amid feeble demand and the running down of order backlogs. By contrast, the services sector remained resilient, still benefiting from the stimulus provided to contact-intensive services by the reopening of the economy. However, historical patterns suggested that the weakness in manufacturing could spill over to the services sector in the months ahead. One possible reason for expecting a lagged slowdown in services related to the fact that monetary policy had been shown to have a more powerful and faster effect on manufacturing than on services.

The contractionary impact of monetary policy was gradually reaching the components of aggregate demand that were typically more sensitive to interest rate changes, namely housing and business investment, as well as durable goods consumption. Expectations of higher mortgage rates weighed heavily on the perceived attractiveness of housing as an investment, while short-term indicators suggested a weakening in business investment owing to tighter financing conditions and falling orders. Consumers were also less inclined to purchase big-ticket items, and survey-based evidence suggested that a rising share of households with variable rate mortgages expected to have difficulties in making their mortgage payments on time. At the same time, private consumption was still expected to pick up, driven by remaining pent-up demand for contact-intensive services following the pandemic and by rising incomes as a result of nominal wage increases and rising employment. Looking ahead, a modest increase in exports was also expected.

The June Eurosystem staff macroeconomic projections for the euro area had revised the outlook for GDP growth downwards slightly for 2023 and 2024, while leaving it unchanged for 2025. Average annual real GDP growth was expected to slow to 0.9% in 2023 (from 3.5% in 2022), before rebounding to 1.5% in 2024 and 1.6% in 2025.

Output was expected to increase over the projection horizon. On the supply side, favourable developments included the ongoing expansion in productive capacity after the pandemic, the easing of supply bottlenecks and the expansion in labour supply (including through immigration). Demand was expected to increase owing to rising domestic incomes, underpinned by a robust labour market; the improvement in the terms of trade and the associated decline in uncertainty; and the recovery in foreign demand. At the same time, the scale of the recovery in demand would be constrained by the ECB's policy tightening. Together with a gradual withdrawal of fiscal support, tighter financing conditions would restrict economic activity in the medium term.

Downside risks to economic growth included Russia's war against Ukraine and an increase in broader geopolitical tensions, which could fragment global trade and thus weigh on the euro area economy. Growth could also be slower if the ECB's monetary policy was transmitted more forcefully than expected. Renewed financial market tensions could lead to even tighter financing conditions than anticipated and could weaken confidence. Moreover, weaker growth in the world economy could further dampen economic activity in the euro area. However, growth could be higher than expected if the strong labour market and receding uncertainty meant that people and businesses became more confident and spent more.

The labour market remained strong. The unemployment rate had stood at its historical low of 6.5% in April. Employment continued to benefit from a strong increase in the labour force, while demand for labour remained at high levels, including as a result of labour hoarding. At the same time, average hours worked per person employed was still somewhat below pre-pandemic levels. Wage pressures continued to strengthen, adding to underlying inflation pressures. Nevertheless, recent wage increases were broadly in line with the March staff projections and therefore had not led to a reassessment of the wage pressures for 2023 in the June projections. At the same time, in some sectors profit levels placed employers in a favourable position to absorb wage increases even as the scope for price increases declined.

There had been large increases in unit profits between the first quarter of 2022 and the fourth quarter of 2022 across all sectors, ranging from around 15% in contact-intensive services to around 23% in agriculture. In the first quarter of 2023, by contrast, some divergence had started to emerge across sectors. While the energy, utility and construction sectors had seen another strong increase in unit profits, the manufacturing sector and contact-intensive services sectors had seen declining unit profits. This implied that the sizeable wage increases had not been passed on to customers in the first quarter. This early evidence of lower unit profits in both manufacturing and contact-intensive services was consistent with the baseline assumption of declining unit profits in the June projections.

Headline inflation as measured by the Harmonised Index of Consumer Prices (HICP) had declined to 6.1% in May, from 7.0% in April. Following an uptick in April, energy inflation had resumed the downward trend seen since last autumn. Food inflation was likely to have peaked in March and stood at 12.5% in May. HICP inflation excluding energy and food (HICPX, or core inflation) had also declined for a second consecutive month, reaching 5.3% in May. In terms of pipeline pressures for food and goods inflation, there was an ongoing improvement at earlier stages of the production process. This improvement was expected to translate into a reduction in pressures from input costs over the rest of the year.

A number of indicators of underlying inflation – notably trimmed measures, exclusion-based measures and model-based indicators, such as the Persistent and Common Component of Inflation (PCCI) – showed signs of softening. The "Supercore" indicator and wage-sensitive components of the HICPX

were levelling off, while domestic inflation was still continuing to increase, reflecting continued strong wage growth and demand for contact-intensive services. This configuration suggested that the external drivers of underlying inflation (rising energy costs and supply bottlenecks) were easing, but rising wages and ongoing effects from the reopening of the economy were still putting upward pressure on the domestic component of underlying inflation.

The different dynamics of goods inflation compared with services inflation, which were related to differences in the tradability and labour content of the different inflation components, implied that it was important to look separately at underlying measures of these two components of the HICP. For goods inflation, the Supercore and PCCI measures had both been declining, with the PCCI having been on a downward path since the end of 2022. The significant downward adjustment of the PCCI indicator largely reflected the decline in energy prices, since a large share of goods production was energy-intensive. Momentum in goods inflation was also on a downward path. By contrast, for services inflation the underlying measures and the momentum did not yet point to any visible decline. While the PCCI indicator for services had stabilised, the Supercore measure was still on an upward trend. Services inflation had declined marginally in May; however, these data were in part affected by a new, cheaper monthly ticket for public transport in Germany.

Turning to inflation expectations, respondents in the Survey of Monetary Analysts had kept their expectations for 2025 and 2026 unchanged. The Consumer Expectations Survey showed that consumer inflation perceptions and expectations had both decreased significantly in April and May after the temporary increase in March.

The June staff projections saw headline HICP inflation slightly above the path envisaged in previous exercises. Headline inflation was expected to decrease from 8.4% in 2022 to an average of 5.4% in 2023, 3.0% in 2024 and 2.2% in 2025. The downward impact from lower energy price assumptions was more than offset by upward revisions in food inflation and core inflation. Underlying price pressures remained strong. Staff had revised up their projections for core inflation, especially for this year and next year, owing to past upward surprises and the implications of the robust labour market for the speed of disinflation. The staff projections now saw core inflation averaging 5.1% in 2023, before declining to averages of 3.0% in 2024 and 2.3% in 2025.

Russia's war against Ukraine remained a significant upside risk to the inflation outlook, as it could push energy and food costs up again. A lasting rise in inflation expectations above the ECB's inflation target of 2%, or higher than anticipated increases in wages or profit margins, could also drive inflation higher, including over the medium term. Recent wage agreements in a number of countries had added to the upside risks to inflation. By contrast, renewed financial market tensions could bring inflation down faster than projected. Weaker demand, for example owing to a stronger transmission of monetary policy, would also lead to lower price pressures, especially over the medium term. Moreover,

inflation would come down faster if declining energy prices and lower food price increases were to pass through to the prices of other goods and services more quickly than was currently anticipated.

Tighter monetary policy continued to be transmitted to bank funding costs. Together with increases in spreads on subordinated bank bonds and on hybrid instruments, and the increased cost of equity for banks, the impact of monetary policy tightening on the risk-free yield curve continued to drive up lending rates for firms and households. The cost of borrowing for firms had increased to 4.4% in April and mortgage rates had risen to 3.4%. Average monthly flows of lending to firms had been negative since November last year, and lending had also contracted slightly in April. Small and newer firms, which tended to be more dependent on bank credit, faced particularly steep increases in their borrowing rates and weak loan flows. Overall, the recent contraction in credit had exceeded the scale indicated by historical patterns.

The short-term dynamics of monetary aggregates had weakened further since the start of the year. The three-month annualised growth rate of M3 had been negative since the start of the year, despite the cushioning effect generated by the shift from overnight to term deposits. This development was connected with the monetary policy tightening in several ways: amid weak lending, loan flows were not supporting money growth; reducing the size of the Eurosystem balance sheet mechanically drained money from the system; banks had increased their long-term funding, mainly via bond issuance, to replace maturing TLTRO funds; and, finally, the additional issuance of government bonds was not being fully absorbed by banks, with some being absorbed by other sectors, in particular households, which had further reduced M3.

Monetary policy considerations and policy options

On the basis of an assessment of the three elements of the ECB's reaction function – the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission – Mr Lane proposed raising the three key ECB interest rates by 25 basis points at the present meeting. The profiles of headline inflation and core inflation had shifted upward in the June staff projections compared with the previous exercise, albeit only slightly for 2025. Indicators of underlying price pressures remained strong, although some showed tentative signs of softening. At the same time, the accumulated policy tightening was increasingly taking hold in the economy, as the tighter monetary policy stance seemed to be gradually felt in real activity.

Mr Lane also proposed confirming the end of reinvestments under the APP as of July. In view of the benign developments in euro area bond markets, market participants expected that reinvestments would stop. Moreover, private investors had been able to smoothly absorb the large-scale public sector issuance since the beginning of the partial APP run-off. At the same time, preserving the option to apply flexibility to reinvestments under the pandemic emergency purchase programme as a first line

of defence against fragmentation risks continued to be warranted, also in view of the proposed end of APP reinvestments in July.

The current constellation of data and projections argued for continuity in communicating the Governing Council’s orientation for its next monetary policy meetings. As in May, the Governing Council needed to convey the message that future decisions would ensure that policy rates would be brought to levels sufficiently restrictive to achieve a timely return of inflation to the target and would be kept at those levels for as long as necessary. Emphasis on data-dependence would allow the Governing Council to adjust the course, as appropriate, in what was still a highly uncertain environment. By the July meeting, in addition to another monthly inflation data release, the Governing Council would also be able to observe the impact of the repayment of the large TLTRO III operation coming due later in June and any market effects of the end of APP reinvestments in July. In addition, there would be other evidence on the impact of the Governing Council’s measures, including new vintages of the ECB euro area bank lending survey and the Corporate Telephone Survey. The emphasis on data-dependence and a clear reaction function provided a suitable framework for reflecting this information in future policy rate decisions.

In line with its monetary policy strategy, the Governing Council needed to assess, in depth, the interrelation between monetary policy and financial stability at the present meeting. The financial stability outlook had remained challenging since the Governing Council’s last review in December 2022. Tighter financing conditions had raised the funding costs of banks and the credit risk of outstanding loans. Together with the recent tensions in the US banking system, these factors could give rise to systemic stress and depress economic growth in the short term. Another factor that weighed on the resilience of the financial sector was a downturn in the real estate markets, which could be amplified by higher borrowing costs and a rise in unemployment. At the same time, euro area banks had strong capital and liquidity positions, which mitigated these financial stability risks. Macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities.

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 the downward revision of expectations for foreign demand – despite the reopening of China – and for the dynamics of competitors’ import prices were two important elements in the Eurosystem staff

projections. Slower increases in prices in the rest of the world would help contain pricing power and eventually dampen core inflation in the euro area. The question was raised as to whether the possible effects of the weakness of the Chinese economy had been fully taken into account in the staff projections’ outlook for euro area foreign demand and whether China might become a source of global disinflation. At the same time, it was argued that economic surprise indices for both China and the United States had been on the upside, which cautioned against assuming that world growth was set to slow. In this context, it was recalled that the growth performance of the Chinese economy would likely have repercussions for global commodity prices and thus was a key risk factor for the euro area inflation outlook. Attention was also drawn to continued high geopolitical risks, which injected uncertainty and volatility into the outlook for global activity and inflation, notably with respect to energy and food. Reference was made in this context to the recent sizeable rebound in gas prices from earlier declines.

With regard to economic activity in the euro area, members concurred with Mr Lane that the economy had stagnated in recent months. As in the fourth quarter of 2022, real GDP had shrunk by 0.1% in the first quarter of 2023, on the back of a drop in private and public consumption. Economic growth was likely to remain weak in the short run but to strengthen in the course of the year as inflation came down and supply disruptions continued to ease. Conditions in different sectors of the economy were uneven: manufacturing continued to weaken, partly owing to lower global demand and tighter euro area financing conditions, while services remained resilient.

It was noted that the outcome for real GDP in the first quarter of 2023 implied a technical recession and was weaker than the figure embedded in the June staff projections, while not implying that the economy was facing a material contraction. In addition, the mechanical estimates presented by Mr Lane pointed to weaker than expected growth also in the current and subsequent quarters. From that perspective, the staff projections for real GDP growth of around 1% this year and 1½% in subsequent years could be on the optimistic side. The question was raised as to whether the current divergence between manufacturing and services was atypically strong, given that the performance of the services sector was still driven by a post-pandemic rebalancing of the economy.

Attention was drawn to the decline in domestic demand in the first quarter of the year, which could be seen as a sign that the tightening of monetary policy was reaching the real economy. It was suggested that transmission had been working as expected but had thus far been concealed by tailwinds for growth, owing to the financial buffers and accumulated savings available to firms and consumers, as well as to the staggered recovery from supply bottlenecks. Although still present, the support from some of these tailwinds was now fading. Looking ahead, it was argued that the baseline growth scenario in the staff projections entailed a possibly too modest, “conservative” impact from monetary policy tightening. This was because the effects of credit supply constraints and the role of quantity and non-price effects in the credit channel of transmission more broadly were typically not explicitly

reflected in traditional macro models. However, it was also noted that there was little evidence of quantity restrictions in credit provision as banks were well-capitalised and profitable.

Members discussed different elements in the growth outlook and the staff projections. Supply-side bottlenecks were seen to have eased as expected, and it was noted that capacity utilisation in manufacturing was close to historical highs. This might indicate a need for additional investment over the projection horizon. In this context, reference was also made to the extra investment required to meet the EU's 2030 climate objectives, especially in the household sector, which was estimated to amount to 2% of GDP annually in net terms. While it was possible that there would be a crowding out of investment owing to higher interest rates, it was more likely that climate-related investment was being driven by subsidies and hence would be relatively resilient to the interest rate cycle. This suggested upside risks to investment. An upside risk was also seen with regard to consumption, given the substantial accumulated savings that remained in place and the higher extra savings associated with the household saving ratio embedded in the June projections.

Members widely agreed that the labour market remained a source of strength. Almost a million new jobs had been added in the first quarter of 2023 and the unemployment rate had stood at its historical low of 6.5% in April. The average number of hours worked had also increased, although it was still somewhat below its pre-pandemic level. In this context, it was emphasised that the labour market expansion was sustained through the extensive margin, i.e. by people joining the labour force, and argued that this implied a better adjustment process than was usually the case in Europe. "Marginally attached" workers were seeking work and there was a significant reduction in the number of underemployed people. However, it was warned that strong inflows into the labour market implied some fragility, as entrants needed time to learn new jobs and therefore obtain some employment stability, which could only be ensured if the economy was not stalled by excessive tightening. The point was made that, while demographic trends were typically slow-moving, in the current post-pandemic environment of labour scarcity and rapid structural changes, the impacts of such trends on labour market developments and on wages could become visible even within a conventional projection horizon.

The role of a high level of employment in supporting aggregate demand and stronger wage pressures due to an increase in the bargaining power of workers was emphasised. As high employment was currently a manifestation of improvements on the supply side, this was consistent with expectations that there would be no material recession and that price pressures would fall over time. However, it was argued that a situation combining full employment with economic stagnation was difficult to rationalise in standard models. Accordingly, the question was raised as to whether one should not expect Okun's law to eventually enforce some consistency between the labour market and economic activity. The same relationship could also be at work in bringing the unemployment gap into better alignment with the output gap – two measures of slack that had been misaligned in more recent times.

It was argued that the potentially persistent rise in sick leave, fall in productivity and decline in average hours worked may negatively affect potential output. In this context, it was emphasised that there was a need for supply-side reforms and improvements, so that the strong labour market would be accompanied by higher productivity growth.

Members concurred that, as the energy crisis receded, governments should roll back the related support measures promptly and in a concerted manner. In doing so, they would avoid driving up medium-term inflationary pressures, which would otherwise call for a stronger monetary policy response. Fiscal policies should be designed to make the euro area economy more productive and gradually bring down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, could also help reduce price pressures in the medium term. The reform of the EU's economic governance framework should be concluded soon. It was felt that risks in the fiscal domain were skewed towards a later and insufficient withdrawal of stimulus in a number of jurisdictions and for the euro area as a whole.

Against this background, members concurred that the economic outlook remained highly uncertain. It was recalled that the latest GDP numbers and results from "nowcasting" models used to estimate very recent or current figures already implied a downside risk to growth relative to the June staff projections. Beyond that, downside risks to growth included Russia's unjustified war against Ukraine and an increase in broader geopolitical tensions, which could fragment global trade and thus weigh on the euro area economy. Growth could also be slower if the effects of monetary policy were more forceful than projected. Renewed financial market tensions could lead to even tighter financing conditions than anticipated and weaken confidence. Additionally, weaker growth in the world economy could further dampen economic activity in the euro area. However, growth could be higher than projected if the strong labour market and receding uncertainty meant people and businesses became more confident and spent more. At the same time, it was argued that some of the risk factors mentioned could also go in the opposite direction. Monetary policy could be transmitted less strongly than projected, and the world economy could grow faster than anticipated.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. While members considered that the second consecutive decline in core inflation was a positive signal, it was widely felt that there was as yet no sufficient or convincing evidence to confirm a turning point. It was emphasised that the momentum in price dynamics had remained strong for all components of inflation, with the exception of energy. Moreover, the outcomes for core inflation had proved stubborn and continued to be higher than projected, thus pointing to greater persistence. However, looking ahead, the degree of persistence was likely to differ across sectors – it was lower in non-energy industrial goods inflation and higher in services inflation. Clearly, the role of external shocks had already diminished and the main drivers of inflation were domestic, including a strong contribution from wages and profits. In particular, strong growth in hospitality

services prices could be expected during the summer and the impact of labour costs was increasing. It was observed that, while food inflation had started to come down somewhat, it remained elevated overall, and geopolitical risks and weather and climate-related factors, including El Niño, pointed to upside risks.

However, doubts were expressed about whether a particular emphasis on core inflation was justified, as it was not seen to be a leading indicator of future headline inflation. In fact, at the current juncture, the role of unwinding energy and food inflation implied that core inflation was lagging behind headline inflation. In this context, it was recalled that, beyond core inflation, all components of headline inflation needed to be analysed and the ECB monitored a wide range of measures of underlying inflation. Moreover, it was recalled that, while some measures of underlying inflation had started to decline, others had continued to grow strongly, and that a decline in underlying inflation would not be sufficient to ensure that inflation returned to the 2% target. With respect to the June staff projections, there was broad agreement that the stubbornness of inflation and higher unit labour costs were key factors in the upward revision of core inflation, especially for 2023 and 2024. At the same time, the extent of the upward revisions to inflation was also questioned, in the light of the latest, more encouraging data and with respect to changes in the assumptions underpinning the June projections compared with the March projections, in particular the assumptions of higher interest rates, lower energy prices and an appreciation of the euro.

Regarding the projected speed of the decline in inflation, it was argued that there were clear disinflationary factors operating in the early stages of the disinflationary process. However, it was important to ask which factors would be operating towards the end of the projection horizon, and whether further disinflation would be harder to achieve the closer inflation came to 2%, since higher wage or inflation expectations could have become entrenched by then. On this point, it was recalled that the expected decline in inflation towards 2% was predicated on wage pressures abating; that, by 2025, real wages would have only barely made up their losses since 2019; and that profit margin and unit profit dynamics would reverse and act as a buffer against higher unit labour costs. This was seen as pointing to a very “narrow path” for getting close to the ECB’s target in 2025. It was mentioned that, in the United States, core Personal Consumption Expenditures inflation, despite reaching a turning point much earlier, was also proving to be more persistent and had repeatedly failed to come down in line with earlier Federal Open Market Committee projections.

Members widely agreed with the assessment of Mr Lane in his introduction that wage pressures, while partly reflecting one-off payments, were becoming an increasingly important source of inflation. Compensation per employee had risen by 5.2% in the first quarter of 2023 and negotiated wages had risen by 4.3%. Moreover, firms in some sectors had been able to keep profits relatively high, especially where demand had outstripped supply.

It was noted that the main problem companies were facing continued to be their capacity to hire skilled labour. As long as this remained the case, employment creation would come with wage pressures. Moreover, the wage drift between actual and negotiated wages was high, which was a reflection of the tight labour markets. Concern was expressed that protracted wage pressures would, in turn, contribute to greater persistence in domestic price pressures, notably as unit labour costs were increasing amid subdued growth in productivity and the continued pricing power of firms.

However, it was pointed out that tightness in the labour market had emerged against the backdrop of an increasing labour force, the fast creation of short-term contracts and migration, all of which were factors that tended to reduce wage pressures. New entrants tended to take jobs paying lower wages, while job movers typically took higher-quality jobs with significant wage increases. Members assessed the outlook for wages from different angles. It was acknowledged that the baseline in the June staff projections contained substantial nominal wage growth. Recent information had pointed to strong wage growth in several countries, but it was argued that outcomes were in line with the baseline projections and did not imply an upside risk. However, it was also recalled that the projections were predicated on the assumption that pressures from wage negotiations would gradually abate. Therefore, as long as this assumption was not visible in the actual data and until there was confirmation that wage pressures had run their full course, an upside risk to wage growth remained. Moreover, given staggered wage-setting and long-term contracts in Europe, the impact of higher wages would be spread over many years to come. Likewise, there was a risk that, in some countries and sectors, union bargaining might go beyond a one-off "catch-up" of real wages with respect to pre-pandemic levels and try to make up for the trend decline in the wage share incurred during past decades.

Nominal wage growth was expected to remain well above its historical average according to the June staff projections. However, it was suggested that, for the time being, this growth could still be considered moderate when viewed against the expectation that real wages would only make up their losses and return to pre-pandemic levels by 2025. While there was currently no evidence of significant second-round effects or a wage-price spiral, a note of warning was given not to underestimate the risk. After all, price levels would remain high even as inflation came down. Whether a wage-price spiral were to unfold would ultimately depend on the ability and willingness of firms to absorb higher unit labour costs in their profit margins. This, in turn, would depend on the economic environment in which firms operated, and hence on monetary policy. In this context, it was reiterated that the high levels of inflation should not lead to tit-for-tat strategies where workers and businesses sought full compensation for price and cost increases respectively. It was recalled that the euro area had been hit by a terms-of-trade shock and policymakers should communicate that, under such conditions, it would be self-defeating for social partners to aim for full compensation. In a number of smaller countries, high wage growth and high inflation had started raising concerns about a revaluation of the real

exchange rate and a loss of competitiveness relative to peers. It was suspected that, in the future, this could also become an issue at the euro area level.

Profits had played an important role in recent developments in output prices, and it was noted that, in the staff projections, the decline in inflation rested on the assumption that margins would shrink. This assumption was considered to be in line with past cyclical behaviour of margins in relation to labour cost developments. However, there was no evidence yet to provide reassurance that profits would revert to earlier patterns in the post-pandemic environment, and profit dynamics had already been strong for some time, notwithstanding variations in activity. It was argued that, ultimately, the behaviour of margins depended on the evolution of pricing power. The more resilient the economy remained, the bigger the risk that firms would pass the higher unit labour costs on in their prices rather than absorb them through lower profit margins.

As regards 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 survey-based indicators. Although most measures currently stood at around 2%, some indicators remained elevated and needed to be monitored closely. It was pointed out that market-based measures stood clearly above 2%, but were close to 2% when corrected for risk premia. However, the argument was made that the measures, while likely still broadly anchored, were standing at levels that would previously have been considered worrying and that the trend was pointing upwards.

Comfort was drawn from the better news coming from the declining medium-term inflation expectations in the ECB’s Consumer Expectations Survey. At the same time, reference was made to the qualitative data in the European Commission’s consumer survey, which showed an unusual gap between inflation perceptions and actual inflation. This suggested that there continued to be a risk of an upward shift in inflation expectations, also in view of the long period of above-target inflation, despite the recent sharp decline in inflation. It was argued in this respect that, ultimately, inflation expectations mattered to the extent that they changed actual behaviour and then showed up in wage or price-setting in the real economy.

Against this background, members considered that there were both upside and downside risks to the inflation outlook. Upside risks to inflation included potential renewed upward pressures on the costs of energy and food, also related to Russia’s war against Ukraine. A lasting rise in inflation expectations above the ECB’s target, or higher than anticipated increases in wages or profit margins, could also drive inflation higher, including over the medium term. Recent wage agreements in a number of countries had added to the upside risks to inflation. By contrast, renewed financial market tensions could bring inflation down faster than projected. Weaker demand, for example due to a stronger transmission of monetary policy, would also lead to lower price pressures, especially over the medium term. Moreover, inflation would come down faster if declining energy prices and lower food price increases were to pass through to other goods and services more quickly than currently anticipated.

A range of views were expressed on the risk assessment with respect to the path for inflation. Significant upside risks to headline and core inflation were seen as stemming from greater persistence and strong wage dynamics over the entire projection horizon. Specific upside risks were associated with food commodity price assumptions, possibly lasting damage to supply capacity from hysteresis effects, not sufficiently restrictive fiscal policy and weaker than projected monetary policy transmission. It was acknowledged that past forecast errors and their implications for increased inflation persistence had partly been incorporated into the baseline, but it was considered that the typical correlation of forecast errors over time still implied an upward risk in the period ahead. At the same time, it was argued that the latest evidence on strong wages and high labour costs had already been largely incorporated into the baseline projections and could therefore no longer be considered an upside risk.

Turning to the monetary and financial analysis, members generally concurred with the assessment provided by Mr Lane in his introduction. The impact of monetary policy tightening on credit and monetary dynamics was judged to be sizeable. Weak bank lending and the reduction in the Eurosystem balance sheet had led to a continued decline in annual broad money growth. Credit dynamics had weakened further, owing to higher borrowing rates, tighter credit supply conditions and lower loan demand. It was maintained that the speed and extent of the contraction in lending could not be fully explained by the increase in policy rates alone or by fundamentals such as economic activity. A view was expressed that credit weakness pointed to increasing risks of an unwarranted intensification of the transmission of the monetary policy stance through the banking sector.

The view was, however, also expressed that credit had remained relatively resilient in the face of sharp rate increases, and the contraction could be explained largely by weaker loan demand rather than by credit supply constraints. It was maintained, moreover, that the credit weakness had been driven mostly by a decrease in short-term loans that firms had used to finance increased working capital needs related to the earlier energy price shock. Doubts were expressed as to whether the weakness in credit exceeded the scale indicated by historical patterns, as such a comparison depended on the period considered as well as on other parameters included in the analysis. Due account needed to be taken of stocks and flows in credit, as well as the associated accumulated liquidity. The view was held that, in response to high inflation, the loan gap, i.e. the deviation of bank credit from a path that would be consistent with past cyclical patterns, tended to first decrease and only later to increase; therefore, it did not provide a reliable measure of credit supply restrictions in an inflationary environment.

Furthermore, it was underlined that the euro area banking sector had weathered the turmoil in March relatively well and was profitable. It was noted that, according to ECB Banking Supervision, bank profitability had developed in a benign way since monetary policy tightening had started, which should support bank lending capacity. Moreover, according to the survey on the access to finance of enterprises, firms still had ample cash owing to the pandemic support measures, which should

attenuate concerns that credit demand was not being met. Attention was drawn to the forthcoming releases of the bank lending survey and the Corporate Telephone Survey, which would shed light on these developments.

At the same time, it was widely acknowledged that funding conditions had tightened for banks and credit was becoming more expensive for firms and households. Borrowing costs and non-price conditions for firms appeared to have adjusted faster than in previous tightening episodes. Regarding bank lending rates, the concern was expressed that possible bank funding tensions and increasing credit risk perceptions might translate into tighter financing conditions than those reflected in the staff macroeconomic projections. In this context it was underlined that credit conditions had been affected not only by the increase in the ECB's policy rates, but also by the reduction in the Eurosystem balance sheet, particularly against the backdrop of the coming TLTRO III repayments in June.

It was noted that the rapid pace of policy rate hikes was reducing borrower creditworthiness and increasing banks' risk perceptions, as signalled in the bank lending survey, which could be expected to dampen lending significantly. The concern was voiced that the credit tightening – in particular the consequences of the reduction in households' net disposable income caused by higher debt servicing costs for variable rate mortgage loans – had not yet fully filtered through to the real economy. In jurisdictions with a prevalence of fixed rate mortgages, the impact of higher rates was more muted and was materialising mainly via the flow of new lending, rather than the stock of outstanding mortgages. It was argued that long rate fixation periods for mortgage debt, the slow rise in deposit rates and still high levels of excess savings were mitigating or slowing the transmission of tighter lending conditions to households. It was recalled that the share of fixed rate mortgages had increased across a number of jurisdictions during the period of low interest rates, likely dampening monetary policy transmission compared with historical precedents.

The Governing Council held its biannual structured exchange on the interrelation between monetary policy and financial stability. Members concurred that the financial stability outlook had remained challenging since the last review in December 2022, as tighter financing conditions were raising the funding costs of banks and the credit risk of outstanding loans. In this context, there was seen to be a risk that excessive monetary policy tightening could hamper the smooth transmission of monetary policy and increase fragmentation risks. Another factor weighing on the resilience of the financial sector was a downturn in the real estate markets, which could be amplified by higher borrowing costs and a rise in unemployment. At the same time, confidence was expressed that euro area banks had strong capital and liquidity positions, and that macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members overall assessed financing conditions to have tightened since the May monetary policy meeting, with past policy rate increases being transmitted forcefully to financial and financing conditions. It was noted, however, that long-term real bond yields were back to the levels that had prevailed at the beginning of the year. Market expectations regarding the policy rate path, as embedded in forward curves and revealed in surveys, had also remained relatively stable since the previous meeting, broadly pricing in two rate increases of 25 basis points for the Governing Council's June and July meetings.

Against this background, it was argued that market participants would be surprised by the upward revision of inflation, and particularly core inflation, in the June staff projections. This could trigger a repricing of the forward curve. The view was held that the level of the peak deposit facility interest rate, as well as its duration, as embodied in the forward curve and reflected in the staff projections, could be judged as insufficient to bring inflation back to the 2% medium-term target, as the projections showed inflation still lying above 2% in 2025. However, it was also underlined that the forward curve embedded in the staff projections foresaw interest rate cuts by the ECB in the first half of 2024, in line with the Survey of Monetary Analysts. As policy rates were approaching the peak of the interest rate cycle, the trade-off perceived by market participants between the level of the peak rate and its duration was seen as becoming more important. However, it was also argued that as long as the prospects for higher and more persistent policy rates were not priced into the term structure of market interest rates, that policy path would not be reflected in financing conditions.

In accordance with the three main elements of its reaction function that the Governing Council had communicated earlier in the year, members evaluated developments since the previous monetary policy meeting related to the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

Starting with the inflation outlook, members broadly concurred with the assessment that, with the upward revision of the inflation path in the June staff projections, inflation was still projected to remain too high for too long, calling into question whether it was returning to target in a timely manner. With upside revisions to both headline and core inflation, the return to target had again been pushed out further into the future. Moreover, upside risks to the inflation outlook were judged to still prevail, mainly owing to more persistent wage-price dynamics than those incorporated into the projections. In addition, it was recalled that, for the inflation projections to materialise, the Governing Council had still, as a minimum, to deliver two successive interest rate increases in June and July, which were embodied in the assumptions on which the projections were based.

It was also argued that bringing inflation down from very high numbers to more moderate levels was easier than achieving a full return to the 2% medium-term target. In this context, it was remarked that

an envisaged return of inflation to 2% towards the end of 2025 could be considered too late, because risks could materialise in the meantime that might keep inflation above the 2% target. It was seen as important for the Governing Council to stress the symmetry of its inflation objective, i.e. that upward and downward deviations from 2% were regarded as equally undesirable. Moreover, a scenario with high inflation and high interest rates was seen as possible if interest rates did not become and stay sufficiently restrictive.

In contrast, it was also maintained that the staff projections, as well as the latest inflation data, showed that the initial supply-side drivers of inflation were gradually waning, although demand-side factors were gaining importance. Headline inflation had been on a declining path since October 2022 and was projected to fall further throughout the projection horizon. Moreover, the most recent incoming data had been in line with the Governing Council's expectations, strengthening confidence that monetary policy was on the right track. At the same time, the prevailing high level of uncertainty was underlined.

It was seen as important that the Governing Council's response to the upward revision of the inflation outlook should not be perceived as a change in its reaction function, but rather as an appropriate response within the parameters of the reaction function. Emphasis was placed on the evidence that market-based measures of inflation compensation had edged up to above 2% and required close monitoring. In particular, longer-term market-based measures remained stubbornly high, which could partly be attributed to risk premia, suggesting that investors saw upside risks to the longer-term inflation outlook prevailing over downside risks. By contrast, several survey-based indicators of inflation expectations had stabilised or even decreased. Weighing up the different elements, inflation expectations were assessed to be still broadly anchored, as evidence was emerging that wage and price-setting behaviour in several euro area countries had started to moderate.

In this context, the weight that was attached to the staff macroeconomic projections, as opposed to actual data, when assessing the monetary policy stance was discussed. On the one hand, it was argued that the Governing Council should focus more on data than on the projections when assessing the inflation outlook. It was argued that attaching more weight to observable data would improve policy decisions, in particular when uncertainty was high. On the other hand, it was maintained that the projections were an important and useful input into the Governing Council's decision-making. They provided discipline and a crucial benchmark for the deliberations and could be scrutinised but should not be disregarded.

Members also assessed the level and persistence of underlying inflation as being a source of concern. Core inflation had again been revised up significantly in the June staff projections. It was cautioned that strong wage growth was becoming a key driver of inflation, and convincing evidence that underlying inflation had peaked was still lacking, as had been underlined by the President during her recent appearance at the European Parliament. It was highlighted, however, that according to recent

data releases core inflation had stabilised and might have reached a turning point, although it was likely to be some time before underlying inflation measures embarked on a steady path of decline.

In this context, it was argued that the Governing Council should not put too much emphasis on the behaviour of core inflation, as its mandate related to headline inflation. Moreover, core inflation did not represent the household consumption basket and had historically not been a good leading indicator of future headline inflation in the euro area.

Finally, turning to the assessment of monetary policy transmission, members generally concurred that interest rates had reached restrictive territory, while it remained unclear at what point the stance would become sufficiently restrictive. There was evidence that the tighter policy stance was being transmitted to financing conditions, credit volumes and the real economy, while the strength of transmission and the ultimate lags in transmission to inflation remained variable and uncertain. Higher borrowing rates were seen to be contributing to a softening in demand, which was required to dampen the underlying inflation dynamics. Moreover, the point was made that the tightening impact of interest rate increases was subject to uncertainty regarding the "neutral rate", which might be pushed up by structural changes in the labour markets and could itself be affected by monetary policy. In this context it was argued that adjustments towards a better functioning labour market needed time to unfold and would benefit from a gradual and cautious conduct of monetary policy.

The transmission of monetary policy was observed to vary across euro area countries, as institutional arrangements as well as fiscal and other national policies differed. Hence, inflation was reacting to the tightening of the monetary policy stance with different lags across countries. It was also cautioned that, as the increase in policy rates had been unprecedentedly fast, the effects of past rate hikes could still be expected to materialise and exert a downward impact on growth and inflation. The argument was made, however, that if inflation expectations started to shift upwards in response to the prolonged period of high inflation, monetary policy would be transmitted less forcefully. Moreover, a higher share of services in HICP implied that changes in interest rates were slower to affect aggregate inflation. All in all, the uncertainty about the transmission of monetary policy was very high, as shown by the substantial differences in estimated effects across models.

Monetary policy decisions and communication

Against the background of these considerations around the Governing Council's reaction function, members agreed that tightening the monetary policy stance by increasing interest rates further was warranted. While past rate increases were being transmitted forcefully to financing conditions and were gradually having an impact across the economy – tighter financing conditions being a key reason why inflation was projected to decline further towards the 2% medium-term target – inflation was still projected to remain too high for too long.

The argument was made that in view of the worsened inflation outlook a strong signal was needed, also considering that past decisions had not been decisive enough to bring inflation back to the 2% target more quickly. Looking ahead, however, it was also maintained that continuing on a gradual tightening path would allow the Governing Council to monitor and assess the impact of past monetary policy decisions and ensure that financial conditions were adjusting in a way that was consistent with inflation moving back to the 2% medium-term target. Emphasis was put on the need to be sufficiently restrictive and persistent in the monetary policy tightening. It was seen as essential to communicate that monetary policy had still more ground to cover to bring inflation back to target in a timely manner. The view was held that the Governing Council could consider increasing interest rates beyond July, if necessary.

A very broad consensus supported the 25 basis point rate increase proposed by Mr Lane, while a preference was also initially expressed for raising the key ECB interest rates by 50 basis points in view of the risk of high inflation becoming more persistent. Emphasis was put on the merit of sticking to a data-dependent, meeting-by-meeting approach in an uncertain environment, particularly as rates were moving closer to a possible peak level.

A very broad consensus also prevailed in favour of confirming the end of reinvestments under the APP as of July, as proposed by Mr Lane, although a preference was also expressed for deferring the decision to a later date, after the effects of the June TLTRO III repayments on banks' liquidity had been assessed. Overall, euro area bond markets were considered to have functioned smoothly since the beginning of the partial APP run-off. Moreover, the end of reinvestments, as signalled at the Governing Council's previous meeting, was expected by market participants. It was noted, however, that the end of reinvestments would coincide with the June TLTRO III repayments, which would remove large amounts of excess liquidity from the system.

It was noted that, in view of the discontinuation of reinvestments under the APP, the Governing Council should discuss whether further climate-related measures should be considered to ensure that the measures were fit for purpose and aligned with the objectives of the Paris Agreement and the EU's climate neutrality objectives.

Members generally agreed that the data-dependent approach to monetary policymaking, combined with the communication on the ECB's reaction function, had served the Governing Council well and should be reconfirmed. At the same time, it was remarked that, while the Governing Council might need to continue with additional interest rate steps, it would also have to be prepared to stop raising rates if required to do so by data and judgement.

By July, and even more so by September, new information would become available that would allow the Governing Council to update its assessment of the inflation outlook, the dynamics of underlying

inflation and the strength of monetary transmission. In this context, a data-dependent approach and meeting-by-meeting optionality were seen as essential.

It was also felt that the Governing Council should stress that fiscal policy needed to be tightened in order to dampen demand and support the disinflation process.

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 15 June 2023

Press release
Monetary policy decisions

Meeting of the ECB's Governing Council, 14-15 June 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 June 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 Assouan
- Ms Buch
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Gilbert

- Mr Haber
- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros
- Mr Martin
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- 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 31 August 2023.