Meeting of 3-4 May 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, 3-4 May 2023

1 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, the market narrative had shifted back from financial stability concerns to inflation concerns and to potential effects on the economy from the turbulence in the banking sector. Markets seemed so far to have digested the bank failures well, especially in the euro area. Measures of systemic stress, volatility and market liquidity had returned to close to their levels before the failure of Silicon Valley Bank (SVB). Risk assets in the euro area had not only largely recovered the losses experienced following the SVB failure, but in some cases had even rallied to new multi-year highs. Sovereign bond spreads had also shown remarkable resilience. Yet investors had significantly scaled back expectations of ECB monetary policy tightening. While the sharp downward shift in expectations for monetary policy rates at the height of the banking tensions had been partially reversed, the peak rate expected for the deposit facility remained around 50 basis points below levels priced in before the failure of SVB. Three potential factors could explain this repricing: receding inflation risks, heightened recession fears in the face of tighter financial conditions, or financial stability concerns. However, none of these explanations was fully borne out by financial market data.

On the basis of market pricing, current risks of systemic stress seemed contained. Implied volatility in US bond markets had retreated to its 2022 average from very high levels in mid-March, while stock market implied volatility in the United States had recently fallen to its lowest level since November 2021. Similarly, liquidity conditions in euro area sovereign bond markets had normalised.

The turbulence had left a lasting mark on bank stock indices, which remained below the levels observed before SVB's failure. However, euro area bank stocks currently stood above their level at the start of 2023, and spillovers from the financial sector to the non-financial corporate sector had been limited. Prices for risk assets had generally been less adversely affected in the euro area than in the United States.

The general resilience of financial markets also extended to sovereign bonds. Sovereign spreads had widened only slightly after the SVB failure, had normalised quickly after the banking tensions had subsided and had since remained close to their pre-SVB levels. This resilience had not been challenged by evolving market expectations for the reduction of the asset purchase programme (APP) portfolio. Both the start of quantitative tightening and expectations of a full roll-off had been absorbed smoothly by the market.

Despite fading concerns about market turbulence, investors had, in response to the banking tensions, significantly scaled back expectations for future ECB interest rate hikes.

A first possible explanation for the pronounced repricing of expectations for ECB interest rates could be receding concerns about inflation risks in the euro area. The decline in inflation-linked swap (ILS) forward rates, which had started at the beginning of March, had continued with the onset of the banking turbulence, in line with an initially disinflationary effect from the turbulence. At the same time, market participants did not seem to see the risks to the longer-term inflation outlook as having been alleviated by the banking tensions. The five-year forward ILS rate five years ahead had remained stubbornly above 2.4% since the Governing Council’s March monetary policy meeting. Investors continued to consider a scenario where inflation remained above target over the longer term significantly more probable than a scenario where it dropped below 2%.

An alternative explanation for the repricing of monetary policy expectations was the perception that tighter financial conditions made a recession more likely, implying less need for further rate hikes. However, most common financial conditions indices for the euro area had remained broadly unchanged since the collapse of SVB, even though bank lending rates had been increasing. There was also little indication in financial markets that the banking sector stress had affected economic growth. Investors were currently pricing in only marginally higher tail risks to the economic outlook for the euro area compared with the pre-SVB period.

The evolution of the exchange rate provided further insights into the expected impact of the banking sector turbulence on the economy. Since the start of the banking tensions the euro had appreciated discernibly against the US dollar, in line with the narrowing of the two-year interest rate differential between the euro area and the United States. Monetary policy convergence between the ECB and the Federal Reserve System seemed to have been a key driver of the euro’s appreciation. The scaling back of rate hike expectations had been greater in the United States than in the euro area. Positive economic data surprises in the euro area had also supported the euro, whereas rising downside risks to the US growth outlook had put pressure on the dollar. All in all, euro-dollar exchange rate developments were consistent with a more muted impact of the banking tensions on the economic outlook in the euro area than in the United States.

A third possible explanation for the repricing of interest rate expectations was related to financial stability concerns. With net outflows of deposits from euro area banks, market-based funding was becoming more important. However, short-term funding conditions in the interbank market had returned to pre-SVB conditions. The increase in credit and liquidity risk premia in money markets in mid-March had proved to be only temporary. Similarly, the effect on longer-term market funding conditions had been limited, and asset swap spreads of bank bonds had also almost returned to pre-SVB levels. At the same time, banks’ increasing use of longer-term bond market funding as an alternative to deposit funding tended to increase their average funding costs. Finally, the vulnerability of banks to rising interest rates depended not only on funding considerations but also on the assets side of their balance sheets. Overall, short-run risks to euro area banks from higher interest rates appeared to be contained.

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

Mr Lane went through the latest economic, monetary and financial developments in the global economy and the euro area since the Governing Council's last monetary policy meeting.

Global economic activity had been stronger than expected in early 2023. The global composite output Purchasing Managers' Index (PMI) had risen further in March and reached 51.8 in the first quarter, up from 48.4 in the last quarter of 2022. At the same time, PMI data signalled a divergence between services, which continued to expand, and manufacturing, which had weakened further into contractionary territory. Since the services sector was less trade-intensive, world trade had remained weak. The euro had appreciated both against the US dollar and in nominal effective terms. Compared with the March ECB staff macroeconomic projections, non-energy commodity prices had remained broadly unchanged, while the current oil futures curve was lower and slightly more steeply downward-sloping. The gas futures curve was also lower, although slightly more upward-sloping at the end of the year than embedded in the ECB projections.

Euro area GDP growth in the first quarter of the year – at 0.1% according to Eurostat's preliminary flash estimate – had been broadly in line with the March staff projections. Excluding the strong negative growth rate for Ireland, it was slightly higher, at 0.2%. The available country data pointed to a positive contribution from net trade owing to buoyant exports, which was offset by a negative contribution from domestic demand. At the same time, developments differed significantly across countries, depending on the relative importance of services versus manufacturing. Lower energy prices, the easing of supply bottlenecks and fiscal policy support for firms and households had continued to shore up the economy. Manufacturing activity was still benefiting from a backlog of orders but its prospects were worsening, as was visible in the manufacturing output PMI for April. The services sector was growing more strongly, owing to the reopening of the economy.

Private domestic demand, especially consumption, was likely to have remained weak. Households were less inclined to purchase "big ticket" items, as the impulse from the additional savings accumulated over the pandemic had progressively waned and financing conditions were tightening. For instance, in the first two months of the year, retail sales and car registrations had declined from their levels at the end of 2022 by 0.4% and 3.7% respectively. The asset allocation of savings flows showed that households had accumulated money in bank accounts during 2020. However, the deposits were subsequently used by and large not to consume more but to invest in other financial assets or in capital formation, chiefly housing. Since 2022 they had also been used to repay debt, contributing to an increase in the saving ratio at the end of 2022.

Turning to investment, housing investment had been contracting since mid-2022. At the beginning of 2023, building construction had rebounded, thanks to good weather and the buffer from accumulated order backlogs, suggesting a temporary recovery in housing investment. However, the PMI for construction remained in negative territory, pointing to a subdued outlook. Affordability and profitability indicators had both declined sharply at the end of 2022. By contrast, non-housing investment and net exports were expected to have contributed positively to GDP growth in the first quarter of 2023. A recovery in capital goods had been helped by easing supply bottlenecks. However, the new orders PMI for capital goods remained in negative territory. As regards prospects for exports, the PMI for manufacturing orders had remained below the 50 threshold in April, while the PMI for services had returned to expansionary territory.

Looking ahead, model estimates and survey data pointed to a further moderate expansion of GDP in the second and third quarters of 2023, broadly in line with the March projection exercise.

The labour market had remained strong in the first few months of 2023. The unemployment rate had been relatively stable since April of the previous year and fallen to a new historical low of 6.5% in March 2023. Employment had grown steadily through higher labour force participation and higher immigration, with older and highly skilled workers behind the expansion. By contrast, average hours worked had been more sluggish. The employment outlook remained positive, according to the April PMI indicators, but with sectoral differences. The employment PMI for services had increased strongly, while the index for manufacturing had declined marginally, although it remained in expansionary territory. In the construction sector, the employment PMI had been in contractionary territory for a year.

Negotiated wage growth had increased strongly, to slightly above 5% in both January and February, from around 3% in December. But wage growth was more moderate if one-off payments were excluded, with rates of 3.1% in December, 3.7% in January and 3.8% in February. The latest settlements monitored in the ECB wage tracker implied comparable signals for wage growth over the coming 12 months, albeit with significant variation across countries. At the same time, the Indeed high-frequency job postings indicator of wage pressures had moderated since last October. The ECB’s Corporate Telephone Survey showed that large companies expected margins to deteriorate in 2023 from elevated 2021-22 levels. The same firms indicated that they continued to expect wages to rise by 5% in 2023.

The fall in energy prices and easing supply bottlenecks, together with strong labour markets and rising wages, were expected to continue to support the economy in the coming months. Later in the year, however, less scope for catch-up dynamics and progressively tighter financing conditions were likely to act as a drag on economic growth.

According to Eurostat’s flash estimate, the annual inflation rate had been 7.0% in April, having dropped from 8.5% in February to 6.9% in March. The uptick in April was due to a positive base effect for energy inflation. Services inflation had also increased slightly. The inflation rates for all other components of the Harmonised Index of Consumer Prices (HICP) had declined. Inflation excluding energy and food (core inflation) had been 5.6% in April, back to its February level after edging slightly higher in March. Food price inflation had remained elevated at 13.6% in April, after 15.5% in March and 15.0% in February. Overall, price pressures remained strong. The inflation momentum, measured as the annualised three-month over three-month price change, had showed a headline inflation rate of around 4% in April, with energy inflation deeply negative. Momentum had not yet declined for either food or services price inflation. It had decelerated slightly for goods inflation, but was still very high.

Indicators of underlying inflation were elevated and, for now, sent mixed signals. While exclusion-based and model-based measures were already declining, other indicators were only levelling off or still creeping up. Among those measures, the model-based Persistent and Common Component of Inflation (PCCI) was declining more strongly than others since it was more quickly affected by the impact of declining energy prices. At the same time, domestic inflation was still increasing and was more indicative of pressures coming from wages. When information was taken from both indicators, the message was therefore mixed. So it was important to acknowledge that measures of underlying inflation would not be sending the same signal for a while, as there was a large relative price adjustment going on. On the one hand, there was a big decline in energy prices and, on the other hand, a big increase in the price of labour. Measures of underlying inflation that still included past energy shocks and the pressures from wages remained high. These measures were not a good predictor of where inflation would be one or two years from now, however, given the reversal of the energy shock, the easing of bottlenecks and the expectation that the catch-up in low real wage growth would fade over time.

Longer-term inflation expectations reported in the ECB Survey of Professional Forecasters, the Consensus Economics survey and the ECB Survey of Monetary Analysts had remained in the range of 2.0-2.1%. Financial market-based measures of inflation compensation had increased, but excluding higher inflation risk premia they had remained broadly unchanged and close to 2%. The upward movement in inflation expectations reflected in the ECB Consumer Expectations Survey also warranted ongoing monitoring.

Short-term euro area forward rates had increased since the beginning of April, partly reversing their earlier declines in the acute phase of the banking tensions. At present, the forward curve peaked at a rate of around 3.75%, to be reached in the third quarter of this year. Further out, the pricing indicated that increasing probability was attached to cuts in the key ECB interest rates starting in the second quarter of 2024.

Reflecting the rise in the risk-free yield curve, interest rates on bank loans had increased further, while overall credit flows remained low. Widening spreads between bank bonds and risk-free rates in the wake of the banking tensions were likely to affect bank lending behaviour. The latest bank lending survey showed a further strong net tightening in the standards applied by banks to corporate and housing loans, and banks cited higher risk perceptions and lower risk tolerance as the main drivers of their loan decisions. The share of rejected applicants had also increased for all loan categories. In parallel, banks reported declining demand for bank credit, owing to the general level of interest rates, weaker fixed investments for firms and worsening housing market prospects for households. Overall, this constituted a tightening impulse that was likely to add to the factors that were expected to weigh on economic growth and dampen inflation over the next two years.

Monetary policy considerations and policy options

Following its March monetary policy meeting, the Governing Council had announced that policy rate decisions would be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

Overall, the incoming information broadly supported the assessment of the medium-term inflation outlook formed at the March meeting. Headline inflation had declined significantly over recent months, but underlying price pressures remained strong. At the same time, the past rate hikes were being transmitted forcefully to euro area financing and monetary conditions, while the lags and strength of transmission to the real economy remained uncertain.

The incoming information was sending a range of signals. Some developments were expected to dampen medium-term inflation dynamics: lower energy prices, the further easing of bottlenecks, the appreciation of the euro, the decline in global prospects for manufacturing and further global monetary tightening. In the other direction, the current strength of core and food price inflation, together with the level of recent wage agreements, posed upside risks to the March projections, especially in terms of the duration of the inflation adjustment process. Regarding underlying inflation, the signals were mixed: while exclusion-based and model-based measures had started to decline, the domestic and wage-intensive components of inflation were still rising. In addition, the momentum in some of these indicators continued to be substantial. In relation to monetary policy transmission, financing conditions continued to tighten. The latest bank lending survey indicated that the extent of credit tightening was stronger than previously expected by the banks, while the recent tensions in the global banking system might also add to risk aversion, curbing credit supply.

With these considerations in mind, the Governing Council needed to strike the right balance between advancing further towards interest rate levels that were sufficiently restrictive to ensure inflation returned to the 2% target in a timely manner and taking into account the elevated uncertainty regarding the speed and strength of the transmission of the cumulative tightening in the policy stance, including through the credit channel. This argued in favour of raising rates by an increment of 25 basis points at the present meeting. The Governing Council's emphasis on data-dependence and on articulating the main criteria informing the rate decisions had been very effective in steadying policy expectations.

The APP portfolio was set to decline by €15 billion per month until the end of June 2023. The realised and expected balance sheet normalisation had so far complemented the tightening of policy interest rates in a smooth manner. Looking ahead, the latest Survey of Monetary Analysts had indicated that, beyond June, investors expected to see an acceleration in the pace of reduction of the APP portfolio to a rate that was consistent with a full run-off. To the extent this expectation was priced in by the market, the yield impact of discontinuing APP reinvestments as of July was expected to be small. Against this background, and in line with the Governing Council principle of data-dependence as well as its commitment to reduce the APP portfolio at a measured and predictable pace, Mr Lane proposed that the Governing Council communicate the expectation that reinvestments would be discontinued as of July. Expressing the decision as an expectation would preserve some flexibility in case adverse tail risks were to materialise, in particular with regard to financial market conditions.

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 global growth excluding the euro area had been higher than expected since the start of the year. The upside surprises had been broad-based, in both advanced and emerging economies. In contrast to economic activity, global trade had been relatively weak over the last few months, as demand had rotated towards domestic services. The euro exchange rate had appreciated since the Governing Council's last monetary policy meeting, which, looking ahead, would contribute to lower inflationary pressures for the euro area. Non-energy commodity prices were broadly unchanged. Oil prices had increased while gas prices had declined, extending their previous large decreases. High inventories had contributed to the improved gas price outlook. In the United States, economic activity was moderating, reflecting weakening domestic demand. In China, real GDP growth had rebounded strongly in the first quarter from its pandemic-induced slump. The reopening of the Chinese economy, with higher than expected growth in China, was mentioned as an external factor that could contribute to lower core inflation in the euro area, as cheap Chinese imports had dampened inflation in Europe and the United States in the past. At the same time, higher demand from China could put upward pressure on global commodity prices, including energy.

With regard to economic activity in the euro area, members concurred with Mr Lane's assessment that lower energy prices, the easing of supply bottlenecks and fiscal policy support for firms and households had contributed to the resilience of the economy. At the same time, private domestic demand, especially consumption, was likely to have remained weak. Business and consumer confidence had recovered steadily in recent months but remained weaker than before Russia's unjustified war against Ukraine and its people. There was also a divergence across sectors of the economy. The manufacturing sector was working through a backlog of orders, but its prospects were worsening. The services sector, on the other hand, was growing more strongly, especially owing to the reopening of the economy. Household incomes were benefiting from the strength of the labour market.

Members highlighted the resilience of economic activity so far. The preliminary flash estimate for GDP growth in the first quarter of 2023 had been better than anticipated earlier, especially when taking into account that the aggregate number was most likely to have been pushed down by volatile transactions in Irish intellectual property products, while broadly in line with the March ECB staff projections. Moreover, incoming data suggested that growth could pick up further in the second and third quarters, in line with the March projections. This implied that the euro area economy would manage to escape a recession and that the exit from accommodative monetary policy had so far been smooth.

While the resilience of economic activity was seen as good news, it was nevertheless argued that strengthening activity would contribute to more persistent upward inflation pressures, making a timely return of inflation to target more difficult. However, it was also pointed out that the better than expected GDP growth had mainly been driven by a reversal in the terms-of-trade shock associated with lower energy prices, together with the easing of bottlenecks and an increase in labour supply, which was one factor supporting potential output. These favourable supply forces could allow an increase in GDP while at the same time also favouring disinflation.

The impact of tighter monetary policy was starting to become more visible in financing conditions in the early stages of transmission. At the same time, this raised the question of how much of the impact of tighter monetary policy was already in the pipeline and had yet to materialise, given the remaining uncertainty about long and variable lags in the transmission of monetary policy to output and inflation. In this context, it was mentioned that the impact of tighter monetary policy was becoming visible in non-financial companies' perceptions of a weaker demand outlook, as flagged in the ECB's latest Corporate Telephone Survey, as monetary policy was working through slowing aggregate demand. With respect to demand components, as financing conditions were tightening, investment was expected to weaken, partly as a result of the fair amount of uncertainty still clouding the outlook. As to private consumption, consumer services and tourism were still strengthening now that the pandemic had been overcome. Moreover, stronger tourism would also contribute to higher exports as non-euro area tourists returned to the euro area, a development that was not related to labour income growth due to domestic demand.

Members concurred that, as the energy crisis faded, governments should roll back the related support measures promptly and in a concerted manner to avoid driving up medium-term inflationary pressures, which would call for a stronger monetary policy response. In this context, it was argued that the current fiscal stance was out of line with the cyclical position of the economy. Moreover, if there were any fiscal tightening in the future it would likely be "too little too late" to be helpful in bringing inflation back to target. Especially as interest rates were rising, the question was whether governments would manage to tighten their fiscal stance at a time when higher inflation would increasingly weigh on public deficits, owing among other things to higher public wages and pension outlays. At the same time, it was mentioned that the size of the energy-related fiscal measures in 2023 and, as a consequence, the impact on inflation of their removal in 2024, would likely be revised down, in line with lower than expected energy prices. Fiscal policies should be oriented towards making the economy more productive and gradually bringing down high public debt. Policies to enhance the euro area's supply capacity, especially in the energy sector, could also help reduce price pressures in the medium term. The reform of the EU's economic governance framework should be concluded soon.

Against this background, the view was expressed that it was no longer evident that the balance of risks to economic activity was skewed to the downside, as had been judged at the preceding monetary policy meeting. Members nonetheless assessed that – even though recent market tensions related to stress in the banking system had largely subsided – renewed financial market tensions, if persistent, would pose a downside risk to the outlook for growth as they could tighten broader credit conditions more strongly than expected and dampen confidence. Russia's war against Ukraine also continued to be a significant downside risk to the economy. However, the recent reversal of past adverse supply shocks, if sustained, could spur confidence and support higher growth than currently expected. The continued resilience of the labour market, by bolstering household confidence and spending, could also lead to higher growth than anticipated.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. Inflation was still being pushed up by the gradual pass-through of past energy cost increases and supply bottlenecks. In services, especially, it was still being pushed higher also by pent-up demand from the reopening of the economy and by rising wages. The information available up to March suggested that underlying inflation remained high. Wage pressures had strengthened further as employees, in a context of a robust labour market, recouped some of the purchasing power they had lost as a result of high inflation. Moreover, in some sectors firms had been able to increase their profit margins on the back of mismatches between supply and demand and the uncertainty created by high and volatile inflation. Although most measures of longer-term inflation expectations currently stood at around 2%, some indicators had edged up and warranted continued monitoring.

Members underlined that, while headline inflation had declined substantially from its earlier peak, the inflation outlook was still too high for too long. Inflation data had continued to surprise on the upside, for both headline and core inflation. All inflation components other than energy prices were significantly higher than had been expected in the March ECB staff projections. According to the mechanical update, headline and core inflation for 2023 would be higher than projected in March. Underlying inflation was proving more persistent, which was argued to point to clear upside risks to the latest projections. While it was felt that the outlook for headline inflation in the medium term remained similar to that in the March projections, developments in underlying inflation had become more worrisome and pointed to increased persistence. Momentum in all components except for energy remained very high or had even increased, especially for services. Against this background, the inflation outlook in the March projections was judged to be too optimistic, as there was still no robust evidence of a turning point in underlying inflation, with a rising risk of inflation becoming more entrenched owing to higher wage growth and of inflation expectations becoming unanchored.

However, it was also argued that the Governing Council should not focus too much on monthly inflation data being 0.1 percentage point higher or lower. What mattered was whether a downward trend in inflation could be expected over the medium term, in line with the projections. Moreover, with respect to changes in the projection assumptions since the March cut-off date, the latest developments in oil prices, food commodity prices and the exchange rate would together mechanically imply a downward impact on inflation, looking ahead. While there were forces, such as wages, that would push inflation up, there were also several factors going in the other direction, including rising interest rates, a stronger exchange rate, lower energy prices, easing supply bottlenecks, an increasing labour supply and lower fiscal subsidies, all of which would be disinflationary.

Food price inflation was widely seen as another important factor behind the still elevated level of headline inflation. Pipeline pressures suggested that the pass-through of past cost shocks to consumer food prices remained incomplete, posing significant upside risks to food inflation in 2023. This also represented an upside risk to prices in related areas such as restaurants and hotel services, and thus to underlying inflation. While commodity prices were falling steeply, consumer prices remained very sticky, suggesting that expanding profit margins were preventing inflation from falling. At the same time, it was argued that a large part of the currently elevated food price inflation could still be explained by higher energy prices. Moreover, there was a big transportation component in food prices, which was labour and energy-intensive.

As regards developments in core inflation, the latest developments were broadly seen as worrisome. The level and momentum of inflation excluding energy and food continued to be very high, so that small improvements in core inflation or other measures of underlying inflation should not be interpreted as an indication of a turning point. Reference was made to the United States, where the policy-relevant measures of core inflation had already started to decline some time ago, albeit at a slow pace. It was argued that underlying inflation in the euro area appeared to be more stubborn and was likely to be stickier than in the United States, since wage and price-setting were typically less flexible in Europe. The observed strength and persistence of core inflation were seen to call into question the earlier hypothesis that euro area inflation was to a larger extent supply-driven and due to external shocks than a result of domestic demand. It was also pointed out that the momentum of services inflation was clearly on the rise, indicating that wages – a key component of services inflation – would become increasingly important in explaining underlying inflation, especially given the resilience in the labour market. Moreover, the demand for hospitality services was expected to strengthen further over the coming months, which should give an additional boost to services and core inflation. In this context reference was made to the recent developments in wage negotiations in the public sector of the largest euro area country, and to evidence of non-linearities and greater persistence in the reaction to pipeline pressures, all of which were worrying for the outlook for underlying inflation.

At the same time, the point was made that, given the earlier large increases in energy prices, it was natural that core inflation would only start to decline with a considerable lag, as also suggested by historical regularities. In this context, it was recalled that there was no stable predictive relationship between core or other indicators of underlying inflation and headline inflation one to two years ahead. If anything, the causality between core and headline inflation went in the opposite direction. Against this background, the view was expressed that too much attention was paid to core inflation, first because core inflation was not representative of the household consumption basket, and second because core inflation had no clear leading indicator properties for future headline inflation. It would therefore be beneficial to explain that the analysis of underlying inflation pressures took a wide range of indicators into account and went well beyond core inflation.

Members recalled that the trend in wages was key to understanding medium-term inflation pressures. Even if it were the case that wage developments had so far remained broadly in line with the March ECB staff projections, this did not necessarily provide reassurance that the trend in wage increases would prove consistent with the ECB’s inflation target. Moreover, some of the latest wage increases, notably in the public sector, were widely seen as worrisome and had not been included in the March projections. There were clear signs that unions had regained bargaining power, which was unlikely to recede. Reference was also made to empirical evidence that the public sector played a leading role in private sector wage-setting in a number of euro area countries.

More generally, as high inflation became more protracted, this exacerbated the underlying social conflict between workers and employers. Moreover, while wage claims had for a long time been in line with domestic inflation and productivity growth, recent wage claims were clearly higher than levels that would be consistent with this regularity in future if inflation declined as anticipated. Wage growth was increasing, with further risks to the upside. In the euro area such developments typically started late and slowly, but they might be hard to stop. Negotiated wages (including one-off payments) had grown by more than 5% year on year in January and February 2023. There had been a significant increase in the growth rate of compensation per employee, which, together with the weakening of labour productivity growth, had implied a sharp increase in unit labour costs.

At the same time, there was already substantial evidence that the longer inflation remained high, the stronger demands for higher wages would become, with second-round effects on other prices. The social dialogue was seen as coming under increasing strain in a number of countries, suggesting that the argument about wages versus profit was becoming more intense. It was therefore contended that signs of a wage-profit-price spiral were emerging. In addition, a remark was made that higher mortgage rates might also induce workers to demand higher wages, giving rise to another channel through which inflation could perpetuate itself.

However, it was also recalled that there were considerable differences in wage developments, so all 20 euro area countries had to be taken together to see what the implications for monetary policy for the whole of the euro area would be. In this context, it was mentioned that there was no uniform message from recent wage indicators. Developments in negotiated wages and the ECB’s wage tracker pointed to a continued acceleration, but the signal from the latter indicator was affected by compositional and methodological issues. By contrast, information from the Indeed online job-matching platform, which covered new hiring, was showing a deceleration in wage dynamics. In addition, it was pointed out that the observed reduction in the unemployment rate reflected both an increase in new hires and a remarkable reduction in unemployment duration, suggesting that European labour markets had become much more fluid than they used to be. This should be positive for productivity and could indeed justify some wage increases if they were related to more robust productivity growth. However, it was also observed that no increase in productivity had been seen in the available macro data so far.

Finally, it was pointed out that the cumulative increase in prices between 2021 and 2024 would be around 20%. This meant that nominal wage increases observed over the past year would need to be put into the context of a “catching-up” process, by which employees were trying to compensate for the lower real wages received for much of the period. The March ECB staff projections had therefore expected significant wage increases, recognising that real wages were likely to recover over the projection horizon. Nonetheless, it was noted that the March projections did foresee inflation eventually coming back to target even with very substantial nominal wage increases. However, it was also argued that the cost of an adverse terms-of-trade shock could not be compensated but had to be shared between workers and employers. Moreover, the benign inflation outcome depicted in the baseline scenario of the staff projections was subject to large upside risks, as higher wages were likely to have a protracted impact and would increase inflation persistence, especially if not absorbed by lower profit margins.

Together with increasing wage pressures, recent elevated profits were seen as warranting closer monitoring. In some countries and sectors profit margins had grown very strongly at the end of last year. Unit profits in the euro area had contributed more than half of the domestic price pressures in the last quarter of 2022. As wage inflation had been much lower than price inflation, profits were plainly on the rise, with prices often clearly outpacing increases in input costs and wages. If wages were chasing prices and profits were chasing wages, this could be an explanation for the increased persistence of high inflation. To fully understand the implications for inflation, it was therefore important to see how profits would develop in the future. In this context, the Corporate Telephone Survey was sending a clear message, suggesting that companies had indeed been able to attain ample mark-ups in 2022, but they did not think that this would persist during the current year. As companies were passing on the higher input costs, it was likely that a reversal of this process would be seen in 2023, with wages contributing more and profits less, in line with past regularities.

As regards longer-term inflation expectations, members recalled that inflation expectations mattered a lot in wage negotiations. In particular, higher inflation expectations today could give rise to higher inflation over a prolonged period because of the long duration of wage agreements. Inflation expectations also mattered a lot in firms’ price-setting. Repeated upside surprises and target overshoots over a long period of time could erode trust in the ECB’s ability and willingness to bring inflation back to the 2% target. Maintaining the credibility of the ECB’s commitment to price stability was especially challenging in light of substantial lags in policy transmission. Attention was drawn to the increase in consumer inflation expectations in March. The question was raised as to whether this could be related to persistently high food inflation, with energy prices having declined significantly.

Against this background, a large number of members assessed the risks to price stability as being clearly tilted to the upside over the policy-relevant horizon, while other members judged that the risks were more symmetric, especially beyond the near term. Overall, the Governing Council assessed that there were still significant upside risks to the inflation outlook. These included existing pipeline pressures that could send retail prices higher than expected in the near term. Moreover, Russia’s war against Ukraine could again push up the costs of energy and food. A lasting rise in inflation expectations above target, or higher than anticipated increases in wages or profit margins, could also drive inflation higher, including over the medium term. Recently negotiated wage agreements had added to the upside risks to inflation, especially if profit margins remained high. The downside risks included renewed financial market tensions, which could bring inflation down faster than projected. Weaker demand, due, for example, to a more marked slowing of bank lending or a stronger transmission of monetary policy, would also lead to lower price pressures than currently anticipated, especially over the medium term.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. Policy rate increases were being transmitted strongly to risk-free interest rates and to financing conditions for firms, households and banks. Growth in loans to firms and households had weakened owing to higher borrowing rates, tighter credit supply conditions and lower demand. The tightening of overall credit standards reported in the latest round of the bank lending survey was stronger than banks had expected in the previous survey round, which suggested that lending might weaken further. The observed weakness in lending meant that money growth had also continued to decline.

It was argued that some of the stronger tightening of credit standards reported in the survey, beyond the level that had been expected by banks in the previous survey round, was likely to be attributable to the recent tensions in the global banking system. At the same time, it was argued that there was no indication of a credit crunch and bank lending seemed to reflect mainly weaker loan demand rather than any quantitative constraints. The view was also expressed that it was surprising that the recent stress and uncertainty in the banking sector had had such a limited impact on the results of the bank lending survey, which had reported unchanged net tightening for loans to firms compared with the previous quarter and an expected deceleration in the pace of tightening in the period ahead. Moreover, it was recalled that the tightening of credit standards had come after a long period of very favourable credit developments, so, to some extent, it reflected a normalisation. In addition, it was felt that the observed tightening of bank lending standards and declining loan demand were welcome evidence that monetary policy transmission was working. Furthermore, access to financing was not seen as a major problem for firms, as was reflected in responses to the European Commission’s business survey regarding obstacles to production. However, credit developments were weakening. When measured in real terms, the contraction in loans to firms as a proportion of GDP was particularly pronounced and similar to the contractions observed in 2008 and in 2011.

Overall, members assessed financing conditions to have tightened since the March monetary policy meeting, while the picture of market-based financial conditions was mixed across markets. The acute strains that arose in financial markets in early March had diminished, as reflected in measures of systemic stress and volatility which had returned to levels seen prior to the emergence of the financial market tensions. Nevertheless, bank stock prices remained notably lower than before the tensions, although they were still higher than at the beginning of the year, while bank bond spreads over risk-free rates had widened somewhat. Banks’ funding costs had risen from low levels, as banks had to compensate for outflows from overnight deposits with more expensive time deposits and market-based debt. This would increase the supply pressure in the market for bank bonds, which was already elevated as banks took steps to pre-fund the large reimbursement due on the targeted longer-term refinancing operation (TLTRO) expiring in June. Yet short-term funding conditions in the interbank market had returned to levels seen prior to the onset of the banking sector tensions. In this context, it was argued that the financial market tensions had led to both a faster increase in funding costs for banks and a faster transmission of monetary policy to financing conditions than previously expected.

Members expressed confidence in the resilience of European banks. Banks were increasingly reporting profits linked to rising net interest income. In this context, it was underlined that financial stress or instability was far from a level that might jeopardise the transmission of monetary policy. Nevertheless, financial fragilities might still surface, with the unprecedented policy rate tightening cycle exposing financial imbalances that had built up during the period of low interest rates. Against this background, the remark was made that it was, in any case, important to uphold the separation principle, which called for the monetary policy stance to be assessed independently of risks related to financial stability, with these being addressed, if needed, by dedicated means.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members evaluated the data obtained since the previous monetary policy meeting against the three criteria specified at the March meeting as being important in driving the Governing Council's reaction to the unfolding circumstances. These criteria comprised (i) the implications of the incoming economic and financial data for the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission.

Starting with the inflation outlook, members broadly concurred with the assessment that, with inflation outturns having again surprised on the upside, the outlook continued to be for too high inflation for too long. The risk of a severe economic downturn and the risk of an impact on financial stability had both eased, and hence some of the factors exerting downward pressure on inflation had receded. These considerations tended to support the inference that inflation risks had moved further to the upside since the March monetary policy meeting. At the same time, commodity prices had fallen, financing conditions had tightened and the effective exchange rate of the euro had appreciated. On balance, weighing up the different factors, it could be concluded that the medium-term inflation outlook was still broadly consistent with the March staff projections.

Members assessed the evidence regarding measures of underlying inflation as being a source of concern. While core inflation had edged down slightly, indicators of underlying inflation ranged overall between 4% and 7%, giving a mixed picture. The momentum of services inflation was clearly on the rise, with wages expected to become increasingly important in explaining underlying inflation. HICP inflation excluding energy and food was still very high and its momentum was rising, while strong wage growth was expected to prevail, with the risk of more persistent inflation as well as the possibility of second-round effects.

Turning to the assessment of monetary policy transmission, members noted that there was now more solid evidence that monetary policy was being transmitted to financing and credit conditions. This was generally seen as a positive development, suggesting that the first stages of transmission were working. The still strong dynamics of underlying inflation could be a reflection of a slower than expected transmission of monetary policy to inflation. On the other hand, it was also argued that, with a very strong labour market and longer interest rate fixation periods for bank loans, transmission could be weaker than usual. However, it was noted that a further tightening of bank credit conditions was still in the pipeline, as the full extent of policy rate increases had not yet been reflected in bank lending rates and credit growth. Furthermore, uncertainty about the transmission channels was currently higher than usual. This was because the extra tightening impulse that, according to the bank lending survey, would result from banks' more cautious lending decisions following the recent banking sector tensions, was hard to quantify precisely and warranted continuous monitoring.

Overall, it was felt that the conditions were not in place to “declare victory” or to be complacent about the inflation outlook. Instead, members concurred that further tightening was needed to bring inflation back to target over the medium term. High inflation was seen to be hurting the most vulnerable parts of society and weakening the euro area’s economic performance.

Emphasis was placed on the evidence that various measures of longer-term inflation expectations had edged up above 2%, indicating risks of an unanchoring of inflation expectations. In particular, market-based measures of longer-term expectations remained stubbornly high, which could partly be attributed to the level of risk premia, suggesting that investors saw upside risks to longer-term inflation prevailing over downside risks. Over shorter horizons, market-based measures of inflation expectations stood below staff inflation projections. Monitoring the inflation expectations of households and firms was also seen as important because they mattered in wage negotiations and firms’ price-setting.

Monetary policy decisions and communication

Against this background, members agreed that a tightening of the monetary policy stance by increasing interest rates further was warranted.

A number of members initially expressed a preference for increasing the key ECB interest rates by 50 basis points in view of the risks to the inflation outlook posed by continued upside inflation surprises and inflation projected to be above target over at least four years, as well as by the elevated risk of an unanchoring of inflation expectations. Such a step would more clearly demonstrate the Governing Council’s determination to achieve price stability in the face of elevated and more persistent inflation. More decisive action was warranted to move rates into sufficiently restrictive territory to ensure a timely return of inflation to target. These members saw the risk of tightening rates too much as being less than the risk of tightening them too little. Moreover, the view was expressed that the financial market turbulence had been short-lived and had not exerted a meaningful additional tightening impulse. Furthermore, the resilience of the euro area economy and receding recession risks, together with broadening price and wage pressures, suggested that underlying inflation was unlikely to decelerate sufficiently soon, which gave rise to increased risks of an unanchoring of expectations.

At the same time, most of these members indicated that they could accept the proposed rate increase of 25 basis points. The ECB’s communication should, however, convey a clear “directional bias” to underline that, on the basis of the present outlook, further interest rate increases would be warranted in order to return inflation to target and to avoid a smaller rate increase being misinterpreted as signalling the prospect of a pause in the current hiking cycle.

Against this background, almost all members supported the 25 basis point rate rise as proposed by Mr Lane, in combination with clear communication that, on the basis of the current data, monetary policy still had more ground to cover. This decision was seen as striking the right balance between meeting the need for further rate increases and accounting for elevated uncertainty about the speed and strength of monetary policy transmission. Since interest rates were already in restrictive territory, raising rates by 25 basis points was seen as preferable, including from a risk management perspective. This magnitude was viewed as prudent, with the possible costs of larger increments outweighing the benefits, given the still elevated uncertainty and the perception that the transmission of much of the impact of previous rate increases was still pending. In addition, the point was made that a smaller increment than those decided since July 2022 would allow the Governing Council to keep raising rates for longer, if underlying inflation pressures persisted or even strengthened through the summer, until there was sufficiently strong evidence that a turning point had been reached and inflation was retreating at an adequate pace. Emphasis was put on the merit of keeping to a data-dependent, meeting-by-meeting approach in an uncertain environment and with rates moving closer to a possible "landing zone". A return to a more standard size of rate increment was also justified in view of the fact that the various monetary policy instruments were reinforcing each other in the transmission of the monetary policy stance.

On this basis it was concluded that reducing the size of the increment from 50 to 25 basis points could be justified for two main reasons. First, substantial ground had been covered thus far, with the Governing Council having raised rates by 350 basis points over nine months, which implied that rates were getting closer to their destination, though they were not there yet. Second, the smaller rate increase also reflected uncertainty about the impact of past decisions, with a great deal of this impact still being in the pipeline. Slowing the pace of rate hikes was also seen as helping the right conclusions to be drawn about the destination. At the same time, it was underlined that reducing the size of the rate increment should not be interpreted as signalling that the Governing Council had opened the door to a pause in its monetary policy tightening cycle.

Members generally agreed that the data-dependent approach, combined with the communication about the ECB's reaction function issued following the March meeting, had served the Governing Council well. Financial markets were assessing progress in terms of the inflation outlook, underlying inflation and the transmission of monetary policy, and were pricing in interest rates accordingly. It was argued that communication should emphasise the importance of being persistent and tenacious, and should make it clear that once the peak rate was reached rates would stay at that level for some time and the increases would not be reversed immediately.

As regards communication of the Governing Council's directional bias, members agreed that it was appropriate to affirm that the Governing Council's future decisions would ensure that the policy rates would be brought to levels that were sufficiently restrictive to achieve a timely return of inflation to the ECB's 2% medium-term target, and would be kept at those levels for as long as necessary. At the same time, there was a strong preference against returning to outright forward guidance on policy rates, which was not regarded as a suitable instrument when rates were well above their lower bound and was seen as inconsistent with the meeting-by-meeting approach to decision-making that remained warranted in a volatile environment.

Turning to the policies affecting the size and composition of the Eurosystem's balance sheet, members widely agreed with Mr Lane's proposal to announce the Governing Council's expectation of discontinuing, as of July 2023, the reinvestment of maturing securities in the APP portfolio.

Members recalled the reasons why the balance sheet needed to be normalised. First, ending reinvestments in July was seen as being consistent with the current monetary policy stance and with the need to support the reduction in excess liquidity, complementing the expiry of the large TLTRO operation in June. In addition, progress with balance sheet normalisation was needed to regain policy space for possible future situations in which policy rates again came close to the lower bound and in order to adhere to the principle of proportionality. In this regard, while the APP had been introduced to provide additional monetary accommodation and to compress term premia when rates were at the lower bound, in the current conditions of ample excess liquidity and upside price pressures, the proportionality of continuing the partial reinvestment policy was questionable. Moreover, the current level of excess liquidity was not necessary to implement the desired monetary policy stance. Furthermore, normalisation was needed to reduce the side effects of a large balance sheet, including the risk of fiscal dominance, the exposure to credit and duration risk, and the impact on financial stability risks and on market functioning. Finally, from a longer-term perspective, a steeper yield curve would support banks' intermediation capacity via maturity transformation. By contrast, keeping down term premia via the APP securities holdings for longer than necessary could negatively affect bank balance sheets and therefore the provision of credit to the private sector.

Members widely viewed financial markets as being able to digest a full portfolio run-off, having calmed after the turbulent weeks in mid-March. Market absorption had been very smooth even in times of market turbulence and despite relatively front-loaded government bond issuance this year. Overall, financial markets were seen as having largely priced in a full run-off by the summer, implying that the impact on long-term yields was likely to be limited.

It was recalled, however, that the reduction in the stock of securities held in the APP portfolio would be accompanied by a considerable decline in excess liquidity linked to the upcoming sizeable TLTRO repayments, with the largest coming due in June. Moreover, the fact that the June repayments were fully expected and priced in by markets did not preclude any impact if liquidity was withdrawn, because a fast contraction of the Eurosystem balance sheet could have wider implications for the financial sector. Over time there was likely to be some pressure on yields, a rise in interest rates on bank deposits, a rotation in household savings from investment funds back into term deposits as the rates on them increased, and a rise in demand for bonds from investment funds.

Reference was made to the need to monitor the composition of the APP portfolio in order to assess whether the composition across and within asset classes remained compatible both with the intended monetary policy stance and with the ECB's Treaty requirement to support the general economic policies in the EU, as also reflected in the ECB's monetary policy strategy. In particular, a request was made to assess whether the overall composition of the portfolio remained aligned with climate goals of the Paris Agreement.

Caution was also expressed against too fast a contraction in the Eurosystem balance sheet. Owing to the TLTRO repayments, the expected pace of the reduction in the balance sheet was already quite fast, while the impact of the APP run-off on the lowering of inflation was seen as small. Moreover, the remark was made that the optimal size of the balance sheet in the long run was uncertain. Some members saw benefits in leaving an announcement about adjustments to APP reinvestments until June or in providing only a directional communication following the present meeting, while deciding on the exact calibration of reinvestments after the second quarter of 2023, at the June monetary policy meeting. This would allow a more complete assessment of the impact of TLTRO reimbursements in June amid lower liquidity during the summer months and was seen as beneficial in view of the high uncertainty and market volatility. Overall, the process of reducing reinvestments under the APP, including the Governing Council's communication of this process, was seen as a success. The expected and realised balance sheet normalisation had already delivered a tightening of longer-term yields, thus supporting the policy stance, while at the same time not measurably increasing volatility.

Against this background, members were ready to join the consensus in support of Mr Lane's proposal, subject to reiterating the principles of gradualism and predictability when announcing the expectation that reinvestment under the APP would be discontinued as of July.

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 4 May 2023 English

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 3-4 May 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 May 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 Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Horváth
- Mr Kaasik
- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- Mr Sleijpen
- Mr Tavlas

- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

- Mr Proissl, Director General Communications
- 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 13 July 2023.

CONTACT

European Central Bank

Directorate General Communications

- Sonnemannstrasse 20
- 60314 Frankfurt am Main, Germany
- +49 69 1344 7455
- media@ecb.europa.eu

Media contacts

You may also be interested in:

Monetary policy decisions

› View page