Meeting of 13-14 April 2022

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 13-14 April 2022

19 May 2022

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

Financial market developments

Ms Schnabel reviewed the latest financial market developments, noting that since the Governing Council's previous monetary policy meeting on 9-10 March 2022 investor risk sentiment had improved considerably. Euro area equity prices had moved close to the levels recorded prior to the war in Ukraine, sovereign spreads had narrowed, and risk-free yields had increased markedly. At the same time, market-based measures of inflation compensation had continued to creep higher and stood well above the Governing Council's 2% target over the entire horizon.

Developments in sovereign yields in the euro area since the previous monetary policy meeting highlighted three facts. First, the GDP-weighted sovereign yield curve in the euro area had shifted upwards since the March meeting and currently stood considerably above the levels recorded prior to the war across the entire maturity spectrum. Second, the euro area yield curve had become steeper. Third, despite the recent rise, both short and long-term euro area nominal bond yields remained low from a historical perspective.

A model-based breakdown of the recent increase in ten-year euro area risk-free rates pointed to two main factors driving the upward shift in sovereign yields since the previous meeting. First, the improvement in the global and euro area macroeconomic outlook and risk sentiment suggested that investors did not see the war's effect on growth as being sufficiently strong and long-lasting to derail the recovery. The second, and related, factor reflected the anticipated monetary policy response. Consistent with expectations of continued growth and the sharp repricing of the inflation outlook, markets expected a faster pace of monetary policy normalisation in the euro area to bring real yields out of negative territory.

Breaking down long-term yields into real rates and the inflation component showed that the rise in nominal long-term interest rates in the euro area since the Russian invasion of Ukraine mainly reflected a marked reappraisal of the inflation outlook by investors, while real interest rates had fallen slightly since March, despite the recent increase in nominal yields.

The rising inflationary pressures were also evident from the inflation-linked swap forward curve, which had shifted markedly higher from the already elevated levels prevailing at the time of the Governing Council's previous monetary policy meeting. This increase in inflation compensation had stemmed from higher inflation risk premia. Genuine inflation expectations had increased only moderately. The sharp rise in inflation risk premia signalled that investors demanded higher compensation for holding inflation risks in their portfolio. The five-year forward inflation-linked swap rate five years ahead, which was a market-based measure of longer-term inflation expectations, stood at around 2.4%. This suggested that even over the longer term investors attached a higher probability to inflation turning out to be higher than expected, rather than lower than expected.

Compared with March, the shift in market-based indicators of monetary policy expectations had been substantial. The overnight index swap (OIS) forward curve had become markedly steeper, with market participants pricing in just under a full 25 basis point rate hike in July this year and almost three 25 basis point rate hikes by the end of the year. Thereafter, markets expected the hiking cycle to continue, with six 25 basis point interest rate hikes expected in 2023. This suggested that markets saw the need for substantial policy action to secure medium-term price stability, reflecting the current, very negative, real short and long-term yields.

The median participant response to the Survey of Monetary Analysts (SMA) showed that the first interest rate hike was still expected to take place in the fourth quarter of 2022, but the share of SMA participants expecting an earlier lift-off had now increased to around 40%. The expected path after lift-off, however, was substantially shallower compared with the path suggested by market pricing. This possibly indicated that rising term premia, on the back of high remaining uncertainty about the pace of policy normalisation, had contributed to the steeper forward curve, with markets' genuine expectations probably being somewhat lower than indicated by the forward curve. Higher uncertainty about expected euro short-term money market rates, as priced in by the market, was in line with the premise of the ECB's "reaction function" becoming more data-dependent.

Markets were preparing for a substantially more pronounced US hiking cycle, compared with expectations in March, and now expected the Federal Open Market Committee (FOMC) to hike rates by about 250 basis points over the next 12 months, with the federal funds rate expected to level off at a level above 3%. Moreover, the FOMC had hinted at a rapid reduction in its USD 9 trillion balance sheet, beginning as soon as at its next policy meeting in May.

Limited movements in the exchange rate of the euro against the US dollar since the March monetary policy meeting suggested that the recent reappraisal by markets of the euro area monetary policy outlook was offsetting, at least in part, the downward pressure on the euro from the pronounced reappraisal of US monetary policy expectations. At the same time, the depreciation of the euro since the beginning of the year in response to the change in relative monetary policy expectations vis-à-vis the United States had been larger than was suggested by cross-country regularities.

Developments in euro area sovereign bond markets were consistent with limited risks of stagnation or recession. Sovereign spreads had been on a sustained downward trend since the Governing Council's previous monetary policy meeting.

Furthermore, the recent strong recovery in equity prices reflected, first and foremost, a reversal of the earlier increase in the equity risk premium, mirroring the improving risk sentiment. A more fundamental factor explaining the resilience of equity prices, and of risk assets more generally, was that the earnings outlook for euro area firms had remained relatively robust, despite the war. Earnings expectations over the next 12 months had, so far, not been lowered. Longer-term earnings expectations had decreased substantially, but had stabilised at very elevated levels. Analysts continued to expect annual earnings growth of about 20% over the next three to five years, compared with a long-run average of around 8%.

The cautious optimism displayed by market participants did not mean that investors were dismissing downside risks. As geopolitical risks remained elevated, markets continued to price in heightened tail risks. For instance, downside risks to equity markets remained elevated in the euro area. Another risk emanated from high margin calls in commodity futures markets, which had caused a large increase in the liquidity demand of non-financial corporations that were hedging their energy price exposures.

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. For global developments, the Spring 2022 World Economic Outlook (WEO) projections from the International Monetary Fund (IMF) had significantly downgraded the forecast of world GDP growth for 2022 and also for 2023. The downward revision was very large for Russia but also significant for countries close to the war zone and reliant on Russia for their imports of energy and metals.

Global supply chain bottlenecks had started to ease after the turn of the year. However, as a consequence of the war and the new lockdowns in China, that easing was stalling, or even reversing, and forward-looking indicators had started to point to a deterioration in global trade dynamics.

The oil price had declined notably from the peaks observed after the Russian invasion of Ukraine. Compared with the day of the March Governing Council meeting, the shorter-run futures path of oil prices was lower, but it was still higher compared with the cut-off date (28 February) for the March ECB staff projections.

There had been relatively minor movements in the euro effective exchange rate since the March Governing Council meeting. Taking a longer-term perspective, the euro exchange rate had largely returned to pre-pandemic levels both in effective terms and against the US dollar.

Turning to euro area activity, the Russian invasion of Ukraine had led to a spike in uncertainty, as indicated for example by the European Commission’s uncertainty measure. The recent evolution of confidence indicators suggested a deterioration in the short-term outlook, owing to the rise in energy prices, the increased uncertainty and the new wave of supply disruptions generated by the war and the lockdowns in China. However, the outlook for the third quarter was still relatively positive, as a boost from tourism could be expected in the summer. Similarly, the assessment for the fourth quarter remained positive. So far, the assessment was that the war would lead to a temporary slowdown in growth, but not a persistent downgrade.

Looking at the components of domestic demand, private consumption was likely to have contracted in the first quarter, with a negative carry-over from the drop in retail sales in December 2021 and the further rise in energy prices hitting incomes. Pandemic restrictions had been lifted, but households had shown a strong negative reaction to the outbreak of the war, with consumer expectations plunging in March. In particular, household expectations regarding their own future financial situation – which generally were a good predictor of consumer spending – had deteriorated sharply.

With regard to business investment, the uncertainty shock was expected to be more harmful to investment than consumption. While investment spending plans would certainly be affected by heightened uncertainty, these plans could also be affected by the rise in energy costs. Historically, the data showed a negative relationship between production costs and the profit rate, so it should not be expected that higher costs would be fully passed through to consumer prices.

While trade data capturing the outbreak of the war were not yet available, the deficit on the energy and food trade balance had continued to deteriorate since the beginning of the year, as import prices for energy and goods continued to increase. This deterioration was partly compensated for by an improvement in the non-energy and non-food trade balance. The Purchasing Managers' Index for manufacturing export orders had fallen into contractionary territory in March owing to the war in Ukraine and lockdowns in China.

Looking at labour market developments, the unemployment rate continued to decline and the labour market participation rate continued to improve. Across sectors, employment in market services, including tourism, had not yet returned to its pre-pandemic level, while the public sector had been a key driver of job creation, with public sector employment standing about 3% above the pre-pandemic level at the end of 2021. However, in March 2022 household expectations regarding unemployment had increased visibly, albeit much less than at the start of the coronavirus (COVID-19) pandemic.

One important factor cushioning the impact of the shock was fiscal policies. The bulk of the euro area measures addressed the hike in energy prices, but part of the new package of measures also increased spending on defence and refugees.

Turning to the latest inflation developments, headline inflation in the Harmonised Index of Consumer Prices (HICP) had hit a new high of 7.5% in March, up from 5.9% in February. By far the biggest contribution came from the energy component, with over 4 percentage points. The recent increase in energy inflation was very large and the reaction of the economy could be subject to non-linearities, as the response of the economy – in terms of both inflation and output dynamics – might not be proportional to its response to the usually much smaller fluctuations in energy prices.

Breaking down energy inflation, the fuel component, which historically accounted for the largest contribution, had been relatively stable. The recent big increases in energy inflation had instead been due to electricity and gas prices. Food inflation had also been on an upward trend since last summer and had reached 5.0% in March.

Goods inflation in March had stood about 2.5 percentage points above its longer-term mean. A significant contribution of about 1 percentage point of this increase was from the pass-through of higher energy costs and from supply bottlenecks. But there was also a significant part that could not simply be attributed to the broadening of the energy shock and the impact of ongoing bottlenecks. Indicators of pipeline pressures signalled that goods inflation, which had historically been very low, would remain high not just in 2022 but also well into 2023.

Services inflation had been going up, and a lot of this seemed to be in areas that were reopening. With the normalisation of travel and tourism, entertainment, restaurants and so on, services that had either cut prices or kept them low during the pandemic were now normalising prices or even increasing them by a larger margin.

A lot of the indicators of underlying inflation in the euro area – both exclusion-based and model-based – had stood well above 2% in February, and HICP inflation excluding energy and food had risen to 3% in March. However, it remained uncertain how persistent the rise in these indicators would be, given the role of temporary pandemic-related factors and the indirect effects of higher energy prices.

Regarding the wage outlook, growth in negotiated wages in the euro area had been gradually increasing but had remained moderate in recent months at less than 2%. Forward-looking information from wage agreements, which often spanned more than one year, supported the view that wage pressures would increase only gradually. Nominal wages were usually expected to be equal to the sum of productivity and consumer prices but could be well below that level in 2022, reflecting a decline in the labour share of income and the negative effects of high import prices on consumer prices.

Looking at inflation expectations, the April 2022 Survey of Professional Forecasters (SPF) showed that the distribution of individual responses had continued to shift to the right. The mode of the distribution was still at 2%, after averaging well below 2% in the 2019-21 SPF rounds. Overall, longer-term inflation expectations (for 2026) reported in the SPF averaged 2.1%, which amounted to an upward revision from 2.0% in the previous round. In both the SPF and the SMA, inflation was expected to be above 2% in 2022 and was seen as very likely to be above 2% in 2023. But for 2024 there was basically an even chance that inflation would be above or below target. This overall scenario reflected a widespread view of inflation dynamics held by experts at a variety of institutions.

Regarding market-based indicators of inflation compensation, these had increased further in the euro area and the increases were particularly large at shorter horizons. For longer horizons, once these indicators were adjusted for risk premia, expectations were by and large around 2%.

Turning to financial and monetary developments, financial conditions were broadly unchanged. However, since the March Governing Council meeting the €STR forward curve had shifted up markedly over short and medium-term tenors, with a steep increase seen even when adjusting for risk premia. Comparing the current forward curve with the situation at the time of the December 2021 Governing Council meeting revealed that there had been a remarkable tightening of market rates that were relevant for pricing bank loans and for sovereign bonds.

Bank funding costs were increasing, driven by the rise in bank bond yields. However, the upward pressure on overall bank funding costs was limited because banks were relying on other funding sources. Interest rates on customer deposits, which accounted for almost half of bank liabilities, still hovered at historic lows, and the outstanding central bank funding continued to be at very favourable rates. Bank lending rates remained low and had so far been overall broadly shielded from the rise in market rates.

According to the latest bank lending survey for the euro area, banks had reported a continued net increase in loan demand from firms in the first quarter of 2022. Banks also reported a net tightening of credit standards on loans to firms in the same quarter, mainly owing to increased risk perceptions and decreased risk tolerance. Moreover, banks expected a considerably stronger net tightening in the second quarter. Banks had reported a net increase in households' loan demand in the first quarter of 2022.

Monetary policy considerations and policy options

Summing up, Mr Lane stressed that the adverse economic impact of the Russian invasion of Ukraine combined several mechanisms. It was evident that the war and the associated uncertainty were weighing heavily on business and consumer confidence. In addition, just as the supply disruptions from the acute phase of the pandemic were easing, the war had created new bottlenecks, while a new set of pandemic measures in Asia was also contributing to supply chain problems. Some sectors faced growing difficulties in sourcing inputs, which was disrupting production. The further sharp rises in energy and commodity prices were increasing the production costs of firms and reducing the purchasing power of households. How the economy would develop was crucially dependent on the evolution of the conflict, on the impact of sanctions and on possible further measures. However, there were also offsetting factors, such as compensatory fiscal measures and the possibility for households to draw on savings accumulated during the pandemic. Moreover, the reopening of the sectors most affected by the pandemic and a strong labour market would continue to support incomes and spending. Furthermore, over time, the euro area would find alternative energy suppliers and adapt production technologies to become less dependent on fossil fuels.

Overall, the war in Ukraine had substantially increased the risks to the growth outlook, which were clearly skewed to the downside. While risks relating to the pandemic had declined, the war might have an even stronger effect on economic sentiment and could further worsen supply-side constraints. Persistently high energy costs, together with a loss of confidence, could drag down demand and restrain consumption and investment more than expected.

Inflation had increased to 7.5% in March, from an already revised 5.9% in February. Energy prices, which had been driven higher after the outbreak of the war and stood 45% above their level one year before, continued to be the main reason for the high rate of inflation. Market-based indicators suggested that energy prices would stay high in the near term but would moderate thereafter. Food prices had also increased sharply owing to elevated transportation and production costs, notably the higher price of fertilisers, which was also related to the war in Ukraine. Core inflation, as measured by the HICP excluding energy and food, had risen from 2.7% in February to 3.0% in March, with an increase in the sectoral inflation rate for both the non-energy industrial goods sector and the services sector.

Overall, the recent developments suggested that inflation rates would remain very high in the short term. The war had aggravated the uncertainty about future energy price developments and would influence the pace at which price pressures from global supply bottlenecks would subside. Measures of underlying inflation had increased to levels above 2% in recent months. It was uncertain how persistent the rise in these indicators would be, given the role of temporary pandemic-related factors and the indirect effects of higher energy prices. Long-lasting impairments to supply potential were also possible if energy prices persisted at elevated levels. While various measures of longer-term inflation expectations derived from financial markets and from expert surveys were largely around 2%, initial signs of above-target revisions in a number of indicators of inflation expectations warranted close monitoring.

Upside risks surrounding the inflation outlook had intensified, especially in the near term. If price pressures fed through into higher inflation expectations and higher than anticipated wage rises, or if supply-side conditions worsened more durably, inflation could turn out to be higher over the medium term. However, if demand were to weaken over the medium term amid a persistent erosion of real incomes by high energy prices and the high cost of other goods and services, this could also ease pressures on prices.

Financial markets had been highly volatile since Russia invaded Ukraine. The upward shift in the risk-free curve had so far not triggered a wider repricing of credit risk. Neither had there been severe strains in money markets or liquidity shortages in the euro area banking system. However, since the Governing Council's March meeting market interest rates and bank funding costs had continued to increase. Bank lending rates for firms and households had so far remained broadly insulated from the increases in market rates, thanks to ample liquidity support, low deposit rates and the overall health of bank balance sheets. Lending to households was holding up, especially for house purchases, while the flow of loans to firms had stabilised. The most recent ECB bank lending survey reported that credit standards on loans to firms and on housing loans had tightened in the first quarter of the year, as lenders became more concerned about the risks facing their customers in an uncertain environment. Participants in the survey expected credit standards to tighten further in the coming months, as banks weighed the adverse economic impact of the war and higher energy prices.

Mr Lane stressed that the Governing Council should be very attentive to the current uncertainties and closely monitor the incoming data in relation to their implications for the medium-term inflation outlook. By the June monetary policy meeting there would be more information about the course of the war and its wider ramifications. This would allow the Governing council to assess more extensively the net impact on the economy and inflation dynamics.

At the same time, Mr Lane highlighted that the Governing Council could conclude that the data available since the 9-10 March meeting supported the expectation that net asset purchases under the asset purchase programme (APP) should be concluded in the third quarter. Looking ahead, monetary policy would depend on incoming data and on the evolving assessment of the outlook. In the current conditions of high uncertainty, there was a need to maintain optionality, gradualism and flexibility in the conduct of monetary policy. In particular, Mr Lane stressed that the Governing Council should state its readiness to adjust all of the instruments within its mandate, incorporating flexibility if warranted, to ensure that inflation stabilised at 2% over the medium term.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members broadly agreed with the assessment of the current economic situation in the euro area and the risks to the outlook provided by Mr Lane in his introduction. Russia's aggression towards Ukraine was affecting the economy, both in Europe and beyond. The conflict and the associated uncertainty were weighing heavily on the confidence of businesses and consumers. Trade disruptions were leading to new shortages of materials and inputs. Surging energy and commodity prices were reducing demand and holding back production. At the same time, economic activity was still being supported by the reopening of the economy after the crisis phase of the pandemic. Looking ahead, how the economy performed was crucially dependent on the evolution of the conflict, on the impact of sanctions and on possible further measures. Inflation had increased significantly and would remain high over the coming months, mainly because of the sharp rise in energy costs. Moreover, inflation pressures had intensified across many sectors.

As regards the external environment, members took note of the assessment provided by Mr Lane that Russia's war in Ukraine and a surge in COVID-19 infections in Asia – with the strict lockdown measures taken by the Chinese government to contain the virus – were clouding the global outlook, amid signs that strains in supply chains had started to increase again. Concern was also expressed about shortages of inputs produced in Russia and Ukraine leading to further strains. The impact of the war in Ukraine would depend on economic sanctions against Russia, which might be extended to oil and gas. This was likely to dampen global growth and raise energy prices further.

Turning to euro area developments, the economy had grown by 0.3% in the final quarter of 2021. It was estimated that growth had remained weak during the first quarter of 2022, owing largely to pandemic-related restrictions. Several factors pointed to slow growth also in the period ahead. The war was already weighing on the confidence of businesses and consumers, including through the uncertainty it brought. With energy and commodity prices rising sharply and the war creating new bottlenecks, households were facing a higher cost of living and firms were confronted with higher production costs. Some sectors faced growing difficulties in sourcing their inputs, which was disrupting production. However, there were also offsetting factors underpinning the ongoing recovery, such as compensatory fiscal measures and the possibility for households to draw on savings they had accumulated during the pandemic. Moreover, the reopening of those sectors most affected by the pandemic and a strong labour market with more people in jobs would continue to support incomes and spending. Fiscal and monetary policy support remained critical, especially in the present difficult geopolitical situation. In addition, the successful implementation of the investment and reform plans under the Next Generation EU programme would accelerate the energy and green transitions.

Members agreed with Mr Lane that heightened uncertainty was affecting the euro area outlook, along with the negative supply shock driven by the surge in energy and other commodity prices. Uncertainty had reached levels that made any assessment of the future course of the economy subject to very wide confidence bands. The energy shock was eroding real incomes severely. The terms-of-trade "tax" from higher energy prices had now risen to 3.5% of euro area GDP. This was expected to squeeze domestic demand, with fiscal measures mitigating the shock but unlikely to fully offset it. Forward-looking business confidence indicators had weakened substantially, in part owing to an intensification of supply chain disruptions. It was therefore argued that a technical recession in the coming quarters could not be ruled out.

At the same time, it was underlined that, overall, the incoming data suggested that the war would slow the recovery but not derail it, unless a less likely “tail” scenario materialised. This was also consistent with financial market developments since the previous Governing Council meeting. In the ECB’s Corporate Telephone Survey (CTS), for example, many firms reported that the impact of the war was being felt primarily in terms of prices and costs, but not in terms of orders and production. While there were significant concerns about future activity, reflecting the high uncertainty, surveys suggested that the immediate impact of the war was more moderate. Recent private sector forecasts continued to predict real GDP growth of around 3% in 2022, with predictions for growth in 2023 largely unchanged from before the war. At this pace of growth, the economy would continue to absorb remaining slack. Finally, it was pointed out that high energy prices were already resulting in a drop in energy consumption, suggesting that the price elasticity of energy might be higher than assumed.

The reaction of household spending and saving propensity was considered a key element in the macroeconomic transmission of the Russia-Ukraine war shock. Indicators related to consumer behaviour were deteriorating and consumer confidence had fallen sharply in March. The expectation of weaker demand was spilling over into production and investment plans, with the result that business expectations had also declined sharply in March. The confidence shock to investment could be very substantial and fuelled by an accelerator mechanism, although uncertainty about the ultimate impact on growth remained exceptionally high at this stage. This effect could be aggravated by the impact of the high degree of uncertainty on household saving rates. Possibly renewed higher saving by households and reduced business investment could, in turn, weaken demand.

This came at a time when household spending capacity was directly affected by the drop in real incomes owing to higher inflation. In this context, it was remarked that the perceived drop in purchasing power, in addition to the actual drop owing to higher inflation, was also important in and of itself as a determinant of consumption decisions. This applied particularly to households in the lowest quintile of the income distribution. At the same time, it was recalled that the hit to real incomes owing to the rise in energy prices was being cushioned to some degree by fiscal measures at the national level, as well as by accumulated savings that still amounted to more than 12% of annual disposable income. Regarding the fiscal policy response to the Russia-Ukraine war, it was highlighted that government measures could soften the domestic impact of the war on the most affected segments of the population.

Positive news was seen to come from a fast-improving labour market, with unemployment falling to a historical low of 6.8% in February. The labour market continued to be very strong – even stronger than had been expected earlier – and the unemployment rate and the ratio of unemployed workers to job vacancies had fallen to record lows. Surveys suggested that firms’ hiring plans remained unaffected by the war. It was pointed out, however, that while public sector employment stood clearly above its pre-pandemic level, employment in the private sector remained somewhat below, in particular when looking at hours worked. Together with workers' concerns about job security, this was likely contributing to moderate wage growth.

Against this background, members assessed the risks to the economic outlook as tilted to the downside. While risks relating to the pandemic had declined, the war in Ukraine might have a stronger effect on economic sentiment and could worsen supply-side constraints again. Persistently high energy costs, together with a loss of confidence, could drag down demand more than expected and constrain consumption and investment.

With regard to price developments, members concurred with the assessment presented by Mr Lane in his introduction. Inflation had increased to a new record high of 7.5% in March, from 5.9% in February. The rise in energy prices after the start of the war had reached an annual rate of 45%. Energy prices continued to be the main contributor to the high rate of inflation, with market-based measures suggesting that energy prices would remain high in the near term but then fall slightly. Nevertheless, price rises had become more widespread. Food prices had increased sharply. This was due to rising transportation and production costs, notably the higher price of fertilisers, which were in part related to the war in Ukraine. Supply bottlenecks, energy costs and the normalisation of demand as the economy reopened after the crisis phase of the pandemic continued to put upward pressure on prices. Measures of underlying inflation had risen to levels well above 2% in recent months. It was uncertain how persistent the rise in these indicators would be, given the role of temporary pandemic-related factors and the indirect effects of higher energy prices, but expected faster growth in wages should support underlying inflation as the economy returned to full capacity over time. While various measures of longer-term inflation expectations derived from financial markets and from expert surveys largely stood at around 2%, initial signs of above-target revisions to those measures warranted close monitoring.

Members noted that higher energy prices driven by the war in Ukraine had been the main, but not the only, reason why inflation in March had once again been higher than projected. The war was also putting a lot of upward pressure on global food prices, which was likely to push euro area consumer food prices up further in the future. In addition, high energy prices were now creeping into all sectors of the economy – affecting both manufacturing and services – and making inflation an increasingly widespread and persistent phenomenon. As a result, measures of underlying inflation had risen to levels significantly above 2% and it was now considered unlikely that inflation would return to the ECB's target in the near term. It was also judged to be relatively unlikely that the drag on private demand from the war would be severe enough to reduce inflation substantially over the medium term.

Even if the economic consequences of the war were greater than currently expected, there were a number of factors that would make inflation more persistent than projected at present. One was related to pipeline pressures. Euro area producer prices had increased by more than 30% in January – an all-time high. The war in Ukraine and the pandemic measures in China suggested that pipeline pressures and bottlenecks were likely to intensify further, affecting consumer prices over a relatively long period of time. Moreover, given the size of the energy shock, the pass-through to consumer prices was likely to be greater than in the past and, in an environment of higher inflation overall, consumers could be more willing to accept a stronger pass-through from costs to prices. A second factor related to wages. So far, only a small number of wage contracts had been renegotiated since inflation started to surge. But there could be little doubt that workers would eventually ask for compensation for the loss in real income. And a third factor related to structural upward pressures on inflation. The war had increased the prospects of a further acceleration in the green transition. This could exacerbate supply and demand imbalances in many commodity markets where the prices of many metals were already at record highs. In addition, European governments were trying to actively limit their dependency on global value chains in areas of strategic importance. This could be expected to accelerate “reshoring” efforts, loosening the brake of globalisation on wages and inflation.

At the same time, it was argued that given the further rise in energy costs owing to the war in Ukraine it was unsurprising that the March inflation figures had been higher than earlier projections. However, stronger energy price pressures in the short term were not inconsistent with lower inflation in the medium term if the lagged effects of weaker demand outweighed the supply effect of the shock. The issue was rather how fast inflation, which was still rising, would decline towards 2%. In addition, it was pointed out that the current increase in inflation was due to global factors: oil and commodity prices, supply bottlenecks and the war in Ukraine. Unlike in the United States, domestic demand in the euro area was still below its potential. This meant that drivers of domestic price pressures, such as wages, employment and medium-term inflation expectations, were not inconsistent overall with the ECB’s price stability objective. With respect to pipeline price pressures, it was argued that these were mostly affecting annual inflation rates one year ahead and were to some extent distorted by the impact of the pandemic and supply chain disruptions, which should in principle be transitory. What was not clear was the extent to which pipeline pressures could fuel a phase of higher inflation lasting into the medium term. It was also pointed out that energy prices appeared to be already below their peaks of this year and inflation in the coming months could already reflect substantial negative base effects.

Members pointed out that it was hard to imagine sustained higher inflation without an increase in wage pressures. While developments in negotiated wages at the euro area level were expected to remain moderate this year, with wage agreements somewhere between 1.5% and 2.5%, evidence from different countries pointed to some heterogeneity. Furthermore, moderate wage demands were to be expected in the current uncertain environment, with workers increasingly concerned about job security.

However, the usefulness of hard data on wages for gauging future inflation pressures was called into question, given that wages reacted with a substantial lag to price increases. It was therefore suggested that it was just a matter of time before wage growth caught up, in view of the large and persistent overshoot of the inflation target. The CTS also suggested that pressures for larger wage increases were building up. Moreover, the picture for the wage outlook could change very quickly, as unemployment was at record low levels, strengthening the bargaining position of employees. While only a few euro area countries had formal wage indexation clauses, as one factor explaining higher wage growth than the euro area average, the situation could change over time and there were other mechanisms for restoring lost purchasing power.

Overall, there was broad consensus that stubbornly high, and higher than expected, inflation increased the risk of second-round effects arising through wage costs. However, views differed on the extent to which such risks were likely to materialise. On the one hand, it was argued that, given the usual time lags, second-round effects would not necessarily result in higher wage growth in the current year. They were more likely to push wage growth up later in 2023. Waiting for wage growth to accelerate before forming a view on future inflation developments would therefore be misguided, as the upside risk to inflation would then already be materialising and the resulting wage-price spiral would be hard to stop. On the other hand, it was argued that second-round effects on wages would require a structural change in the labour market, and specifically in the structural parameters of the wage Phillips curve, which represented the relationship between wage growth and unemployment. The currently estimated parameters suggested only a very low pass-through from price changes to wages. As there was so far little evidence of structural changes taking place in the labour market, second-round effects through wages were unlikely at the current juncture.

As regards longer-term inflation expectations, members took note of the assessments provided by Ms Schnabel and Mr Lane of the latest developments in market-based measures of inflation compensation and survey-based indicators. It was argued that there were increasing signs that the current high inflation was becoming entrenched in expectations, with a number of indicators of longer-term inflation expectations at least starting to become unanchored from the ECB's inflation target. In the financial markets, medium and long-term inflation-linked swap rates were now above 2%, even though this was partly due to the risk premia reflected in the rates. Moreover, rising premia implied that investors were demanding insurance against the risk of inflation being above 2%. Private sector forecasts, such as those covered by the SPF, were also moving above 2%. Preliminary evidence from the Survey on the Access to Finance of Enterprises (SAFE) suggested that inflation expectations had become an important factor in determining companies' future selling prices. Early results from the Consumer Expectations Survey (CES) showed that households' inflation expectations three years ahead had increased significantly. It was consequently argued that there were some indications of longer-term inflation expectations starting to move away from the target.

However, it was also underlined that, in general, financial market indicators of longer-term inflation expectations were around 2%, which was broadly consistent with the ECB's 2% medium-term target, given that risk premia had to be subtracted from the market swap rates. This did not suggest signs of inflation expectations becoming unanchored. Moreover, against the backdrop of the current large inflation shock, it was regarded as normal that the inflation expectations of households and firms should temporarily rise somewhat. The fact that inflation expectations had increased so little in response to very high inflation rates, despite the fact that households and firms typically adapt their expectations to recent developments, could actually be seen as a sign of the credibility of the ECB's policy. This muted reaction of inflation expectations was very different from what had happened following the oil shock in the 1970s.

Overall, there was wide agreement that while various measures of longer-term inflation expectations derived from financial markets and from expert surveys largely stood at around 2%, initial signs of above-target revisions to those measures warranted close monitoring.

Against this background, members assessed the upside risks surrounding the inflation outlook to have intensified, especially in the near term. The risks to the medium-term inflation outlook included above-target moves in inflation expectations, higher than anticipated wage rises and a durable worsening of supply-side conditions. However, if demand were to weaken over the medium term, it would lower pressure on prices.

Turning to the monetary and financial analysis, members widely concurred with the assessments provided by Ms Schnabel and Mr Lane in their introductions. Nominal long-term interest rates had been gradually rising, mainly owing to higher inflation compensation, while real long-term interest rates had remained below the levels observed before Russia's invasion of Ukraine. Short-term nominal interest rates had been rising on expectations of a normalisation of the Governing Council's monetary policy stance, but also reflected to some extent a tighter monetary policy in the United States. The question was therefore raised as to whether the anticipation of further rate increases would lead to a shift in the timing of consumption and investment by households and firms. It was noted that, in view of the Governing Council's recent decisions, the dynamics observed in financial markets so far had to be considered benign. The pace of policy normalisation as expected by market participants appeared gradual from a historical perspective, while interest rate spreads between sovereign and risk-free rates had remained contained. This was in part seen as testimony to the efforts to strengthen the euro area banking and financial system, which was much more robust than it had been a decade ago. Overall, financing conditions were assessed as favourable, with real rates remaining in negative territory and at historical lows.

It was remarked that the euro exchange rate had stabilised, although its future dynamics would depend on the relative monetary policy stances in the euro area and the United States. The argument was made that smaller interest rate differentials would strengthen the euro, directly lowering the import cost of commodities priced in US dollars. This would counter inflationary pressures, while it could also exert a negative effect on economic activity.

According to the most recent euro area bank lending survey, a further tightening of credit standards on loans to firms and on housing loans had to be expected in the coming months. This was likely to dampen lending growth and could give rise to tensions in credit supply. It was highlighted that banks' funding costs were increasing. If banks also tightened their lending standards as the survey suggested, this could translate into a higher cost of bank borrowing for the private sector. Indeed, mortgage rates offered by non-bank lenders had risen noticeably in a few jurisdictions, leading to a tightening of financing conditions even before any change in the ECB policy rates. However, it was also pointed out that bank lending rates for firms and households had so far remained broadly insulated from the increases in market rates, and credit conditions did not currently signal lending constraints for the non-financial sector. Furthermore, it was cautioned that the more restrictive stance reported in the bank lending survey might in part represent a normalisation after a period of very favourable conditions.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members widely expressed concern over the high inflation numbers, which had become a major issue for households and businesses. Both headline and underlying inflation were at historically high levels, with price pressures extending well beyond energy. If owner-occupied housing costs had been included in the HICP, underlying inflation would have been even higher, by 0.7 percentage points, in the fourth quarter of 2021. It was noted that various indicators of longer-term inflation expectations had been creeping up, with an increased risk of inflation expectations becoming unanchored from the target. At the same time, it was also argued that developments in market-based indicators of longer-term inflation expectations could still generally be interpreted as positive, suggesting it was more likely than a few months earlier that the Governing Council's 2% inflation target would be met on a sustained basis.

Against this background some members viewed it as important to act without undue delay in order to demonstrate the Governing Council's determination to achieve price stability in the medium term. Such action was deemed necessary to prevent the temporary bout of higher inflation from becoming entrenched and to prevent inflation expectations from rising further from the Governing Council's target, which would make it significantly more costly to bring inflation back to the target. These members judged that the highly accommodative monetary policy stance, which had been appropriate when inflation expectations risked becoming unanchored to the downside, was no longer consistent with the inflation outlook, which was characterised by high inflation levels and increasing inflation expectations. At present monetary policy was still contributing to stimulating the economy as real interest rates remained in deep negative territory.

Past projection errors, for both headline and underlying inflation, were contributing to these concerns. Many of the upside risks to the inflation outlook that the Governing Council had already discussed last summer had materialised even before the war started. These included more persistent supply and demand imbalances, and the fact that the futures curve on which the energy price assumptions were based might not be a good predictor of future energy price pressures.

Other members argued, however, that adjusting the monetary policy stance too aggressively could prove counterproductive, as it would lower growth while inflation remained elevated because monetary policy was unable to address the immediate causes of high inflation. The sequence of measures decided by the Governing Council at previous meetings to normalise the monetary policy stance were recalled. These measures included the decrease in net asset purchases; the phasing-out of the pandemic emergency purchase programme (PEPP), of the pandemic emergency longer-term refinancing operations (PELTROs) and of the special interest rate on the targeted longer-term refinancing operations (TLTROs); and the communication of the expected end of the APP in the third quarter of 2022. It was highlighted that the ongoing normalisation was visible in market interest rates and could be expected to weigh on the economy in the coming quarters. However, the view was also expressed that real rates remained exceptionally low and the dampening of aggregate demand as a result of higher nominal rates would be insufficient to bring inflation back to 2% in the medium term without a further adjustment of the monetary policy stance.

Monetary policy decisions and communication

All in all, members widely shared the view that the gradual normalisation of the monetary policy stance, which the Governing Council had started at its December meeting, should be continued and had to be adjusted to the medium-term inflation outlook, which had changed since that time. Given the Governing Council's current assessment of the medium-term inflation outlook and the highly accommodative monetary policy stance, there was broad agreement that the Governing Council should express its judgement that the data received since the last meeting reinforced its expectation that net asset purchases under the APP should be concluded in the third quarter. The view that net asset purchases should end sooner rather than later in the third quarter was widely expressed.

Looking ahead, members voiced some nuances related to the appropriate pace of the gradual normalisation.

On the one hand, some members viewed the higher than expected inflation figure in March and inflation expectations moving above the 2% target as requiring an adjustment of the monetary policy stance towards a neutral position sooner rather than later and a modification of the Governing Council's inflation narrative in line with the stated data-dependency of its monetary policy. This implied that net asset purchases should be ended as soon as possible, opening the possibility for a first interest rate hike shortly after. It was noted that if the upside risks to the inflation outlook were confirmed in the June Eurosystem staff macroeconomic projections, the Governing Council would face the question of whether continuing net purchases beyond June could still be seen as proportionate.

A risk was also seen that, if the Governing Council did not signal a faster policy normalisation process, inflation expectations would continue to rise further from a level which was already above the Governing Council's target. It was stressed that the assessment of the outlook had evolved substantially since March and that, if these changes to the outlook were confirmed in June, concrete steps to accelerate the pace of policy normalisation would be required to ensure that inflation stabilised at 2% over the medium term. Such a path was seen as safeguarding optionality while remaining within the boundaries of the Governing Council's policy guidance and thereby avoiding an increase in perceived policy uncertainty. It would also help to demonstrate the Governing Council's readiness to adjust its tools as appropriate, thereby strengthening its credibility to deliver on its mandate.

In this context, it was also recalled that acting too late could lead to a materialisation of second-round effects and might have high economic, financial stability and credibility costs if the Governing Council were forced to tighten more aggressively at a later stage in order to re-anchor inflation expectations. It was argued that, while it typically took some time for higher expected inflation to be reflected in wage-setting, the opposite process was also lengthy; if higher inflation expectations became entrenched in wage agreements, lowering inflation would become harder. In this context, experience from the 1970s was referred to as having demonstrated how essential a commitment to price stability was for the ability of monetary policy to contain inflationary effects of adverse supply shocks.

Other members, however, maintained that the gradual normalisation process embodied in financial market expectations was consistent with longer-term inflation expectations remaining anchored at 2% and did not require a reappraisal of the monetary policy path. This would not support accelerating the timing of any restrictive measures, including in relation to the end of net asset purchases. In view of the stability of the longer-term inflation outlook, embodied both in market-based indicators and the March baseline ECB staff projections, a shift in the monetary policy guidance from a gradual normalisation to a more aggressive and accelerated tightening did not seem justified. Considering the high uncertainty surrounding the medium-term outlook for price stability, it seemed advisable to proceed with further actions very carefully. It was also noted that being too proactive in the normalisation of the stance could prove costly if it resulted in financial market turbulence or had to be reversed later.

A gradual normalisation was also deemed consistent with the estimated low level of the natural interest rate in the euro area, which implied that even relatively small steps might be sufficient to turn the current accommodative monetary policy stance into a restrictive stance. Model-based estimates suggested that the natural real interest rate was still negative, although it had to be acknowledged that uncertainty surrounding the estimated values was high. Moreover, there was a gap between estimates for the US and euro area natural real interest rates, which might be explained partly by differences in productivity, labour supply and demographics as well as the level of excess liquidity. Notwithstanding the low level of the natural rate, it was recalled that the expected path of the nominal key ECB interest rates would approach a neutral level only at a very late stage of the policy normalisation process.

Overall, the view prevailed that, in the light of the heightened uncertainty resulting from the still ongoing effects of the pandemic and the war in Ukraine, optionality, gradualism, and flexibility remained important features of the Governing Council's monetary policy conduct. In particular, it was seen as advisable to maintain optionality and defer a decision regarding the precise timing of the end of net asset purchases until the Governing Council's June meeting, which would allow the Governing Council to benefit from additional data and the new Eurosystem staff projections. As uncertainty was exceptionally high, different scenarios for future developments in the inflation outlook could be envisaged. It was also highlighted that Mr Lane's proposal left all options open for decisions to be taken at the June meeting. In particular, the proposal was seen as consistent with the possibility of deciding to end net asset purchases already at the end of the second quarter or early in the third quarter.

All in all, members agreed that the monetary policy proposal by Mr Lane in his introduction was in line with keeping all optionality, in the light of the current high uncertainty, and would allow the Governing Council to reassess the inflation outlook on the basis of the incoming information at its June meeting. This approach implied, on the one hand, that the Governing Council remained on its course of a gradual normalisation of monetary policy, consistent with its forward guidance that interest rates would be raised some time after the end of net asset purchases. On the other hand, considering that "some time" had been defined as a period between one week and several months at the March press conference, the approach did not prevent a timely rate rise if conditions so warranted.

As regards the forward guidance on interest rates, the view was expressed that the criteria for interest rate hikes were already clearly met. In this context, it was stressed that the Governing Council should pay the same attention to longer-term inflation expectations moving above target as it had when inflation expectations had fallen below target in the past, in line with the Governing Council's commitment to "symmetry". Otherwise there was a risk of "falling behind the curve".

Overall, however, it was judged that the forward guidance conditions for an upward adjustment of the key ECB interest rates would become crucial for the policy discussion at the Governing Council's June meeting. This pertained both to the two criteria applicable to the projected path of inflation and to the third condition, i.e. that the realised progress in underlying inflation be sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term.

Although spreads between sovereign bond yields and risk-free rates had remained broadly stable since the last Governing Council meeting, it was deemed important to address a possible resurgence of fragmentation in euro area financial conditions, if necessary, in order to ensure a continuous transmission of monetary policy throughout the euro area. Reference was made to the "separation principle", i.e. the idea that the appropriate monetary policy stance could be set independently of the deployment of instruments designed to avoid a sudden disruption of financial markets that could be triggered by a tightening of the stance. The argument was made that flexibility should be a permanent feature of the Governing Council's toolbox, and all of the ECB's instruments could be adjusted within the mandate, incorporating flexibility if warranted, to ensure that inflation stabilised at the Governing Council's 2% target over the medium term. In addition, it was recalled that the reinvestment of assets purchased under the PEPP could be used to address possible episodes of financial market tensions related to the pandemic, if needed.

Regarding communication, members broadly agreed that the policy guidance that had been provided in March should be confirmed and the consistency of future action with that guidance should be emphasised, while asserting that the Governing Council would continue to act according to the established principles of flexibility, optionality and gradualism.

Although communication had to acknowledge the increase in inflation and its detrimental effects on households' cost of living, as well as real wealth and disposable income, the view was expressed that the Governing Council needed to be careful to not create the impression that monetary policy was able to address high energy inflation, which was driving a significant part of current inflation figures. Instead, the ECB's communication had to underline the need for monetary policy to address the persistence of inflation that could result from second-round effects, and avoid creating the perception of inaction in the presence of high inflation figures. Finally, the Governing Council had to emphasise that it was willing to take whatever action was needed to fulfil the ECB's mandate to pursue price stability and to bring inflation back to 2% over the medium term.

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 ECB's 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 to the press conference of 14 April 2022 (English)](#)

Press release

[Monetary policy decisions](#)

Meeting of the ECB's Governing Council, 13-14 April 2022

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- 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 Wunsch

* Members not holding a voting right in April 2022 under Article 10.2 of the ESCB Statute.

Other attendees

- 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

Accompanying persons

- Mr Bitans
- Ms Buch
- Mr Cassidy
- Mr Demarco
- Ms Donnery
- Mr Gavilán
- Mr Gilbert
- Mr Goulard
- Mr Haber

- Mr Kaasik
- Mr Koukoularides
- Mr Kuodis
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rosalino
- Mr Sleijpen
- Mr Tavlas
- Mr Välimäki
- Mr Vanackere

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 Thursday, 7 July 2022.

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