Meeting of 7-8 September 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, 7-8 September 2022

6 October 2022

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

Financial market developments

Ms Schnabel started by noting that the narrative in financial markets had shifted since the Governing Council's previous monetary policy meeting in July. Initially, fears of a recession had dominated global asset prices and financial conditions had eased on the expectation that the pace of interest rate increases by central banks around the world would slow down, as a recession was perceived to do part of the job of bringing inflation back to the target level. However, more recently the focus of investors had gradually shifted back towards a tighter monetary policy stance as inflation outcomes had continued to be higher than expected.

In this environment, there had been four key observations. First, volatility in interest rate markets remained at historically high levels, reflecting very high uncertainty regarding inflation, as well as heightened data dependence of monetary policy. Second, monetary policy normalisation in the euro area was now expected to proceed at a significantly faster pace than had been expected at the time of the Governing Council's previous monetary policy meeting. Third, the summer rally in risk assets had been halted and partly reversed by investors' reappraisal of the future path of monetary policy. Finally, the sensitivity of euro area sovereign bond yield spreads to policy rate expectations remained notably weaker than before the Governing Council's ad hoc meeting on 15 June 2022.

Volatility in global interest rate markets and currency markets remained elevated. The heightened volatility in interest rate markets had primarily been driven by the uncertainty around the future course of inflation and the shift of monetary policy to a meeting-by-meeting approach, which had increased data dependency.

Regarding the change in policy rate expectations, markets had reassessed both the extent and the pace of policy normalisation. After reaching a trough in late July, the "terminal rate" (the level at which market participants expected the policy interest rate to peak) had rebounded markedly and currently stood close to the peak seen in mid-June. The expected speed of progress towards this terminal rate had also increased, as investors expected a less gradual tightening cycle.

The steeper expected policy path partly reflected the fact that investors attached an increasing probability to a scenario of inflation being higher for longer. Investors now expected inflation to peak in December, instead of September, as had been expected at the time of the July meeting. Options markets also pointed to rising upside risks to inflation, with investors currently pricing in a probability of around 15% that inflation would, on average, be above 4% over the next five years. Moreover, some measures of longer-term inflation compensation had started to creep higher again.

In the euro area, with the latest increase in front-end inflation swap rates, real short-term rates were expected to remain highly accommodative for some time to come. This contrasted markedly with developments in the United States, where, according to market-based estimates, comparable rates were expected to be in restrictive territory in 2023.

Ms Schnabel then explained how the reappraisal of monetary policy expectations had been transmitted to broader financial markets. Equity prices had increased notably during the summer, in spite of the weaker growth outlook, but had started to decline in the second half of August owing to increased concern about inflation – and the associated increase in discount rates – and weaker corporate earnings growth expectations. Yet, the decline in risk asset prices had been partly offset by an improvement in investor sentiment, as investors now required less compensation for holding risky assets instead of risk-free bonds. Overall, US stock markets were slightly down, while euro area markets were notably below the levels prevailing at the time of the Governing Council's July meeting. A key factor in this divergence had been the sharp rise in European energy prices, which weighed on households' real disposable income and firms' earnings expectations.

High energy prices in Europe and rising downside risks to growth in the euro area relative to the United States were also weighing on the euro exchange rate, as was the divergence of the expected path of the policy rate differential between the two economies.

In euro area fixed income markets, in tandem with the repricing of other risk assets, corporate bond spreads had temporarily narrowed during the early summer, in line with a recovery in investors' risk appetite, before reversing some of the narrowing in August.

Euro area sovereign spreads had gradually widened, reflecting the shift in policy rate expectations. Yet, the link between spreads and interest rate expectations seemed to have become weaker since the Governing Council's ad hoc meeting on 15 June 2022.

In money markets, the pass-through of the 50 basis point rate hike in July had been smooth, with some exceptions in the repo and Treasury bill markets. Specifically, there had been only a partial pass-through to German non-general collateral rates following the July hike, mainly reflecting the scarcity of German Bund collateral.

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

Mr Lane then went through the latest economic, monetary and financial developments in the global economy and the euro area. After the unusually high economic growth rates recorded at the start of the year as sectors reopened, global activity had slowed to the average growth rates observed before the pandemic. The deceleration in trade, coupled with a fall in new export orders, pointed to a continued loss of momentum. Despite a reduction in the Purchasing Managers' Index (PMI) for suppliers' delivery times, resulting from weakening demand and the partial resolution of supply bottlenecks, the overall level of supply bottlenecks remained elevated. The euro had been depreciating since the start of 2021, driven in part by monetary policy expectations and the worsening terms of trade.

Turning to euro area activity, there had been a significant moderation in the manufacturing sector since the start of 2022, with the PMI for manufacturing output falling below the threshold of 50 – indicating a contraction – in the second quarter. The level of the PMI for services activity had been higher but was also weakening – even in the accommodation and food sectors, which had benefited most from the reopening of the economy. After the euro area economy had grown by 0.8% in the second quarter of 2022, mechanical short-term forecasting tools pointed to a substantial slowdown in activity in the third and fourth quarters.

Focusing on demand components, private consumption had recovered significantly in the second quarter thanks to a strong contribution from the consumption of services, while the consumption of durable goods had continued to be weak over the period. The European Commission survey pointed to a significant weakening of demand for contact-intensive services in the future, together with a weakening of demand for goods from already low levels. The European Commission's uncertainty indicator pointed to a big increase in household uncertainty and in the perceived need for precautionary savings.

Moving on to investment, after a first quarter that had still been affected by supply bottlenecks and lockdowns, non-construction investment had recorded a strong growth rate in the second quarter of 2022. By contrast, the contribution of construction investment had been limited, with housing investment declining. Survey indicators suggested a moderation in non-construction investment in the second half of the year.

The euro area goods trade balance had stabilised at around 3% of GDP in June, with the energy balance resulting in a deficit of around 5% of GDP in the second quarter. The effect on income of the terms-of-trade loss amounted to about 5 percentage points, which constituted the income transfer to energy-exporting countries outside the euro area and implied 5 percentage points less available income for domestic spending.

The labour market had remained robust in the second quarter, but the PMI for employment signalled a moderation in the third quarter across all sectors. An analysis of the relationship between unemployment and the job vacancy rate – the Beveridge curve – helped to better understand the dynamics in the labour market. In the euro area there was currently a historically low unemployment rate and a historically high vacancy rate. By comparison, in the United States the ratio of vacancies to unemployment was a lot higher.

Turning to fiscal policies, euro area governments had provided even more support in 2022, in response to the war in Ukraine, notwithstanding the scaling-back of pandemic-related measures. According to Eurosystem models, fiscal support had raised euro area growth by around 0.4 percentage points and lowered inflation in the Harmonised Index of Consumer Prices (HICP) by around 0.6 percentage points this year. Since the support measures were designed to be temporary, their unwinding was estimated to push inflation higher in both 2023 and 2024. Despite the higher fiscal support, the euro area deficit continued to be estimated to fall to 3.8% of GDP in 2022.

Moving on to the latest inflation developments, HICP inflation had increased to 9.1% in August. Energy continued to contribute about half of total headline inflation, but all other components also played significant roles.

The September 2022 ECB staff macroeconomic projections featured a significant upward revision to inflation in the period to the third quarter of 2023. This was mostly due to higher energy and food commodity prices, but core inflation also accounted for an upward revision of about 1 percentage point. This revision, in turn, was related to the assumption of a speedier pass-through of energy and food inflation to core inflation. From the last quarter of 2023 onwards, the upward revisions were smaller.

The overall picture of broadening inflationary pressures remained in place. Many indicators of underlying inflation had shifted further upwards. However, in terms of momentum, as reflected in monthly changes, some indicators had started to flatten or had even turned slightly negative. This was likely due to the fact that these indicators were more sensitive to changes in oil prices, which had fallen.

Looking at pipeline pressures for goods price inflation, some measures remained robust. However, import prices for intermediate goods, i.e. goods in the early stages of the production chain, had moderated to some extent.

Services price inflation had increased from a pre-pandemic rate of 1.5% in 2019 to above 3% in July 2022. A decomposition into supply and demand factors showed that demand factors were making an increasing contribution to services price inflation in 2022. So, it was not only supply shocks that were important, but the recovery of demand also played a role. That said, it was important to distinguish between a recovery in demand and a situation of excess demand.

This distinction also mattered for the comparison of inflation in the euro area and in the United States. In the United States, the pick-up in core inflation was closely matched by a pick-up in wage growth. This was not the case in the euro area, where there was a clear disconnect between the evolution of core inflation and that of negotiated wages. In the euro area, inflation in items in the HICP basket with a relatively high share of wages in direct input costs had broadly followed the dynamics of negotiated wages and had thus remained quite contained overall. The large movements in euro area core inflation were instead due to other components, such as manufacturing goods and other items with a relatively low share of wages in direct input costs. It followed that the factors behind the increase in core inflation in the two economies were different, with wages playing a central role in the United States but not in the euro area.

Turning to the latest wage developments, in the second quarter euro area negotiated wages had grown by 2.4%. The experimental ECB wage tracker pointed to a gradual acceleration in wage growth over the coming quarters. Recently concluded wage agreements included increases of around 3%, on average, in the euro area for both 2022 and 2023. However, in the agreements concluded in the third quarter, wage increases for 2023 were slightly lower than in the agreements concluded in the second quarter. So far there had not been an accelerating trend in the data.

With regard to inflation expectations, the Survey of Monetary Analysts (SMA) showed that analysts had been continuously re-estimating the inflation rate for this year and next year. However, for 2023, the projected inflation rate was 4%, which was significantly below the 5.5% inflation rate included in the September staff projections. The SMA also pointed to a stable 2% inflation rate for 2024. Three-year ahead inflation expectations, as measured by responses to the ECB's Consumer Expectations Survey, had jumped in March this year and since then had continued to fluctuate around the March level.

Market-based measures of inflation compensation had increased strongly for the near term. This increase largely reflected expectations of higher near-term inflation, but the energy shock and the uncertainty related to the supply of Russian gas had also caused inflation risk premia to increase. Looking further ahead, however, inflation compensation measures embedded a very steep decline, to around 2%, by mid-2024.

Mr Lane then recalled the key assumptions featured in the September staff projections. Compared with the June projections, oil prices had been revised down moderately, while gas and electricity prices had been revised up sharply. Short-term interest rates had also been revised up significantly for 2023 and 2024, with three-month interest rates now seen as being close to 2% for 2023 and remaining around that level for 2024. So a significant tightening of financing conditions was embedded in the projections, which reflected the ECB's monetary policy tightening.

Moving on to the main features of the September staff projections, it was useful to look at some key figures expressed as changes in the fourth quarter relative to the previous year's fourth quarter. This better captured the developments in the interim, cleaned of carry-over effects that were influencing annual averages.

Inflation was expected to average 9.2% in the fourth quarter of 2022, relative to the fourth quarter of 2021. Inflation was then seen to fall to 3.3% in the fourth quarter of 2023 and to 2.2% in the fourth quarter of 2024. When looking at annual averages, inflation was expected to be 5.5% next year. The difference with respect to the 3.3% expected in the fourth quarter of 2023 was due to the fact that the annual figure for 2023 embedded a large carry-over effect, given the high starting point of the projection. Thus, the annual figures shown in the ECB staff projections featured a significant drop in momentum when looking at the quarterly inflation developments.

At the same time, the decline in core inflation was expected to be less pronounced. While the energy and supply bottleneck shocks were expected to have less of an impact, some catch-up in wages to recover the loss in real wages, on the back of a strong labour market, implied that core inflation would remain above 2% over the projection horizon.

Turning to financial and monetary developments, Mr Lane noted that the tightening of financing conditions had continued and its impact was spreading across the economy. Banks' bond funding costs had seen a strong increase for both covered bonds and senior unsecured bonds. In addition, deposit rates for firms and households had started to increase. Both the nominal cost of firms' debt financing and household borrowing costs were expected to increase further later in the year.

The volume of loans to firms remained strong, as firms preferred to borrow now rather than later, while the net issuance of debt securities was negative, as firms continued to substitute bond issuance with bank loans, given the relatively lower rates on loans. Loan flows to households remained solid, but lending for house purchase was showing the first signs of a slowdown. Forward-looking indicators pointed to a slowdown in private sector borrowing in the second half of the year.

Turning to developments in M3, there had been a significant moderation in money growth rates over the past year. After the end of the Eurosystem's net asset purchases, money creation had been supported by bank lending, but as the growth of credit to the private sector was expected to slow, money creation was expected to decelerate further. Corporate and household deposit accumulation had normalised in recent months, with annual deposit growth rates standing close to their pre-pandemic averages.

Summing up, Mr Lane stressed that price pressures were extraordinarily high and likely to persist for an extended period. At 38.3% in August, energy price inflation had remained at extremely elevated levels and had again been the largest contributor to overall inflation, which had stood at 9.1% in August. Food price inflation had also risen in August, to 10.6%, from 9.8% in July, partly reflecting higher input costs related to energy, disruptions to trade in food commodities and adverse weather conditions. Market-based indicators suggested that, in the near term, oil prices would moderate, but wholesale gas prices would stay extraordinarily high. While supply bottlenecks had been easing, these continued to gradually feed through to consumer prices. Recovering demand in the services sector had also contributed to the rise in inflation, and the recent depreciation of the euro had added to the build-up of inflationary pressures. Price pressures had continued to strengthen and broaden across the economy, in part owing to the impact of high energy costs across the whole economy. Accordingly, most measures of underlying inflation remained at elevated levels. Inflation could rise further in the near term. As the current supply-side drivers of inflation faded over time and the normalisation of monetary policy worked its way through to the economy and price-setting, inflation would come down. Resilient labour markets and some catch-up to compensate for higher inflation were likely to support growth in wages. At the same time, incoming data and recent wage agreements indicated that wage dynamics remained contained overall. Most measures of longer-term inflation expectations stood at around 2%, although recent above-target revisions to some indicators warranted continued monitoring.

The staff projections for inflation had been revised up, especially for the near term. Headline HICP inflation was expected to remain at very high levels for the rest of 2022 as a result of extremely elevated energy and food commodity prices, as well as the reopening of the economy and supply bottlenecks. Compared with the June projections, headline inflation had been revised up by 1.3 percentage points for 2022, 2.0 percentage points for 2023 and 0.2 percentage points for 2024. The upward revisions reflected recent data surprises, exceptional increases in the assumptions for wholesale gas and electricity prices, stronger wage growth and the depreciation of the euro. HICP inflation was projected to average 8.1% in 2022, before subsequently decreasing to 5.5% in 2023 and 2.3% in 2024. The projected decline was largely attributable to expectations of falling energy and food commodity prices over the projection horizon. HICP inflation excluding energy and food was also likely to remain at elevated levels until the middle of 2023, but was expected to decline thereafter as the effects of the reopening of the economy subsided and supply bottlenecks and energy input cost pressures eased. The latest staff projections saw inflation excluding energy and food reaching 3.9% in 2022, 3.4% in 2023 and 2.3% in 2024.

After a rebound in activity in the first half of 2022, the latest data pointed to a substantial slowdown in euro area economic growth, with the economy expected to stagnate later in 2022 and in the first quarter of 2023. Very high energy prices were reducing the purchasing power of people’s incomes and, while easing, supply bottlenecks were still constraining economic activity. Although employment had risen by 0.4% in the second quarter and survey indicators of employment perceptions still suggested further growth in the third quarter of 2022, high-frequency indicators signalled that job vacancies had started to plateau in July, possibly leading to a peak in the second half of the year.

The weaker outlook was also reflected in the new staff projections, notwithstanding upward revisions in the back data. Compared with the June projections, GDP growth had been revised up by 0.3 percentage points for 2022, with growth in the first half of the year higher than expected. In contrast, growth had been revised down by 1.2 percentage points for 2023 and by 0.2 percentage points for 2024, owing mainly to the impact of energy supply disruptions, higher inflation and declining confidence. The new projections saw real GDP growing by 3.1% in 2022 and slowing markedly to 0.9% in 2023. As the energy market rebalanced, uncertainty declined, supply bottlenecks were resolved and real incomes recovered over the medium term, growth was expected to rebound and to stand at 1.9% in 2024.

In the context of the slowing global economy, downside risks to the growth outlook had intensified, in particular in the near term. As reflected in the downside scenario in the staff projections, a long-lasting war in Ukraine remained a significant risk to growth, especially if firms and households faced rationing of energy supplies. In such a situation, confidence could deteriorate further and supply-side constraints could worsen again. Energy and food costs could also remain persistently higher than expected. A further deterioration in the global economic outlook could be an additional drag on euro area external demand.

The risks to the inflation outlook were primarily on the upside. A further disruption of energy supplies was a major risk in the short term. Over the medium term, inflation could turn out to be higher than expected because of a persistent worsening of the production capacity of the euro area economy, further increases in energy and food prices, inflation expectations rising above the ECB’s inflation target and higher than anticipated wage rises. However, if energy costs were to decline or demand were to weaken over the medium term, it would lower pressures on prices.

Market interest rates had increased in anticipation of further monetary policy normalisation in response to the inflation outlook. Credit to firms had become more expensive over recent months and bank lending rates for households stood at their highest levels in more than five years. The volume of bank lending to firms had remained strong, however, in part reflecting the need to finance high production costs and inventory building. Mortgage lending to households was moderating because of tightening credit standards, rising borrowing costs and weak consumer confidence. Sovereign yields had moved broadly in line with risk-free rates, against the backdrop of the ongoing application of flexibility in reinvestments under the pandemic emergency purchase programme (PEPP) and reflecting the unanimous approval of the

Transmission Protection Instrument at the 20-21 July Governing Council meeting. Corporate bonds and equities had rallied for most of the period since that meeting, on the back of improving risk sentiment, but had lately fallen back as discount rates increased.

Monetary policy considerations and policy options

Mr Lane proposed that the three key ECB interest rates be raised by 75 basis points at the present meeting. This major step would frontload the transition from the prevailing highly accommodative level of policy rates towards levels that would ensure a timely return of inflation to the ECB's 2% medium-term target. He furthermore proposed to communicate that, based on the current assessment, over the next several meetings interest rates were expected to be raised further to dampen demand and guard against the risk of a persistent upward shift in inflation expectations.

Mr Lane recalled that the monetary policy strategy stipulated that the appropriate monetary policy response to a deviation of inflation from the target was context-specific and depended on the origin, magnitude and persistence of the deviation. With inflation expected to be well above target for a long period, in view of the net upside risks to inflation and taking into account the fact that the key policy rates were still highly accommodative, it was appropriate to take this major step. The communication of this decision should make it clear that the appropriate monetary policy for the euro area would continue to take into account the fact that the energy shock remained a dominant driving force behind inflation dynamics and the general economic outlook, including through the impact of the very significant terms-of-trade deterioration. In particular, the inflation dynamics associated with the energy shock component – to which the euro area was particularly exposed – were of a different nature to that of demand-driven overheating dynamics.

In line with a meeting-by-meeting approach to setting interest rates, the Governing Council should also underline that its policy would continue to be data-dependent and was not on a pre-set path, and that future interest rate decisions would reflect the evolving inflation outlook and the incoming data.

In addition, Mr Lane proposed that the Governing Council continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio.

Finally, Mr Lane proposed that the two-tier system for the remuneration of excess reserves be suspended by setting the multiplier to zero. With a positive deposit facility rate, the two-tier system was no longer necessary, as its role was to support the bank-based transmission of monetary policy when the deposit facility rate was negative.

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. After a rebound in activity in the first half of 2022, the latest data pointed to a substantial slowdown in euro area economic growth, with the economy expected to stagnate later in 2022 and in the first quarter of

2023. Very high energy prices were reducing the purchasing power of people's incomes and, while easing, supply bottlenecks were still constraining economic activity. In addition, the adverse geopolitical situation – especially Russia's war in Ukraine – was weighing on the confidence of businesses and consumers. This outlook was reflected in the September staff projections for economic growth, which had been revised down markedly for the remainder of the current year and well into 2023. Inflation remained far too high and was likely to stay above target for an extended period. Soaring energy and food prices, demand pressures in some sectors as a result of the reopening of the economy and supply bottlenecks were still driving up inflation. Price pressures had continued to strengthen and broaden across the economy, and inflation could rise further in the near term. However, as the current drivers of inflation faded over time and the normalisation of monetary policy worked its way through to the economy and price-setting, inflation would come down.

Global economic activity had decelerated in the first half of 2022, on the back of supply-side disruptions and other headwinds, and growth momentum had weakened significantly over recent months. Looking ahead, weakening global activity would also weigh on global trade and euro area foreign demand, despite easing pressures on global supply chains, with global growth expected to remain moderate in the second half of the year as high inflation eroded real incomes.

In the context of a global monetary policy tightening cycle, members saw differences between the economic situation in the United States and in the euro area. In the United States, price pressures were more related to overheating domestic demand, while in the euro area they reflected, to a greater extent, imported inflation and a sequence of supply shocks. More visible wage pressures in the United States were seen to reflect the fact that the labour market had adjusted through an increase in redundancies rather than a reduction in hours worked per person employed. This implied that, at present, with a strong recovery in activity and employment, the United States was seeing a sharp rise in the number of job vacancies, which had led to a shift in the cyclical relationship between job vacancies and unemployment (as represented by the Beveridge curve). In the euro area, the relationship had remained stable overall. This suggested that the current higher wage pressures in the United States reflected a more pronounced labour market tightness than in the euro area. Moreover, the euro area had been more exposed to the surge in energy prices – particularly gas prices – since the start of the war in Ukraine, as the main driver of high inflation.

It was also noted that the trend depreciation of the euro over the past year, notably vis-à-vis the US dollar, could add to inflationary pressures for the euro area in the period ahead. The weakening of the euro against the US dollar could be explained by a number of factors. These included the different implications of the energy shock for the economies' respective terms of trade, diverging cyclical conditions and different risks associated with the war and the energy crisis. At the same time, the faster tightening of US monetary policy was also seen to have played an important role.

Turning to developments in the euro area, the economy had grown by 0.8% in the second quarter of 2022, owing mainly to strong consumer spending on contact-intensive services, as a result of the end of pandemic-related restrictions. Over the summer, as people travelled more, countries with large tourism sectors had benefited especially. At the same time, businesses had suffered from high energy costs and continued supply bottlenecks, although the latter had been easing gradually. While buoyant tourism had been supporting economic growth during the third quarter, the economy was expected to slow down substantially over the remainder of the year. There were four main reasons behind this. First, high inflation was dampening spending and production throughout the economy, and these headwinds were being reinforced by gas supply disruptions. Second, the strong rebound in demand for services that had come with the reopening of the economy would run out of steam in the following months. Third, weakening global demand, also in the context of tighter monetary policy in many major economies, and worsening terms of trade would mean less support for the euro area economy. Fourth, uncertainty remained high and confidence was falling sharply. At the same time, the labour market had remained robust, supporting economic activity. More than 600,000 people had entered employment in the second quarter of 2022 and the unemployment rate had stood at a historical low of 6.6% in July. Total hours worked had increased further, by 0.6%, in the second quarter of 2022 and had surpassed pre-pandemic levels.

With regard to economic activity, members concurred with Mr Lane that there were increasing signs of a downturn in the euro area that could extend into 2023. However, it was also highlighted that the economy had demonstrated considerable strength in the second quarter of 2022, with a quarter-on-quarter growth rate of 0.8%. Looking ahead, it was highlighted that the baseline in the September staff projections did not suggest a recession, although it did foresee a period of stagnation around the turn of the year. However, it was mentioned that a range of models and indicators suggested that a recession was likely next year. If there were to be a complete shutdown of gas supplies from Russia, this could turn into an outright recession.

The reaction of domestic demand was considered a key element in the further transmission of high energy prices, as well as the less accommodative monetary policy. It was recalled that an important feature of the latest projections was that high energy prices would inevitably weigh on consumption as real incomes declined. In addition, business investment was expected to be worse than previously anticipated, especially as energy-intensive firms and firms operating in the energy sector might be exposed to financial stress generated by higher energy prices.

Members noted that, in addition to the negative impact from the surge in energy and other commodity prices, there was uncertainty about the distribution of the associated terms-of-trade loss among workers and firms. In this context, the view was expressed that it would take time before the income losses due to the terms-of-trade shock were fully absorbed, as firms and workers would seek to recoup lost profits and real incomes.

Regarding the fiscal policy response to higher energy prices, members agreed that measures should be temporary and targeted at the most vulnerable households and firms in order to limit the risk of fuelling inflationary pressures. However, the concern was expressed that governments would find it difficult to keep measures targeted and to reverse them in a timely manner. The view was taken that, in the context of an adverse supply shock, governments were well advised to reduce their deficits and to put their finances on a structural consolidation path, especially in those countries where public debt sustainability might be called into question.

At the same time, the point was made that addressing the energy crisis as a supply shock required, first and foremost, action on the side of governments. It was argued that monetary policy primarily controlled inflation via a dampening effect on economic activity, with long and variable lags. It could not therefore control short-term inflation developments on which initiatives by governments and the European Commission could have a stronger impact.

With regard to potential output, it was commented that the impact of the war and the pandemic on the productive capacity of the economy was turning out to be bigger and longer-lasting than expected, so that demand might need to be reduced commensurately if inflation were to be curbed. If the supply side was hit harder than the demand side, this could fuel inflationary pressures even if real incomes declined. According to survey evidence, companies' production constraints were mainly related to shortages of labour and equipment rather than insufficient demand. Hence the question was raised as to whether the output gap might have already closed, in line with indications coming from the unemployment gap that pointed to a potential underestimation of the role of capacity constraints in driving inflation. However, the view was also expressed that aggregate demand was still clearly below potential. All in all, it was clear that both demand and supply factors were playing an important role in determining the current degree of economic slack in the euro area.

Against this background, members assessed that, in the context of the slowing global economy, risks to growth were primarily on the downside, particularly in the near term. As reflected in the downside scenario in the staff projections, a long-lasting war in Ukraine remained a significant risk to growth, especially if firms and households faced rationing of energy supplies. In such a situation, confidence could deteriorate further and supply-side constraints could worsen again. Energy and food costs could also remain persistently higher than expected. A further deterioration in the global economic outlook could be an additional drag on euro area external demand.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. Inflation had risen further to 9.1% in August. Energy price inflation had remained extremely elevated, at 38.3%, and it was again the dominant component of overall inflation. Market-based indicators suggested that, in the near term, oil prices would moderate, while wholesale gas prices would stay extraordinarily high. Food price inflation had also risen in August, to 10.6%, partly reflecting higher input costs related to energy, disruptions of trade in food commodities and adverse weather conditions. While supply bottlenecks had been easing, these continued to gradually feed through to consumer prices and were putting upward pressure on inflation, as was recovering demand in the services sector. The depreciation of the euro had also added to the build-up of inflationary pressures.

Price pressures were spreading across more and more sectors, owing in part to the impact of high energy costs across the whole economy. Accordingly, measures of underlying inflation remained at elevated levels. Resilient labour markets and some catch-up to compensate for higher inflation were likely to support growth in wages. At the same time, the latest data and wage agreements indicated that wage dynamics remained contained overall. Most measures of longer-term inflation expectations currently stood at around 2%, although recent above-target revisions to some indicators warranted continued monitoring.

It was widely underlined that recent high inflation outcomes had largely been driven by higher energy prices. Recent developments in energy markets also suggested that headline inflation would not reach a turning point before the end of the year. Month-on-month inflation rates continued to indicate strong momentum. The argument was made that the nature of the inflation process was changing. Inflation had started to become self-reinforcing, to the point that even a projected marked weakening in growth was not sufficient to bring inflation back to target. This was also the message from the downside scenario prepared by ECB staff, which pointed to a significant recession with inflation standing even higher at the end of the horizon, well above the ECB’s target. Moreover, demand-side factors had become an important driver of underlying inflation, which also stood well above target in the baseline projection for 2024. Inflation had continued to broaden to more sectors and spending categories. Moreover, producer price inflation for core consumer goods continued to rise and the unprecedented size of pipeline pressures implied that firms would very likely continue to pass a substantial amount of these cost increases on to consumers.

However, it was also argued that inflation was still largely driven by the pass-through of supply shocks in the goods market, which appeared to be unwinding, with the exception of volatile gas prices. A recession was becoming increasingly likely and would mitigate inflationary pressures. With expectations still anchored and wage growth contained, there were no convincing signs that second-round effects were already materialising.

Members recalled that wage pressures were key to understanding the risk of higher energy prices having second-round effects on inflation. While wage developments in the euro area appeared moderate overall, there was evidence of differences between countries. In some euro area countries, labour markets were clearly overheated, which should ultimately lead to higher wages. However, while wages were a lagging indicator of the business cycle in general, and although a number of important wage negotiations would only take place in the autumn, it was generally observed that there were so far no convincing signs of second-round effects through wages. In this context, it was commented that the usefulness of ongoing wage developments as an indicator of future inflation pressures was questionable given that wages reacted gradually and with a substantial lag to labour market conditions in the euro area.

As regards longer-term inflation expectations, most measures of market and survey-based inflation expectations were considered to be broadly anchored and in line with price stability in the medium term. At the same time, it was argued that a number of indicators pointed to an increasing risk of longer-term inflation expectations becoming unanchored. Consumers’ medium-term inflation expectations, as reported in the Consumer Expectations Survey, had gradually increased, and in July the median expectations for inflation three years ahead had stood at 3%. The mean of the longer-term inflation expectations reported in the ECB Survey of Professional Forecasters had increased to 2.2%, which was also a historical high. It was highlighted that a prolonged period of very high inflation had in itself increased the risk of inflation expectations becoming unanchored, in particular if they were being affected by recent experience, as suggested by empirical evidence. Higher than expected inflation figures exacerbated the risk of second-round effects via wages, creating upside risks to the inflation outlook. Projection models might be unable to fully capture the persistence and scale of the current inflationary episode. The expected decline in inflation towards the end of the projection horizon was therefore seen to be surrounded by a higher than usual degree of uncertainty.

Against this background, members assessed that the risks to the inflation outlook were primarily on the upside. In the same way as for growth, the major risk in the short term was a further disruption of energy supplies. Over the medium term, inflation might turn out to be higher than expected because of a persistent worsening of the production capacity of the euro area economy, further increases in energy and food prices, a rise in inflation expectations above the target, or higher than anticipated wage rises. The point was made that an expansion of unfunded or partially funded government support could also constitute an upside risk to inflation. However, if energy costs were to decline or demand were to weaken over the medium term, it would lower pressures on prices. Reference was made to the very useful large set of sensitivity analyses carried out by ECB staff in the context of the latest projections. It was also widely felt that, at times of extraordinary statistical uncertainty around the baseline projections, the precise numbers foreseen for inflation at the end of the projection horizon mattered less than the assessment of risks, which were seen to be on the upside throughout the horizon, including over the policy-relevant medium-term horizon.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. Credit to firms had become more expensive over recent months, and bank lending rates for households stood at their highest levels in more than five years. In terms of volumes, bank lending to firms had so far remained strong, in part reflecting the need to finance high production costs and inventory building. Mortgage lending to households was moderating because of tightening credit standards, rising borrowing costs and weak consumer confidence. However, it was noted that, despite an increase in the cost of mortgages, credit growth had remained resilient. In parallel with the apparent resilience of the real economy, the banking sector was so far still holding up well, with bank profitability benefiting from higher operating income, lower operating expenses, lower loan loss provisions and better asset quality. This could be expected to mitigate the risk of negative feedback loops between the financial sector and the rest of the economy once economic growth slowed, even if pockets of vulnerability could still appear.

Although market interest rates had increased in anticipation of further monetary policy rate increases in response to the inflation outlook, it was maintained that market conditions did not show signs of destabilisation. It was also noted that financial market fragmentation had not reappeared since the Governing Council’s last monetary policy meeting, and sovereign yields had moved broadly in line with risk-free rates. Corporate bond spreads had also narrowed since the previous monetary policy meeting, while equity markets, except for the financial sector, had been broadly weaker.

It was underlined that the euro had depreciated by nearly 20% against the US dollar since June 2021, amplifying the energy price shock and adding to import price pressures for an extended period. Overall, financial conditions had tightened somewhat in the euro area since the last monetary policy meeting, while remaining relatively loose, particularly in real terms and when the exchange rate was taken into account. At the same time, higher market interest rates were starting to feed through to bank lending rates and financing conditions for the real economy, with further increases to be expected.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members agreed that it was appropriate to take a further step on the path of monetary policy normalisation. Overall, the current level of the ECB's key policy rates was judged to be still highly accommodative; with inflation at 9.1% in August 2022 and the deposit facility rate at 0%, short-term real rates were deeply negative. Inflation was far too high and likely to stay above the Governing Council's target for an extended period. It was therefore essential that it be brought back to 2% in a timely manner.

Inflation had repeatedly been higher than expected in recent months and inflationary pressures were seen as unlikely to abate on their own. The inflation projections had been revised upwards for the current year and for next year, while the projection for 2024 had drifted upwards over the past few quarters and now clearly exceeded the Governing Council's target of 2%. Risks surrounding the projected inflation path remained tilted to the upside over the entire projection horizon. Moreover, month-on-month figures for headline and core inflation were rising strongly.

While it was underlined that supply shocks, in particular those affecting energy prices, were the main driver of the current high level of inflation and the worsening outlook, demand-side factors also played a role. While monetary policy was not equipped to address supply shocks, it clearly affected the balance of supply and demand. Hence it was argued that putting too much emphasis on supply-side problems could risk neglecting the fact that aggregate demand had to adjust to curb inflation. In this regard, it was maintained that the expected weakening in economic activity would not be sufficient to reduce inflation to a significant extent and would not in itself bring projected inflation back to target. This was seen to present the Governing Council with the difficult challenge of ensuring that inflation returned to target in a timely manner without unnecessarily exacerbating an economic downturn. However, it was also argued that growth concerns should, in any case, not prevent a needed forceful increase in interest rates. Moreover, it was remarked that, without a timely reduction in monetary policy accommodation, inflationary pressures resulting from a depreciation of the euro might increase further, while lower exchange rates provided limited support to economic activity in an environment of continued global supply bottlenecks and shortages.

While monetary policy could not prevent first-round effects from higher energy prices and the impact of supply shocks, its primary responsibility was to counter risks of second-round effects and prevent an unanchoring of inflation expectations. Such risks were increasing, with inflation becoming more persistent than initially expected.

Against this background, the Governing Council's response to upside deviations from the ECB's target ought to be as forceful as it had been when inflation had been too low. It was recalled that the Governing Council regarded deviations of inflation from target in either direction as equally undesirable. The ECB's monetary policy strategy prescribed that price stability had to be maintained with a medium-term orientation, and the magnitude and persistence of the deviation from the Governing Council's inflation target, as well as the context and origin of inflation pressures, had to be taken into account. At the same time, it was argued that acting forcefully now could avoid the need to increase interest rates more sharply later in the economic cycle when the economy was slowing down. Moreover, it was maintained that the longer high inflation persisted, the higher the risk that inflation expectations could become unanchored and the costlier it would be to bring them back to target.

Turning to the size of the interest rate increase, a very large number of members, in line with Mr Lane's proposal, expressed a preference for raising the key ECB interest rates by 75 basis points. A 75 basis point increase was judged to be a proportionate response to the further upward revisions to the inflation outlook and an important signal that the Governing Council was determined to bring inflation back to its 2% target in a timely manner. The fact that inflation had repeatedly been higher than expected and the upward revision to the medium-term inflation projections were seen as calling for a faster pace of monetary policy normalisation to keep inflation expectations anchored at the target level in the medium term. Market participants had priced in a larger interest rate increase than in July in response to the latest inflation data.

Since the deposit facility rate was, at 0%, far from a level that could be considered neutral in terms of monetary policy accommodation, and in view of the worse inflation outlook, progress towards a level that supported a return of inflation to 2% had to be frontloaded. While the Governing Council's decision in July to raise the ECB's key policy rates by 50 basis points had been an important first step in normalising the interest rate level, it was argued that policy would remain expansionary after a 75 basis point rate hike.

Some members expressed a preference for increasing the key ECB interest rates by 50 basis points. While a 25 basis point increase was seen as clearly insufficient to address the current inflation outlook, it was argued that a 50 basis point hike would be large enough to signal determination in proceeding with the interest rate normalisation that the Governing Council had begun at its July meeting. With the looming risk of a recession, which would mitigate inflationary pressures, an increase of 50 basis points, if part of a sustained path towards more neutral rate levels, might prove sufficient to return inflation to the Governing Council's 2% target over the medium term once transitory shocks had faded. What needed to be addressed was the risk of the sharp rise in inflation, exacerbated by the war, destabilising inflation expectations. A response that was too aggressive could also exacerbate a recession, with few benefits for inflation in the short term.

So far, inflation expectations were still anchored and wage growth remained moderate, with little evidence of second-round effects. Moreover, the size of the upward revision in the staff inflation projection for 2024 was not seen as sufficiently large as to require a more aggressive response, since it was uncertain how much inflation was likely to dampen domestic demand and high uncertainty surrounded the projections, particularly towards the end of the projection horizon. It was noted that the euro area was less affected by excess demand than the United States. Supply-side factors such as energy played a much larger role in the euro area, wage inflation was more moderate and medium-term inflation expectations were better anchored.

Monetary policy decisions and communication

At the end of the discussion, all members joined a consensus to raise the three key ECB interest rates by 75 basis points, while reaffirming that the Governing Council's decision remained data-dependent and that a 75 basis point increase should not signal that the Governing Council intended to agree on interest rate increases of a similar magnitude at its future meetings. It was seen as essential to communicate prudently on the way forward and to counter the risk of increased volatility in the bond market by referring to a frontloading of interest rate normalisation.

Members widely concurred with Mr Lane that monetary policy should continue to be data-dependent and not follow a pre-set path, and that interest rates should be set on a meeting-by-meeting basis. At the same time, it was considered important to indicate that interest rates would be raised further over subsequent meetings as part of the normalisation process.

Regarding the interest rate level ultimately required to stabilise inflation at 2% over the medium term and the time at which that level was to be reached, it was stressed that these were subject to uncertainty, model-dependent and context-specific, and changed over time. In addition, the "neutral rate of interest" depended on long-term trends in factors such as productivity and demographics, as well as the interplay between savings and investment behaviour. Hence, the concept was debatable, unobservable and difficult to measure in real time.

Despite these difficulties, there was broad consensus that, even after the current decision, the key policy rates would remain significantly below the neutral rate.

Looking beyond the configuration of the key ECB interest rates, it was underlined that the Eurosystem's large balance sheet was continuing to provide significant monetary policy accommodation by compressing term premia. It was seen as appropriate to reiterate that the Governing Council stood ready to adjust all of its instruments within its mandate to ensure that inflation returned to its medium-term target of 2%.

Members also agreed with Mr Lane's proposal to continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio. Containing unwarranted volatility in sovereign bond markets was generally seen as an essential complement to a 75 basis point interest rate increase and signalled the ECB's commitment to ensure a smooth transmission of monetary policy throughout the euro area.

Finally, members agreed with Mr Lane's proposal to suspend the two-tier system for the remuneration of excess reserves by setting the multiplier to zero, since the two-tier system was no longer considered necessary in view of the positive value that the deposit facility rate would reach as a consequence of the decision to raise the three policy rates by 75 basis points.

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 8 September 2022 English

Press releases

Monetary policy decisions

Meeting of the ECB’s Governing Council, 7-8 September 2022

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 September 2022 under Article 10.2 of the ESCB Statute.

** As observer.

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 Buch
- Mr Cassidy
- Mr Demarco
- Mr Garnier, Alternate to Mr Villeroy de Galhau on Thursday

- Mr Gavilán
- Mr Gilbert
- Mr Haber
- Mr Kaasik
- Mr Koukoularides
- Mr Kuodis
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Tavlas
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 24 November 2022.

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