Bank of Finland and FIN-FSA hold seminar on ‘Impact of AI on Economy, Finance and Supervision’

News 13 November 2024 9:15 AM

“The AI and data revolution must be harnessed to improve Europe’s competitiveness and stability, as well as to enhance the resilience of the economy and financial system,” said Deputy Governor of the Bank of Finland Marja Nykänen in her opening remarks at the two-day seminar.

The event brings together representatives from the sector and from universities and public authorities to discuss practical AI applications and the opportunities and limitations of AI. The different speakers will look at the current situation as well as the outlook regarding future uses of AI. Speaking at the seminar will be Professor of Economics Anton Korinek from the University of Virginia and other top experts from both Finland and abroad.

The Bank of Finland and the FIN-FSA have a long tradition of using and analysing data. A shared project on the data economy is also in progress, and this is focusing especially on efficient data analysis using AI. *“New technologies and large datasets promise new insights that can help drive forward our understanding of the functioning of our economy, and improve supervisory work,”* Nykänen said.

AI will continue to be one tool among many, and decisions will still be made by people. *“It is important to underline that AI is a virtual assistant, not a decision-maker. Indeed, human oversight and critical assessment are now more important than ever,”* said the Deputy Governor.

You are welcome to watch the live stream of the seminar. The event will not be recorded for later viewing.

Programme

New online work sheds light on German influences in Finland’s banknote history

News 14 October 2024 3:45 PM

Starting from Johannes Gutenberg, the role of Germans in the development of printing technology is well known. His innovation gained a significant foothold everywhere. In contrast, the role of the Germans in developing the design, engraving and printing of banknotes outside of Germany is a less well documented in the literature. Even though the Grand Duchy of Finland was part of the Russian Empire, Germans had a role in every series of Finnish banknotes during the Russian period. This applied even to banknotes printed in St. Petersburg, as all of the parties contracted by the Bank of Finland in the printing process were of German origin.

The Bank of Finland and the German foundation Giesecke+Devrient Stiftung Geldscheinsammlung have jointly published the following work written by Heinonen: “Vom Zettel zum Geldschein: Deutsche Einflüsse auf das Design und den Druck von Banknoten im Großfürstentum Finnland” [From piece of paper to banknote: German influence on the design and printing of the banknotes of the Grand Duchy of Finland]. The work is published on the respective websites of the Bank of Finland and the foundation. A English-language summary of the book and a Finnish-language presentation of the themes of the work will also be published.

The Giesecke+Devrient Stiftung Geldscheinsammlung foundation has funded the German-language translation of the work from Heinonen’s English-language manuscript. The book is richly illustrated.

Heinonen has had a long international career in the field of banknotes. For over ten years, he was the first Director, Banknotes at the European Central Bank, where he was responsible for the adoption of the new European cash currency. Heinonen is a well-known author of monetary history works and an internationally respected banknote expert, who has chaired, for example, the Banknote Ethics Initiative and the Executive Committee of the Central Bank Counterfeit Deterrence Group.

Previously, the Bank of Finland has published the following works written by Heinonen: “Viimeiset markat – Suomen markkamääräiset setelityypit 1945–2002” (2012), “Ensimmäiset eurot – Eurosetelisarjan synty, liikkeeseenlasku ja ensi vuosikymmen” (2014), “Sodan ja rauhan rahat – Suomen erikoinen setelihistoria 1917–1945” (2016), “Ruplista markkoihin – Suomen suuriruhtinaskunnan setelit 1812–1898” (2018) and “Hallitus kansan kukkarolla – Seteleiden leikkaaminen vuosien 1945 ja 1946 vaihteessa” (2020) as well as the report “Keskuspankin elektroninen raha: Suomen Pankin toimirahakokeilu 1990-luvun alkupuoliskolla” (2021).

Heinonen’s work “Ensimmäiset eurot” has been published in German, “Die Ersten Euros” (2014) and in English, “The first euros” (2015).

On 15 October 2024, a public event will be held at the Bank of Finland Museum, where Antti Heinonen will present the themes of the book to a Finnish audience. The Finnish-language presentation materials of the event will be published on the Bank of Finland’s website.

For further information, please contact Antti Heinonen (antti.heinonen@bof.fi) and media@bof.fi (requests for interviews).

New look for Bank of Finland’s websites

News 10 October 2024 9:00 AM

Our new website design and content were inspired by the feedback from users. The most important aspects of the redesign are a sharper focus on matters of current interest and a consistent look for the four different websites.

“We wanted to make the sites more usable and to make it easier to find information and publications. Information on interest rates, for example, which a lot of users go to, can now be found easily and quickly on the home page of suomenpankki.fi,” says Head of Web and Digital Communications Mari Hienonen.

The purpose of the website redesign is to

- standardise the appearance, content and navigation logic of all four websites
- raise the profile of topical content with the aid of automatic highlighting
- update the technical solutions and publication system
- freshen up the visual appearance and improve the accessibility of content.

The practical improvements brought with the redesign include the positioning of interest rate information higher on the suomenpankki.fi home page, and the ability to search publications for information.

Take a look for yourself:

- suomenpankki.fi/en
- rahamuseo.fi/en
- talousosaamiskeskus.fi/en
- bofit.fi/en

Further information

Mari Hienonen, Head of Web and Digital Communications, tel. +358 9 183 2591, mari.hienonen(at)bof.fi

Nordic Baltic Crisis Simulation Exercise, 2024

News 20 September 2024 3:30 PM

Nearly 450 participants took part in the exercise, representing authorities from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden, as well as the relevant European Union authorities: European Commission, ECB, Single Resolution Board (SRB) and European Banking Authority (EBA). A staff member of the International Monetary Fund was also invited to participate as an observer.

The purpose of the exercise was to test communication, information sharing and collaboration between the authorities during crisis management in a highly uncertain and time pressured environment. The exercise was designed in line with a crisis scenario where the fictitious banks went through three phases that could be foreseen in a bank crisis management process: 1) the transition from normal business to recovery including addressing liquidity issues, 2) the movement from recovery to resolution, with resolution authorities assuming control of the bank and 3) after resolution, the return of the restructured bank to the market. During the exercise, authorities applied the tools and powers at their disposal according to the EU regulatory framework for banking supervision and crisis management.

Following the successful conclusion of the exercise, authorities will document and share the lessons learnt, and will integrate them into their existing crisis management routines. This will strengthen their crisis preparedness and further enhance the crisis management framework in the Nordic-Baltic region.

A preparation team established under the Nordic Baltic Stability Group (NBSG) and led by the Danish resolution entity Finansiel Stabilitet was formed in 2023 to prepare the exercise. The team was advised by Oliver Wyman in the preparation of the exercise. The NBSG consists of government ministries, central banks, supervisory authorities, and resolution authorities in the eight Nordic and Baltic countries. In the context of the NBSG, the Nordic and Baltic authorities have agreed to conduct regular financial crisis simulation exercises.

Account of the ECB Governing Council's monetary policy meeting, 17-18 July 2024

News 22 August 2024 2:30 PM

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 17-18 July 2024

22 August 2024

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

Financial market developments

Ms Schnabel noted that since the Governing Council's previous monetary policy meeting on 5-6 June 2024, financial markets had moved in response to political news, which had caused some volatility, and in response to weaker than expected US inflation data. The announcement of snap elections in France had dented investors' risk appetite and the rally in euro area risk asset markets. However, the resulting rise in volatility in some market segments had remained contained and short-lived, without signs of systemic stress or fragmentation. Risk premia had risen only modestly, and the euro exchange rate had recovered quickly. Macroeconomic news had been muted, with small negative macroeconomic surprises in both the euro area and the United States. Expectations regarding ECB policy rates had remained broadly unchanged amid some volatility following the elections for the European Parliament, but had edged lower after the release of US consumer price index (CPI) data. Euro area financial conditions had also remained broadly unchanged, with continued benign market conditions. The absorption of the net issuance of government bonds had continued to proceed smoothly as investor demand remained strong.

Political uncertainty had affected financial markets, as reflected in a spike in implied volatility in the euro area stock market. However, implied volatility had remained contained from a longer-term perspective and had retreated swiftly to previous lows. By contrast, option-implied volatility in euro area bond markets had hardly moved and stood close to the lowest level seen since 2021. Moreover, investor risk appetite in the euro area had recovered quickly after a temporary slump and currently stood well above the levels seen at the start of the year, pointing to continued strong investor risk sentiment.

The resilience of financial markets and a high degree of investor differentiation had also been visible in sovereign bond markets. The increase in sovereign spreads over the German Bund had been small from a historical perspective. Spreads had narrowed again after the initial spike in volatility and currently stood below the levels prevailing before the European parliamentary elections, with the exception of French sovereign bond spreads, which stood slightly higher.

Investor differentiation had also extended to euro area equity markets and corporate bond markets. Overall, however, the impact on euro area stock market valuations had been muted and short-lived. Developments in euro area corporate bond markets had mirrored those in equity markets, with spreads of investment-grade financial corporate bonds and non-financial corporate bonds in the euro area, excluding France, having narrowed overall. The EUR/USD exchange rate had initially depreciated somewhat, but had quickly recovered its losses, and was broadly unchanged from the levels prevailing at the time of the Governing

Council's previous monetary policy meeting.

As regards expectations about US monetary policy, following the June meeting of the Federal Open Market Committee the probability of a cut in US interest rates in September had initially declined slightly. However, this had been counterbalanced subsequently by the somewhat weaker than expected US macroeconomic data and, in particular, the June release of US CPI data, which had pushed the US fed funds futures curve substantially lower than it had been at the time of the June Governing Council meeting.

US developments had also spilled over to some extent to expectations regarding ECB interest rates. Rate expectations had remained broadly unaffected by the political uncertainty after the European elections, but had edged lower in July after the weaker than expected US CPI data release. However, the current market pricing of the expected policy rate path remained relatively close to the peak forward curve in late May and substantially above the trough in rate expectations reached at the start of the year. Moreover, as regards the speed and extent of the rate-cutting cycle, participants in the Survey of Monetary Analysts (SMA) had not changed their views since the previous survey round and, on average, continued to expect 25 basis point rate cuts at every quarterly meeting at which new staff projections were available until December 2025. This was broadly in line with expectations in financial markets and with other surveys, with some differences regarding the expected level of the terminal rate.

The more moderate downward shift of the euro area forward curve relative to the United States could partly reflect the fact that euro area core inflation – as measured by the Harmonised Index of Consumer Prices (HICP) excluding energy and food – had continued to surprise to the upside, in contrast to the latest US inflation data release. Euro area near-term "inflation fixings" (swap contracts linked to specific monthly releases in euro area year-on-year HICP inflation excluding tobacco) had edged up since the Governing Council's previous monetary policy meeting, but they remained below the level foreseen in the June 2024 Eurosystem staff macroeconomic projections. Moreover, according to market participants, risks to the longer-term inflation outlook remained tilted to the upside, as evidenced by option-implied probabilities for five-year forward inflation-linked swap rates five years ahead. Under the assumption of risk neutrality – meaning that investors assessed an overshooting of the inflation target to be as costly as an undershooting – investors were pricing in a substantially higher probability of inflation overshooting a level of 2.5% than of it undershooting a level of 1.5%. This could reflect the anticipation of more frequent adverse supply shocks, as signalled by positive inflation risk premia.

At the same time, developments in euro area real interest rates had been mixed recently. While ten-year real rates had remained broadly unchanged amid high volatility, two-year and five-year real rates had dropped since the Governing Council's previous monetary policy meeting.

The absorption of government securities had continued to proceed smoothly, including for France. Recent auctions had continued to see strong investor demand, with auction results being in line with past regularities. Over the past year net issuance had found strong demand among foreign investors, with foreign hedge funds emerging as important players in European sovereign bond markets.

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

Starting with inflation in the euro area, Mr Lane noted that headline HICP inflation had declined slightly to 2.5% in June, after rising to 2.6% in May. Energy inflation had edged down to 0.2%, from 0.3% in May, despite upward base effects; food inflation had fallen to 2.4% from 2.6% in May. Goods price inflation and services price inflation had been 0.7% and 4.1% respectively in both May and June.

While some measures of underlying inflation had ticked up in May, owing to one-off factors, most measures of underlying inflation had either been stable or edged down in June compared with May. On average over the second quarter of 2024, all measures of underlying inflation had declined compared with the previous quarter.

In relation to current wage developments, compensation per employee had increased to 5.0% in the first quarter of 2024, in line with the June staff projections. Negotiated wages remained an important driver of total compensation. After decreasing slightly in the fourth quarter of 2023 to 4.5%, negotiated wage growth including one-off payments had increased to 4.7% in the first quarter of 2024. The forward-looking wage trackers had continued to signal elevated wage pressures this year, largely driven by catch-up dynamics. Wage agreements in the euro area’s largest economy accounted for the bulk of the latest tracker information, as agreements had been reached in the wholesale, retail, chemical and construction sectors, which tended to have long contract durations and therefore a more pronounced catch-up component during this phase. The Indeed tracker, which reflected wages for new hires, had picked up to 3.7% in June, from 3.5% in May.

However, beyond the near term the responses from firms participating in the ECB’s Corporate Telephone Survey (CTS) and the Survey on the Access to Finance of Enterprises (SAFE) had pointed to materially lower wage growth in 2025. This picture was also reflected in the year-by-year profile of recently agreed multi-year wage contracts. The participants in the ECB’s Survey of Professional Forecasters (SPF) also expected a marked deceleration in wage growth in 2025. According to the SPF, the expected deceleration in wage growth next year was attributable to the catch-up to past inflation playing a much smaller role and to the decline in expected inflation.

For domestic price pressures to moderate in the period ahead, profits also needed to play their part. In the first quarter the annual growth rate of the GDP deflator had declined more than expected, falling to 3.6%, from 5.1% in the fourth quarter of 2023. The largest contribution to this decline had come from unit profits, with the contribution of the annual growth rate of unit profits turning negative in the first quarter of 2024.

Headline inflation was expected to fluctuate around current levels for the remainder of 2024. It should then resume its downward path and decline to the ECB’s target of 2% in the second half of 2025 owing to the fading impact of the past inflation surge, weaker growth in labour costs and the unfolding effects of restrictive monetary policy. Medium and longer-term inflation expectations had remained broadly stable, with most standing at around 2%.

Turning to the global economy, growth momentum was increasing, with the global composite Purchasing Managers’ Index (PMI) excluding the euro area rising to 53.2 in the second quarter, from 52.6 in the first quarter, and other survey-based indicators also signalling a further improvement in global activity. Global trade continued to strengthen, driven by a frontloading of demand, as firms rebuilt inventories after a long phase of destocking. This was also confirmed by the July 2024 update of the IMF World Economic Outlook (WEO), which projected global real GDP growth to be 3.2% in 2024 and 3.3% in 2025, and global trade growth to be 3.1% in 2024 and 3.4% in 2025. Compared with the April WEO, there was basically no change in the outlook for global growth and trade.

The euro exchange rate had remained broadly stable, both against the US dollar and in nominal effective terms, since the last Governing Council meeting, while oil prices had increased by 15% to USD 88 per barrel of Brent crude oil. The increase in the oil price since the last meeting reflected tighter supply conditions and rising geopolitical concerns. European natural gas prices had decreased by 7% since the last Governing Council meeting, to stand at around €31 per megawatt-hour, as demand remained subdued and gas storage levels were high.

The incoming information indicated that the euro area economy had continued to expand in the second quarter of 2024. The services sector continued to lead the recovery, although the services component of the PMI had softened somewhat in June. Construction output, which had been boosted by favourable weather in Germany and fiscal incentives in Italy in the first quarter, had fallen in April. Non-construction investment had risen moderately in the first quarter but was likely to remain muted for the rest of the year. Manufacturing activity had shown renewed signs of weakness, with the PMI indicators for output and new orders dropping further into contractionary territory, at 46.1 and 44.4 respectively in June. Goods exports had been weak.

The overall narrative remained that of a consumption-led recovery with rising real incomes translating into rising consumption. The latest data for the first quarter supported the view that consumption was growing overall. Consumer confidence had slowly increased in the second quarter, but remained subdued compared with its pre-pandemic average level.

Employment had expanded by 0.3% in the first quarter, in line with economic activity and supported by a further expansion of 0.3% in the labour force. The unemployment rate had remained unchanged at 6.4% in May. Survey indicators suggested that positive, but moderating, employment growth would continue. The PMI for employment had averaged 51.7 in the second quarter, suggesting employment growth of around 0.2%, compared with 0.1% in the June staff projections. At the same time, labour demand seemed to be gradually moderating. The ECB’s labour hoarding indicator – which measured the share of firms holding on to workers despite a deteriorating outlook – had declined further in the second quarter, and the Indeed job postings had declined by 1.8% from May to June, following the deceleration in the job vacancy rate in the first quarter of the year.

Turning to fiscal policies, the level of fiscal support in the euro area remained sizeable and was likely to be somewhat stronger than assumed in the June Eurosystem staff projections. While concrete fiscal news since the June projections had been relatively limited, the uncertainty surrounding the fiscal outlook had increased.

The policy rate cut in June had been transmitted smoothly to money market interest rates, while broader financial conditions had been somewhat volatile. Financing conditions for firms and households remained at restrictive levels, as the effects of past policy rate increases continued to work their way through the transmission chain. The average interest rate on new business loans had declined slightly to 5.1% in May, while interest rates on new mortgage loans had remained constant at 3.8% for the third consecutive month. Growth in loans to firms and households had remained broadly stable at very subdued rates over the past several months. The annual growth in broad money – as measured by M3 – had continued to recover, reaching 1.6% in May, driven by strong net foreign inflows.

Taken together, the information from the euro area bank lending survey (BLS) and the SAFE suggested that credit supply conditions for loans to firms were stabilising but still tight, with demand persistently weak. While respondents to the July BLS had reported a slight tightening in credit standards for loans to firms, participants in the SAFE had seen a small net improvement in bank loan availability. According to both surveys, demand for corporate loans had declined further in the second quarter of 2024. On the household side, the BLS had signalled an easing in standards for mortgages but a moderate tightening for consumer credit. Net demand for housing loans and consumer credit had increased for the first time since mid-2022.

Monetary policy considerations and policy options

In the aggregate, Mr Lane concluded that the incoming information broadly supported the previous assessment of the medium-term inflation outlook. The overall quarterly profile of measures of underlying inflation remained in line with the picture of gradually diminishing price pressures. The weakening in the economic data also helped to contain upside inflation risks. The elevated wage growth was in line with expectations, and firms had seen their profits decline, buffering the inflationary impact of higher labour costs. Monetary policy was keeping financing conditions restrictive. At the same time, domestic price pressures were still high, services inflation was elevated and headline inflation was likely to remain above the target well into next year.

Against this background, Mr Lane proposed keeping the three key ECB policy rates unchanged. The information available at the Governing Council’s next monetary policy meeting in September would incorporate a wealth of fresh data and the new staff macroeconomic projections for the euro area. Data for the second quarter would also be available – including GDP growth, compensation per employee, profit margins and productivity – alongside two more HICP releases, as well as monetary indicators and more timely soft indicators for activity and consumer confidence.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

Looking at the external environment, members took note of the outlook for global growth presented by Mr Lane. The July 2024 update of the IMF's April WEO entailed broadly unchanged expectations for real GDP growth in 2024 and 2025, which were somewhat above those embedded in the June Eurosystem staff projections. This was positive news, as solid growth in global activity and trade was an important element in the anticipated euro area recovery. At the same time, attention was drawn to the latest, softer data on economic activity for both the United States and China. It was argued that the external environment had recently become more clearly disinflationary, mitigating concerns over "higher for longer" inflation. Of late, inflation had declined in the United States, and the issue of a possible divergence of US and euro area monetary policy – much discussed in the spring – was abating.

With regard to the euro area economy, members widely noted that the medium-term outlook discussed during the previous Governing Council meeting and entailed in the June 2024 Eurosystem staff projections had not changed overall. The most recent data revealed that inflation was more persistent than previously anticipated, while activity indicators had disappointed on the downside. It was argued that the short-term outlook had thus become somewhat more "stagflationary". At the same time, it was contended that weaker activity was likely to dampen inflation over time.

On economic activity, members concurred with Mr Lane that the incoming information indicated that the euro area economy had grown in the second quarter, but likely at a slower pace than in the first quarter. Services continued to lead the recovery, while industrial production and goods exports had been weak. Indicators pointed to muted investment growth in 2024, amid heightened uncertainty. The recovery was expected to be supported by consumption, driven by stronger real incomes resulting from lower inflation and higher nominal wages. Moreover, exports should pick up with a rise in global demand. Finally, monetary policy should exert less of a drag on demand over time.

In their discussion, members acknowledged that the short-term outlook for growth had deteriorated. This was visible in both soft and hard data, most notably in weak PMI indicators for manufacturing. The prospect of somewhat lower short-term growth than embedded in the staff projections was also corroborated by the latest surveys, such as the SPF and the SMA. Concerns were expressed that muted activity might not only be of a temporary or cyclical nature. This inference was supported notably by the fact that there were few signs of a recovery in manufacturing and industrial production, even though the adverse impact of earlier energy and terms-of-trade shocks had largely faded. Reference was made to the share of energy costs in GDP, which had fallen back to close to its longer-term average. It was doubtful that short-term cyclical phenomena could fully explain the weak performance of manufacturing. Rather, this was consistent with the observed subdued developments in exports and might well reflect a more lasting or structural loss of competitiveness, casting doubt on the capacity of the euro area to recover on the back of growth in world trade.

It was stressed that the economy remained lopsided, as the recovery continued to be driven, in essence, by activity in services. This was confirmed by positive incoming information on the services PMI and services production. Tourism had been playing an important role in recent services activity, but it was questionable whether this type of spending could support the economy sustainably in the second half of the year. It was also observed that the moderate recovery in consumer confidence was still from low levels and that the saving ratio was increasing. The point was made that the increase in the saving ratio reflected, to a large extent, increases in the non-labour income of high-income households that were likely to save rather than consume out of additional income. Moreover, greater saving was seen as a natural reaction to the higher interest rates on deposits offered in the context of past monetary policy tightening. However, the strong increase in savings observed in the first quarter of the year was raising questions about the consumption-based narrative embedded in the projections. Overall, despite all these layers of uncertainty, it was felt that the euro area economy remained on track for a consumption-led recovery, in line with rising real income growth. Survey results entailed some positive signs for future household spending and, according to the latest BLS, households' demand for loans had risen.

Turning to the labour market, incoming data confirmed continued resilience. The unemployment rate was unchanged at 6.4% in May, its lowest level since the start of the euro. Employment had grown by 0.3% in the first quarter, supported by a further increase in the labour force, which had expanded at the same rate. More jobs were likely to have been created in the second quarter, mainly in the services sector. At the same time, firms were gradually reducing their job postings, albeit from high levels.

Members widely pointed to continued tightness in the labour market. It was noted that this tightness had persisted despite immigration and rising labour force participation. Participants in the ECB's CTS continued to report difficulties in recruiting, which highlighted continued labour shortages. At the same time, the CTS findings suggested that firms were responding to these shortages by investing in labour-saving technology such as automation and digitalisation. It was noted that employment growth continued to be driven mainly by the services sector. However, a note of caution was expressed that the observed state of the labour market had two interpretations. On the one hand, its persistent resilience was reinforcing the prediction that a soft landing of the economy was indeed achievable. On the other, the lack of sustained growth dynamics raised concerns about the durability of what appeared to be the most inclusive and vibrant labour market in the history of the euro area.

With respect to national fiscal and structural policies, members reiterated that these policies should aim to make the economy more productive and competitive, which would help raise potential growth and reduce price pressures in the medium term. An effective, speedy and full implementation of the Next Generation EU (NGEU) programme, progress towards capital markets union and the completion of banking union, and a strengthening of the Single Market were key factors that would help foster innovation and increase investment in the green and digital transitions. The European Commission's recent guidance calling for EU Member States to strengthen fiscal sustainability and the Eurogroup's statement on the fiscal stance for the euro area in 2025 were welcome. Implementing the EU's revised economic governance framework fully and without delay would help governments bring down budget deficits and debt ratios on a sustained basis.

The course of fiscal policy was seen as posing challenges in the coming months. Concerns were expressed that, in a period of political uncertainty and changing governments, there might be less fiscal consolidation than expected thus far. A combination of fiscal slippage in some countries and fiscal discipline in others was leading to a divergence in fiscal positions and greater vulnerability. In September euro area countries would have to present their multi-year budgetary plans. Markets would then start analysing how compliant these plans were with the fiscal rules, the credibility of which depended on early and serious compliance efforts. Promotion of a sound fiscal regime called for being vocal about the need for structural reforms as well, since weak economic growth implied a higher risk of slippages in complying with the fiscal rules. In this context, it was also suggested that in the implementation of the NGEU programme the emphasis should be more on effectiveness than on speediness, given the risk of inefficiencies associated with limited administrative capacity on the part of the implementation authorities.

Members assessed that the risks to economic growth were tilted to the downside. A weaker world economy or an escalation in trade tensions between major economies would weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. This might result in firms and households becoming less confident about the future and global trade being disrupted. Growth could also be lower if the effects of monetary policy turned out stronger than expected. Growth could be higher if inflation came down more quickly than expected and rising confidence and real incomes meant that spending increased by more than anticipated, or if the world economy grew more strongly than expected. The point was made that the continuous presence of macro risks, such as geopolitical fragmentation and a lack of fiscal discipline, might fuel uncertainty and hamper planning, although it appeared that, thus far, the economy had shown resilience to this type of uncertainty.

With regard to price developments, members concurred with the assessment provided by Mr Lane that the incoming information broadly confirmed the medium-term inflation outlook. Annual inflation had eased slightly to 2.5% in June, with both goods price inflation and services price inflation unchanged, at 0.7% and 4.1% respectively. While some measures of underlying inflation had ticked up in May owing to one-off factors, most measures had either been stable or edged down in June. Inflation was expected to fluctuate around current levels for the rest of the year, partly owing to energy-related base effects. It was then expected to decline towards target over the second half of next year, owing to weaker growth in labour costs, the effects of restrictive monetary policy and the fading impact of the past inflation surge.

Members considered that the short-term inflation outlook had remained broadly in line with the June projections, although pointing to somewhat higher profiles for services inflation and core inflation, partly associated with increases in tourism-related prices. It was also emphasised that the disinflationary process in headline HICP inflation over the shorter-term horizon was more evident when adjusting for the impact of energy-related base effects that were causing some volatility in the latter part of this year. It was noted that surveys and markets were somewhat more optimistic about inflation over the short term than the June projections, while they were somewhat more pessimistic about economic growth.

The persistence in services inflation remained the central element shaping the inflation outlook. A remark was made that the risk of seeing high services inflation for a longer period had not been mitigated by the tepid recovery. This was not just an issue for the euro area but seemed to hold true more broadly. For the euro area, in June services inflation had been higher than expected and a string of consecutive upward surprises had been observed. Services inflation had dropped fairly quickly from its peak in mid-2023 to 4% in November 2023, but since then it had hovered around that level. In contrast to goods price inflation, where the decline had proceeded very quickly, progress in reducing services inflation appeared to have stalled. At current levels, services inflation was almost twice as high as its average before the global financial crisis. Moreover, the persistence of services inflation was broad-based across euro area countries and components rather than being driven by individual categories, and momentum remained high despite its recent decline. As disinflation in non-energy industrial goods was flattening out and high freight costs and rising protectionism might put upward pressure on goods price inflation in the future, a further decline in core inflation would need to rely on disinflation in services.

At the same time, the point was made that services inflation was a sluggish and lagging element in the inflation process. For some items, in particular, the latest observations may have reflected “laggards” – delayed backward-looking repricing in some specific subsectors – rather than a generalised forward-looking price resetting.

Members agreed that the triangular relationship between wages, productivity and profits remained central to assessing domestic price pressures and the inflation outlook more generally. It was argued that the expected disinflationary trend was based on dynamics in these three variables, which were quite aligned with historical patterns. However, it was cautioned that the evolution of these variables remained surrounded by a high level of uncertainty. Developments thus warranted close monitoring and the data for the second quarter would be important inputs for the Governing Council’s next monetary policy meeting in September.

Concerning wages specifically, in the first quarter of this year all available measures had pointed to continued elevated growth, but this had been largely anticipated in the June projections. While the latest data showed that wages in the euro area were still rising at an elevated pace, it was maintained that the most recent aggregate developments to a large extent reflected developments in specific sectors and countries rather than a broad-based trend. The profile for wage growth embedded in the latest projections was downward-sloping for 2025 and 2026, and this expectation was supported by results from a number of surveys. While survey indications of lower wage growth were favourable news for the inflation outlook, caution was expressed that this decline still needed to appear in the data, which, so far, had remained exceptionally high by historical standards.

In this context, it was considered useful to look at decompositions of wage growth into its main drivers, such as the catch-up component, forward-looking inflation expectations, labour market tightness and compensation for higher productivity. Reference was made to evidence from the CTS, where more than half of respondents had indicated that recruiting had become harder at prevailing wages. In case labour scarcity turned out to be a structural phenomenon caused, for example, by demographic factors or changes in preferences for leisure, it was important to assess how far wage increases reflected the increased negotiation power of workers, whether individual or collective, and how far they merely reflected real wage catch-up in the wake of the inflation surge.

The staggered process of collective wage bargaining implied a deferred impact of inflation on real wage catch-up. Real wages of a very large share of workers in some countries still fell short of their pre-pandemic levels. Looking ahead, this provided for some protractedness in wage dynamics. While from an inflation perspective it was desirable for the catch-up to proceed in a contained manner, it was also a healthy element underpinning real income growth and benefiting the euro area economy. At the same time, concerns were expressed that wages might continue to grow more strongly than would be consistent with the inflation target – even after the catch-up process had been completed. However, the more real wages caught up, the lower the incentives for workers to claim higher wage increases and for firms to pass on those wage increases in the current environment of weak demand.

As regards longer-term inflation expectations, members took note of the latest developments in market-based measures of inflation compensation and survey-based indicators. Measures of longer-term inflation expectations had remained broadly stable, with most standing at around 2%. Current inflation expectations were well anchored, but suggested that inflation was unlikely to undershoot the target as distributions were still skewed to the upside. This was generally valid for expectations derived from the Consumer Expectations Survey, the SAFE, the SPF and the SMA. The option-implied probabilities for five-year forward inflation-linked swap rates five years ahead were higher for outcomes above 2.5% than for outcomes below 1.5%. However, analysts' longer-term inflation expectations as reported in the SMA did not show the same asymmetry. It was suggested that, in principle, larger upside than downside risks could be reconciled with expectations of more frequent adverse supply shocks in the future.

Regarding risks, members assessed that inflation could turn out higher than anticipated if wages or profits increased by more than expected. Upside risks to inflation also stemmed from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices. By contrast, inflation might surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly.

The point was made that downside risks to aggregate demand would come with downside risks to inflation over the medium term. At the same time, it was argued that there were still good reasons to remain watchful of upside risks to inflation. First, incoming data, particularly for services inflation, had been above earlier expectations. Second, key building blocks of the disinflation narrative, such as the expected pick-up in productivity and moderation in wage growth, had yet to appear in the actual data. At present, unit labour costs were still growing fast.

Turning to the monetary and financial analysis, members underlined that the policy rate cut in June had been transmitted smoothly to money market interest rates. Market interest rates had edged down since the Governing Council's previous monetary policy meeting in June, although they had been fluctuating to some extent since then in response to data releases. On average market participants were currently pricing in almost two additional 25 basis point cuts by the end of the year, but had attached almost no probability to a cut at the July monetary policy meeting.

Overall, broader financial conditions had changed little since the Governing Council's previous monetary policy meeting in June, but they had been somewhat volatile in the meantime. Financial markets had been affected by political uncertainty in the euro area, although the overall effects and increase in volatility had remained muted and had largely been reversed. Financing costs had remained broadly stable at restrictive levels, as previous policy rate increases continued to work their way through the transmission chain. The average interest rate on new loans to firms had edged down in May, while mortgage rates had remained unchanged.

Lending conditions had remained tight. According to the latest BLS, credit standards for lending to firms had tightened slightly in the second quarter, while standards for mortgages had eased moderately. The BLS also highlighted continued sluggish demand from firms for loans and credit lines, though expected growth in loan demand had turned positive. Moreover, households' demand for mortgages and consumer loans had risen. The view was expressed that, overall, the BLS results suggested that the transmission of monetary policy restriction was likely to have passed its peak.

Credit growth also remained subdued. Growth of bank lending to firms and households had remained at low levels in May and had only marginally increased from the previous month. The annual growth rate of M3 had continued its gradual recovery while remaining relatively subdued. It was largely being driven by inflows of funds from outside the euro area.

Monetary policy stance and policy considerations

Turning to the monetary policy stance, members assessed the data that had become available since the last monetary policy meeting in accordance with the three main elements that the Governing Council had communicated in 2023 as shaping its reaction function.

Starting with the inflation outlook, members broadly concurred with the assessment that had been presented by Mr Lane in his introduction. The incoming information and forward-looking indicators had generally supported the Governing Council's previous assessment of the medium-term inflation outlook. Recent developments and the latest data were still broadly consistent with the June staff projections. Headline inflation was expected to fluctuate around current levels for the rest of the year, partly owing to energy-related base effects. But inflation was expected to decline towards the target over the second half of next year and then stabilise around the target in 2026. It was also important to note that inflation expectations had remained firmly anchored, with most measures of longer-term inflation expectations standing at around 2%. At the same time, the current distribution of inflation expectations was still skewed to the upside. In addition, services inflation had continued to be more persistent than expected.

With regard to underlying inflation, members noted that while some measures of underlying inflation had ticked up in May owing to one-off factors, most measures had either been stable or edged down in June. Still, the signals from the different measures of underlying inflation remained mixed. Domestic inflation continued to be elevated, at the top of the range of these measures, and appeared to be stickier than expected. Core inflation also remained relatively high. It had been higher than expected, showing some persistence, and was still subject to upside risks given the repeated upside surprises in services inflation. More generally, many measures of underlying inflation were likely to be fairly flat for the remainder of the year. Interpreting these data had become trickier because, as inflation approached the target, these measures would naturally adjust more slowly. It was therefore becoming harder to determine whether or not the slower decline signalled a genuine stalling of the disinflation process. Labour cost dynamics would continue to be a key concern, with the interaction between wages, productivity and profits likely to be particularly important for the evolution of domestic inflation, as captured by the GDP deflator. In this respect, it was comforting to see that domestic cost pressures from high wage growth, including in the services sector, had been increasingly buffered by unit profits.

Finally, members generally agreed that monetary policy transmission was unfolding according to expectations. Monetary policy was keeping financing conditions restrictive and the transmission of past policy rate hikes remained strong. Tight financing conditions partly explained the sluggishness in domestic demand and would continue to weigh on activity in the coming months. The view was taken that the ongoing contraction of the Eurosystem balance sheet added to that restrictiveness. At the same time, the continued growth of profits in the services sector, albeit at lower rates, and the strength of services demand suggested a weaker transmission of monetary policy to the part of the economy that was exerting the strongest inflationary pressures. That said, monetary policy would probably take longer to be transmitted to the services sector. And even if transmission to services inflation was relatively weaker, this should not be seen in isolation from the relatively low goods price inflation.

Monetary policy decisions and communication

Against this background, all members agreed with Mr Lane’s proposal to maintain the three key ECB interest rates at their current levels. Members concurred that the incoming information broadly supported the Governing Council’s previous assessment of the medium-term inflation outlook. While some measures of underlying inflation had ticked up in May owing to one-off factors, most measures had either been stable or edged down in June. In line with expectations, the inflationary impact of high wage growth had been buffered by profits. Monetary policy was keeping financing conditions restrictive. At the same time, domestic price pressures were still high, services inflation was elevated and headline inflation was likely to remain above the target well into 2025. It was remarked that these developments suggested that the last mile of disinflation was more challenging and that the task of bringing inflation down sustainably to the 2% target was not yet assured, despite the significant progress made.

With inflation coming down only gradually, it was seen as natural that the Governing Council’s policy response should be cautious. This supported a pause at the current meeting. Such a cautious approach was particularly warranted given the prevailing uncertainties about the evolution of wages, profits, productivity and services inflation. All of these would need further monitoring and assessment as new data arrived in order to gain further confidence in the inflation outlook. By the time of the September meeting extensive new data would be available, such as the July and August inflation data; national account information on the second quarter, including compensation per employee, profits and productivity; an update on monetary data; and a new set of staff projections.

In terms of timing, it was argued that the Governing Council could afford to be patient and wait for more data to confirm that disinflation was indeed on track. A cautious approach would also allow the Governing Council to respond by following a more gradual path of reducing policy rates if inflation was more persistent than currently foreseen. The importance of bringing inflation down sustainably to the target in a timely manner was reiterated. It mattered both for credibility and because a further delay could entail high costs, with inflation expectations being more fragile than usual owing to inflation having been above target for so long. At the same time, it was underlined that a gradual attenuation of policy restriction was a balancing act, as it was also important not to unduly harm the economy by keeping rates at a restrictive level for too long.

Members emphasised that they remained determined to ensure inflation would return to the 2% medium-term target in a timely manner and that they would keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. It was also seen as important to maintain a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. There should be no pre-commitment to a particular rate path, since the exact pace at which inflation would return to target remained uncertain. It was nonetheless also important to keep an eye on the real economy. The September meeting was widely seen as a good time to re-evaluate the level of monetary policy restriction. That meeting should be approached with an open mind, which also implied that data dependence was not equivalent to being overly focused on specific, single data points. Finally, policy should continue to be based on the established elements of the reaction function.

Members also agreed with the Executive Board proposal to continue applying flexibility in the partial reinvestment of redemptions falling due in the pandemic emergency purchase programme portfolio.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the

President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

[Monetary policy statement for the press conference of 18 July 2024]

Press release

[Monetary policy decisions]

Meeting of the ECB's Governing Council, 17-18 July 2024

Members

- Ms Lagarde President
- Mr de Guindos Vice-President
- Mr Centeno
- Mr Cipollone
- Ms Delgado
- Mr Elderson
- Mr Kazāks*
- Mr Kažimír
- Mr Knot
- Mr Lane
- Mr Makhlouf
- Mr Müller
- Mr Nagel*
- Mr Panetta
- Mr Patsalides*
- Mr Rehn
- Mr Reinesch*
- Ms Schnabel
- Mr Scicluna
- Mr Šimkus*
- Mr Stournaras
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch

* Members not holding a voting right in July 2024 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 Arpa

- Ms Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Gilbert
- Mr Haber Alternate to Mr Holzmann
- Mr Kaasik
- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros
- Mr Martin
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- Mr Šošić
- Mr Tavlas
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 10 October 2024.

Bank of Finland at the Europe Forum in Turku: From peace project to security union and a common economic policy as an EU security guarantee

News 14 August 2024 9:40 AM

This autumn marks the thirtieth anniversary of Finland’s advisory referendum on joining the European Union, which was held after a lively campaign. The Finnish people signalled that the country’s Parliament should approve the EU Accession Treaty. With the referendum over, distinguished EU researcher Esko Antola urged politicians to lay aside their differences and to take with them to Brussels the shared national objectives of Finland. Antola noted that joining the EU was, after all, motivated not only by the drive for economic prosperity but also by a desire for peace and cooperation.

The thirtieth anniversary is now being marked in circumstances where the EU is seeking a new role as a security provider. This transformation will be examined by **Juhana Aunesluoma**, Professor of Political History at the University of Helsinki, in this year’s Esko Antola Lecture ‘From peace project to security union – EU transformation and Finland 1994–2024’. Following the lecture there will be commentary from **Laura Kolbe**, Professor of European History at the University of Helsinki. A panel discussion will then be held, when Kolbe and Aunesluoma will be joined by Governor of the Bank of Finland **Olli Rehn**. The panel discussion will be moderated by **Elisa Newby**, Head of General Secretariat at the Bank of Finland.

The second of the Bank of Finland’s events at the Europe Forum in Turku will discuss the idea of a common economic policy as an EU security guarantee. The discussion panellists will be **Juha Jokela**, Programme Director at the Finnish Institute of International Affairs, **Taneli Lahti**, Head of Cabinet for Commissioner Jutta Urpilainen, and **Niclas Poitiers**, Research Fellow at Bruegel. The discussion will be moderated by **Juha Kilponen**, who heads the Monetary Policy and Research Department at the Bank of Finland.

The security situation in Europe has been fundamentally shaken by Russia embarking on its war against Ukraine and by its continued aggression on the territory of an independent state. Sharing a long border with Russia, Finland ought to have a clear desire to strengthen common security policy within the EU, but this also calls for greater coherence in EU economic policy.

The Europe Forum event in Turku is an annual event that examines Finland’s role in Europe and in the European Union. The theme of this year’s Europe Forum is ‘Europe’s secure future’. This year’s Esko Antola Lecture is the fifth such lecture organised by the Bank of Finland for the Europe Forum programme. The lecture is named after Esko Antola, a pioneer of research in European studies in Finland.

The Europe Forum programme is available here: https://europeforum.fi/en/programme. The Europe Forum events are open to everyone, but attendance in person requires advance registration online.

The Bank of Finland’s events at the Europe Forum:

- Esko Antola Lecture ‘From peace project to security union – EU transformation and Finland 1994–2024’, The Little Stage, Turku City Theatre, Thursday 29 August at 11:00. Join the livestream here.
- ‘A common economic policy as an EU security guarantee?’ – Panel discussion, The Little Stage, Turku City Theatre, Thursday 29 August at 16:00. The discussion will be in English. Join the livestream here.

ECB Monetary policy decisions

News 18 July 2024 3:25 PM

ECB press release 18 July 2024

The Governing Council today decided to keep the three key ECB interest rates unchanged. The incoming information broadly supports the Governing Council's previous assessment of the medium-term inflation outlook. While some measures of underlying inflation ticked up in May owing to one-off factors, most measures were either stable or edged down in June. In line with expectations, the inflationary impact of high wage growth has been buffered by profits. Monetary policy is keeping financing conditions restrictive. At the same time, domestic price pressures are still high, services inflation is elevated and headline inflation is likely to remain above the target well into next year.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. It will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. The Governing Council will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. In particular, its interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. The Governing Council is not pre-committing to a particular rate path.

Key ECB interest rates

The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 4.25%, 4.50% and 3.75% respectively.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The Eurosystem no longer reinvests all of the principal payments from maturing securities purchased under the PEPP, reducing the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

***

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

Account of the ECB Governing Council’s monetary policy meeting, 5-6 June 2024

News 4 July 2024 2:30 PM

ACCOUNT OF THE MONETARY POLICY MEETING OF THE GOVERNING COUNCIL OF THE EUROPEAN CENTRAL BANK HELD IN FRANKFURT AM MAIN ON WEDNESDAY AND THURSDAY, 5-6 JUNE 2024

4 July 2024

1. REVIEW OF FINANCIAL, ECONOMIC AND MONETARY DEVELOPMENTS AND POLICY OPTIONS

FINANCIAL MARKET DEVELOPMENTS

Ms Schnabel noted that since the Governing Council’s previous monetary policy meeting on 10-11 April 2024, the narrative in financial markets had converged across major advanced economies. It had moved towards a more gradual easing cycle and high-for-longer interest rates, owing to a more protracted “last mile” of disinflation. The key drivers of financial market developments had been a stronger euro area economy, signs of a cooling US economy and strong investor risk appetite.

Euro area macroeconomic data had continued to turn out better than expected over the past four months, strengthening investors’ view that the economic recovery was on track. By contrast, macroeconomic data surprises in the United States had become less favourable. Tentative signs of the US labour market cooling and inflation in line with expectations had eased investors’ concerns that the Federal Reserve System might have to hike interest rates again.

Looking at how the incoming data had affected expectations for ECB monetary policy, the expected timing of the first rate cut had remained unchanged. Markets and survey participants were almost certain there would be a first cut of 25 basis points in June. Yet the overnight index swap (OIS) forward curve had edged higher beyond June. It was cumulatively pricing in around 20 basis points less in rate cuts by the end of 2024 than it had before the Governing Council’s previous monetary policy meeting in April. In the June Survey of Monetary Analysts (SMA) the median participant expected three rate cuts of 25 basis points each by the end of 2024. This was more than the cuts embedded in market pricing, but one cut less than survey participants had expected before the Governing Council’s previous monetary policy meeting.

With US inflation having repeatedly surprised on the upside since the Federal Reserve’s pivot in December 2023, market pricing in the United States had also gradually shifted towards fewer and later rate cuts in 2024. Most recently, however, more subdued US economic data and an inflation release broadly in line with expectations had caused market participants to again price in a slightly steeper easing cycle.

As a result, the narrative of monetary policy divergence across the Atlantic had not played out strongly so far. By the end of 2024 policy rate cuts were expected to diverge modestly, as the ECB was expected to start its easing cycle ahead of the Federal Reserve, but that divergence was expected to vanish by the end of 2025. Hence, monetary policy was expected to remain relatively synchronised, with markets anticipating a more gradual and cautious easing cycle across both economies. Yet the uncertainty around this gradual easing cycle remained high on both sides of the Atlantic.

Market expectations of a more gradual easing cycle and elevated uncertainty around the rate path rested upon anticipation of a more protracted and bumpier disinflation path. At the start of 2024, investors had expected swift and continuous disinflation. At that time markets had priced in euro area headline inflation (excluding tobacco) returning to the 2% target by June 2024 and subsequently staying around that level. Since then, markets had gradually priced in a bumpier inflation profile. While investors still expected inflation to be close to 2% by June 2025, they expected it to hover in a range of 2.3% to 2.5% until at least the end of 2024. At the same time, the medium and longer-term inflation profile had also edged up, suggesting that investors did not anticipate a scenario in which inflation would return to below-target levels, as seen during the "low-for-long" period.

The reconvergence in policy rate expectations between the euro area and the United States had also been reflected in longer-term risk-free yields. Since the Governing Council's previous monetary policy meeting, the spread between US and euro area nominal yields had narrowed from its peak in April. Movements in yield differentials between the euro area and the United States had been mirrored in the euro-US dollar exchange rate, with the euro recently having recovered some of its losses against the US dollar.

Euro area financial conditions had been mixed in recent weeks. One important driver of these conditions had been risk asset prices. After the downward correction in equity markets in mid-April 2024, when US rate cuts had been pushed out in time, stock markets had recovered across major economies, temporarily even reaching new all-time highs in the euro area and the United States.

The combination of buoyant risk sentiment globally and recovering domestic growth momentum had also continued to contain sovereign bond spreads. At the same time, market absorption in euro area government bond markets had remained smooth, supported by benign liquidity conditions. The smooth market absorption was even more remarkable when considering the further increase in the net issuance of euro area government bonds in 2024. Together with the reduction in the Eurosystem's market footprint, this had resulted in record levels of net supply in 2024.

Strong investor risk appetite had fostered low corporate bond spreads, which had narrowed further for high-yield bonds since the Governing Council's previous monetary policy meeting in April. Therefore, risks of price corrections continued to be elevated, especially in the high-yield segment. Overall, asset price configurations in equity markets and in the sovereign and corporate bond space pointed to stretched valuations in riskier market segments and to risks of price corrections if the historically buoyant risk sentiment turned.

Pricing in risk asset markets continued to be supported by still abundant central bank liquidity. Euro area excess liquidity had continued to decline and stood 33% or €1.6 trillion below its peak of €4.7 trillion in November 2022. The spread between the euro short-term rate (€STR) and the deposit facility rate showed few signs of a lift-off from its floor. At -9.3 basis points, it remained close to the levels seen over the past year.

THE GLOBAL ENVIRONMENT AND ECONOMIC AND MONETARY DEVELOPMENTS IN THE EURO AREA

Starting with the global economy, Mr Lane stressed that 2023 had still been part of the post-pandemic normalisation process. The supply side had been a big driver of the strong performance of global growth, while euro area competitors' export prices had fallen. The carry-over from that was partly responsible for the low levels of goods inflation now observed in the euro area. Developments in global activity were looking favourable up to April, mainly because of the soft data, but the outlook for global trade in the second quarter was mixed.

Looking ahead, the June 2024 Eurosystem staff macroeconomic projections were built on a stable external environment. In annual terms, world GDP excluding the euro area was projected to grow at 3.3% in 2024 and 2025. Growth in euro area foreign demand was set to recover this year, rising to 2.1% from 0.8% last year. It was subsequently expected to grow at rates of around 3%. The euro had remained broadly stable both against the US dollar and in nominal effective terms since the last monetary policy meeting of the Governing Council. From a longer-term perspective too, the EUR/USD exchange rate had been broadly stable, though the euro had appreciated since the start of the year in trade-weighted terms. Oil prices had shown sizeable fluctuations over the past year and had decreased by 16% to USD 78 per barrel since the April Governing Council meeting. Looking ahead, they were expected to remain volatile, which was also linked to geopolitical risks. Gas prices meanwhile had gone in the other direction: since the last Governing Council meeting, European gas prices had increased by 32% to €36 per megawatt, although demand remained subdued and gas storage levels were high.

Turning to the euro area, headline inflation had been 2.6% in May according to the flash estimate, 0.2 percentage points higher than in April. Energy inflation had increased to 0.3% from -0.6% in April, mainly driven by upward base effects, while food inflation had receded to 2.6% in May from 2.8% in April. Inflation excluding energy and food (core inflation) had risen to 2.9% in May from 2.7% in April. The decline in goods inflation by 0.1 percentage points to 0.8% had been offset by a rebound in services inflation. This had increased to 4.1% in May after having slowed in April – for the first time in five months – to 3.7%.

Most measures of underlying inflation had eased further, reflecting the fading impact of past large supply shocks and weaker demand, and were drifting lower towards 2%. At the same time, some underlying inflation indicators remained relatively high, reflecting the lagged unwinding of past inflationary shocks, strong ongoing labour cost increases and/or the one-off repricing in some services items.

Wage growth was still elevated, driven by the ongoing adjustment to the past inflation surge. Negotiated wage growth had increased to 4.7% in the first quarter of 2024, 0.2 percentage points higher than in the last quarter of 2023. The stronger growth in the first quarter included very large one-off payments in the public sector of the euro area’s largest economy. More broadly, the design of some multi-year wage settlements in that economy specified large increases in 2024 – to compensate for the lack of earlier adjustments to the inflation surge – but much smaller increases in 2025.

Forward-looking wage trackers signalled that wage dynamics would remain strong in 2024 but decelerate in 2025. For this year many wage contracts had already been concluded. The Indeed wage tracker had declined to 3.4% in April. Similarly, firms participating in the Corporate Telephone Survey in April expected wages to grow by 4.3% in 2024, compared with 5.4% in 2023. Therefore wage growth would continue to be a key driver of inflation in 2024, even though the net impact of labour cost increases on prices was being buffered by a lower contribution from profits.

The GDP deflator was expected to still come in high for the first quarter of 2024, but to decelerate significantly compared with the fourth quarter of 2023, when it had stood at 5.3%. The deceleration in domestic price pressures was therefore continuing and the projections foresaw a further moderation. This relied on the ongoing compression of profits and a continued decline in unit labour costs, linked to the scale of the procyclical improvement in productivity.

Inflation was projected to fluctuate around current levels in the coming months. The headline inflation profile in 2024 was affected by the rolling back of fiscal measures and upward energy base effects. Headline inflation was then expected to decline towards the target over the second half of the following year, owing to weaker growth in labour costs in 2025 than in 2024, the lagged impact of past monetary policy tightening gradually feeding through to consumer prices, and the fading impact of the energy crisis and the pandemic on price and wage dynamics. The June Eurosystem staff projections saw inflation averaging 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026. Compared with the March ECB staff projections, headline inflation had been revised up by 0.2 percentage points for both 2024 and 2025 and was unchanged for 2026.

For core inflation, staff projected an average of 2.8% in 2024, 2.2% in 2025 and 2.0% in 2026. This implied an upward revision of 0.2 percentage points in 2024 and 0.1 percentage points in 2025, while the projection for 2026 remained unchanged.

A central element in this projection was the gradual easing of nominal wage growth from initially elevated levels. The upward impact of inflation compensation pressures in a tight labour market was seen as fading in the period ahead. A recovery in productivity growth should support the moderation in labour cost pressures. Moreover, profit growth should weaken and partially buffer the pass-through of labour costs to prices.

Measures of shorter-term inflation expectations had declined since the previous year, while longer-term inflation expectations had remained broadly stable, with most standing at around 2%.

With some uncertainty surrounding the staff projections, it was useful to compare projections for the fourth quarter of each year. The fourth quarter was less affected by carry-over effects. Relative to the outlook in September 2023, the projected timely return of inflation to target had been reconfirmed in the December, March and June staff projections. The stability of projected inflation at the end of 2025 over the last four rounds of projections had been remarkable. In addition, the inflation outlook for 2026 had been reconfirmed over the last two rounds.

Turning to economic activity, after five quarters of stagnation, euro area GDP had grown by 0.3% over the first quarter of 2024. Preliminary aggregates for national GDP figures available so far showed that economic growth in the first quarter had mainly been driven by net exports, and domestic demand had only played a fairly limited role. Incoming information suggested continued growth in the short run, driven by a pick-up in consumption growth amid rising real disposable income and improving confidence. Over the medium term the negative impact of the past monetary policy tightening was seen to fade gradually. Growth would also benefit from a resilient labour market, with the unemployment rate declining further from historically low levels.

The services sector had been expanding at a solid pace, with accommodation and food services contributing to the dynamism. Manufacturing activity had also improved significantly in May, according to the Purchasing Managers' Index (PMI) survey, but it remained in contractionary territory.

With regard to consumption, surveys signalled strong developments in contact-intensive services, while for goods – both retail and durable goods such as motor cars – surveys pointed to figures well below normal levels. There had clearly been a recovery in consumer confidence in the course of 2023 as the terms of trade improved, but confidence had been fairly flat for several months now. Consumer uncertainty had come down but was still relatively high. Housing investment had increased in the first quarter – helped by temporary factors in the largest euro area economy, such as the mild weather. Business investment was projected to grow over the year.

For most of 2023 global imports had grown more strongly than euro area exports, leading to a loss in market share for the euro area. Since the start of 2024 euro area exports had been growing more quickly than global imports, but global imports were decelerating. Forward-looking PMIs remained muted for exports, but an expansion of activity in the tourism sector was expected, although not on the same scale as in the previous two years.

The unemployment rate had edged down to 6.4% in April, the lowest level since the start of the euro. Employment had increased in line with economic activity in the first quarter and was expected to grow moderately in the second quarter. Some indicators suggested a marginal softening of labour market conditions. The job vacancy rate had declined by 0.1 percentage points to 2.8% in the first quarter of the year, which was still high but continued the gradual easing from its peak in the second quarter of 2022. The Indeed job postings suggested that this trend would continue in the second quarter.

Developments in fiscal policies pointed to an improvement in the budget balance over the next few years. Active fiscal adjustment in 2024 was seen as easier than in the austerity years because a large part related to the reversal of fiscal subsidies, and this was considerably less painful than cutting pay or reducing employment. The fiscal multipliers were also smaller. In terms of dynamics, there was only a limited revision of fiscal plans compared with the March projections.

The recovery should strengthen in the coming quarters. The latest staff projections saw economic growth at 0.9% in 2024, 1.4% in 2025 and 1.6% in 2026. Compared with the March projections, the outlook for GDP growth had been revised up by 0.3 percentage points for 2024, owing to the positive surprise at the start of the year and improved forward-looking information. For 2025 it had been revised down marginally by 0.1 percentage points, while it was unrevised for 2026.

Risk-free market interest rates had increased for most maturities since the previous monetary policy meeting. The market had priced in higher real rates on the back of higher than anticipated inflation readings and the stronger economy. Financing costs had plateaued at restrictive levels as the past policy rate increases had worked their way through the financial system. The average interest rates on new loans to firms and new mortgages had been unchanged in April, at 5.2% and 3.8% respectively. Credit dynamics remained weak. Bank lending to firms had grown at an annual rate of 0.3% in April, down slightly on the previous month. Growth in loans to households had been unchanged at 0.2% on an annual basis. The annual growth in broad money as measured by M3 had risen to 1.3% in April, from 0.9% in March, as the euro area’s growing current account surplus and non-resident demand for euro-denominated securities gave rise to monetary inflows from outside the euro area.

MONETARY POLICY CONSIDERATIONS AND POLICY OPTIONS

Overall, the updated joint assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission (the three elements of the ECB’s “reaction function”) supported increased confidence that inflation was converging to target in a timely and sustained manner. In particular, inflation was projected by staff to fall from 5.4% in 2023 to 2.5% in 2024, on average, and to decline towards target over the second half of 2025. Reflecting higher energy and non-energy commodity prices and the recent upside surprises in services inflation, this disinflation was somewhat slower in the updated projections. At the same time, the incoming data suggested that the economic recovery was proceeding only at a moderate pace (which, in turn, pointed to contained risks of demand-driven inflation pressures).

A granular analysis of the drivers of domestic inflation, services inflation and wage growth indicated that these should see a marked deceleration in 2025 relative to 2024. The partial data already available for the first quarter of 2024 also showed that the compression of unit profits was helping to absorb wage growth, thus giving grounds for increased confidence about the assumption that profits would be playing an important buffering role. Over time, disinflation would be supported by the restrictive monetary policy stance and the fading impact of past inflation on ongoing price pressures, while the countervailing impact of the reversal of fiscal support measures would fall out of the data.

Relative to the start of the holding period in September 2023, when the ECB had brought the policy rates to their current levels, the projected timely return of inflation to target had been reconfirmed in the December, March and June projection rounds. For instance, the inflation rate projected for the end of 2025 had been remarkably stable over the last four projection rounds. In particular, between the September 2023 and the June 2024 rounds, the projected HICP inflation rate for the fourth quarter of 2025 compared with a year earlier had fluctuated within a very narrow interval of 1.9-2.0%. The inflation outlook for 2026 had been confirmed over the last two projection rounds. Moreover, the overall speed of disinflation had been faster than expected. Over this period, inflation had come down by 2.6 percentage points. Whereas, at the start of the holding period, staff had seen inflation averaging 5.6% in 2023 and 3.2% in 2024, inflation had actually averaged 5.4% in 2023 and the inflation rate for 2024 had been marked down to 2.5% in the latest projection exercise. The set of underlying inflation indicators also showed considerable progress compared with the start of the holding period, with most gauges drifting lower towards 2%. This improvement in the inflation profile had reduced the risk that “too high for too long” inflation posed to the stability of inflation expectations, including through its impact on future wage settlements. Measures of shorter-term inflation expectations had declined over recent months, while measures of longer-term inflation expectations had remained broadly stable, with most standing at around 2%.

Meanwhile, the transmission side of the reaction function remained strong. Mortgage rates were measurably lower than their autumn peak, but indices of the affordability of mortgage loans still pointed to restrictive conditions. Rates on corporate loans had been moving sideways in nominal terms (and therefore upwards in real terms), dampening demand for external finance. Activity was recovering, although less so in the segments of demand most sensitive to interest rates, such as construction activity – abstracting from temporary factors – and non-construction business investment. Overall, the incoming data on financing conditions signalled that the monetary stance remained restrictive, and this would help maintain the disinflationary process. In particular, compared with the start of the holding period, real lending rates for firms and households had risen markedly.

An interest rate decision should be robust across a wide range of scenarios. At a still clearly restrictive level of 3.75% for the deposit facility rate, even large upside shocks to inflation (including more persistent than expected services inflation or weaker than expected monetary transmission) could be addressed by a slower pace of rate cuts than in the baseline rate path embedded in the projections. At the same time, a policy rate level of 3.75% offered greater protection against downside shocks than if it remained at 4.0%.

Based on this assessment, it was now appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady. Accordingly, Mr Lane proposed that the three key ECB interest rates be lowered by 25 basis points.

At the same time, Mr Lane underlined that the high level of uncertainty and the still elevated price pressures evident in the domestic inflation, services inflation and wage growth indicators meant that a restrictive monetary stance would still need to be maintained, following a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. Over time, the incoming data would provide information about the balance between one-off elements and the persistent component in inflation, while the evolution of cost dynamics (including the interplay between compensation and productivity) and domestic pricing power would depend on the strength and composition of the cyclical recovery. In charting the future course of policy, the Governing Council should also maintain its three-part evaluation framework based on the inflation outlook, the dynamics of underlying inflation and the state of monetary policy transmission.

The Governing Council should also confirm its previously communicated intention to reduce the PEPP portfolio by €7.5 billion per month, on average, over the second half of the year, and reiterate its intention to discontinue reinvestments under the PEPP at the end of 2024. The operational modalities for partial reinvestments of PEPP redemptions should closely follow the precedent of the APP partial reinvestment phase, which would help ensure that the process remained transparent and as neutral as possible to the pricing in financial markets. Furthermore, Mr Lane proposed that flexibility continue to be allowed in the remaining PEPP reinvestments as an effective first line of defence against fragmentation risks, but to be exercised only if market conditions deteriorated.

Finally, in line with the monetary policy strategy, staff had assessed the links between monetary policy and financial stability. The analysis suggested that euro area banks remained resilient. The improving economic outlook had fostered financial stability, but heightened geopolitical risks clouded the horizon. An unexpected tightening of global financing conditions could prompt a repricing of financial and non-financial assets, with negative effects on the wider economy. Macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities. The measures that were currently in place or would soon take effect were helping to keep the financial system resilient.

2. GOVERNING COUNCIL’S DISCUSSION AND MONETARY POLICY DECISIONS

ECONOMIC, MONETARY AND FINANCIAL ANALYSES

As regards the external environment, the latest data, both soft and hard, pointed to sustained momentum in global activity and a strengthening of global trade in the first half of 2024. Members pointed to uncertainty related to political and economic developments in the world's two largest economies and their potential spillovers to the euro area. A question was raised regarding growth policies adopted in China and their impact on activity and inflation in the euro area. Strong expansion of manufacturing capacity would boost Chinese exports and likely imply a loss of export market share and lower economic growth for the euro area, associated with stronger disinflationary forces. At the same time, if a large part of European production capacity were to be driven out of the market, it would mean costly write-offs of investment with possibly inflationary consequences.

Concern was expressed that the global trading system could see increased fragmentation into separate economic blocs if authorities engaged in reciprocal tariff-raising. While deglobalisation was, as yet, not clearly visible in the data, it was considered an important risk for the future. However, quantifying this risk was difficult and possible outcomes could lie anywhere between limited sector-specific consequences and a wider breakdown of trade links. The view was put forward that deglobalisation, greater protectionism and the rising costs of climate change were global trends affecting the supply side of the economy and giving rise to longer-term inflation pressures.

With regard to the euro area economy, members widely noted that the June 2024 Eurosystem staff projections entailed upward revisions to both economic growth and inflation. Inflation was likely to stay above target well into next year. Headline and core inflation had both been revised up for 2024 and 2025 compared with the March projections. On economic activity, the latest data lent support to the recovery that had been anticipated in previous projection rounds. After five quarters of stagnation, the euro area economy had grown by 0.3% over the first quarter of 2024.

The upward surprise in first quarter growth was seen as allaying fears of a materialisation of the downside risks that had been identified in previous discussions. Concerns that monetary policy would unduly hold back growth were also diminishing. However, it was argued that the better than expected outcome had relied on a pick-up in construction and net exports, in part reflecting temporary factors. Nonetheless, the surprise had prompted staff to revise up their growth expectations significantly for 2024 as a whole, following a succession of projection rounds with downward revisions.

In this context, some doubts were raised about whether the recovery would take place as expected, since this depended on a pick-up in private consumption for which there was no convincing evidence as yet in the data. It was also noted that the staff projections entailed an upward revision to the saving ratio. In addition, the concern was raised that, in the presence of both domestic political and geopolitical uncertainties, the saving ratio could go even higher than expected. If this were to happen, consumption could be curtailed for longer. However, as the upward revision to household savings came at the same time as a more favourable growth outlook – and the revision kept the ratio well above pre-pandemic levels – a higher propensity to consume could also be envisaged, with the associated upside risk to consumption growth in the baseline.

Like consumption, investment had also remained weak in the first quarter. It was argued that it likely reflected a fair amount of replacement investment, which could not be expected to provide a strong impulse for the recovery. Business investment was being held back by weak final demand and high borrowing costs. At the same time it was suggested that, from a sectoral perspective, the expected recovery in activity was well on track. The weakness in manufacturing appeared to have bottomed out and the latest survey data supported the notion of a services-led recovery. While the impact of restrictive monetary policy was seen to be gradually fading, the services sector had anyway been affected less strongly. This sector was less capital-intensive and thus less interest rate-sensitive, while still responding to the indirect influence of monetary policy through a general dampening of aggregate demand. Tourism was seen as an important component in the growth of services and was driven to a large extent by domestic real incomes in the euro area and, to a lesser extent, by foreign demand.

Turning to the labour market, members considered that, overall, it had remained persistently robust. This was a key element in the soft landing of the economy. It was seen as puzzling that the market indicators of labour hoarding were still relatively unchanged and that there was not more labour shedding and unemployment – at least in industry and construction. Shortages of labour persisted, especially in the services sector. At the same time, the point was made that, coming from historically high employment and low unemployment, the market could realistically only be expected to slacken. Moreover, net employment gains concealed much larger numbers for turnover and new contracts, suggesting that firms were using this churning to foster productivity gains and thus help absorb a rising wage bill.

With respect to fiscal and structural policies, members reiterated that national policies should aim at making the economy more productive and competitive. This would help raise potential growth and reduce price pressures in the medium term. An effective, speedy and full implementation of the Next Generation EU (NGEU) programme, progress towards capital markets union and the completion of banking union, and a strengthening of the Single Market would help foster innovation and increase investment in the green and digital transitions. Implementing the EU's revised economic governance framework fully and without delay would help governments bring down budget deficits and debt ratios on a sustained basis. It was stressed that a speedy and full implementation of NGEU programmes for innovation and green transitioning would also help reduce price pressures in the medium term. Some concern was expressed that, in a period of political uncertainty and multiple elections, fiscal policy might show less consolidation by the end of this year than was factored into the current projections.

Against this background, members assessed that the risks to economic growth were balanced in the near term but remained tilted to the downside over the medium term. A weaker world economy or an escalation in trade tensions between major economies would weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. Adverse geopolitical developments could result in firms and households becoming less confident about the future and global trade being disrupted. Growth could also be lower if the effects of monetary policy turned out stronger than expected. Growth could be higher if inflation came down more quickly than expected and rising confidence and real incomes meant that spending increased by more than anticipated, or if the world economy grew more strongly than expected. It was suggested that risks to growth could also emerge from wage increases if these decoupled from the pace that firms could realistically absorb in productivity increases, implying a loss of competitiveness and market share, and ultimately a fall in investment and activity. Seen from a different angle, a weaker than expected economic recovery would curtail the expected productivity increases and lead to lower profit margins. This would reduce the economy's capacity to absorb the increases in real wages already embedded in wage contracts and the projection baseline.

With regard to price developments, members concurred with the assessment by Mr Lane that the latest data were a reflection of the bumpy profile of headline inflation expected in 2024. On the one hand, the fact that the latest figures for headline and, in particular, services inflation had been higher than in the March 2024 projections was seen to increase the uncertainty surrounding the further disinflation path. On the other hand, it was argued that the upward surprise in the latest data had been incorporated by staff into the June projections without subsequent offsetting, which was a prudent approach.

It was underlined that the upward revision of inflation in 2024 and 2025 had pushed the return to target to the end of 2025. While the projection for 2026 was unchanged, it was pointed out that this rested on the assumption that energy and food inflation would move below their longer-term averages. In view of the notoriously volatile nature of these two components and their exposure to the effects of geopolitics as well as climate change and transition policies, these benign assumptions were seen to be highly uncertain. In the shorter term, the projected inflation path was bumpy for the remainder of 2024, which was mainly due to base effects and was thus anticipated. When the inflation path was corrected for base effects, both the recent actual outcomes and the projected trend over the short-term horizon were seen to point clearly downwards. It was widely underlined that, despite the upward inflation surprises in April and May, the bigger picture remained one of ongoing disinflation.

Members noted that the May inflation numbers had been released after the cut-off date for the projections. Services inflation, at 4.1% in May, had surprised on the upside, had shown persistence, and was demonstrating strong momentum. However, a lot of persistence was already embedded in the projections and it was therefore argued that recent outcomes should not be viewed unambiguously as an upside risk to the current baseline inflation path. The strength of services inflation in the past few months stemmed, to a large extent, from the resetting of infrequently changed prices in areas such as insurance and healthcare. The wage-sensitive part of services inflation had continued to moderate. It was noted that, for core inflation, the persistence of services inflation had so far been broadly offset by the strong disinflation in the goods sector. This could not be expected to continue, in view of the fading impact of the reversal of past supply side shocks. Moreover, new headwinds could emerge for goods inflation in a world that was more prone to frequent supply chain disruptions, geopolitical fragmentation, protectionism and climate change dynamics. Hence, in the future low goods inflation would not always reliably compensate for an overshooting in services inflation.

Turning to domestic price pressures, wages were still rising strongly, making up for the past inflation surge, and were now the main determinant of inflation persistence. Owing to the staggered nature of the wage-adjustment process and the important role of one-off payments, the process of wages catching up with prices would likely feed into inflation for a considerable time, as seen in the pick-up in the growth of negotiated wages in the first quarter. All labour cost indicators, including Eurostat's new labour cost index, were at very high levels, and the anticipated moderation still had to materialise. At the same time, forward-looking indicators signalled that wage growth would moderate over the course of the year. Profits were absorbing part of the pronounced rise in unit labour costs, which reduced its inflationary effects.

It was reiterated that wages were a key element in the assessment of the inflation outlook. This was related in particular to their prominent role in the setting of services prices, but a range of indicators needed to be considered to form a holistic assessment. Growth in negotiated wages had increased to 4.7% in the first quarter of 2024. Moreover, data already available for a number of euro area countries suggested that growth in compensation per employee for the euro area as a whole was likely to remain in the first quarter at the elevated levels recorded in the fourth quarter of 2023.

The point was made that most of the latest wage information had already been incorporated in the baseline of the June staff projections and thus did not indicate upside risk. The same data, however, had already contributed to upward revisions of wage growth compared with the March projections, which was a warning not to underestimate the strength of wage dynamics and the scope for further surprises in the course of 2024. At the same time, it was emphasised that, taking into account available country-based estimates, the euro area GDP deflator, unit labour costs and unit profits had probably increased more slowly in the first quarter of 2024 than had been embedded in the June projections.

High current wage growth was considered to reflect to a large extent workers seeking compensation for past purchasing power losses. Wage dynamics were therefore likely to slow once this process was complete and inflation was normalising. It was cautioned that the catching up could nonetheless imply a drawn-out process and bumpy wage path, depending on when contracts came up for renewal in the staggered wage-setting process and for which period of inflation they were compensating. Attention was drawn to one-off payments, which played an important role, particularly in light of fiscal incentives that were set to expire. However, there were indications from unions that such one-off payments might not be transitory but in future be factored into regular pay rises.

More generally, a view was expressed that the catching up could lead real wages to exceed their pre-war or pre-pandemic levels or trends in an environment of protracted labour scarcity and possible shifts in bargaining power between capital and labour. In addition, it was remarked that the scope for buffering higher wages via a compression of profit margins was more limited in the services sector, which was also less exposed to international competition and was experiencing robust demand. However, there were also risks going in the opposite direction for the wage growth profile. It was argued that some of the recent high wage settlements had taken place in sectors which had made substantial profits over the past three years.

This allowed employers to grant generous wage increases and to absorb them without passing them on to final prices.

Incoming data on the critical relationship between wages, productivity and profits was seen, overall, as supporting prudent inflation projections and an ongoing disinflation process. However, it was also cautioned that uncertainty surrounding the outlook was very high and that, in the transition to lower inflation after a period of large shocks and possible structural changes, such relationships might start evolving differently from historical patterns. Hence, continued prudence was warranted with respect to relying on standard projection models, and more actual data was needed to provide sufficient confidence that disinflation would continue and not stall on the last mile. At the same time, diminishing projection errors were seen to give grounds for renewing confidence in the projections.

As regards longer-term inflation expectations, measures had, overall, remained broadly stable, with most standing at around 2%. Somewhat higher rates for market-based measures essentially reflected higher inflation risk premia, while “genuine” inflation expectations remained anchored at the inflation target. While the anchoring of expectations across indicators could be taken as a sign of the credibility of monetary policy, the literature on “experience effects” warned that extended periods of high inflation could have a lasting impact on the formation of inflation expectations, making them more fragile and anchoring more difficult in the future. In this context, however, comfort was drawn from the gradual lowering of consumer inflation expectations, even if levels in household surveys typically remained above the ECB’s inflation target. This was seen as signalling trust in the disinflation process and would have a self-fulfilling element if it contributed to a moderation in wage claims and firms’ pricing power.

Members assessed that inflation could turn out higher than anticipated if wages or profits increased by more than expected. Upside risks to inflation also stemmed from the heightened geopolitical tensions, which could push energy prices and freight costs higher in the near term and disrupt global trade. Moreover, extreme weather events, and the unfolding climate crisis more broadly, could drive up food prices. By contrast, inflation could surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly. It was suggested that there could be further risk factors for inflation, related for instance to the extent of the expected pick-up in productivity growth or the evolution of the fiscal stance underpinning the inflation outlook. However, these elements could develop in either direction and were therefore not decisive elements in the balance of risks.

Against this background, members expressed different views regarding directional changes in the balance of risks. On the one hand, it was argued that, all other things being equal, the staff’s upward revisions to the baseline implied a reduction in remaining upside risks and made the risks more balanced. On the other hand, it was maintained that the downside risk related to a stronger transmission of monetary policy was gradually receding, while continued upside risks such as from higher labour costs shifted the balance to the upside.

Turning to the monetary and financial analysis, market interest rates had risen since the Governing Council’s previous meeting and real interest rates had also recently increased. Market participants were fully pricing in a 25 basis point cut in the key ECB interest rates at the June meeting, with between one and two further cuts priced in by the end of the year. A shallower easing cycle was now expected on both sides of the Atlantic amid similarities in recent inflation trends globally.

Financial markets were supported by strong risk appetite, which contrasted with the limited risk appetite among euro area consumers and firms. This suggested either that financial market sentiment would weaken at some point or that the real economy would catch up. Market sentiment was also buoyant despite heightened geopolitical risks and uncertainties. The risk of mispricing in financial markets was therefore being monitored, also from a financial stability perspective.

Financing costs had plateaued at restrictive levels as the past policy rate increases had worked their way through the financial system. The average interest rates on new loans to firms and on new mortgages had been unchanged in April. But lending rates had increased in real terms since the time of the last rate hike in September 2023.

Credit dynamics remained weak. Credit flows to firms had been broadly stable at low levels in both March and April, taking bank lending and debt securities together. Firms' demand for loans for investment remained very weak, owing to both low aggregate demand and continuing high borrowing costs. Growth in loans for house purchase remained stagnant, while consumer credit growth was more resilient, yet still weak. The annual growth in broad money – as measured by M3 – continued its gradual recovery while remaining relatively subdued.

Looking ahead, loan growth was likely to gradually pick up. At the same time, it was highlighted that banks had not reduced their liquid asset holdings as targeted longer-term refinancing operations had matured and appeared to have a strong preference for liquidity. The lower supply of central bank liquidity in the system could therefore reduce the appetite of banks to lend. In this respect, the view was also expressed that as long as banks benefited from ample excess reserves remunerated at the deposit facility rate, they had a limited incentive to expand risky lending to the real economy.

In their biannual structured exchange on the links between monetary policy and financial stability, members concurred that euro area banks had remained resilient and continued to have robust capital and liquidity positions. The improving economic outlook had fostered financial stability, as also highlighted in the recently published Financial Stability Review. At the same time, geopolitical factors could increase risks in the period ahead. An unexpected tightening of global financing conditions could prompt a repricing of financial and non-financial assets, with negative effects on the wider economy. Macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities, and the measures currently in place or soon to take effect were helping to keep the financial system resilient.

MONETARY POLICY STANCE AND POLICY CONSIDERATIONS

Turning to the monetary policy stance, members assessed the data that had become available since the last monetary policy meeting in accordance with the three main elements that the Governing Council had communicated in 2023 as shaping its reaction function. These comprised the inflation outlook, the dynamics of underlying inflation, and the strength of monetary policy transmission.

Starting with the inflation outlook, members broadly concurred with the assessment that had been presented by Mr Lane in his introduction. The June staff projections for headline inflation had been revised up for 2024 and 2025 compared with the March projections. Inflation was expected to fluctuate around current levels for the rest of the year, including due to energy-related base effects. But it was still expected to decline towards the ECB's 2% target over the second half of next year, owing to weaker growth in labour costs, the unfolding effects of the ECB's restrictive monetary policy, and the fading impact of the energy crisis and the pandemic. Subsequently, inflation was expected to remain close to the target in a sustainable manner. Measures of longer-term inflation expectations had also remained broadly stable, with most anchored at around the 2% target, even though market-based expectations had moved up in the most recent period. The inflation expectations of consumers and firms had continued to decline gradually as well. Together, these developments in inflation expectations gave an indication of public trust and confidence in the disinflation process and the return of inflation to the 2% target.

Members generally expressed confidence in the inflation outlook confirming an ongoing disinflation process, as also reflected in the staff projections, although recent data suggested inflation could be stickier than had previously been expected and the exact speed at which it would return to target was uncertain. At the same time and from a longer-term perspective, it was highlighted that different vintages of projections made over the past year for inflation in 2025 had fluctuated in a narrow range of between 2% and 2.2%. This renewed stability could give rise to greater confidence in the reliability and robustness of the projections, and showed inflation remaining on track to meet the target in the medium term, notwithstanding the upward revisions in the inflation projections for 2024 and 2025. Smaller projection errors for headline inflation also supported confidence in this inflation outlook.

Members also broadly concurred that further progress had been made in terms of the dynamics of underlying inflation. Most measures of underlying inflation had declined further in April, the last month for which data were available, confirming the picture of gradually diminishing price pressures. At the same time, domestic price pressures remained strong, as wage growth was elevated. The staff projections for core inflation had also been revised up for 2024 and 2025 compared with the March projections, and momentum in both services and core inflation remained fairly strong. It would therefore still take time for more clarity to be obtained on the dynamics of important inflation drivers. Moreover, further evidence was required on both the extent to which unit profits would absorb the inflationary pressures from higher wages and whether productivity growth would rebound as expected.

Finally, members generally agreed that monetary policy transmission remained strong. Real interest rates stood close to their peak in this cycle. Monetary policy clearly remained in restrictive territory and would continue to do so for some time even if interest rates were cut further. This remained true even allowing for an upward shift in the natural rate of interest. The view was expressed that ongoing quantitative tightening also needed to be taken into account in the assessment of the policy stance. The restrictiveness of policy was reflected in weak credit dynamics and subdued aggregate demand. This had helped to lower inflation but also weighed on growth. Transmission would probably continue to unfold for some time, given that monetary policy affected the economy with long and variable lags. While the peak impact of restrictive monetary policy on financing conditions and GDP had probably already occurred, lags between the effect on output and the effect on prices could imply that the peak impact on inflation was still to come. Within that process, the transmission to services inflation could be weaker and slower than the transmission to goods inflation.

Overall, most members expressed continued or increased confidence that inflation was on track to decline sustainably to the 2% inflation target in a timely manner and by the end of 2025 at the latest. Some of the most recent data had been slightly less favourable than anticipated or hoped for in March and April. But it had been expected that the disinflationary path would be bumpy and noisy, with surprises likely in either direction. It was important to recognise that a smooth, linear disinflation process in 2024 was not a prerequisite for confidence in a timely return of inflation to the target. In addition, different indicators were providing contrasting signals on the future disinflation path.

More generally, it was important to step back and focus on the bigger picture. An excessive focus on individual observations and the details of developments between meetings ran the risk of not being able to see the wood for the trees. Being data-dependent meant not only looking at the most recent data but also assessing and being driven by all three reaction function elements, which included considering the wider inflation outlook. Recent developments and noise should not detract from the longer-term perspective indicating consistent disinflation and a timely and sustainable return of inflation to the 2% target. Despite recent volatility, the overall disinflation process had been proceeding well, with substantial progress made since the Governing Council last raised interest rates in September 2023. This was evident in the significant and greater than expected decline in both headline and core inflation since 2022 and since the time of the last rate hike. Headline inflation had halved since the time of the last hike, from 5.2% to 2.6%. The inflation outlook, especially for 2024, had also improved in the latest staff projections compared with the September and December 2023 rounds, even if the pace of disinflation was somewhat slower than had been anticipated in March and inflation projections for 2025 were slightly higher than they had been in September 2023. Market participants had remained confident in the medium-term disinflation process, even if volatility in nearer-term rate expectations reflected uncertainty over the pace of disinflation. It was important, therefore, not to overreact to adverse data or inflation numbers for a single month, since these did not necessarily imply a new trend and could reflect one-off factors, in the same way that it had been important not to overreact to positive numbers in previous months.

On balance, in the discussion of the inflation outlook and of the assessment of risks increased confidence was expressed that inflation would decline towards the 2% target over the second half of 2025 and subsequently remain sustainably at around that level. At the same time, it was underlined that decisions about the future always had to be taken in the face of uncertainty. So a key question was to assess when there was enough confirmation and confidence that inflation would return to target in a timely manner. At some point, it was necessary to make a judgement call based on the information available, even if that information was less conclusive than might be preferred. Such an approach should not be seen as conflicting with data-dependence, as waiting for full confirmation would almost certainly imply cutting interest rates too late, potentially creating a significant risk of undershooting the target.

It was also highlighted that the degree of restrictiveness needed to reduce inflation from 2.6% to 2% was likely to be lower than that in place since September 2023. Moreover, even following a 25 basis point cut, interest rates would remain in restrictive territory in relation to any current estimate of the natural or neutral rate of interest. This meant that stronger demand should not endanger the return of inflation to target and that upside shocks to inflation could be addressed by opting for a slower pace of rate reductions compared with the baseline rate path embedded in the projections. So there appeared to be little risk of needing to reverse policy unless large external shocks occurred, in which case such a policy reversal could be convincingly justified. Moreover, cutting interest rates by 25 basis points offered greater protection against downside shocks than keeping them at their current levels. Cutting interest rates now was thus robust across a wide range of scenarios and still maintained a cautious approach.

Some members felt that the data available since the last meeting had not increased their confidence that inflation would converge to the 2% target by 2025 but instead pointed to greater uncertainty in the outlook. For these members, even if the general disinflation trend remained intact in the bigger picture, the relevant point of comparison was with the data at the time of the last monetary policy meeting, or at most with the previous staff projections. At the time of the April meeting, interest rates had been kept on hold because there had not been sufficient confidence that inflation would return sustainably to the 2% target in a timely manner. Since then, however, wage growth had surprised to the upside and inflation seemed to be stickier, mainly on account of services inflation. Services inflation momentum was very high, and the pace of domestic disinflation had been overestimated in the recent period. Wage growth had also strengthened, and it was suggested that further significant wage pressures were in the pipeline. This pointed to greater stickiness ahead, which could increase price pressures for some time, even if wages themselves were a lagging indicator. In addition, the June staff projections for both headline and core inflation in 2024 and 2025 had been revised up compared with the March projections, with the latest projections for core inflation in 2024 barely changed from last September. Moreover, the projected return of headline inflation to the 2% target had been pushed out to the final quarter of 2025, after an already lengthy period of high inflation. Therefore, any further delay in bringing inflation back to target could make it more difficult to continue to anchor inflation expectations in the future. All of this suggested that the last mile, as the final phase of disinflation, was the most difficult.

These members also viewed risks to the inflation outlook as being tilted to the upside, partly because downside risks to inflation had diminished since the last meeting owing to the ongoing economic recovery but also owing to heightened geopolitical risks. It was argued that a small undershooting of inflation would be much less costly than a continued overshooting, especially as the anchoring of inflation expectations should not be taken as given.

Together, these considerations suggested that cutting interest rates was not fully in line with the principle of data-dependence, and that there was a case for keeping interest rates unchanged at the current meeting. Nevertheless, a willingness to support Mr Lane’s proposal was expressed, notwithstanding the reservations put forward.

MONETARY POLICY DECISIONS AND COMMUNICATION

Against this background, almost all members agreed with the proposal by Mr Lane to lower the three key ECB interest rates by 25 basis points. Based on the updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it was seen as appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady. Since the meeting in September 2023 inflation had fallen by more than 2.5 percentage points and the inflation outlook had improved markedly. The inflation projection for the fourth quarter of 2025 had fluctuated in a very narrow range of between 1.9% and 2% over that period, increasing confidence in the reliability, solidity and robustness of the projection showing that inflation would return to the 2% target in a timely manner. Underlying inflation had also eased, reinforcing the signs that price pressures had weakened, and over this period inflation expectations had broadly declined at all horizons. Monetary policy had kept financing conditions restrictive. By dampening demand and keeping inflation expectations well anchored, this had made a major contribution to bringing inflation back down.

A dissenting view was upheld, maintaining that the incoming data since the last meeting and upside risks to inflation did not support the case for a rate cut. In particular, current inflationary pressures evident in the recent data showed stickiness in inflation. This stickiness could be exacerbated by several different geopolitical risks. In addition, a decoupling from the path of US interest rates would risk adding to inflationary pressures via exchange rate effects.

With regard to future meetings, members emphasised that they remained determined to ensure that inflation returned sustainably to the 2% medium-term target in a timely manner and affirmed that they would keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. In view of continuing uncertainty surrounding the disinflationary process and the bumpy path ahead, it was seen as important to maintain a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and there should be no pre-commitment to a particular rate path, so that full optionality could be retained. Members also reiterated that monetary policy should continue to be based on the established elements of the reaction function.

Turning to communication, members agreed that it was important to convey the increased confidence in the disinflationary process that had justified the policy decision, while highlighting the need for continued caution and patience regarding the future disinflation path and continued determination to bring inflation back to target in a timely manner.

Members agreed with Mr Lane’s proposal to confirm the reduction of the Eurosystem’s holdings of securities under the PEPP by €7.5 billion per month on average over the second half of the year, with the modalities for reducing the PEPP holdings to be broadly in line with those followed under the APP. They also agreed to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio. In this context, it was noted that the earlier announcement of the intended PEPP run-off had been absorbed very smoothly by the markets.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

MONETARY POLICY STATEMENT

Monetary policy statement for the press conference of 6 June 2024

PRESS RELEASE

Monetary policy decisions

MEETING OF THE ECB’S GOVERNING COUNCIL, 5-6 JUNE 2024

MEMBERS

- Ms Lagarde, President

- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Cipollone
- Mr Elderson
- Mr Hernández de Cos
- Mr Holzmann
- Mr Kazāks*
- Mr Kažimír
- Mr Knot*
- Mr Lane
- Mr Makhlouf
- Mr Müller
- Mr Nagel
- Mr Panetta
- Mr Patsalides*
- Mr Rehn
- Mr Reinesch
- Ms Schnabel
- Mr Scicluna
- Mr Šimkus
- Mr Stournaras*
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić*
- Mr Wunsch

* Members not holding a voting right in June 2024 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

- Ms Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Horváth
- Mr Kaasik
- Mr Koukoularides
- Mr Kroes
- Mr Lünnemann
- Mr Madouros
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- Mr Šošić
- Mr Tavlas

- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

OTHER ECB STAFF

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

Release of the next monetary policy account foreseen on 22 August 2024.

Bank of Finland conference discussed monetary policy decision-making and implementation in low and high inflation environments

News 28 June 2024 11:12 AM

The international conference, held for the third time, discussed monetary policy in low and high inflation environments.

In his speech, Rehn discussed the exceptional inflation dynamics of the past crisis years and reflected on the main themes of the ECB’s upcoming monetary policy strategy review.

“For me, the experiences of recent years have, above all, highlighted the crucial role of inflation expectations in the making of monetary policy. Likewise, they have underscored the importance of a firm commitment to a medium-term inflation target in line with our strategy,” Rehn said.

Monetary policy analysis to support decision-making

In his speech, Governor of the Bank of Italy **Fabio Panetta** spoke about the outlook for monetary policy. According to Panetta, the main risks that the euro area may face in the medium term are a new wave of geopolitical shocks and increased political uncertainty within countries. Panetta expects, however, that, barring new upheavals, we will soon transition from the saga of the “last mile” to the reality of the “first smile” and the restoration of price stability.

Philip R. Lane, Chief Economist and Member of the Executive Board of the ECB, on the other hand, highlighted the role of modern monetary analysis at the ECB. According to Lane, extensive monetary analysis helps policymakers to form a better overall view of economic developments and to take into account the nexus of money, supply and demand of credit, and the real economy.

“Through expanding computation capacity and new machine learning techniques, the improved availability of granular data on financial intermediation is further broadening its scope and the relevance of its findings. For these reasons, monetary analysis plays a central role at the ECB,” Lane said.

In her speech, **Annette Vissing-Jørgensen**, Senior Adviser, Federal Reserve Board, spoke about the different factors that influence the optimal size of central bank balance sheets and how these factors differ between the euro area and the United States.

The event also included a topical discussion on monetary policy frameworks in low and high inflation environments. Participating in the discussion were **Signe Krogstrup**, Governor, Danmarks Nationalbank, **Mārtiņš Kazāks**, Governor, Latvijas Banka, and **Hong K. Bahng**, Director, Bank of Korea. The discussion was chaired by **Tuomas Välimäki**, Member of the Board, Bank of Finland.

Governor Olli Rehn’s speech

Photos from the conference

ECB Monetary policy decisions

News 6 June 2024 3:22 PM

ECB press release 6 June 2024

The Governing Council today decided to lower the three key ECB interest rates by 25 basis points. Based on an updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it is now appropriate to moderate the degree of monetary policy restriction after nine months of holding rates steady. Since the Governing Council meeting in September 2023, inflation has fallen by more than 2.5 percentage points and the inflation outlook has improved markedly. Underlying inflation has also eased, reinforcing the signs that price pressures have weakened, and inflation expectations have declined at all horizons. Monetary policy has kept financing conditions restrictive. By dampening demand and keeping inflation expectations well anchored, this has made a major contribution to bringing inflation back down.

At the same time, despite the progress over recent quarters, domestic price pressures remain strong as wage growth is elevated, and inflation is likely to stay above target well into next year. The latest Eurosystem staff projections for both headline and core inflation have been revised up for 2024 and 2025 compared with the March projections. Staff now see headline inflation averaging 2.5% in 2024, 2.2% in 2025 and 1.9% in 2026. For inflation excluding energy and food, staff project an average of 2.8% in 2024, 2.2% in 2025 and 2.0% in 2026. Economic growth is expected to pick up to 0.9% in 2024, 1.4% in 2025 and 1.6% in 2026.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. It will keep policy rates sufficiently restrictive for as long as necessary to achieve this aim. The Governing Council will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction. In particular, its interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission. The Governing Council is not pre-committing to a particular rate path.

The Governing Council today also confirmed that it will reduce the Eurosystem’s holdings of securities under the pandemic emergency purchase programme (PEPP) by €7.5 billion per month on average over the second half of the year. The modalities for reducing the PEPP holdings will be broadly in line with those followed under the asset purchase programme (APP).

Key ECB interest rates

The Governing Council decided to lower the three key ECB interest rates by 25 basis points. Accordingly, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will be decreased to 4.25%, 4.50% and 3.75% respectively, with effect from 12 June 2024.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The Governing Council will continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP until the end of June 2024. Over the second half of the year, it will reduce the

PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

***

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

Account of the ECB Governing Council's monetary policy meeting, 10-11 April 2024

News 10 May 2024 2:30 PM

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 10-11 April 2024

10 May 2024

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

Financial market developments

Ms Schnabel noted that since the Governing Council's previous monetary policy meeting on 6-7 March 2024 financial markets had started to price in some divergence between the monetary policy paths expected in the euro area and in the United States. This was reflected in a widening interest rate differential. In the United States, a series of solid economic data releases had signalled the US economy's resilience to the current levels of interest rates. This had led financial markets to expect the timing of a first interest rate cut to be later and the overall extent of monetary policy easing to be less than previously anticipated.

In the euro area, by contrast, expectations regarding the path of the ECB's monetary policy had changed to a lesser extent. Owing to the Governing Council's communication and incoming euro area economic data, spillovers of US rate expectations to the short end of the euro area yield curve had remained contained. Investors saw almost no chance of a rate cut at the present meeting, but had fully priced in a rate cut for June, followed by another two rate cuts later in the year. This was in line with evidence from the April round of the Survey of Monetary Analysts (SMA).

The increasing divergence between expected developments in euro area and US short-term interest rates had been mirrored in a visible divergence between longer-term interest rates in the two economies. Euro area longer-term overnight index swap (OIS) rates had increased only modestly since the Governing Council's previous monetary policy meeting on 6-7 March 2024, while OIS rates in the United States had increased notably over the same period. The increase in the United States reflected a rise in both the real interest rate and inflation compensation. This had not spilled over to the euro area, which pointed to a degree of decoupling of the longer end of the yield curve. An unprecedented combination of macroeconomic and monetary policy shocks common to both economies had driven the co-movement of US and euro area interest rates in 2022 and 2023 to the closest level seen since the global financial crisis. Since the start of 2024 the extent of the co-movement had diminished, as both macroeconomic developments and the outlook for monetary policy had become less synchronised across the two economies. The resulting widening of the yield differential since the Governing Council's monetary policy meeting in March had been accompanied by a slight depreciation of the euro exchange rate vis-à-vis the US dollar.

While recent ECB communication had cemented expectations of the timing of the initial cut in policy interest rates, the uncertainty around the subsequent policy path remained elevated. Volatility in euro area interest rate markets remained markedly elevated compared with the period before the ECB began to hike rates. By contrast, the benign macroeconomic developments in the global economy – especially in the

United States – and reduced downside tail risks to economic growth had gone hand in hand with very low volatility in risk asset markets. Measures of implied volatility in euro area and US equity markets had returned to pre-pandemic levels.

One source of still elevated uncertainty about the path of the ECB's monetary policy was that, based on options pricing, investors continued to assess risks to the euro area inflation outlook to be tilted to the upside despite the ongoing disinflation process. Among the drivers of these perceived upside risks to the inflation outlook, food prices had increased sharply over recent weeks, in part owing to extreme weather events related to climate change and the El Niño phenomenon. Brent crude oil prices had risen above USD 90 per barrel on fears of rising tensions in the Middle East.

Risk asset markets remained resilient to monetary policy uncertainty. The benchmark EURO STOXX index had increased further since the March monetary policy meeting, but the latest equity valuations continued to stand close to the historical median in the euro area. The rally in euro area equity markets since the start of the year had mainly been driven by large, internationally active euro area firms. Small and medium-sized companies, which were likely to be more dependent on domestic markets, had benefited less from the global risk-on environment. Given stretched market valuations in some segments, especially in the United States, the risk of a market correction had increased.

The combination of buoyant global risk asset markets with resilient growth and low market volatility had also continued to support euro area sovereign spreads vis-à-vis OIS rates. Despite a recent small uptick, spreads had remained at compressed levels, notwithstanding higher debt servicing costs and a recent deterioration in the fiscal outlook in several euro area economies.

As regards bank funding, markets were functioning well and liquidity was being redistributed smoothly in the banking system as excess liquidity declined. The recent repayments in March 2024 of funds borrowed in the seventh operation of the third series of targeted longer-term refinancing operations (TLTROs) had led to a further drop in euro area excess liquidity, which had declined by 31% – falling by €1.5 trillion from its peak of €4.7 trillion in November 2022. The increase in the take-up of funds in standard refinancing operations relative to the size of repayments in March had been very limited and was comparable to levels seen at the time of earlier TLTRO repayments. Banks had adapted to lower central bank funding by increasing their funding from other sources, including repo borrowing, amid significantly increased activity in secured money markets. Another important funding source had been new bank bond issuance. In particular, covered bond issuance had picked up markedly in 2022 and 2023, reversing developments seen over the previous two years.

Overall, it was encouraging that bond and money markets were functioning smoothly with signs of reduced fragmentation risks. Developments in bank funding markets would continue to be closely monitored, in line with the Governing Council's decisions in the context of the operational framework review.

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

Starting with the global economy, Mr Lane reviewed the incoming information, which pointed to a modest pick-up in global activity in the first quarter. Global trade was expected to recover gradually during the year as the economic recovery proceeded, expenditure patterns gradually rebalanced from services back to goods, and the inventory cycle normalised. However, the tensions in the Red Sea area remained a downside risk to trade.

The euro exchange rate had remained broadly stable since the March monetary policy meeting, both against the US dollar and in nominal effective terms. There had been a clear jump in oil prices since the March meeting, with Brent crude oil increasing by 4.7%, to USD 92.8 per barrel. The price futures curve implied a partial retracement of the latest increases over the coming months. European natural gas prices had increased by 6.9% since the March meeting, but still stood a lot lower than at the time of the December 2023 meeting. Metal prices had increased somewhat. Food commodity prices had increased substantially since the

March meeting, driven mainly by rising cocoa prices.

Turning to the euro area, Mr Lane highlighted that headline inflation, as measured by the Harmonised Index of Consumer Prices (HICP), had been improving gradually over the past few months and had declined to 2.4% in March, from 2.6% in February. Energy inflation had risen to -1.8% in March, from -3.7% in the previous month, mainly owing to an upward base effect and the reversal of some fiscal support measures. Food inflation had weakened further to 2.7% in March, from 3.9% in February, with processed food inflation continuing to decline and unprocessed food inflation turning negative. Core inflation (i.e. the HICP excluding energy and food) had decreased to 2.9% in March, from 3.1% in February. The non-energy industrial goods inflation rate had again decelerated, to 1.1% in March, from 1.6% in the previous month. Services inflation had remained unchanged at 4.0% in March, owing in part to the early timing of Easter. Many observers had noticed that the momentum of inflation had picked up again, which was visible across the different components – but it was important to note that this was taken into account in the March 2024 ECB staff macroeconomic projections.

Focusing on services, inflation had come down from 5.6% at the peak last summer to 4% in March. A large part of that reduction had been due to the pandemic reopening effects fading away, particularly in "contact-intensive" services such as tourism, accommodation and restaurants. There was a tight correlation between wages and the inflation rate in wage-sensitive sectors, which explained why a material drop in services inflation would not be seen until 2025, in line with the projected deceleration in wages in 2025 compared with 2024.

Most measures of underlying inflation had declined further in February, confirming the picture of gradually diminishing price pressures. The impact of past adverse supply shocks was continuing to fade and tight monetary policy still weighed on demand. At the lower end of the range of measures, the indicators based on the Persistent and Common Component of Inflation (PCCI) had edged higher but remained close to 2%. The annual rate of domestic inflation was unchanged at 4.5%.

Wage pressures were gradually moderating but remained elevated compared with a steady-state benchmark. Annual growth in compensation per employee had decelerated to 4.6% in the fourth quarter of 2023, from 5.1% in the third quarter. This outcome was 0.2 percentage points below the March ECB staff projections. Growth in compensation per hour had also slowed, falling in annual terms to 4.4% in the fourth quarter of 2023 from 5.0% in the third quarter. The wages and salaries component of the labour cost indicator had decreased to 3.3% in the fourth quarter, from 5.1% in the third quarter. Annual unit labour cost growth had fallen to 5.8% in the fourth quarter, from 6.5% in the previous quarter, but remained high, in part reflecting weak productivity growth. Negotiated wage growth, including one-off payments, had declined from 4.7% in the third quarter of 2023 to 4.5% in the fourth quarter. The ECB's forward-looking wage trackers had also continued to show signs of easing. The Indeed tracker, based on job adverts, and the feedback from firms participating in the Corporate Telephone Survey (CTS) and the Survey on the Access to Finance of Enterprises (SAFE) pointed to lower wage growth in the course of the year.

The ongoing and projected deceleration in wage growth remained the fundamental underpinning of the expected convergence of inflation to the ECB's 2% target in 2025. But it was important to emphasise that wage growth was not going to be stable for the rest of this year and that the reduction in wage pressures was not going to follow a linear trend. Negotiated wage growth would bounce around – mainly as a result of one-off payments. It was therefore important to keep in mind the overall dynamics, as embedded in the projections, rather than just the latest reading.

Profits continued to buffer the pass-through of higher labour costs to inflation. Annual growth in unit profits had decelerated further in the fourth quarter of 2023, falling to 2.8% from 4.7% in the third quarter. The significant decline was the main driver of the reduction in the annual growth rate of the GDP deflator, which had fallen by 0.6 percentage points to stand at 5.3% in the fourth quarter.

Turning to inflation expectations, in the Survey of Professional Forecasters (SPF), the centre of the distribution of long-term inflation expectations had remained around 2% since inflation had peaked in the fourth quarter of 2022. But the right tail of the distribution, which reflected a risk measure, implied that far fewer respondents now expected inflation to be noticeably above target in the longer term. This was reassuring in terms of people having a solid understanding of the inflation target. From the perspective of firms, as reflected in the SAFE, median expectations and the interquartile range for inflation one year ahead were lower than in the previous survey round. Selling price expectations of firms were also lower, as reported in the SAFE, as well as in the corresponding European Commission survey that captured near-term selling price expectations.

Looking ahead, headline inflation was expected to fluctuate around current levels in the near term, on account of base effects in the energy component and the reversal of the upward effect of the early timing of Easter on services inflation in March. Nevertheless, inflation was expected to decline to the ECB's target in 2025 as labour cost pressures eased; the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy continued to dissipate; and the disinflationary impact of monetary policy further unfolded.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and disrupt global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation might surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly.

The euro area economy had remained weak in the first quarter of 2024. The data available continued to point to a divergence between weak manufacturing sectors and improving services sectors, partly reflecting the persistent adverse impact of past energy price shocks on manufacturing output. Economic activity was expected to pick up modestly in the second quarter and to gain some momentum over the course of the year. The recovery should be supported by rising real incomes, resulting from lower inflation, increased wages and improved terms of trade. In addition, growth in euro area exports should pick up over the coming quarters as the global economy recovered and spending shifted further towards tradables. Finally, monetary policy should exert less of a drag on demand over time.

Consumer confidence had picked up to some extent, but it was still subdued compared with the levels prevailing before the war in Ukraine. The latest Consumer Expectations Survey (CES) showed signs of an upward trend in consumers' plans for major purchases and holidays.

Concerning housing investment, survey indicators remained very weak. The most recent property price data for the fourth quarter of 2023 showed that, after dropping, residential property prices were stabilising. For business investment, indications from surveys also remained weak – but with substantial variation across countries.

With regard to the labour market, weak GDP growth together with strong employment growth in 2023 had resulted in weak labour productivity. The unemployment rate had remained unchanged at a historical low of 6.5% in February. At the same time, the tightness in the labour market continued to decline gradually, with employers posting fewer job vacancies.

Looking at the fiscal stance, the euro area cyclically adjusted primary deficit in 2023 was likely to have been somewhat larger than indicated in the March ECB staff projections,

The risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. This might result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if inflation came down more quickly than expected and rising real incomes meant that spending increased by more than anticipated, or if the world economy grew more strongly than expected.

Turning to the analysis of monetary and financial developments, risk-free interest rates had been broadly stable since the Governing Council's previous monetary policy meeting and the transmission of the restrictive monetary policy stance to broader financing conditions remained strong. Lending rates on business loans and mortgages had edged lower in February but remained elevated at 5.1% and 3.8% respectively. The information available continued to signal stagnant loan dynamics against the backdrop of weak aggregate demand, tight credit standards and restrictive monetary policy. The annual growth rate of bank loans to firms had increased slightly to 0.4% in February, but for loans to households it was unchanged at 0.3% in February. Weak credit creation had weighed on M3 growth, which had remained subdued at 0.4% in February, up from 0.1% in January. Bank funding costs remained at historically high levels.

The information from the latest bank lending survey (BLS) and the SAFE was consistent with persistently weak credit demand and a stabilisation at tight levels in credit supply conditions for firms. The BLS indicated a further modest net tightening of bank credit standards for loans to firms, mainly on account of banks' risk perceptions. In parallel, banks cited higher interest rates and cutbacks to investment plans as the main factors behind the further marked decline in net loan demand among firms in the first quarter of 2024. Confirming this profile, in the SAFE, companies had reported a decrease in the availability of bank loans. The SAFE had also registered a marked drop in the share of firms applying for bank loans. For households, the results of the BLS had indicated a moderate decline in net demand for loans for house purchase and broadly stable net demand for consumer credit. Credit standards for household mortgages had eased in the first quarter for the first time in over two years, but standards for consumer credit had tightened further.

Monetary policy considerations and policy options

Based on the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, Mr Lane proposed keeping the three key ECB interest rates unchanged. The incoming data were in line with the medium-term inflation trajectory embedded in the March ECB staff macroeconomic projections, which foresaw headline inflation returning to target by mid-2025. Headline inflation had declined further in March and, looking beyond some near-term volatility associated with base effects and the reversal of various fiscal measures, it was expected to resume its downward path later in the year. Taken together, the range of underlying inflation measures also indicated further disinflation could be expected. At the same time, year-on-year domestic inflation and services inflation were edging down only slowly. Accordingly, the Governing Council needed further confirmation that wage growth was decelerating as anticipated and that profit margins continued to buffer the pass-through of higher labour costs to inflation.

Further progress towards the target in the course of 2025 would be underpinned by the next phase of deceleration in wage growth, the ongoing fading-out of the energy shock and supply bottlenecks, and a smaller contribution from the reversal of fiscal measures. These disinflationary pressures would also be reinforced by the cumulative demand-dampening impact of the restrictive monetary stance, including by limiting the capacity of firms to pass on cost increases. The incoming data confirmed that the transmission of monetary tightening remained strong. There were some signs of stabilisation in credit supply at a tight level and some easing in the pricing of new loans, primarily owing to an anticipation of future policy rate cuts.

Based on the three elements of its reaction function, the Governing Council could conclude that the key ECB interest rates were at levels that were making a substantial contribution to the ongoing disinflation process. The Governing Council's future decisions would ensure that its policy rates would stay sufficiently restrictive for as long as necessary. If the Governing Council's updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase its confidence that inflation was converging to target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction. In any event, the Governing Council would continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and it was not pre-committing to a particular rate path.

2. Governing Council’s discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, global GDP growth had remained subdued but there were early signs of improvement. Global growth momentum was building up, with a strong increase in the Purchasing Managers' Index (PMI) for manufacturing. Moreover, despite only modest GDP growth, global trade had seen a rebound driven by emerging market economies. Strong economic data in the United States and a rebound of the UK economy were seen as supporting the global recovery. Members noted that industrial activity in China had been better than expected, but also stressed the uncertainties and risks for global growth related to the country’s recovery.

Members took note of the release of consumer price index (CPI) data for March in the United States, which had been higher than expected. The data were seen as confirmation that global inflation currently reflected mainly “sticky” services price developments. But it was also pointed out that recent US inflation outcomes reflected idiosyncratic factors. In any case, the depreciation of the euro following the release of the US inflation data pointed to a need for close monitoring of the impact of the exchange rate on euro area inflation. Spillovers from the United States through a sustained exchange rate effect would likely slow the disinflationary process in the euro area. More generally, it was argued that the exchange rate effects would depend on the underlying shocks driving economic activity and inflation. In this respect, inflation developments in the United States and the euro area were seen to be different in nature, with those in the United States being driven more strongly by demand factors and those in the euro area more by supply factors.

With regard to the euro area economy, members widely agreed that latest information broadly vindicated the growth and inflation outlooks entailed in the March 2024 staff projections. This indicated that the forecasting ability of the quarterly projection exercises had been restored.

On economic activity, members concurred with Mr Lane that the economy had remained weak in the first quarter of 2024. While spending on services was resilient, manufacturing firms were facing weak demand and production was still subdued, especially in energy-intensive sectors. Surveys pointed to a gradual recovery over the course of the year, led by services. The PMI for future activity 12 months ahead had reached its long-term average in March, and some incoming hard data were confirming this picture. This recovery was expected to be supported by rising real incomes, resulting from lower inflation, increased wages and improved terms of trade. In addition, growth in euro area exports was expected to pick up over the coming quarters, as the global economy recovered and spending shifted further towards tradables. Finally, monetary policy should exert less of a drag on demand over time.

Members acknowledged the mixed signals in the latest data. While some soft indicators had become more favourable, some hard indicators persistently pointed to weak growth momentum. Mechanical nowcasting tools indicated quarter-on-quarter real GDP growth in the first and second quarters that was broadly in line with the March staff projections, with a slight downward risk for the first quarter. Even though growth in the first quarter was still estimated to have been weak, comfort was drawn from the observation that the latest data were consistent with the March staff projections showing a recovery in activity as of the second quarter. At the same time, it was recalled that achieving the profile of the baseline projection remained quite a challenge. Observed upward movements in incoming data should therefore not be equated with a materialisation of upside risks to the baseline projections. Against this background, it was remarked that there were as yet no signs of a recovery in private consumption, which was expected to be the growth engine in 2024. Similarly, the latest weak indicators of business sentiment did not bode well for investment prospects. Even the relatively sluggish recovery foreseen in the staff projections had yet to unfold. Meanwhile, it was reassuring that a recession had been avoided despite the monetary policy stance contributing to bringing inflation down from double digits to moderate levels. It was also observed that the euro area growth landscape was heterogeneous, both across countries and across sectors. Less energy-intensive sectors were growing faster than energy-intensive ones, which could be seen as pointing to structural rather than cyclical weakness.

With respect to fiscal and structural policies, members reiterated that governments should continue to roll back energy-related support measures so that disinflation would stay on track. Implementing the EU's revised economic governance framework fully and without delay would help governments bring down budget deficits and debt ratios on a sustained basis. National fiscal and structural policies should be aimed at making the economy more productive and competitive, which would help to reduce price pressures in the medium term. At the European level, an effective and speedy implementation of the Next Generation EU programme and a strengthening of the Single Market would help foster innovation and increase investment in the green and digital transitions. More determined and concrete efforts to complete the banking union and the capital markets union would help mobilise the massive private investment necessary to achieve this, as the Governing Council had stressed in its statement of 7 March 2024.

It was highlighted that the assumptions for fiscal policies embedded in the March staff projections constituted an element of uncertainty and risk. Concerns were expressed about the sizeable upward revisions to the deficit and debt figures for 2023 in a number of euro area countries. The need for fiscal prudence and consolidation across the euro area had to be clearly spelled out. This was especially important in view of the special situation in 2024, with the transition to a new EU framework for assessing excessive deficits and fiscal trajectories. At the same time, it was widely considered good news from a monetary policy perspective that there would soon be a new framework in place, providing guiding principles and enhancing prospects for more credible implementation.

Turning to the labour market, it was recalled that the unemployment rate was at its lowest level since the introduction of the euro. At the same time, the tightness in the labour market continued to diminish gradually, with employers posting fewer job vacancies. Labour market developments could be seen from different perspectives. On the one hand, it was suggested that the state of the labour market had remained broadly unchanged and its tightness remained a concern for the medium-term inflation outlook. The unemployment rate was at a historical low, employment was growing robustly, and indicators of tightness continued to stand well above pre-pandemic levels. On the other hand, it was acknowledged that the direction of developments in the indicators implied some cooling of labour demand. This was particularly visible in decreasing job vacancies. Concerns were expressed that the labour market support to the economy had reached its limit. Labour supply had already increased substantially and firms had limited buffers left for hoarding labour. A turn of the cycle in the labour market could thus imply greater labour shedding and reduced hirings. A deterioration in the employment outlook could prompt lower consumption.

On that basis, members assessed the risks to economic growth as remaining tilted to the downside. Growth could be lower if the effects of monetary policy turned out to be stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. This might result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if inflation came down more quickly than expected and rising real incomes lifted spending more than anticipated, or if the world economy grew faster than expected.

The downside risks to economic growth were seen as particularly relevant for the short term and were confirmed by the mechanical nowcasting tools. However, the view was also expressed that near-term risks were now balanced, with reference made to recent rebounds in survey-based indicators and some hard data. Looking ahead, it was stressed that factors that had previously cushioned the economy against potential adverse shocks – including high levels of liquidity, ample household savings, fiscal space, rising labour supply and sizeable business profit margins – had partly diminished. It was also suggested that the geopolitical risk stemming from the conflict in the Middle East had increased in tandem with the escalation of the conflict during past weeks.

With regard to price developments, members concurred with the assessment by Mr Lane that the incoming information had broadly confirmed the previous assessment of the medium-term inflation outlook. Inflation had continued to edge down from an annual rate of 2.6% in February to 2.4% in March, led by lower food and goods price inflation. However, services price inflation had remained high in March, at 4.0%. Most measures of underlying inflation had fallen further in February, confirming the picture of gradually diminishing price pressures. While domestic inflation remained high, wages and unit profits had grown less strongly in the last quarter of 2023 than anticipated, and more recent indicators pointed to further moderation in wage growth. Unit labour cost growth had remained high, in part reflecting weak productivity growth, but firms were using profits to absorb part of the rise in labour costs. Inflation was expected to fluctuate around current levels in the coming months and to then decline to the inflation target next year, owing to weaker growth in labour costs, the unfolding effects of restrictive monetary policy, and the fading of the impact of the energy crisis and the post-pandemic reopening.

Members saw the latest inflation developments as evidence that the impact of the past extraordinary shocks was waning and economic relationships were normalising. This bolstered confidence in the projections and the expected path towards reaching the ECB's inflation target in 2025. Outcomes for the first quarter of 2024 were very similar to what had been anticipated in the March staff projections. Members took note of the bumpy profile of headline inflation for 2024 as indicated by the projections and that there would be no downward linear trend for the remainder of the year. Many of the expected "bumps" were related to base effects in energy inflation and were already taken into account in the baseline projections. While headline inflation was naturally a key variable to monitor, it was not the only one that would be particularly volatile. Services inflation, which had recently seen an increase in momentum, as measured by the annualised three-month-on-three-month rate, and developments in wage growth were also affected. In this respect, it was important to identify the underlying direction of developments and to look at the big picture.

There was broad agreement that services inflation and the role of wages remained key issues for the inflation outlook. This was also signalled by services inflation having stayed at the high level of 4% over the past five months. Moreover, the indicator of domestic inflation, which reflected inflation in those HICP items with relatively low import intensity, was standing at around 4.5%. Meanwhile, the GDP deflator, a measure of domestic inflation in the national accounts, had remained above 5% in the fourth quarter of 2023. In view of these figures, conclusive evidence of progress on disinflation in the more persistent domestic components had yet to become apparent. At the same time, the greater "stickiness" of services inflation was seen as natural, as it was less affected by the fading of supply-side shocks. In addition, the transmission of monetary policy to the services sector was likely weaker because services were less capital-intensive, while the pass-through from wages was higher owing to the characteristic cost structures in that sector. The capacity for services firms to absorb higher wage costs through profit margin compression remained uncertain, as they had neither experienced the same level of profit margin increases in the wake of the pandemic as other sectors, nor benefited as much from the declines in other input costs. For these reasons, developments in services inflation warranted close monitoring and further confirmation was required of weakening pressures on both wages and profits. However, disaggregated data available up to February suggested that price pressures in services had not come from the more wage-sensitive items. Instead, these pressures had come from items typically affected by repricing at the beginning of the year to include adjustments for past cost increases, for instance insurance policies or goods and services with administered prices.

Turning to domestic price pressures more broadly, as measured by the GDP deflator in the national accounts, members saw the wages-profits-productivity triangle as key to assessing the speed and extent of further disinflation. There was still considerable uncertainty about whether assumptions and expectations regarding these variables would play out as projected in March. Having a new data point and new projections for these variables was therefore important but euro area national account data for the first quarter of 2024 would only be released shortly after the Governing Council's June monetary policy meeting. It was underlined that the inflation outlook remained very sensitive to the behaviour of profit margins. Concern was expressed that margins might not absorb higher costs to the extent assumed in the projections. It was argued that still elevated margins combined with a relatively weak economic environment could be an indication of persistently strong pricing power and relatively weak competition. At least, this could be the case for businesses serving domestic demand – and notably the services sector. This could then lead to further increases in wages and, in turn, might put additional competitive pressure on exporters.

It was pointed out that there had been no additional upward pressure on wages from recently signed wage agreements and that wage growth was so far broadly in line with the projections. If anything, wage pressures had even diminished somewhat compared with earlier expectations. It was suggested that, with wage growth having begun to moderate as expected, the focus should shift to productivity developments. These were crucial from the perspective of ultimate labour cost pressures, which would be higher if productivity growth did not recover as quickly and as strongly as foreseen in the baseline of the March staff projections. It was argued that this might be the case if current low and negative productivity growth rates turned out to be not merely cyclical, but also partly structural in nature. The point was made that with the bleak investment outlook embedded in the projections it was difficult to see a more structural improvement in labour productivity.

As regards longer-term inflation expectations, market-based measures of inflation compensation and survey-based indicators had remained broadly stable, with most standing around 2%. The fact that inflation expectations had remained well anchored was seen as reassuring, since it indicated that the monetary policy stance was having the desired effect.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and disrupt global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation could surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly.

Further upside risks could result from higher growth in unit labour costs, especially if productivity growth did not recover as expected. Upside risks were also seen as prevailing in food and oil prices. The risk of second-round effects was, however, considered to be relatively small in an environment of general disinflation, unlike in 2022-23. Nevertheless, it was noted that oil prices had increased substantially in the year to date and were significantly higher than in the assumptions for the March projections. This pointed to some upside risk for inflation. Moreover, the slowdown in inflation had recently been supported by lower gas and electricity prices, following a relatively warm winter and low demand due to a recession in manufacturing sectors. This implied upside risks as and when typically inelastic energy demand met with a recovery in economic activity or a colder period. The upside risks to food prices were partly related to extreme weather events, including the El Niño and La Niña phenomena, and climate shocks.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane and Ms Schnabel in their introductions. Market interest rates had been broadly stable since the Governing Council's previous meeting and wider financing conditions had remained restrictive. Financial markets had been calm and steady since the meeting in March, amid a further compression of risk premia. Markets were pricing in a first cut in ECB interest rates in June, with further cuts priced in by the end of the year.

It appeared that peak restrictiveness in euro area financing conditions might have passed. Interest rates on new loans to households and firms had started to come down, primarily in anticipation of future policy rate cuts, while average rates on existing loans were still edging up overall. The most recent information had continued to signal weak bank loan dynamics on the back of weak aggregate demand, tight credit standards and restrictive monetary policy.

Bank lending to firms, in particular, was seen as persistently weak. In part, this was due to lower demand for loans from firms. The decline had also been reported by banks and firms in the latest BLS and the SAFE, and reflected still elevated borrowing rates and cutbacks in investment plans. As for lending to households, credit standards for mortgages had eased for the first time in over two years but standards for consumer credit had tightened further. The point was made that weaker demand for consumer credit and an increase in rejected bank loan applications could suggest fragile household balance sheets or greater risk aversion by banks. If so, this in turn would signal risks of a more persistent weakness in consumption. Overall, the latest credit developments remained subdued and could point to a pick-up in credit growth later on, with loan creation being held back by higher rates and tighter credit standards. It was highlighted that the ratio of credit to GDP had been falling rapidly, with continued weak credit dynamics seen as posing a risk to the recovery or raising the prospect of a "credit-less recovery" as liquidity buffers diminished. However, signs of stabilisation were visible in loan flows to both households and firms, despite some volatility around the turn of the year.

Monetary policy stance and policy considerations

Turning to the monetary policy stance, members assessed the data that had become available since the last monetary policy meeting in accordance with the three main elements that the Governing Council had communicated in 2023 as shaping its reaction function. These comprised (i) the implications of the incoming economic and financial data for the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission. Overall, each of the three elements suggested that the key ECB interest rates were at levels that were making a substantial contribution to the ongoing disinflation process.

Starting with the inflation outlook, members widely agreed that the data were broadly in line with the medium-term inflation trajectory embedded in the March staff projections, which foresaw headline inflation returning to target by mid-2025. While inflation had come in slightly higher than expected in February, the increase had been offset by a weaker than expected outturn in March. Overall, the figures suggested limited news, thus broadly validating the projections. Economic growth was assessed as having been slightly weaker than expected in the first quarter of 2024, but the narrative of an improving growth outlook remained intact. While significant risks remained around the baseline projections for both growth and inflation, members expressed increasing confidence in the projections, since the extraordinary shocks of the recent past were waning and economic relationships were normalising. Moreover, inflation expectations had remained well anchored. At the same time, the view was widely shared that further evidence was required to gain sufficient confidence that inflation was solidly on track to return to the ECB's target in a timely and sustained manner.

Members also generally concurred that further progress had been made regarding underlying inflation. Most measures had continued to decline and were expected to continue on a downward path in the period ahead. Indications from wages and profit margins were broadly in line with the March staff projections or suggested slightly more muted developments than anticipated. At the same time, domestic inflation was still elevated and there had been little progress in services inflation, which was steady at 4%. It was stressed that a return of inflation to target remained conditional on a rebound in productivity growth and a significant compression of unit profits through the absorption of higher costs.

The most recent data confirmed that the transmission of monetary tightening continued to be strong. While there had been some signs of stabilisation in credit conditions at a restrictive level, further weak credit data were suggesting that the credit channel of monetary policy transmission was more powerful than previously expected. The decline in the demand for loans, as reported in the BLS, was seen as a downside risk for the growth outlook because it pointed to weak investment. At the same time, it was argued that the tightening impulse from monetary policy had already reached its peak, with the likelihood of a gradual easing of conditions in the near future. Forward-looking indicators were recovering, with firms indicating in their responses to the SAFE that they were expecting an increase in both investment and turnover. Moreover, the transmission of monetary policy was seen as weaker for the services sector than for other parts of the economy because services were less capital-intensive and therefore less interest rate-sensitive.

With inflation declining and a delayed pick-up in economic growth, it was regarded as important to assess how restrictive the monetary policy stance was, as a basis for future monetary policy decisions. It was underlined that there was considerable uncertainty about the degree of restrictiveness of the ECB's monetary policy stance, both measured against unobservable concepts like the neutral rate of interest and judged by the transmission lags to the capital, labour and goods markets in the real economy and ultimately to inflation.

One way of assessing the restrictiveness of monetary policy was to evaluate the level of policy rates relative to available model-based estimates of the natural or neutral rate of interest. In this context, it was argued that ongoing structural changes might have led to an increase in such benchmark rates. These changes included the anticipation of the significant global investment needs to address climate change and the green transition, geopolitical shifts and trade fragmentation leading to deglobalisation, and advances in artificial intelligence and digitalisation. In addition, rising public debt burdens worldwide might exert further upward pressure on the natural rate of interest. At the same time, it was recalled that staff estimates for the euro area, published recently in the ECB's Economic Bulletin, did not suggest a significant increase. In view of the sizeable model and parameter uncertainty attached to such model-based constructs, the natural rate – while providing useful indications – was seen as being of limited use for day-to-day policymaking. For the time being, to assess the restrictiveness of monetary policy, it was preferable to look at incoming data.

Monetary policy decisions and communication

Against this background, a very large majority of members agreed with Mr Lane's proposal to maintain the three key ECB interest rates at their current levels. Members concurred that the most recent information had broadly confirmed the March staff projections, thus increasing their confidence that the disinflationary process was continuing. At the same time, important new data – including new staff projections – would be released ahead of the June meeting, allowing the Governing Council to make a more comprehensive assessment. While progress had been seen, monitoring the triangle between wages, productivity growth and profits continued to be key. It was seen as plausible that the Governing Council would be in a position to start easing monetary policy restriction at the June meeting if additional evidence received by then confirmed the medium-term inflation outlook embedded in the March projections.

A few members felt sufficiently confident that the three elements of the Governing Council's reaction function gave grounds for a reduction in the policy rates already at the present meeting. It was recalled that, since the last policy rate increase in September 2023, the decline in expected inflation had implied a further tightening in the policy stance, with real rates currently close to the peak of the cycle. Moreover, policy rates were seen as likely to remain in restrictive territory for some time, while the effects of the present restrictive policy stance would continue to be felt even after the start of the easing phase. It was also remarked that the reduction of the Eurosystem balance sheet was having a contractionary impact on the economy. Moreover, while there were currently no significant risks of inflation expectations becoming unanchored to the downside, such risks could emerge if the current weakness in growth persisted.

These members also referred to risk management considerations, seeing the balance of risks as having shifted recently. The risk of undershooting the inflation target and eventually having to pay too high a price in terms of declining activity was now seen as being at least as high as the risk of acting too early and overshooting the target over the medium term.

All in all, a broad consensus emerged whereby members agreed it was prudent to wait until the next monetary policy meeting to see further evidence of, and gain sufficient confidence in, a timely and sustained return of inflation to target. Compared with the outlook in March, no major surprise had been observed that would justify action at the present meeting. Conversely, as long as the available data continued to confirm the projections, looking ahead the policy path underlying the projections was seen as broadly consistent with a return of inflation to target in the medium term. Members stressed the value of waiting until June for further evidence confirming, or indicating a change to, the outlook, but also the value of taking into account any existing or new risks materialising by June, including renewed risks to inflation posed by a possible escalation of geopolitical tensions. The next projections in June would allow a more comprehensive analysis of the main risks and their implications for price stability.

Members stressed that maintaining a data-dependent approach with full optionality at every meeting was warranted, thus allowing all incoming data to be taken into account while excluding a pre-commitment to any particular rate path. Data dependence meant not overly focusing on one data point, as the path many indicators took was likely to be bumpy. Headline inflation, in particular, was expected to fluctuate around current levels in the near term and to decline again later on, suggesting that some bumpiness in the inflation profile was foreseen and consistent with a return of inflation to target by mid-2025.

On the whole, members felt that markets had understood the ECB's communication and reaction function and were prepared for the possibility of a rate cut at the June meeting, should the data confirm the current outlook.

Members also agreed with the Executive Board proposal to continue applying flexibility in reinvesting redemptions falling due in the pandemic emergency purchase programme portfolio.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

Monetary policy statement for the press conference of 11 April 2024

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 10-11 April 2024

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Cipollone
- 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 Patsalides
- Mr Rehn*
- Mr Reinesch
- Ms Schnabel
- Mr Scicluna
- Mr Šimkus
- Mr Stournaras

- Mr Vasle
- Mr Villeroy de Galhau*
- Mr Vujčić
- Mr Wunsch*

* Members not holding a voting right in March 2024 under Article 10.2 of the ESCB Statute.

Other attendees

- Mr Dombrovskis, Commission Executive Vice-President**
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

** In accordance with Article 284 of the Treaty on the Functioning of the European Union.

Accompanying persons

- Ms Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr De Backer
- Mr Gavilán
- Mr Gilbert
- Mr Haber
- Mr Kaasik
- Mr Kelly
- Mr Koukoularides
- Mr Lünnemann
- Mr Martin
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Rutkaste
- Mr Šošić
- Mr Tavlas
- Mr Välimäki
- 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 4 July 2024.

Bank of Finland rules for counterparties and customers – Rules update 6.5.2024

News 6 May 2024 8:00 AM

In addition, the document *Implementation of monetary policy operations and collateral management at the Bank of Finland* included in the Bank of Finland rules has been updated, for example regarding the use of credit claims as collateral. Furthermore, the Bank of Finland's monetary policy counterparty agreements have been clarified and updated in line with the amendments to the ECB Guidelines.

The changes will enter into force on 6 May 2024.

See: Bank of Finland rules for counterparties and customers

ECB Monetary policy decisions

News 11 April 2024 3:19 PM

[ECB press release 11 April 2024]

The Governing Council today decided to keep the three key ECB interest rates unchanged. The incoming information has broadly confirmed the Governing Council's previous assessment of the medium-term inflation outlook. Inflation has continued to fall, led by lower food and goods price inflation. Most measures of underlying inflation are easing, wage growth is gradually moderating, and firms are absorbing part of the rise in labour costs in their profits. Financing conditions remain restrictive and the past interest rate increases continue to weigh on demand, which is helping to push down inflation. But domestic price pressures are strong and are keeping services price inflation high.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. It considers that the key ECB interest rates are at levels that are making a substantial contribution to the ongoing disinflation process. The Governing Council's future decisions will ensure that its policy rates will stay sufficiently restrictive for as long as necessary. If the Governing Council's updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase its confidence that inflation is converging to the target in a sustained manner, it would be appropriate to reduce the current level of monetary policy restriction. In any event, the Governing Council will continue to follow a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and it is not pre-committing to a particular rate path.

Key ECB interest rates

The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 4.50%, 4.75% and 4.00% respectively.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The Governing Council intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

***

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

Account of the ECB Governing Council’s monetary policy meeting, 6-7 March 2024

News 4 April 2024 2:30 PM

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 6-7 March 2024

4 April 2024

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

Financial market developments

Ms Schnabel noted that, since the Governing Council’s previous monetary policy meeting on 24-25 January 2024, monetary policy expectations had retracted further from the early and large interest rate cuts initially foreseen at the turn of the year.

More favourable news on the global economy and less favourable news on inflation had both been key factors in shaping financial market developments. In the case of the first factor, macroeconomic data surprises had moved into positive territory in the euro area, the United States and China for the first time since May 2023. As a result, investors attached a discernibly lower probability to the scenario of a hard landing for the global economy.

The second factor related to a reassessment of the medium-term inflation outlook. Higher than expected inflation releases in the euro area and the United States, especially for core inflation, had dented investors’ hopes of rapid and smooth disinflation. Looking at the path of headline and core inflation in the euro area (as measured, respectively, by the Harmonised Index of Consumer Prices – HICP – and the overall index excluding energy and food) over 2024, inflation-linked bond markets were pricing in somewhat higher headline inflation rates throughout the year, compared with expectations at the time of the Governing Council’s monetary policy meeting in January.

In response to investors’ expectations of lower downside tail risks to economic activity and a slightly bumpier path of disinflation, rate markets had priced in a substantially shallower easing cycle in the euro area, with expected cumulative interest rate cuts by the end of 2024 having declined notably from around 160 basis points in late December to around 90 basis points at present. After the latest repricing, the gap between expectations in interest rate markets and those reported by market analysts had largely disappeared.

In the United States, strong labour market data, higher than expected inflation figures and more cautious communication by the Federal Reserve System had triggered an even greater repricing of policy rate expectations. As a result, overnight index swap (OIS) forward curves were also pricing in a substantially shallower easing cycle in the United States.

A key explanatory factor for expectations of a synchronised monetary policy easing cycle across advanced economies was the common component in global inflation. Markets anticipated that the disinflationary momentum would continue unfolding synchronously over the coming year. Spillovers from the United States were another factor explaining the close co-movement of monetary policy expectations across jurisdictions. US data releases continued to exert a significant influence on yields in other advanced economies.

A decomposition of euro area and US OIS rates across different maturities into inflation compensation and real rates showed that, in the euro area, inflation compensation had increased notably across the curve. At the same time, real rates had declined, in particular at the longer end, implying a mild loosening of financing conditions through risk-free rates. In the United States, the rise in inflation compensation was slightly less pronounced, with real rates remaining firm across the curve.

The widening yield differential had been mirrored by a slight depreciation in the euro's exchange rate against the US dollar. In nominal effective terms, the euro had remained broadly unchanged, while the US dollar had appreciated.

Despite the repricing of the near-term inflation outlook, risks to the longer-term inflation outlook had not materially changed since January 2024, as the five-year forward inflation-linked swap (ILS) rate five years ahead had remained broadly unchanged. Compared with the close-to-peak levels at the September 2023 Governing Council meeting, ILS forward rates had come down materially, driven mostly by a decline in inflation risk premia. The sharp past tightening seemed to have been effective in containing and eventually lowering risks to the longer-term inflation outlook. Nevertheless, the five-year forward ILS rate five years ahead still stood markedly above its historical mean. Consistent with ILS rates, euro area option prices also indicated that risks of high inflation had come down but remained somewhat elevated compared with historical averages.

Risk asset markets appeared to have looked through the tightening impulse stemming from expectations of a later and shallower easing cycle, supported by improved risk sentiment. The benchmark stock market indices across all major advanced and emerging economies, including China, had followed a bullish trend since the Governing Council's January meeting.

The buoyant risk sentiment had also been visible in corporate bond markets. The same was true for sovereign bond markets, where spreads over German Bunds had continued to narrow, with the differential between Italian and German ten-year government bond yields at its smallest since March 2022. Investors appeared to remain keen on locking in attractive returns amid expectations that the peak of the tightening cycle had been reached. Bid-to-cover ratios continued their gradual upward trend, pointing to strong demand for bonds despite record high sovereign issuance for the year to date.

Despite the benign price developments across risk asset markets, some pockets of risk were emerging, for example related to the commercial real estate market, but these had not had broader repercussions for financial intermediaries and markets. Moreover, the continued rally in riskier market segments – despite the repricing of monetary policy expectations – and stretched valuations of some assets could point to complacency in financial markets.

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

Starting with the global outlook, Mr Lane noted that global economic activity was still subdued but there were some signs of improvement. Trade momentum in goods and services was expected to strengthen in the first quarter of the year. The March ECB staff macroeconomic projections for the euro area foresaw a significant pick-up in euro area foreign demand, in line with previous exercises. Euro area foreign demand was projected to grow by 2.4% in 2024, 3.1% in 2025 and 3.2% in 2026, reflecting expectations of a normalisation in demand for goods, which would benefit European producers. As for commodities, since the last meeting oil prices had increased, while gas prices had declined further. International metal prices had also declined, although food prices had edged up.

Turning to the euro area, Mr Lane recalled that, according to the recent Eurostat flash release, euro area headline inflation had declined to 2.6% in February from 2.8% in January. While energy inflation had become less negative, partly owing to the withdrawal of some fiscal support, food inflation had fallen strongly to 4.0% in February from 5.6% in January. This reflected an easing in both processed and unprocessed food inflation. Core inflation had decreased to 3.1% in February from 3.3% in January. Over the same period, the rate of non-energy industrial goods inflation had decelerated to 1.6% from 2.0%. Services inflation had edged down by 0.1 percentage points to 3.9%. Inflation in wage-sensitive services remained higher than in non-wage-sensitive services, supporting the view that high wage growth was playing an important role in elevated services inflation.

Most measures of underlying inflation had declined further in January, as the impact of past adverse supply shocks continued to fade, lower energy prices reduced cost pressures and tighter monetary policy weighed on demand. At the lower end of the range, the indicator of the Persistent and Common Component of Inflation had been close to 2% since November. However, the annual growth rate of the indicator of domestic inflation was unchanged at 4.5%. Domestic price pressures as measured by growth in the GDP deflator were still high, although the deflator was projected to continue to decrease gradually. Profit growth offered a first buffer against high labour cost pressures and would recover thereafter.

According to the March ECB staff projections, growth in compensation per employee was estimated to have slowed to 4.8% in the fourth quarter of 2023, from 5.3% in the third quarter. Based on already available country data, the forthcoming release of euro area data on 8 March for the growth in compensation per employee in the fourth quarter of 2023 was expected to turn out slightly lower than projected. Negotiated wage growth including one-off payments had declined in the fourth quarter by 0.2 percentage points to 4.5%. The latest signals from the ECB forward-looking wage trackers also indicated a gradual slowing of negotiated wage growth in the euro area. Additionally, the contribution from wage drift – the most cyclically sensitive element of compensation – had declined visibly, having been around 2 percentage points at the start of 2022. Both the Indeed tracker and feedback from firms participating in the ECB’s Corporate Telephone Survey pointed to lower wage growth this year compared with 2023. Moreover, profits seemed to be absorbing part of the rising labour costs, which would reduce their inflationary effects.

Inflation was expected to continue its downward path in the coming months. In the near term, there would likely be some volatility in headline inflation owing to base effects in the energy component and to the timing of Easter. Thereafter, headline inflation was expected to decline to the ECB’s target as labour cost dynamics moderated and past energy shocks, supply bottlenecks and pandemic reopening effects dissipated. Headline inflation was projected to average 2.3% in 2024, 2.0% in 2025 and 1.9% in 2026. Relative to the December projections, headline inflation had been revised down by 0.4 percentage points for 2024 and 0.1 percentage points for 2025, while remaining unchanged for 2026. Core inflation projections had been revised down across the projection horizon to 2.6% for this year, 2.1% for 2025 and 2.0% for 2026. This implied downward revisions to core inflation of 0.1 percentage points for this year, 0.2 percentage points for next year and 0.1 percentage points for 2026.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and disrupt global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation could surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly.

Economic activity in the euro area had remained weak in the first two months of 2024. Consumers continued to hold back on spending, housing investment had remained subdued and companies had exported less, reflecting a slowdown in external demand and some losses in competitiveness. Business investment had also remained weak, reflecting the impact of restrictive monetary policy, the depletion of order backlogs and subdued demand.

Forward-looking indicators such as Purchasing Managers’ Indices (PMIs) were improving but remained at low levels overall. While surveys pointed to a gradual recovery in economic activity over the course of the year, the recovery was expected to proceed at a slower pace than previously anticipated. This reflected the carry-over from the recent weaker data outturns for 2023 and the still-subdued level of survey indicators. As inflation fell and wages kept growing, real incomes would rebound, supporting growth. Further ahead, both housing and business investment should be supported by an easing of financing conditions. Business investment was also expected to pick up as demand strengthened. In addition, demand for euro area exports should improve as global demand rebounded and price competitiveness pressures eased.

With respect to domestic demand components, the projections saw a significant pick-up in consumption in 2024. Investment was expected to contract as a result of the ongoing transmission of monetary policy tightening and was hence not expected to contribute to the recovery this year. The recovery would instead be led by consumption and exports, with goods consumption playing a key role. This was, in turn, interconnected with the projection for labour costs. Unit labour costs were seen as decelerating more quickly than compensation per employee over the projection horizon, owing to the expected pick-up in productivity. Manufacturing output, especially, had been depressed, but labour had not yet been shed, which resulted in a higher ratio of employment to output and hence lower labour productivity. The projections suggested that a recovery in output – and especially manufacturing output – would be achieved through a recovery in productivity. Taken together, these factors explained the glide path back to the inflation target.

Employment had grown by 0.3% in the final quarter of 2023, again outpacing economic activity. The unemployment rate had edged down to a historical low of 6.4% in January from 6.5% in December, which itself had been revised up. Meanwhile, employers were announcing fewer job vacancies and fewer firms were reporting that their production was being limited by labour shortages.

As for the labour market, the construction and manufacturing sectors remained basically in stagnation or even contraction, with the latest employment PMIs remaining well below 50. Looking at services, in the high-tech sector employment PMIs remained at levels slightly above 50, while in the low-tech sector they had recovered strongly and stood above 55. There was also a noticeable decline in the number of firms reporting that labour was limiting their production possibilities – especially in services.

The new ECB staff projections indicated subdued growth in the near term, followed by a recovery thanks to rising real incomes, the fading impact of past monetary policy tightening on financing conditions and improving foreign demand. Output growth was expected to average 0.6% in 2024, 1.5% in 2025 and 1.6% in 2026. Relative to the December projections, growth had been revised down by 0.2 percentage points for 2024, while it was unchanged for 2025 and had been revised up by 0.1 percentage points for 2026. The fiscal outlook in the March 2024 projections was little changed from the December 2023 projections.

The risks to economic activity remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. This could result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if inflation came down more quickly than expected, if rising real incomes meant that spending increased by more than anticipated, or if the world economy grew more strongly than expected.

Turning to the monetary and financial analysis, market interest rates had increased since the last monetary policy meeting. The transmission of past policy rate hikes to broader financing conditions remained strong. Lending rates on business loans had broadly stabilised, while mortgage rates had declined in December and January. Nevertheless, lending rates remained elevated at 5.2% for business loans and 3.9% for mortgages.

High bank lending rates, tight credit standards and lower business investment continued to dampen demand for loans with longer maturities. The annual growth rate of bank lending to firms, which had turned positive and stood at 0.5% in December, had edged lower again in January, reaching 0.2% owing to a negative flow in the month. The year-on-year growth in loans to households had continued to weaken, slowing to 0.3% in January.

The annual growth rates of M3 – the broad monetary aggregate – and M1 – the narrow monetary aggregate of currency in circulation and overnight deposits – had remained weak in January, standing at 0.1% and -8.6% respectively. After standing in negative territory until November, the annual growth rate of M3 had been marginally positive in December and January. The increase in M3 was mostly explained by the strengthening of net inflows from the rest of the world, driven mainly by the strong trade surplus amid weak imports. Weak deposit creation continued to underpin a shift in bank funding composition towards more expensive funding sources.

Monetary policy considerations and policy options

Based on the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, at the meeting Mr Lane proposed keeping the three key ECB interest rates unchanged.

The three elements of the Governing Council's reaction function supported an unchanged policy at the meeting. Headline inflation was now projected to be markedly lower in 2024 compared with previous expectations, returning to target by mid-2025 and slightly undershooting 2% in subsequent quarters. Growth was expected to recover only gradually through most of 2024. The overall trend in underlying inflation continued to soften. At the same time, some key measures including domestic inflation remained elevated, while further confirmation was still needed concerning the projected outlook for wage inflation and unit margins. The third criterion, namely the ongoing strong transmission of monetary policy, was confirmed, albeit with some signs of stabilisation owing to the anticipation of future rate cuts.

Based on those three criteria, the key ECB interest rates were at levels that, maintained for a sufficiently long duration, would make a substantial contribution to the ECB's goal of returning inflation to its medium-term target in a timely manner. This warranted continuing to follow a data-dependent approach to determining the appropriate level and duration of restriction, while ensuring that policy rates would be set at sufficiently restrictive levels for as long as necessary. An overall evaluation of the policy trajectory could be obtained from the joint evolution of the inflation outlook (including the new staff projections), underlying inflation and the strength of monetary transmission in recent months. The developments here should increase confidence that the monetary policy decisions already taken would deliver the ECB's medium-term inflation target, especially in view of the projected narrowing of the distance to the target already in 2024. At the same time, only further along in the disinflation process could the ECB be sufficiently confident that inflation would hit the target in a timely manner and settle at target sustainably.

Mr Lane also proposed preserving the option to apply flexibility in reinvesting redemptions coming due in the pandemic emergency purchase programme (PEPP) portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, while global GDP growth remained subdued, there were early signs of improvement. A broad set of early indicators suggested that global growth had declined throughout 2023, reflecting tight monetary policy working its way through the global economy and fading tailwinds for consumption, such as from pandemic-related excess savings. Indicators had improved at the turn of the year, so global growth was expected to pick up in the first quarter of 2024 following a moderation in the last quarter of 2023. Global trade had also showed early signs of improvement at the start of 2024. The post-pandemic factors that had caused a period of weak trade in 2023, for example owing to the rotation of demand from goods to services, should ease in the period ahead. As regards key global economies, growth in the United States had been above expectations in the last quarter of 2023 and the labour market had been robust. At the same time, the Chinese economy continued to struggle with a weakening housing sector. Overall, it was underlined that the global economic outlook was still uncertain.

Turning to energy commodities, oil prices were expected to decline because of the supply surplus in the global market, which was expected to persist in 2024 despite OPEC+ producers having announced production cuts. European gas prices had fallen further since the Governing Council's last monetary policy meeting, as demand remained subdued and gas storage levels were relatively high. Nevertheless, it was highlighted that gas prices were volatile. With respect to the international determinants of consumer price inflation, price pressures were limited – despite the tensions in the Red Sea area – as demand for goods was still weak and inventory levels remained high.

With regard to economic activity in the euro area, members concurred with Mr Lane that the economy remained weak. Consumers continued to hold back on their spending, investment had moderated and companies were exporting less, reflecting a slowdown in external demand and some losses in competitiveness. However, surveys pointed to a gradual recovery over the course of the year. As inflation was falling and wages continued to grow, real incomes would rebound, supporting growth. In addition, the dampening impact of past interest rate increases would gradually fade and demand for euro area exports should pick up. The unemployment rate was at its lowest since the start of the euro. Employment had grown by 0.3% in the final quarter of 2023, again outpacing economic activity. As a result, output per person had declined further. Meanwhile, employers were posting fewer job vacancies and fewer firms were reporting that their production was being limited by labour shortages.

Members widely acknowledged the weaker than expected growth in the short term. Economic activity had stagnated for five quarters in a row and was expected to remain weak for two more quarters. Moreover, risks were seen to be on the downside, as mechanical nowcasting tools still showed lower numbers than those in the March projections for the first and second quarters of 2024. Consequently, the euro area economy was so far not showing convincing signs of improvement, which would likely imply six quarters of economic stagnation. Across sectors, there was also no indication of a recovery in manufacturing or construction, while private consumption, investment and external demand had remained weak overall throughout 2023.

At the same time, it was pointed out that data available since the last Governing Council meeting had confirmed the bottoming-out of the euro area economy, which was being supported by foreign demand recovering and the continued solid growth in the United States, as well as recently some more positive news about China. The most recent PMIs for the euro area had been stronger than expected, with services moving back into expansionary territory, while manufacturing remained weak but stood significantly above the trough of last summer. New orders had also been steadily increasing in the manufacturing and services sectors since November.

Members expressed broad agreement with the latest macroeconomic staff projections. It was emphasised that the March projections had seen the fifth consecutive downward revision to growth and the second downward revision to inflation for 2024, with also a downward revision to inflation for 2025. The macroeconomic projections had now broadly converged with the Consensus Economics forecasts, both for 2024 and for 2025.

At the same time, it was noted that the projections for growth and inflation, as well as credit developments, were pointing to a benign outlook, in which both a hard landing and a credit crunch would be avoided. The macroeconomic projections overall showed an encouraging picture, with an outlook that was well on track to bring inflation back to target. Revisions were becoming smaller, so there was reason to have more confidence in the baseline projections, although the risks to the growth outlook were still tilted to the downside, at least in the short term. Moreover, the contributions of cyclical and structural factors to growth and longer-term potential were hard to disentangle in real time.

The main drivers of the expected recovery were increasing real incomes, higher government consumption, improving terms of trade and monetary policy becoming less restrictive. Private consumption was expected to pick up once real household income started to gradually improve, supporting a concomitant recovery in business investment. In this context, it would be important for investment to resume in line with what was necessary for the digital and green transformations, which would ultimately also reduce medium-term price stability risks and benefit monetary policy by increasing the robustness of the supply side of the economy.

In addition, fiscal policy was seen as a key driver of economic growth over the projection horizon, in terms of both government consumption and public investment, in particular through the Next Generation EU (NGEU) programme. The release of the final 2023 deficit figures in the coming weeks should enable a clearer assessment of the fiscal policy stance. Several countries were running excessively high deficits, which might pose challenges further down the road. However, it was mentioned that in some countries the fiscal imbalances stemmed to a large extent from shortfalls in tax receipts, reflecting the weak economy, rather than from spending overruns.

It was reiterated that governments should continue to roll back energy-related support measures to allow the disinflation process to proceed sustainably. Fiscal and structural policies should be strengthened to make the euro area economy more productive and competitive, expand supply capacity and gradually bring down high public debt ratios. A speedier implementation of the NGEU programme and more determined efforts to remove national barriers to deeper and more integrated banking and capital markets could help increase investment in the green and digital transitions and reduce price pressures in the medium term. The EU’s revised economic governance framework should be implemented without delay.

Turning to the labour market, it was widely stressed that a thorough understanding of the market remained crucial for assessing the outlook for wages and inflation. This applied not just to wage dynamics but also to labour productivity. It was pointed out that the share of firms citing labour shortages as a constraint on output remained high but had been falling, pointing to less labour market tightness. However, firms continued to hoard labour, which could be interpreted as a sign that they were trying to avoid shortages in the future. Labour hoarding would allow them to meet a future resurgence in demand with the workforce already in place, which had positive implications for labour productivity.

Additionally, it was remarked that monetary policy transmission remained strong, with a significant portion of recent downward revisions to the growth outlook seeming to stem from monetary policy having a more forceful effect on growth than expected. Looking ahead, the projected improvement in economic activity was also based on rate cuts as embedded in the market rate assumptions underpinning the projections.

Against this background, members assessed that the risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East were major sources of geopolitical risk. This could result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if inflation came down more quickly than expected and rising real incomes meant that spending increased by more than anticipated, or if the world economy grew more strongly than expected.

The point was made that two scenarios could unfold if downside risks to economic activity materialised. In one possible scenario, weak demand would lead to a slowdown in profit and wage growth and inflation would be dampened. In an alternative downside scenario, however, the projected recovery in productivity would not materialise. Given the ongoing strength of wage developments, weaker economic growth could translate into higher unit labour costs, contributing to upside domestic price pressures and slowing down the disinflation process.

With regard to price developments, members concurred with the assessment presented by Mr Lane in his introduction and welcomed the recent decline in inflation, reflecting a faster than anticipated disinflationary process. This was partly due to the unwinding of past supply shocks but was also a sign that monetary policy was working. Over the past year both headline and core inflation had fallen by several percentage points, and even services inflation had declined over the past six months. The latest staff projections suggested that inflation would, at least temporarily, already reach a trough close to target in the second half of 2024, which was much earlier than previously expected. On this basis, the view was expressed that the disinflation process was making good progress.

At the same time, it was mentioned that the disinflationary process remained bumpy and fragile, and that a timely and sustainable return to target as foreseen in the projections still relied on a sufficiently restrictive monetary policy stance. Inflation momentum, as measured by the annualised three-month-on-three-month rate, had jumped for all HICP components except food. This was consistent with the latest PMIs showing that the share of services firms indicating rising selling prices had steadily increased since November, which posed upside risks to the inflation outlook, especially for core inflation. One important upside risk was associated with energy prices, which had recently eased significantly. For gas prices, in particular, risks were strongly tilted to the upside, as shown by option-implied distributions. It was important to keep in mind that wrong assumptions on energy prices would eventually feed through to all inflation components, either through input prices or indirectly, via wages. That implied that the benign inflation outlook in the latest projections depended critically on the favourable energy price assumptions. Moreover, the combination of El Niño and La Niña, in conjunction with the impact of global warming and climate change, was creating upside risks for food prices. It was added that month-on-month figures showed that core inflation had again been on the rise for the last couple of months, which called for continued caution on the inflation outlook.

Services inflation, with the latest figure at 3.9%, had barely moved from the 4% recorded for November, which lent further support to the picture of “last mile” persistence in that component of inflation. In January, around 90% of the services consumption basket had still been growing at an annual rate above 2%. The turnaround in services inflation had started late, only from July 2023, and services inflation had lost a mere 1.7 percentage points of the 4 percentage point increase observed since the start of the pandemic. Given the large and rising weight of services in euro area value added, this stickiness had significantly restrained the overall disinflation process. At the same time, monetary policy transmission to services inflation might be weaker and slower than in manufacturing, as services tended to be less capital-intensive and hence less exposed to changes in external financing conditions. In the October 2023 Corporate Telephone Survey, services firms had reported hardly any impact of financing conditions on their past or future activity, in part reflecting their large cash buffers. Moreover, less exposure to global competition meant there was less pressure on services firms to absorb rising costs by curtailing their margins. Overall, this evidence was consistent with the notion that monetary policy transmission to services inflation worked mainly indirectly, through the effect of monetary policy on inflation expectations and wages, as well as through a general dampening of aggregate demand. Furthermore, the rotation of consumption from goods back to services and the resilience of the labour market might have weakened even this indirect transmission channel. All this argued for perseverance in keeping monetary policy sufficiently restrictive. While the progress on inflation had indeed been encouraging, the February inflation figure was a warning sign that the last mile was likely to be more uncertain, slower and bumpier.

At the same time, it was recalled that services inflation had always been more persistent. Although it had indeed remained stubbornly high for the last four months, that was to be expected and had already been incorporated in the projections. Moreover, owing to weaker productivity growth in the services sector, services inflation had traditionally been higher on average than the overall inflation rate. While the annual growth rate of services inflation in February had still been too high, its momentum had been on a falling trend since April 2023 and had been close to 2% in January 2024, although it had picked up again in February to 3.1%. In this context, it was also mentioned that between November and January services inflation had been pushed up by developments in transport, insurance services and package holidays. These components were not classified as wage-sensitive. More generally, it was argued that wage-sensitive components had not exerted particular upward pressure on services inflation since last June. Services inflation had mainly been higher than goods inflation because of the rotation of demand from goods to services after the pandemic, with the result that it had started to increase later, had peaked later and had started to decrease later. The point was made that services inflation had also been higher than in a normal disinflation episode because wages had responded at a slower pace to the supply shock from energy prices. Given the price level gap between goods and services, it was at present not clear whether services prices would converge to goods prices or the other way round.

Turning to wage and profit developments, members recalled that information on the nexus of wages, profits and productivity remained a key element in building confidence around the inflation outlook. There were still several question marks over all three elements of this nexus, so more evidence was needed before it could be concluded that inflation had durably turned the corner. The March 2024 staff projections foresaw a significant decline in the growth of unit labour costs, which had been revised down for 2025 and 2026 compared with the December 2023 projections. But convincing evidence was yet to emerge that nominal wage growth was coming down as expected and, in particular, that firms were absorbing the higher unit labour costs through their profits. Revisions compared with the December staff projections implied significantly stronger contributions from unit profits to domestic inflation than had been expected, and the GDP deflator had so far remained stubbornly above 5%. While the most recent data on profits in 2023 were encouraging, a much stronger absorption of higher labour costs by lower profit margins needed to materialise over 2024.

Furthermore, the projections envisaged a steady recovery of productivity growth over the projection horizon. This might not materialise if the observed slowdown in productivity growth was due not only to cyclical factors such as labour hoarding, but also to factors such as a change in the composition of the labour force, structurally higher sick leave or a shift in employment towards the services sector, which could make the productivity slowdown more persistent. More generally, a significant part of the current weakness in manufacturing was likely to be of a structural nature, which would have different implications for the evolution of inflation, particularly as previous downward revisions to potential output growth might prove insufficient. At the same time, it was mentioned that labour productivity was procyclical in the euro area, so that when economic activity was subdued, weak productivity developments could also be interpreted as a sign of excessive monetary policy tightening.

Incoming information on wages in many countries suggested that wage developments continued to deserve special attention. While the data for the whole euro area on compensation per employee for the fourth quarter of 2023 were not yet available, information had already been received for 15 euro area countries. That information suggested wage growth had slowed significantly in the fourth quarter of last year. As regards the GDP deflator, the headline figure for the fourth quarter had already been released for some countries and incorporated in the March ECB staff projections. The incoming wage growth figures for the first quarter of 2024 from the Indeed tracker based on job adverts could be seen as a leading indicator for negotiated wages. These figures suggested that negotiated wage increases could slow further. Especially when comparing with the inflation outlook contained in the September 2023 staff projections, the subsequent downside inflation surprises had diminished the need for nominal wages to catch up with past inflation.

The question was also raised whether, in the near future, profit margins would be able to keep absorbing the rise in unit labour costs. Otherwise, businesses might increasingly pass on higher unit labour costs by raising prices. In 2022 the level of profits had been atypically high, which suggested that there was sufficient room for margins to compress and that profits would likely be affected by weak demand.

As regards longer-term inflation expectations, members took note of the assessments by Ms Schnabel and Mr Lane of the latest developments in market-based measures of inflation compensation and survey-based indicators. Market-based measures of inflation compensation had come down notably and remained broadly anchored at 2%.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and disrupt global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation could surprise on the downside if monetary policy dampened demand more than expected, or if the economic environment in the rest of the world worsened unexpectedly.

Turning to the monetary and financial analysis, members largely concurred with the assessments provided by Mr Lane and Ms Schnabel in their introductions. Market interest rates had risen since the Governing Council’s previous meeting. These had converged towards the views of analysts and now priced in three fewer interest rate cuts in 2024, with an 85% probability of a first rate cut in June. It was argued that this repricing reflected a recognition that disinflation was going to be slower and less certain than previously expected. In addition, spillovers from higher market interest rates in the United States were also mentioned. Market expectations for future interest rates were seen as broadly in line with macroeconomic fundamentals, including the inflation outlook and interest rate assumptions as embedded in the latest staff projections.

Financial markets had continued to function well but might be underpricing risk in some asset categories. Spreads on high-yield corporate bonds in the euro area had narrowed to levels not seen for the past 15 years but could widen if defaults picked up. Sovereign bond spreads had also continued to narrow but could increase as a result of fiscal risks. Equity markets appeared buoyant, especially in the United States. Meanwhile, the euro exchange rate had changed little, both against the US dollar and in nominal effective terms.

Members agreed that the ECB’s restrictive monetary policy had been transmitted strongly to broader financing conditions for firms and households and that these conditions remained tight. It was remarked that a reduced supply of liquidity was also contributing to monetary tightening, owing to ongoing and prospective reductions in the asset purchase programme (APP) and PEPP portfolios, as well as maturing targeted longer-term refinancing operations. Interest rates on business loans had broadly stabilised and mortgage rates had declined in December and January. This had contributed to a slight easing in financing conditions, but lending rates remained elevated in historical terms. Furthermore, continued repricing of the outstanding stock of loans was also contributing to a strong transmission of the past rate hikes. Bank funding costs were high, and banks were tightening lending standards and increasingly favouring safer assets as the riskiness of borrowers increased. This had negative implications for credit supply. It was also contended that because new loans were less risky their risk-adjusted cost was actually still rising.

There were signs that annual growth in bank loans to firms was stabilising at low levels, notwithstanding some volatility in monthly flows around the turn of the year. Meanwhile the growth in loans to households continued to weaken in annual terms. Broad money, as measured by M3, was growing at a subdued annual rate, with the three-month annualised growth rate momentum rebounding somewhat since mid-2023. It was also argued that the impact of credit tightening had been stronger than expected, especially on mortgage lending. Additionally, the outlook for credit remained moderate, owing to the substantial impact of high interest rates and tight credit standards over the projection horizon. Caution was expressed about assuming that a turning point in lending growth had been reached. Attention was drawn to analysis suggesting that the ratio of corporate bank loans to GDP was projected to fall to historical lows of below 35% in the coming quarters. At the same time, it was argued that the staff projections did not entail a credit crunch. Also, credit dynamics still appeared to suggest a soft landing, given increasing evidence that loan growth had reached a trough. Moreover, declining bank funding costs should also support slightly lower lending rates on new loans. In that context, it was argued that the peak of monetary policy transmission to bank lending volumes might have been reached.

Some concerns were expressed that financial stability risks were emerging, given signs of financial distress among low income households. The proportion of mortgage holders struggling to meet payments was rising rapidly to historical highs, which would probably persist for an extended period. The risks facing some non-financial firms and the risks from the commercial real estate sector were also highlighted. Against this background, banks’ non-performing and underperforming loans were increasing, which could make it tougher for non-financial corporates to access bank credit. Narrow spreads on high-yield bonds were currently a mitigating factor, but if spreads were to increase owing to higher default rates, non-financial corporates’ access to debt financing could suffer. At the same time, bank equity prices remained elevated overall, suggesting that asset quality risks remained contained.

Monetary policy stance and policy considerations

Turning to the monetary policy stance, members assessed the data available since the last monetary policy meeting in accordance with the three main elements that the Governing Council had communicated in 2023 as shaping its reaction function. These comprised (i) the implications of the incoming economic and financial data for the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission. Overall, there had been further progress on all three elements, which warranted increased confidence that inflation was on track to reach the ECB's target in a timely and sustainable manner. However, more data and evidence were needed for the Governing Council to be sufficiently confident of this.

Starting with the inflation outlook, members broadly concurred with the assessment that had been presented by Mr Lane in his introduction. Inflation was continuing to decline towards the 2% target broadly as expected, and this good progress was seen as encouraging. The fact that inflation had been slightly higher than anticipated in February was not seen as changing this general picture. Nevertheless, it was argued that the associated increase in momentum for all HICP components except food, as measured by the annualised three-month-on-three-month rate of inflation, was a warning. A more uncertain, slower and bumpier disinflation process could lie ahead. Still, inflation was expected to continue its downward trend in the coming months – near-term projections having been revised down compared with the December staff projections – and to show continued moderation in 2024. A bumpy profile and a trough were expected after the summer, driven by base effects. Further ahead, inflation was on track to decline to the 2% target as a result of moderating labour costs and the fading effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy. According to the latest staff projections, inflation was expected to be back at target – or even slightly below target – in the medium term, and earlier than had been previously anticipated, especially compared with the September 2023 staff projections.

Members agreed that most measures of underlying inflation had declined further since the last monetary policy meeting, owing to the indirect effects of lower energy prices receding, the impact of past supply shocks fading and tight monetary policy weighing on demand. The staff projections for core inflation had also been revised down. It was now expected to fall to 2% in 2026. However, domestic price pressures were still elevated, owing to a combination of robust wage growth, falling labour productivity and sticky services inflation. It remained to be seen whether unit labour costs would decline in line with the projections, which relied on a recovery in productivity growth together with moderating wage growth. Further uncertainty surrounded both the projected continued decline in the contribution of unit profits to the GDP deflator as well as the extent to which firms would absorb higher labour costs, rather than passing them on to consumers. It was also noted that, over the entire horizon, the March ECB staff projections for core inflation were at the lower end of a range of other forecasts. Continuing uncertainty about the effects of the wage-profits-productivity nexus on domestic inflation highlighted the need for caution and for more evidence that core inflation would continue to decline. At the same time, there were signs that wage growth was starting to moderate. In addition, profits were absorbing part of the rising labour costs, reducing their inflationary effects. Moreover, services inflation could be expected to be more persistent and lag behind other components of inflation.

Finally, members generally agreed that monetary policy transmission was working well, with less uncertainty about the strength of transmission than when interest rates were still rising. Monetary policy was being transmitted robustly to financial markets, financing conditions, credit conditions and aggregate demand. This had helped to lower inflation but had also weighed on growth – potentially more than had been expected and with measurable effects on small and young enterprises. It was recalled that a significant part of policy transmission remained in the pipeline, as the coming quarters would see the impact of past policy tightening continuing to be transmitted to bank funding conditions, broader financing conditions, credit volumes and the real economy. It was also argued that there would be some tightening in financing conditions in 2024 stemming from the contraction of the Eurosystem balance sheet. At the same time, it was contended that the tightening impulse from monetary policy was gradually fading. The point was made that financial and financing conditions – and thereby the effective monetary policy stance – had already eased and might continue to ease as markets repriced their rate expectations. Moreover, transmission was seen as weaker and slower for services inflation, which tended to be less capital-intensive and therefore less reliant on external financing.

Overall, members expressed increased confidence that inflation was on track to decline sustainably to the

2% inflation target in a timely manner. However, patience and caution were still needed, and more evidence and data were required for the Governing Council to be sufficiently confident that the task had been accomplished. It was therefore important not to be complacent, as the disinflationary process remained fragile and conditional on a number of benign assumptions about wages, profits and productivity. Furthermore, a smooth and sustainable return of inflation to target, as implied by the projections, was also contingent on the monetary policy stance remaining restrictive enough for long enough. At the same time, it was widely felt that, while there were clearly risks to the outlook, monetary policy was working and the disinflation process remained solid and robust. The view was taken that the risks of overshooting versus undershooting the ECB's symmetric inflation target in the medium term were broadly balanced or becoming more balanced.

Monetary policy decisions and communication

All members agreed with the proposal by Mr Lane to maintain the three key ECB interest rates at their current levels. There was consensus that it would be premature to discuss rate cuts at the present meeting. Instead, it was affirmed that it was important to be further along in the disinflation process and accumulate additional evidence for the Governing Council to be sufficiently confident that inflation was set to return to target in a timely and sustainable manner. It was reiterated that, based on its current assessment, the Governing Council considered the key ECB interest rates to be at levels that, maintained for a sufficiently long duration, would make a substantial contribution to returning inflation to its 2% medium-term target in a timely manner. Future decisions would ensure that policy rates would be set at sufficiently restrictive levels for as long as necessary.

Members underlined the need for policy to remain data-dependent and to continue to be based on the elements of the reaction function already communicated. While it was wise to await incoming data and evidence, the case for considering rate cuts was strengthening. This was based on the latest ECB staff projections, the further progress on the three criteria specified by the Governing Council in 2023, more contained projection errors and a more balanced risk assessment, with the date of a first rate cut coming more clearly into view. It was also recalled that the ECB's focus and mandate were price stability in the euro area, although spillovers from other major policy areas would naturally be taken into account.

It was highlighted that, in addition to new staff projections, the Governing Council would have significantly more data and information by the June meeting, especially on wage dynamics. By contrast, the new information available in time for the April meeting would be much more limited, making it harder to be sufficiently confident about the sustainability of the disinflation process by then. Questions remained about the sustainability of the disinflationary process, particularly in services and domestic inflation, on account of the uncertain outlook for wage growth, productivity growth and profit margins. In order to increase confidence that inflation would sustainably return to the ECB's target, incoming data needed to confirm that important assumptions and predictions about these indicators in the March ECB staff projections would indeed hold true.

Members also agreed with Mr Lane's proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio, in line with the Executive Board proposal presented by Ms Schnabel in her introduction.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

Monetary policy statement for the press conference of 7 March 2024

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 6-7 March 2024

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Cipollone
- 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 Reinesch
- Mr Rehn*
- Ms Schnabel
- Mr Scicluna
- Mr Šimkus
- Mr Stournaras
- Mr Vasle*
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch*

* Members not holding a voting right in March 2024 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

- Ms Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Horváth
- Mr Kaasik

- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Sleijpen
- Mr Šošić
- Mr Tavlas
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

Other ECB staff

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

Release of the next monetary policy account foreseen on 10 May 2024.

Resilience of European banks is good, but financial stability risks are elevated amid geopolitical uncertainty – European Systemic Risk Board’s latest assessment

News 28 March 2024 11:30 AM

At its meeting on 21 March 2024, the General Board of the European Systemic Risk Board (ESRB) acknowledged the resilience of Europe’s banking system but concluded that risks to EU financial stability remained elevated amid high geopolitical uncertainty.

“The effects of the escalation in geopolitical confrontation must be taken into account in the financial system as well. We have entered – on an evidently permanent basis – a more volatile time where risks can emerge which could spark even severe disruptions in the financial system. It’s therefore essential to maintain and further strengthen the financial system’s resilience in Europe, ensuring that the capacity of banks to lend to businesses and households remains solid,” says Governor of the Bank of Finland Olli Rehn, who also serves as First Vice-Chair on the General Board of the ESRB.

The General Board noted, in regard to the macroprudential policy stance, that countries are taking appropriate measures to enhance banking sector resilience. The General Board welcomed that 27 European Economic Area (EEA) countries have built up, or are building up, capital buffers in the form of a countercyclical capital buffer and/or systemic risk buffer.

The General Board also exchanged views on other current themes that are important for financial stability, such as the impact of interest rates and inflation on financial stability, the risks related to non-bank financial intermediation, and systemic cyber threats and operational risks.

The European Systemic Risk Board’s press release published today has more details of the meeting.

ECB Monetary policy decisions

News 7 March 2024 3:22 PM

ECB press release 7 March 2024

The Governing Council today decided to keep the three key ECB interest rates unchanged. Since the last Governing Council meeting in January, inflation has declined further. In the latest ECB staff projections, inflation has been revised down, in particular for 2024 which mainly reflects a lower contribution from energy prices. Staff now project inflation to average 2.3% in 2024, 2.0% in 2025 and 1.9% in 2026. The projections for inflation excluding energy and food have also been revised down and average 2.6% for 2024, 2.1% for 2025 and 2.0% for 2026. Although most measures of underlying inflation have eased further, domestic price pressures remain high, in part owing to strong growth in wages. Financing conditions are restrictive and the past interest rate increases continue to weigh on demand, which is helping push down inflation. Staff have revised down their growth projection for 2024 to 0.6%, with economic activity expected to remain subdued in the near term. Thereafter, staff expect the economy to pick up and to grow at 1.5% in 2025 and 1.6% in 2026, supported initially by consumption and later also by investment.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. Based on its current assessment, the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. The Governing Council's future decisions will ensure that policy rates will be set at sufficiently restrictive levels for as long as necessary.

The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

Key ECB interest rates

The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 4.50%, 4.75% and 4.00% respectively.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The Governing Council intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

***

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

Account of the ECB Governing Council’s monetary policy meeting, 24-25 January 2024

News 22 February 2024 2:30 PM

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 24-25 January 2024

22 February 2024

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

Financial market developments

Ms Schnabel noted that, since the Governing Council’s previous monetary policy meeting on 13-14 December 2023, the rapid easing of financial conditions observed after the 25-26 October meeting had levelled off and been pared back slightly.

Financial conditions had eased sharply in November and December, as the narrative in financial markets had shifted from “high for longer” to swift disinflation and imminent monetary policy easing. After the Governing Council’s 13-14 December meeting, financial conditions had continued to ease until late December but had tightened slightly thereafter. This followed ECB communication that had countered the aggressive market pricing of a rate-cutting cycle starting as early as March 2024.

While the probability of a 25 basis point cut in April still stood at around 60%, a first cut was now fully priced in only for June. Expected cumulative rate cuts by the end of the year had declined slightly since the December meeting, to around 130 basis points. Policy rate expectations in US forward markets had also been scaled back, although to a slightly lesser extent. US interest rate markets were positioned for an initial 25 basis point cut in May, with a 40% probability of a March cut. Moreover, investors expected almost the same magnitude of cumulative cuts as in the euro area in the course of 2024, anticipating a globally synchronised normalisation cycle.

However, the uncertainty around this policy path was high, as reflected in the persistent volatility in bond markets. The easing of global financial conditions in November and December 2023 had gone hand-in-hand with lower volatility in risk asset markets. Implied volatility in euro area equity markets had dropped to its lowest level since the onset of the coronavirus pandemic in February 2020, despite significant geopolitical tensions and risks of protracted economic weakness. Yet, lower implied volatility in risk asset markets was not accompanied by meaningfully lower implied volatility in bond markets, which had decoupled from equity market volatility.

There were two potential sources of heightened monetary policy uncertainty. The first was the timing and pace of the policy adjustment, while the second was the extent of the required policy adjustment. Respondents to the January 2024 ECB Survey of Monetary Analysts (SMA) had raised their expectations for the pace of rate cuts over the year but remained more cautious than financial market pricing. While markets foresaw a cumulative easing of around 130 basis points, SMA respondents expected total cuts of 100 basis points by the end of the year. Differences in the outlook for inflation could explain the discrepancy between market pricing and analysts' expectations for the future path of monetary policy. Investors trading in financial markets were discernibly more optimistic about the inflation outlook than the median SMA respondent. Another explanation could be different speeds in adjusting to new information. During the interest rate tightening cycle in 2022 and 2023, rate markets had consistently led survey expectations, often by several months.

The second source of uncertainty about the medium-term policy rate path concerned the extent of adjustment required to return to a neutral policy rate and the uncertainty surrounding estimates of such a rate. SMA participants had raised, noticeably, their median longer-run expectations for policy rates compared with levels during the period before the start of the ECB's hiking path.

The expected reversal of the 2023 tightening was also visible in longer tenors of the yield curve. The euro area ten-year real overnight index swap (OIS) rate remained close to early 2023 levels and slightly below its September 2023 level, when the ECB had last hiked interest rates. The corresponding nominal OIS interest rate had even fallen below early 2023 levels. In the United States, the ten-year real OIS interest rate had fallen to a similar degree since late October but remained above early 2023 levels. The reappraisal of the monetary policy outlook had been the dominant driver of the decline in bond yields since the Governing Council's October monetary policy meeting, along with news on the growth outlook and fiscal developments.

The rescaling of the earlier aggressive market pricing had also affected risk asset markets. Yet, euro area equity markets remained broadly unchanged since the December meeting. A longer perspective, since the start of 2023, revealed that developments in equity markets, as in other risk asset markets, had been robust, providing an easing impulse to financial conditions. The somewhat stronger repricing of monetary policy expectations in the euro area than in the United States had been reflected in a slight appreciation of the euro, with the US dollar moving lower against a broad set of currencies.

Intra-euro area sovereign bond spreads had declined further, as the announcement regarding the phasing-out of reinvestment under the pandemic emergency purchase programme (PEPP) had been well absorbed by the market and some government bonds had seen record demand. The announcement on the PEPP and the ongoing gradual and predictable unwinding of the Eurosystem's bond portfolios under the asset purchase programme (APP) had not amplified the sensitivity of spreads to changes in risk-free rates, suggesting that fragmentation risks remained muted.

Absorption in euro area government bond markets had been supported by benign liquidity conditions, underpinned by the return of foreign investors and investment funds. The prospects for smooth and healthy market absorption remained largely in place for 2024. Benign market conditions had also been evident in 2023 year-end trading and repo market functioning. Repo rate declines in general collateral and non-general collateral markets had been substantially more contained than at the 2021 and 2022 year-ends.

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

Reviewing the global environment, Mr Lane noted that global economic activity had moderated in the fourth quarter of 2023. At the same time, global trade growth was improving as post-pandemic patterns normalised. However, the recent tensions in the Red Sea and Gulf of Aden were a downside risk to trade, since these could adversely affect delivery times and maritime shipping costs, especially on routes between China and Europe. Since the end of December, there had been a big drop in transit volumes, with some shipping re-routing around Africa. So far, the rental price for container vessels was relatively unaffected, likely owing to spare capacity, while shipping prices had already increased.

Oil production was not expected to be affected by the developments in the Red Sea area. The latest projections from the International Energy Agency estimated that oil supply and demand would remain broadly in balance in the first quarter of 2024 and that the market would move into surplus in the remainder of the year. However, there had been notable movements in energy prices. Oil futures prices were significantly above levels at the time of the Governing Council's December meeting but gas futures prices were significantly lower. Mr Lane noted that, when analysing energy prices, it was also important to look at the EU Emissions Trading System (EU ETS) market. Emissions allowance prices had fallen 22% within the first three weeks of January, reflecting weak demand from the industry and power sectors. In the case of the power sector, this was due to the increased use of renewables.

Concerning global commodities, there had been little movement in food and metal prices since the last Governing Council meeting. Also since then, there had been limited change in the euro's exchange rates, both against the US dollar and in nominal effective terms.

Turning to the euro area, Mr Lane recalled that inflation had risen to 2.9% in December, from 2.4% in November, owing to energy-related base effects. However, the increase was less than expected. While services inflation had remained steady at 4.0%, food and non-energy industrial goods inflation had continued to decline. Looking ahead, headline inflation and core inflation – as measured, respectively, by the Harmonised Index of Consumer Prices (HICP) and the HICP excluding energy and food – were expected to continue their downward trajectory.

Domestic inflation remained high at 4.5%, owing to the elevated pace of wage increases and falling labour productivity, but it too had started to ease. Indicators of momentum in headline inflation and all of its components had eased further. The annualised three-month-on-three-month growth rate of seasonally adjusted core inflation had fallen below 1.5%, with momentum in goods inflation at zero and momentum in services and food inflation close to 2%. A broad range of underlying inflation measures had also fallen in December. This reflected the fading impact of past shocks, as well as weaker demand that was, in part, the result of the ongoing strong transmission of tighter monetary policy. Among the different measures, the Persistent and Common Component of Inflation, which was the best predictor of inflation one and two years ahead, had eased to 2% in December.

Overall, the December inflation data provided further evidence that the disinflationary process was well on track and in fact might be running faster than previously expected. However, several headwinds were expected to increase inflation momentum again, as embedded in the December Eurosystem staff macroeconomic projections. This was largely due to the increasing role of wage pressures in explaining the dynamics of core inflation and also to the fading out of some of the energy price falls and the disinflationary pressures coming from the removal of supply bottlenecks.

Historically, the Purchasing Managers' Indices (PMIs) for prices had not been able to capture developments in goods and services inflation very well. Since 2020, however, the correlation had improved, with the PMIs showing a six-month leading property for goods and a nine-month leading property for services. On this basis, the PMIs suggested that downward pressures on goods and services inflation were likely to continue in the near term. However, the latest readings showed a small reversal, suggesting that these pressures were set to weaken.

Looking ahead, the expected slowdown in the disinflationary process was also evident from a decomposition of services inflation into "wage-intensive" and "not wage-intensive" components. So far, the declines in services inflation observed earlier had been driven by the not wage-intensive component, while the contribution from the wage-intensive component had declined only very gradually.

The pace of wage growth remained elevated but there were some initial signs of a deceleration. Unit labour costs had grown by 6.7% and compensation per employee by 5.3% in the third quarter of 2023. Negotiated wage growth had decreased from 4.8% in September to 4.6% in October. The forward-looking wage trackers signalled wage dynamics that were broadly in line with the December staff projections. Mr Lane also recalled that the wage tracker contained both old and new contracts, renegotiated at different points in time. New agreements signed at the end of 2023, if one-off payments were included, showed increases still above 5%. Moreover, many negotiations taking place in the first quarter of 2024 were expected to be concluded in February or March.

Survey-based measures of wage expectations showed that firms and professional forecasters expected a decline in wage growth in 2024. According to the January Corporate Telephone Survey, wage growth was expected to fall from 5.3% in 2023 to 4.4% in 2024. These expectations were a bit lower than in previous rounds. Similarly, in the latest Survey of Professional Forecasters, expectations for the annual growth in compensation per employee pointed to easing wage growth from 2024 onwards and had been revised down for the longer-term horizon. In particular, as of 2026, expected wage growth was below 3%, which was generally seen as the trend increase consistent with the ECB's 2% medium-term inflation target.

The contribution of unit profits to domestic price pressures had continued to decrease in the third quarter of 2023, suggesting that – as expected – profit margins were absorbing some of the price pressures coming from wage increases. The January Corporate Telephone Survey suggested that firms had adjusted their profit margins during 2023. Although reported profit margins had edged up somewhat at the end of the year, they remained below the long-term average after being above it from early 2021 to mid-2023. This further confirmed that profits had started to mitigate the inflationary effects of wage increases.

Looking ahead, inflation was expected to ease further over the course of 2024, as the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy faded and tighter monetary policy constrained demand.

Measures of shorter-term inflation expectations had come down markedly, while longer-term inflation expectations mostly stood around 2%. Market-based measures of inflation compensation implied by fixings contracts – measures extracted from swap contracts linked to very near-term euro area inflation releases – indicated that investors were expecting inflation to fall to 2% as early as April and to stay at or below 2% for most of the remainder of 2024. The Consumer Expectations Survey showed that perceptions about inflation had finally declined in recent months. Households' expectations one year ahead had declined considerably between October and December, whereas three-year ahead expectations had moved sideways since October. As regards professional forecasters, their inflation expectations had shifted down over the entire horizon, with longer-term expectations now standing at 2%.

Upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and hamper global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins remained resilient. By contrast, inflation might surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly. Moreover, inflation could decline more quickly in the near term if energy prices evolved in line with the recent downward shift in market expectations for the future path of oil and gas prices.

The euro area economy had likely stagnated in the final quarter of 2023, following a mild contraction in real GDP in the third quarter. The latest statistical releases for services and industrial production indicated a drop relative to the third quarter, and survey indicators including the PMIs remained at levels consistent with falling activity. However, in January, forward-looking indicators signalled some pick-up in growth further ahead.

Turning to the components of demand, private consumption was estimated to have remained subdued at the end of 2023. Mr Lane recalled that the December staff projections entailed a significant recovery in private consumption during 2024. Indicators were not yet available for the first quarter. However, firms' expectations had remained contained for retail trade, while they continued to be above historical averages for contact-intensive services.

Moving on to housing investment, this was the GDP demand component most visibly affected by monetary policy transmission. Housing investment had been contracting over the past two years and was estimated to have also declined in the final quarter of 2023. The December projections entailed a slower rate of decline. At the same time, the PMI for housing output remained in deeply negative territory but with some signs of bottoming out.

Regarding business investment, the picture was mixed. Business investment had still been growing in 2023, but the expectation in the December projections was that it would decline in the fourth quarter. There had been an accumulation of stocks of finished capital goods that might have cushioned the decline in investment in the recent past. Additionally, the existing order books for capital goods were helping to keep investment growth in positive territory. However, new orders were still falling sharply, which suggested a period of weak investment ahead.

On the trade side, in spite of the recovery in global trade, euro area exports had remained subdued as 2023 drew to a close. Imports also continued to be weak, owing to an unfavourable composition of demand and to the inventory destocking cycle, both at the global level and in the euro area.

The labour market continued to be robust. The unemployment rate had fallen back to 6.4% in November, even as more workers entered the labour force. Labour market conditions had benefited from the 2022 surge in profit margins, which enabled firms to hoard labour despite demand tailing off. At the same time, momentum in demand for labour was decelerating, with fewer vacancies being advertised.

Turning to fiscal policies, news on fiscal measures had been limited. The few measures taken were cancelling each other out at the euro area aggregate level, as some countries had implemented new measures and others were rolling back their previous plans.

The risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out to be stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This might result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if rising real incomes led to a greater increase in spending than anticipated, or the world economy grew more strongly than expected.

Turning to the monetary and financial analysis, market interest rates had moved broadly sideways since the previous Governing Council meeting. Similarly, at the longer end of the yield curve, risk-free rates and sovereign bond yields were little changed overall, despite some fluctuations in the intervening period.

Monetary aggregates had continued to decline in annual terms and remained close to historical lows. M3 – the broad monetary aggregate – had declined by 0.9%, year on year, in November 2023. This decline was consistent with the lack of aggregate growth in bank lending and, if measured in real terms, the decline was much larger. M1 – the narrow monetary aggregate of currency in circulation and overnight deposits – had continued to fall very sharply in November, against a background of portfolio shifts.

The transmission of the restrictive monetary policy stance to broader financing conditions remained exceptionally strong. Lending rates on business loans had declined slightly to 5.2% in November but remained close to their historical highs. Mortgage rates had increased further to 4.0%. The January bank lending survey suggested that higher borrowing rates, with the associated cutbacks in investment plans and house purchases, had led to a further drop in credit demand in the fourth quarter. Against this background, credit dynamics had improved somewhat but, overall, remained weak in November, despite an increase in short-term loans to firms likely associated with their greater working capital needs. At the same time, the further tightening in credit standards for loans to companies reported in January was quite moderate, in a sign that the trend towards ever more restrictive credit conditions observed over the last two years might be flattening out.

Monetary policy considerations and policy options

Overall, the incoming information had broadly confirmed the Governing Council’s previous assessment of the medium-term inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Inflation was heading towards the 2% target, possibly at a faster pace than previously expected. The current levels of the policy interest rates would make a substantial contribution to reaching that goal if maintained for a sufficiently long duration. In terms of an overall evaluation of the policy rate trajectory, the disinflationary process needed to be further along for the Governing Council to be sufficiently confident that inflation would hit the target in a timely manner and settle sustainably at that level. Therefore, Mr Lane proposed keeping the three key ECB interest rates unchanged.

The three elements of the Governing Council's reaction function gave a robust framework for assessing the data and guiding decisions over the upcoming policy meetings. The Governing Council should continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions should remain based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

Finally, Mr Lane proposed preserving the option to apply flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism still related to the pandemic.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, members took note of the assessment provided by Mr Lane that, while global GDP growth was seen to have decelerated in the fourth quarter of 2023, incoming trade data suggested that goods trade momentum was turning positive again. This was in line with the assessment that a normalisation of the inventory cycle and consumption patterns between goods and services should support trade. Moreover, the impact on global trade from recent developments in the Red Sea area was seen as contained so far. Looking at key global economies, the United States was on course for a soft landing, while in China GDP growth had slowed in the last quarter of 2023. In the context of weaker Chinese domestic demand, it was argued that Chinese exports would put additional negative pressure on international prices. The weakness in China had also been negatively affecting euro area exports, increasing uncertainty around the economic outlook.

Turning to energy commodities, oil prices had increased since the December Governing Council meeting, while European gas prices had declined further as demand remained subdued and gas storage facilities were relatively full. The euro area economy was seen as particularly exposed to geopolitical risk, which was likely to remain elevated for years to come. First, the war in Ukraine remained an important risk factor. Second, the conflict in the Middle East had resulted in rising freight costs and a lengthening of delivery times owing to the recent attacks on freight ships in the Red Sea and the Gulf of Aden. So far there had been no major disruption of trade and the main impact had come from ships taking longer routes around Africa, resulting in higher shipping rates and longer delivery times. However, this had, anecdotally, already led to some euro area companies halting production because of a lack of components. In this context of heightened global uncertainty, it was seen as puzzling that international energy price developments had remained overall very benign.

With regard to economic activity, members concurred with Mr Lane that the euro area economy was likely to have stagnated in the final quarter of 2023. The incoming data continued to signal weakness in the near term. However, some forward-looking survey indicators pointed to a pick-up in growth further ahead. The labour market had remained robust. The unemployment rate, at 6.4% in November, had fallen back to its lowest level since the start of the euro and more workers had entered the labour force. At the same time, demand for labour was slowing, with fewer job vacancies being advertised. Governments should continue to roll back energy-related support measures to avoid driving up medium-term inflationary pressures. Fiscal and structural policies should be designed to make the euro area economy more productive and competitive, as well as to gradually bring down high public debt ratios. Structural reforms and investments to enhance the euro area's supply capacity – which would be supported by the full implementation of the Next Generation EU programme – could help reduce price pressures in the medium term, while supporting the green and digital transitions. Following the recent ECOFIN Council agreement on the reform of the EU's economic governance framework, the legislative process should be concluded swiftly so that the new rules could be implemented without delay. Moreover, it was imperative that progress towards capital markets union and the completion of banking union be accelerated.

Members widely acknowledged that growth would likely be weaker than expected in the short term. So far, however, the decline in inflation was coming at a relatively mild cost in terms of economic activity. On the one hand, survey indicators suggested that the economy might have bottomed out. PMI indicators had plateaued and were even showing an uptick, feeding into the view that there would be a soft landing. Looking at the flash PMIs for January, manufacturing activity, although still firmly in negative territory, was on an upward path. The forward-looking PMIs for services had increased notably and employment expectations had also edged up moderately. On the other hand, it was pointed out that the economy was now likely to have stagnated for the fifth quarter in a row and the next staff projections would most likely shift the start of the recovery by one or two quarters again. Consumer confidence remained low and the PMI indicator for services had come in below analysts' expectations in January. The ECB's contacts with non-financial corporations showed that the business environment was perceived as not worsening, but also not improving. The Governing Council therefore still needed to see clearer signs that the recovery was on track.

Looking ahead, the main factor behind the expected recovery – according to the December 2023 staff projections – was consumption, which was seen picking up as real household income gradually improved. Investment was seen as another potential driver. Housing investment had been quite weak for almost two years, but it might gradually recover with mortgage rates coming off their peak. Reference was made to the bank lending survey, which foresaw an increase in households' demand for loans for house purchase in the first quarter of 2024. Business investment had held up better than anticipated, and it might continue to do so given the still high stock of orders for capital goods and profits remaining above pre-pandemic trends, especially if financial conditions loosened further. This was seen as posing an upward risk to the economic outlook, notably in the short term, in view of the weak investment trajectory that the December projections anticipated. At the same time, it was stressed that monetary transmission remained very strong, particularly in the housing sector, as reflected in weak developments for housing loans.

Turning to the labour market, conditions there were seen as persistently very tight. Unemployment was still at an all-time low, so it could be argued that the "sacrifice ratio" of bringing down inflation had been virtually zero. Given the very tight labour market, it was prudent for the Governing Council to exercise caution on wage prospects and to await evidence that wage growth was actually moderating as projected for 2024. It was argued that the Governing Council would need to see some hard data confirming that wages had turned the corner. At the same time, it was highlighted that the labour market was clearly showing signs of cooling, and that was likely to have a dampening effect on future wage growth. Given significant labour hoarding, either economic activity would have to recover soon or employment and wage growth had to fall. Some softening of labour market conditions was already visible in a decline in job vacancies, which was typically the first variable that started to adjust.

Against this background, members assessed that the risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This might result in firms and households becoming less confident about the future and global trade being disrupted. Growth could be higher if rising real incomes meant spending increased by more than anticipated, or if the world economy grew more strongly than expected.

In this context, the view was expressed that the risks surrounding growth and inflation in the December staff projections were, overall, increasingly on the downside. It was remarked that a lower figure for activity in the fourth quarter, with the economy stagnating or even contracting, would mechanically imply substantially lower growth for 2024 owing to a carry-over effect. Moreover, the growth rate in both 2023 and 2024 would remain far below potential, mainly as a result of tighter financial conditions, weak sentiment, the withdrawal of fiscal support and the lagged effect of monetary policy tightening.

As euro area growth remained disappointing, also from a medium-term perspective, it was regarded as important to stress the need for structural reforms to address low productivity and impediments on the supply side. Low potential growth in Europe highlighted the importance of making progress towards capital markets union, as well as improving the functioning of the Single Market and other factor and product markets. In this context, it was pointed out that national governments were faced with several structural challenges, including an ageing population and the green and digital transitions, all to be tackled against a backdrop of heightened geopolitical risks. Even if activity and sentiment in the manufacturing sector were slowly improving, firms continued to face structural headwinds that were unrelated to the ECB’s monetary policy and needed to be tackled first and foremost by governments via structural reforms.

On the reform of the EU’s fiscal governance framework, it was stressed that the European Commission and the European Council should implement the new rules as transparently and as efficiently as possible, and in a way that permitted further progress towards fiscal consolidation and could simultaneously create headroom for investment. It was also recalled that governments needed to bring down high public debt ratios while being ready to contribute to closing the investment gap for the green transition and adaptation to climate change. This implied that they also had to adjust not only the path of “headline” fiscal policies but also the composition of budgets, to be able to pursue truly sustainable levels of economic activity that were resilient to the increasingly plausible scenario that the world would fall short of the objectives of the Paris Agreement.

With regard to price developments, members concurred with the assessment presented by Mr Lane in his introduction. Inflation had risen to 2.9% in December as some of the past fiscal measures to cushion the impact of high energy prices dropped out of the annual inflation rate, although the rebound was weaker than expected. Aside from this base effect, the overall trend of declining inflation had continued. Food price inflation had eased to 6.1% in December. HICP inflation excluding energy and food had also declined again, to 3.4%, owing to goods inflation falling to 2.5%. Services inflation was stable at 4.0%. Inflation was expected to ease further over the course of 2024 as the effects of past energy shocks, supply bottlenecks and the post-pandemic reopening of the economy faded, and tighter monetary policy continued to weigh on demand. Almost all measures of underlying inflation had declined further in December. The elevated rate of wage increases and falling labour productivity were keeping domestic price pressures high, although these too had started to ease. At the same time, lower unit profits had started to moderate the inflationary effect of rising unit labour costs. Measures of shorter-term inflation expectations had come down markedly, while measures of longer-term inflation expectations mostly stood around 2%.

Members stressed that the recent decline in inflation was good news. Headline and underlying inflation figures had recently been continuously below the predicted levels, suggesting a faster than anticipated disinflationary process. It was therefore likely that in March, with the new projections, there would be a downward revision to inflation for 2024. In this context, it was highlighted that the staff projections tended to underestimate changes in inflation momentum in both directions. Moreover, downside inflation surprises were currently occurring in parallel with downside growth surprises and repeated signs of a stronger than expected transmission of monetary policy. Additionally, market participants were expecting a lower inflation profile, notably for 2024. The view was expressed that this suggested the risks to the inflation projections might be moving to the downside, especially for the short term.

However, it was emphasised that the outlook for inflation remained particularly clouded over the short term. Seasonality could play a disproportionate role, with many firms posting new prices at the start of the year. This was likely to complicate the interpretation of incoming inflation numbers. Moreover, it was underlined that extracting a signal from the month-by-month data on how inflation would evolve over the medium term was subject to considerable uncertainty. In this regard, the medium-term component of wage dynamics and the evolution of inflation expectations remained crucial. It also remained an open issue as to how the pandemic-related changes in the prices of services would unwind relative to goods prices. There could be either more protracted deflation in goods prices or an extended period of services inflation above normal levels, with services prices typically stickier and more heavily determined by wages.

While headline inflation was generally seen as being on track towards the ECB's 2% inflation target, this path remained surrounded by considerable uncertainty, especially with respect to the medium term. The prospect of inflation returning to target in a timely and sustained manner therefore remained fragile and depended on a number of benign assumptions materialising. In particular, emphasis was placed on the projected decline of record high unit labour cost growth, which was predicated on a rebound in productivity alongside a moderation in wage growth in 2024. Moreover, it was assumed that higher labour costs would continue to be absorbed by profits, as indicated by a projected smaller contribution from unit profits to domestic inflation. Reference was again made to the "last mile" difficulties, with the final stretch to the inflation target seen as more challenging than earlier phases. This was seen as a risk because the swift disinflation following the reversal of supply shocks and the forceful monetary tightening would soon start to wane, and the domestic components of inflation might prove more persistent or new shocks might derail progress. For example, although the momentum of services inflation had slowed, the annual growth rate had remained high, at 4% in December. Similarly, domestic inflation had come down but remained above other measures of underlying inflation. Moreover, the absorption of higher input costs by lower profit margins was not assured, as was suggested by the increase in selling price expectations over three successive months.

Turning to wage developments in more detail, members recalled that wage pressures were key to the medium-term inflation outlook. So far, wage growth had remained strong and, together with negative productivity growth, had led to a historically large increase of 6.7% in unit labour costs in the third quarter of 2023. The distance between current wage growth of around 5% and a trend increase of 3% or 2½% that was compatible with the 2% inflation target, assuming 1% or ½% trend productivity growth, was regarded as quite significant and likely to diminish only gradually over time. It remained to be seen whether unit labour cost growth would decline sharply in 2024 as assumed in the December staff projections, which relied partly on a rather strong recovery in productivity growth combined with a moderation in wage growth.

Despite stagnation, it was underlined that the economy continued to add jobs. The unemployment rate was clearly below all available estimates of the non-accelerating inflation rate of unemployment (NAIRU) for the euro area. Hence trade unions would probably still see themselves as being in quite a powerful negotiating position. It should also be kept in mind that the backloading of wage increases in some countries implied more persistent pressure on wage growth, stretching well into 2025. At the same time, the reason why unit labour costs were expected to improve significantly this year was because the economy was expected to recover strongly according to the December projections. So, under the baseline scenario, firms could increase output this year without necessarily adding to employment, and an improvement in productivity ensured that unit labour costs would decline more quickly than wages. If the economy were to grow by less, unit labour costs might not retrench and inflation pressure might persist. However, it was also argued that this was unlikely to happen, as firms would face weaker demand and pricing power and would thus eventually respond with layoffs, which would pre-empt a further decline in labour productivity.

Moreover, it was pointed out that nominal wage growth of around 5% – according to the latest available data for compensation per employee (for the third quarter of 2023) – was not necessarily an excessive number during a "catching-up" phase, taking into account that real wages had declined by about 7% since the beginning of the inflation surge. A recovery in real wages, as also embodied in the December projections, could be regarded as necessary for the euro area economy to recover from its current period of stagnation. In a context of weak demand, this should not be expected to put upward pressure on inflation. Conversely, if employment and wages were to weaken too much, there was a risk that the economy could quickly find itself back in a situation of low growth and low inflation. Moreover, in a context of rapid disinflation, it also seemed likely that trade unions would accept lower nominal wage increases to achieve the same real wage increases. Finally, caution was expressed against overinterpreting the signal from current wage growth, as the labour market typically lagged output dynamics and the impact of monetary policy tightening should therefore also become visible in wage growth with a lag.

Against this background, it was widely felt that the signal from wage growth in the first quarter of this year would be important, as many wage contracts were scheduled to be settled in the coming months. At the moment it was an open question as to how workers would react to the new environment of falling inflation, with the level of prices still high compared with wage levels. The incoming information from the wage trackers was broadly in line with the baseline in the December staff projections. Hence the question was raised as to whether new wage agreements would corroborate recent first signs of moderation in line with the projections, and whether firms would continue to compress margins. These were two elements which would be consistent with inflation returning to target in the medium term. Finally, it was also recalled that, while negotiated wages were typically a lagging indicator of economic growth, the wage drift – the other component of total wage growth – was more immediately responsive to the overall business cycle. In the context of an economy that had been stagnating for nearly one and a half years, it was thus likely that this component of wage growth would turn out to be weaker than suggested by the information in the wage tracker for negotiated wages.

Attention was drawn to another reason why inflation could be falling in spite of increasing wages. Since wages amounted to only around 40% of firms’ total costs and most indicators of intermediate costs were currently falling, when wages and intermediate costs were taken together, pressure on inflation from total costs was declining. As changes in producer prices typically led changes in consumer prices by a few quarters, this decline in cost pressure could be expected to be transmitted to consumer prices in the next couple of quarters. Now that intermediate costs were moving in the opposite direction to wages, wage growth was not a sufficient indicator to capture overall cost pressures in the economy, given that prices were typically set as a mark-up over total costs, not just wage costs.

The question was also raised as to whether, in the near future, profit margins would have enough scope to continue absorbing the rise in unit labour costs. If not, businesses might increasingly pass high unit labour costs through to prices. Firms’ profits were far from the exceptional levels of 2022, a time when firms purportedly took advantage of high inflation to increase profit margins. In fact, profit margins had already come down to the point where anecdotal evidence suggested that some firms were now starting to cut back on investment because they felt constrained by a lack of profitability. The performance of the manufacturing sector was weaker and the sector was also exposed to global competition, so profits might continue to buffer unit labour costs. By contrast, the services sector was largely shielded from global competition and demand was still robust. Therefore, the high unit labour costs in this sector were likely to be passed through to prices more easily. In this context, it was also noted that stock returns suggested that corporate profitability was, overall, still high. Moreover, there was significant uncertainty surrounding the link between wages and price-setting, and it was underlined that the Governing Council needed to monitor a broad set of variables to understand how the current state of the labour market would ultimately affect inflation, rather than relying on only a few indicators.

As regards longer-term inflation expectations, market-based measures had come down notably and remained broadly anchored at 2%, reflecting the market’s view that inflation would fall rapidly and stabilise around 2%. In this context, reference was made to risks of a downward unanchoring of inflation expectations, as a result of the weakness in economic activity and of a faster and broader disinflation than anticipated. At the same time, the view was expressed that there were no indications that expectations would become unanchored to the downside, with the inflation expectations of households and firms instead being skewed to the upside. Overall, developments were widely seen as going in the right direction.

Against this background, upside risks to inflation included the heightened geopolitical tensions, especially in the Middle East, which could push energy prices and freight costs higher in the near term and hamper global trade. Inflation could also turn out higher than anticipated if wages increased by more than expected or profit margins proved more resilient. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected, or if the economic environment in the rest of the world worsened unexpectedly. Moreover, inflation could decline more quickly in the near term if energy prices evolved in line with the recent downward shift in market expectations for the future path of oil and gas prices.

Turning to the monetary and financial analysis, market interest rates were broadly unchanged compared with the levels at the time of the Governing Council's previous meeting but had shown substantial volatility. The rapid fall in market interest rates until around the turn of the year had subsequently reversed on the back of communication by Governing Council members that had curbed expectations of imminent policy rate cuts. This had led markets to price in a lower probability of policy rate cuts at the upcoming meetings of the Governing Council. Nevertheless, expected cumulative rate cuts for 2024 were currently nearly double the 75 basis points that had been embedded in the December staff projections. In addition, it was argued that the markets were expecting lower interest rates because they were expecting lower growth and inflation than projected, especially in 2024.

In this respect, it was widely felt that the current market pricing of future interest rates was not a sign that markets did not understand the ECB's reaction function. Instead, it appeared that markets simply expected inflation to be lower than foreseen in the December staff projections, notably for 2024. Given that market expectations for inflation and for the future path of nominal interest rates had moved lower in tandem, the profile of expected real interest rates had remained broadly unchanged. It was important not to dismiss the markets' assessment, and it was advisable to exercise humility when judging market expectations for inflation and rates. However, this did not mean that the Governing Council had to follow or validate these expectations. Market pricing would likely respond both to incoming data and to the Governing Council's communication of its own assessment.

Euro area equity markets were assessed to have been quite buoyant in 2023 and also to have remained robust into 2024, despite the weaker outlook for economic growth. It was argued that this could, in part, reflect the repricing of the outlook for interest rates by financial markets, which might be underpricing the risk of a shallower monetary policy easing cycle. An alternative interpretation of the strength in equity markets was that financial market participants might be expecting profits to remain resilient, which could justify current stock market valuations, notably of globally active firms.

Members also pointed out that euro area financial markets had continued to function well, with sovereign and corporate bond spreads generally contained and mostly narrowing. There was no evidence of market fragmentation amid the normalisation of the Eurosystem balance sheet, which was a welcome development. Overall, there had been a significant loosening of financial conditions since the October monetary policy meeting, when the Governing Council had first paused the hiking cycle after the series of interest rate increases implemented since July 2022. Financial conditions were broadly unchanged from the time of the December meeting and had tightened only slightly since the trough around the end of 2023.

Members agreed that the ECB's restrictive monetary policy had been strongly transmitted to financing conditions for firms and households, while some evidence had recently emerged that borrowing costs might have reached a peak. Bank lending rates for firms had fallen in November 2023 for the first time in a long period and, although mortgage rates had increased further, the bank lending survey suggested some flattening-out in the tightening of credit standards and an easing in the terms and conditions for housing loans. However, it was recalled that, even if rates on new lending might be reaching a turning point, much of the repricing of the existing stock of loans at higher rates remained in the pipeline.

Credit dynamics had improved somewhat but remained weak overall. This weakness reflected the impact of past monetary policy tightening, which, as reported in the latest bank lending survey, had also contributed to a further drop in credit demand in the fourth quarter of 2023. On the credit supply side, it was argued that weak incentives for bank lending might also have played a role. Banks had attractive alternative ways of putting their liquidity to work, including by investing in bond markets and placing funds in the ECB's deposit facility. Anecdotal evidence nevertheless suggested that loan supply was not seen as a major problem by firms, who cited other issues, such as regulation and the lack of qualified labour, as being more important. Overall, it was assessed that the monetary policy transmission to credit volumes had remained strong, especially for mortgages. At the same time, credit dynamics appeared to be in line with the narrative of a soft landing for the economy. Moreover, the fact that monthly lending flows to firms had reached their highest level in more than a year and loans to households had picked up could be an indication that credit dynamics might be close to a turning point, and that the peak of monetary transmission to bank lending volumes might have been reached.

Finally, it was remarked that, in response to changes in the monetary policy stance, banks' funding strategies were gradually normalising in terms of both the configuration of bank interest rates and their recourse to the Eurosystem balance sheet. Banks had benefited from being able to draw on well-functioning funding markets with stable and sustainable spreads. While more diversified funding strategies might imply an increase in aggregate bank funding costs, they contributed to robust bank balance sheets and therefore increased the resilience of banks to shocks in the prevailing uncertain macro-financial environment. This would also support an orderly and smooth transmission of monetary policy if shocks were to materialise.

Monetary policy stance and policy considerations

Turning to the monetary policy stance, members assessed the incoming data since the last Governing Council meeting in accordance with the three main elements that the Governing Council had communicated in 2023 to be important in shaping its reaction function. These elements were (i) the implications of the incoming economic and financial data for the inflation outlook, (ii) the dynamics of underlying inflation, and (iii) the strength of monetary policy transmission. Overall, members saw the latest developments in economic activity and inflation as being consistent with the current monetary policy stance. There had been further progress on all three elements of the reaction function, which gave grounds to be confident that monetary policy was working.

Starting with the inflation outlook, data releases issued since the previous meeting suggested that disinflation was broadly proceeding as envisaged, or even at a slightly faster pace than previously expected. It was argued that, on the basis of current information and updated assumptions, and in particular lower energy prices, the new staff projections due in March were likely to show a downward revision to inflation for 2024. However, it was underlined that the important question from a policy perspective was the extent to which the news on near-term inflation would be translated into changes in the medium-term inflation outlook. While the incoming information had broadly confirmed the previous assessment of the medium-term inflation outlook, it would be premature to draw any firm conclusions in this regard, as a more complete evaluation was needed when the March projections were available. While inflation had been decreasing faster than expected, this could partly be attributed to one-off factors and energy price developments that might easily reverse. For an assessment of the medium-term inflation outlook, a wide range of variables needed to be considered, in particular the extent to which disinflation would lead to lower wage claims.

For the new staff projections, the prevailing market expectations regarding interest rates were also important as conditioning assumptions. Market expectations were currently significantly lower than those underlying the December projections. Since the lower path for interest rates currently expected by markets was in part an endogenous reaction to lower inflation, the extent to which lower nominal rates would translate into higher growth and inflation in the future needed to be carefully assessed. This should include looking at how the expected path of real rates would change in the projections with new assumptions.

Members noted that measures of underlying inflation had passed their peak, having fallen since the summer, and HICP inflation excluding energy and food had been weaker than predicted in recent data releases. Momentum had also come down in those measures of underlying inflation that remained relatively high, including services inflation and domestic inflation. Yet, wage growth had remained strong, with only limited indications of a turnaround thus far. Moreover, unit labour costs had risen sharply, in part reflecting weak productivity growth, and it remained to be seen whether they would grow as slowly as foreseen in the projections, which were predicated on a recovery in productivity growth together with moderating wage growth. Further uncertainty pertained to how much the contribution of unit profits to domestic inflation would continue to decline as projected, with firms absorbing higher labour costs rather than passing them on to consumers.

Turning to the assessment of monetary policy transmission, members noted that there was solid evidence that monetary policy was being transmitted to financial markets, financing conditions and credit conditions, with the impact most likely having been stronger than expected. However, uncertainty remained about the timing of the peak impact, as well as the ultimate overall effect of monetary policy tightening on the real economy and inflation.

All in all, members signalled that continuity, caution and patience were still needed, since the disinflationary process remained fragile and letting up too early could undo some of the progress made. While the initial inflation shock had largely reversed, the task that lay ahead was the reversal of second-round effects, which might prove to be more stubborn. At the same time, members expressed increased confidence that inflation would be brought back towards the 2% inflation target in a timely manner. The point was made that, for the first time in many meetings, the risks to reaching the inflation target were seen as broadly balanced or at least becoming more even. At the same time, the view was also expressed that, after several years of significantly overshooting the inflation target, the costs of another overshooting were likely higher than the costs of undershooting.

In this context, members underlined the fact that the ECB’s inflation target was symmetric, implying the need to avoid both an undershooting and an overshooting, unless policy rates were close to the effective lower bound. At the same time, there was likely to be some volatility in inflation on the path to achieving the 2% target, and new shocks could materialise. Even if the projections foresaw a temporary period of inflation below 2%, as long as such a deviation was neither large nor persistent, the policy conclusion, in keeping with the ECB’s medium-term orientation, was that the Governing Council did not necessarily have to act. However, it was recalled that, since the ECB’s monetary policy strategy did not prescribe an average inflation target, the Governing Council should not aim at any such undershooting and all persistent deviations from the inflation target in either direction required a policy response.

Monetary policy decisions and communication

Against this background, all members agreed with the proposal by Mr Lane to maintain the three key ECB interest rates at their current levels. It was affirmed that further progress needed to be made in the disinflationary process before the Governing Council could be sufficiently confident that inflation was set to hit the ECB’s target in a timely manner and in a sustainable way. At the present juncture it was regarded as important for monetary policy to stay the course and for the Governing Council to proceed with a steady hand. At the same time, members underlined the fact that monetary policy remained data-dependent. It was reiterated that, based on its current assessment, the Governing Council considered the key ECB interest rates to be at levels that, if maintained for a sufficiently long duration, would make a substantial contribution to returning inflation to the medium-term target in a timely manner. Future decisions would ensure that policy rates would be set at sufficiently restrictive levels for as long as necessary.

There was broad consensus among members that it was premature to discuss rate cuts at the present meeting and members widely referred to risk management considerations to support this view. The risk of cutting policy rates too early was still seen as outweighing that of cutting rates too late. Having to reverse course, in the event that economic activity picked up more strongly than expected, wage growth accelerated or renewed inflationary pressures emerged, could entail high reputational costs. The point was also made that the risk of an inadvertent overtightening of monetary policy was mitigated by the fact that financial markets were already pricing in a number of rate cuts in 2024, contributing to a loosening of both financial and financing conditions. However, it was also argued that such a loosening might be premature and could possibly derail or delay a timely return of inflation to target. In any case, members agreed that following a data-dependent rather than a calendar-based approach was important, in line with the elements of the reaction function that the Governing Council had communicated in 2023.

Members also agreed with the Executive Board proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

Monetary policy statement for the press conference of 25 January 2024

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 24-25 January 2024

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno*
- Mr Cipollone
- 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 Reinesch*
- Ms Schnabel
- Mr Scicluna*
- Mr Šimkus
- Mr Stournaras
- Mr Välimäki, temporarily replacing Mr Rehn
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch

* Members not holding a voting right in January 2024 under Article 10.2 of the ESCB Statute.

Other attendees

- Mr Dombrovskis, Commission Executive Vice-President**
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy

- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

** In accordance with Article 284 of the Treaty on the Functioning of the European Union.

Accompanying persons

- Ms Bénassy-Quéré
- Mr Dabušinskas
- Mr Demarco
- Mr Gavilán
- Mr Haber
- Mr Kaasik
- Mr Koukoularides
- Mr Lünnemann
- Mr Madouros
- Mr Martin
- Ms Mauderer
- Mr Nicoletti Altimari
- Mr Novo
- Mr Pösö
- Mr Rutkaste
- Mr Sleijpen
- Mr Šošić
- 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 4 April 2024.

ECB steps up climate work with focus on green transition, climate and nature-related risks

News 30 January 2024 3:45 PM

ECB press release 30 January 2024

- Increasing impact of climate crisis on economy and financial system drives need for more action
- ECB reaffirms commitment to ongoing climate actions and will review them regularly
- Three focus areas to guide work for 2024 and 2025: implications of green transition, physical impact of climate change, and nature-related risks for the economy and financial system

The European Central Bank (ECB) has decided to expand its work on climate change, identifying three focus areas that will guide its activities in 2024 and 2025:

1. the **impact and risks of the transition to a green economy**, especially the associated transition costs and investment needs;
2. the **increasing physical impact** of climate change, and how measures to adapt to a hotter world affect the economy;
3. the **risks stemming from nature loss and degradation**, how they interact with climate-related risks and how they could affect the ECB's work through their impact on the economy and financial system.

"A hotter climate and the degradation of natural capital are forcing change in our economy and financial system. We must understand and keep up with this change to continue to fulfil our mandate", said ECB President Christine Lagarde. "By broadening and intensifying our efforts we can better understand the implications of these changes and, in doing so, help to underpin stability and support the green transition of the economy and the financial system."

To this end, the following concrete measures have been agreed.

- On the **transition to a green economy**, the ECB will intensify its work on the effects of transition funding, green investment needs, transition plans and how the green transition affects aspects of our economy such as labour, productivity and growth. The results will also inform the ECB's macro modelling framework. Furthermore, the ECB will explore, within its mandate, the case for further changes to its monetary policy instruments and portfolios in view of this transition.
- On the **increasing physical impact of climate change**, the ECB will deepen its analysis of the impact of extreme weather events on inflation and the financial system, and how this can be integrated into climate scenarios and macroeconomic projections. It will also assess the potential impact of adaptation, or lack thereof, to climate change on the economy and financial sector, including related investment needs and the insurance protection gap.
- On **nature loss and degradation**, the ECB will analyse the close link with climate change, and the associated economic and financial implications. It will also further explore the role of ecosystems for the economy and the financial system.
- With regard to its **own operations**, the ECB will launch its eighth Environmental Management Programme to support achieving its 2030 carbon reduction targets. Together with the entire Eurosystem, its work will include eco-design principles for the future **euro banknote series** and incorporate environmental footprint considerations into the design of a digital euro that is currently in the preparation phase.

The decision to step up efforts in these areas follows the ECB's stocktake of its climate actions since launching its 2022 climate agenda, and an adjustment of its work plan in the light of the changing environment and improvements in data availability and methodologies.

The work planned for these focus areas will complement the ECB's current climate-related actions in its ongoing tasks, including monetary policy and banking supervision. The ECB will improve its climate-related indicators, risk monitoring and disclosures, and continue to contribute to the development of climate-related policies in European and international fora. Looking ahead, the ECB remains committed to regularly reviewing these actions to ensure they are fit for purpose and contribute to fulfilling its mandate.

A comprehensive overview of the planned work programme for 2024 and 2025 is available in the Annex and more information can be found on the ECB's website.

Notes

- The ECB needs to account for the effects of climate change in the conduct of its tasks within its mandate. Additionally, without prejudice to its price stability objective, the ECB must support the general economic policies in the European Union, with a view to contributing to a high level of protection of and improvement in the quality of the environment. This includes the goals of the European Climate Law. Under Article 11 of the Treaty on the Functioning of the European Union, the ECB is also required to integrate environmental protection requirements into the definition and implementation of its policies and activities.
- The ECB introduced climate change considerations into its monetary policy framework following its strategy review in 2021.

ECB Monetary policy decisions

News 25 January 2024 3:21 PM

ECB press release 25 January 2024

The Governing Council today decided to keep the three key ECB interest rates unchanged. The incoming information has broadly confirmed its previous assessment of the medium-term inflation outlook. Aside from an energy-related upward base effect on headline inflation, the declining trend in underlying inflation has continued, and the past interest rate increases keep being transmitted forcefully into financing conditions. Tight financing conditions are dampening demand, and this is helping to push down inflation.

The Governing Council is determined to ensure that inflation returns to its 2% medium-term target in a timely manner. Based on its current assessment, the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. The Governing Council's future decisions will ensure that its policy rates will be set at sufficiently restrictive levels for as long as necessary.

The Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions will be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

Key ECB interest rates

The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 4.50%, 4.75% and 4.00% respectively.

Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP)

The APP portfolio is declining at a measured and predictable pace, as the Eurosystem no longer reinvests the principal payments from maturing securities.

The Governing Council intends to continue to reinvest, in full, the principal payments from maturing securities purchased under the PEPP during the first half of 2024. Over the second half of the year, it intends to reduce the PEPP portfolio by €7.5 billion per month on average. The Governing Council intends to discontinue reinvestments under the PEPP at the end of 2024.

The Governing Council will continue applying flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic.

Refinancing operations

As banks are repaying the amounts borrowed under the targeted longer-term refinancing operations, the Governing Council will regularly assess how targeted lending operations and their ongoing repayment are contributing to its monetary policy stance.

***

The Governing Council stands ready to adjust all of its instruments within its mandate to ensure that inflation returns to its 2% target over the medium term and to preserve the smooth functioning of monetary policy transmission. Moreover, the Transmission Protection Instrument is available to counter unwarranted, disorderly market dynamics that pose a serious threat to the transmission of monetary policy across all euro area countries, thus allowing the Governing Council to more effectively deliver on its price stability mandate.

The President of the ECB will comment on the considerations underlying these decisions at a press conference starting at 14:45 CET today.

Account of the ECB Governing Council’s monetary policy meeting, 13-14 December 2023

News 18 January 2024 2:30 PM

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 December 2023

18 January 2024

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

Financial market developments

Ms Schnabel noted that since the Governing Council’s previous monetary policy meeting on 25-26 October 2023 the narrative in financial markets had entirely turned around, proving once again its high sensitivity to incoming data and central bank communication. Markets had turned bullish, driven by expectations of quick and “immaculate” disinflation and an early and sharp monetary policy reversal. This repricing had supported risk asset prices, with equity markets soaring and sovereign and corporate credit spreads narrowing amid continued smooth market absorption. Buoyant risk asset markets and a stronger euro exchange rate were consistent with investors pricing in a bottoming-out rather than a deterioration in the euro area’s economic growth momentum.

Looking at the key drivers of financial market developments and monetary policy expectations, the first and dominant factor had been the downward surprise in inflation worldwide. Second, other macroeconomic data, excluding inflation, had also come in better than expected in the euro area, alleviating fears of a “hard landing” of the economy. The third factor supporting investor risk appetite had been diminishing impact of geopolitical tensions, accompanied by lower oil prices.

The pronounced swing in market pricing over recent months had resulted in strong movements in financial conditions indices. The tightening in euro area financial conditions seen in September and October on the back of expectations that interest rates would be high for longer, as well as a decompression of term premia, had more than reversed in November and early December when investors had positioned for rapid disinflation. Almost all components of the standard financial conditions indices pointed towards a substantial loosening of financial conditions to levels last seen at the start of the year.

Investors had substantially revised their assessment of both the near-term and longer-term inflation outlook since the Governing Council’s previous monetary policy meeting. They now expected inflation to come down much more quickly and to stand close to the ECB’s 2% inflation target thereafter. The inflation-linked swap (ILS) forward curve pointed to three features of markets’ pricing of annual inflation in the Harmonised Index of Consumer Prices (HICP) beyond 2024. First, market-based measures of compensation for headline inflation in the euro area had moved lower over the entire maturity spectrum. Second, investors did not foresee a scenario in which inflation would return to below-target levels. Third, compared with the period before the global financial crisis, the ILS forward curve was currently more upward-sloping, driven by inflation risk premia that were gradually increasing over the horizon. In other words, in the new global economic and geopolitical landscape, upside risks to longer-term inflation were seen as more prominent than before the global financial crisis.

The disinflation narrative, which had first emerged in the United States, had found fertile ground in the euro area, spilling over into euro area short-term rate markets, especially after the flash estimate of euro area inflation in November had come in lower than expected. Markets were currently pricing in an earlier first rate cut by the ECB and a swifter rate-cutting cycle than they had at the time of the Governing Council's previous monetary policy meeting. A 25 basis point cut in April 2024 had been fully priced in by markets as of 13 December, even prior to the release of the policy rate decision by the US Federal Open Market Committee (FOMC). Expected cumulative rate cuts in the euro area by the end of 2024 had increased to nearly 140 basis points, from around 60 basis points at the time of the Governing Council's previous monetary policy meeting.

One important factor behind the sharp downward adjustment in forward rates had been the pricing-out of further rate hikes. At the time of the October Governing Council meeting, option prices had pointed, under the assumption of risk neutrality, to a 25% probability of a further 25 basis point rate hike. As of 13 December, markets attached only an 8% probability to a further rate hike. By contrast, the most likely outcomes reported by survey respondents were less affected by changes in the tails of the distribution of responses. This could partly explain the substantial divergence between survey-based and market-based expectations, with analysts expecting later and fewer rate cuts than market participants. Participants in the Survey of Monetary Analysts expected a cumulative cut of 75 basis points, starting only in July 2024. Another factor that could explain this divergence was that analysts tended to be more sluggish in revising their expectations, waiting for firmer central bank guidance. Similar developments had been seen at the start of the tightening cycle, when survey results had lagged the forward curves in the euro area and the United States for several months.

As a result of the inflation and monetary policy repricing, real rates at the very short end of the curve had risen measurably as investors reappraised the near-term inflation outlook, while nominal short-term rates had been more "sticky", reflecting the ECB's communication. Looking beyond the short term, however, real forward rates had dropped markedly over the entire maturity spectrum as the decline in nominal interest rates had been greater than the downward revision to the inflation outlook over the medium and longer term. In other words, the previous tightening had been partly reversed.

A decomposition of euro area equity price movements showed that the strong rise in share prices since the Governing Council's previous monetary policy meeting had been driven by the accommodative monetary policy repricing, with a small countervailing effect from earnings expectations. Developments in fixed income markets were consistent with market participants positioning for a bottoming-out rather than a further deterioration in the growth momentum of the euro area economy. The reappraisal of the policy rate outlook, in combination with somewhat better macroeconomic news for the euro area, had reversed the widening of spreads for corporate and sovereign bonds that had been observed in September and October.

Regarding possible adjustments to reinvestments in the pandemic emergency purchase programme (PEPP) portfolio, the December results of the Survey of Monetary Analysts suggested that markets were already expecting a partial run-down of PEPP reinvestments from the middle of 2024 and a full run-off after December 2024. Moreover, the sustained demand for bonds in primary and secondary markets amid the ongoing run-down of the asset purchase programme (APP) portfolio was likely to support the smooth market absorption of an earlier end to full PEPP reinvestments. Private investors had stepped in as the Eurosystem had reduced its footprint in sovereign and corporate bond markets. The smooth absorption had also been supported by debt managers tapping into retail demand and reducing somewhat the maturity of newly issued debt.

Banks' funding conditions had also benefited from the monetary policy repricing and improved risk sentiment. Euro area bank bond spreads had narrowed, most notably for riskier bonds. Investor appetite for bank bonds had led to healthy primary market issuance activity, even in the Additional Tier 1 (AT1) bond segment. The increased recourse to market-based funding by banks amid more favourable funding conditions suggested that banks were able to smoothly absorb repayments of targeted longer-term refinancing operations (TLTROs), as also suggested by notable voluntary repayments. Year-end dynamics in funding markets were expected to be calm. The generally smaller Eurosystem footprint in bond markets and lower excess liquidity should help to reduce distortions in the repo markets on reporting dates.

Turning to exchange rate developments, the euro had initially appreciated markedly against the US dollar after the Governing Council's October monetary policy meeting. This appreciation had been stronger than suggested by movements in interest rate differentials and had been partly the result of improved investor sentiment on the back of the global repricing of monetary policy, which had weighed on the US dollar. Since late November the euro had partly reversed its gains. However, speculative positions pointed to a future appreciation of the euro against the dollar, consistent with expectations of a "soft landing" of the euro area economy.

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

Reviewing the global economy, Mr Lane noted that in 2023 world real GDP had been stronger, while global trade had turned out weaker, than had been projected in December 2022. One reason for the drop in the elasticity of trade to global growth was related to the post-pandemic normalisation of the composition of demand from more trade-intensive goods to less trade-intensive services. The most recent data showed that consumption of goods and services was approaching the respective pre-pandemic trends, suggesting that the process of change in the composition of demand was coming to an end. The global inventory cycle was also returning to more normal fluctuations. During the pandemic, trade had been pushed higher by a strong build-up of inventories, much of which were imported inventories, because of global supply chain problems. As the supply chain disruptions unwound and new orders declined, the historically high stock of inventories had been run down. The normalisation of the inventory cycle was expected to contribute to a strengthening in trade growth and a normalisation of trade elasticities in the period ahead.

Turning to the euro area, Mr Lane recalled that the November flash estimate for inflation had been substantially lower than expected, with headline inflation falling to 2.4%, from 2.9% in October. All of the main components of the HICP had contributed to the decline. Core inflation (i.e. excluding the energy and food components) had decreased to 3.6% in November, from 4.2% in October. The decline in non-energy industrial goods inflation to 2.9%, from 3.5%, reflected easing supply chain bottlenecks and slowing demand growth. Services inflation had declined to 4.0% in November, from 4.6% in October. All measures of underlying inflation had fallen in October. While the annual rate of domestic inflation had remained elevated at 5%, the momentum in this indicator had declined markedly over the last three months.

Compared with one year ago, there had been very strong disinflation. Headline inflation had fallen by around 8 percentage points over the last year owing, in particular, to the massive declines in the energy component. When looking back at the inflation projections of December 2022, staff had been correct in foreseeing the major disinflation process a year ahead. This disinflationary process over the course of 2023 was due not only to base effects from the large energy price increases in 2022 but also to lower energy inflation in 2023. Food prices had also contributed to this disinflation – as had core inflation more recently.

Looking ahead, the current assessment was that inflation had reached the end of the strongest phase of the disinflationary cycle. While core inflation and food inflation were expected to continue their gradual decline, upward energy-related base effects and the expiry of the fiscal measures introduced to compensate for the effects of inflation were pushing up headline inflation. In terms of inflation momentum, as measured by the annualised three-month-on-three-month percentage changes in inflation, goods inflation had fallen to below 1% in November. However, momentum in services inflation, while declining, remained strong.

Focusing on the measures of underlying inflation, Mr Lane recalled that these measures were supposed to capture the persistent component of inflation, which was the component of inflation that was expected to persist one or two years ahead. During the past two years all measures of underlying inflation had first increased and then fallen significantly, giving only a blurred signal on the underlying inflationary forces.

Measures that were adjusted for energy and supply bottleneck shocks had seen a less steep increase and decrease. So, while the decline in underlying inflation was also evident in these adjusted measures, they pointed to a smaller improvement from a lower peak level. The decline in the adjusted measures of underlying inflation could be partly attributed to the effects of monetary policy. In other words, without the action of monetary policy, underlying inflation would have stayed higher.

An analysis of price dynamics for individual items in the core inflation basket showed that items accounting for almost half of core inflation were sensitive to monetary policy, and that these were the items that had lately declined more. This helped to explain the decline in underlying inflation and demonstrated that monetary policy was working its way through the economy as envisaged.

Short-term selling price expectations of firms, as reported in the European Commission’s latest business survey, pointed to a normalisation in manufacturing, as the share of firms expecting to charge higher prices three months ahead was close to its long-term average.

The latest Eurostat release showed that the rate of increase in compensation per employee had declined by 0.3 percentage points to stand at 5.2% in the third quarter, with the contribution of unit profits to the GDP deflator also falling substantially. This suggested that, as expected, moderating growth in profits was beginning to absorb some of the inflationary effects of wage increases. However, wage growth remained strong. Negotiated wage growth including one-off payments had increased to 4.7% in the third quarter, from 4.4% in the second quarter. Forward-looking wage trackers continued to signal high pressures, although there had been some deceleration in the Indeed wage tracker.

As regards inflation expectations, the October round of the ECB’s Consumer Expectations Survey showed that consumers had still not adjusted their perception of past inflation downwards, which was a risk factor for upcoming wage negotiations. On the side of professional forecasters, by contrast, the latest Survey of Monetary Analysts showed a sizeable drop in inflation expectations for 2024. Longer-term inflation expectations reported in the survey remained stable at 2%.

In the near term, headline inflation was set to pick up again, owing to energy-related base effects and the expiry of fiscal measures aimed at limiting the repercussions of the energy price shock. For 2024, the staff projections saw inflation declining only gradually – as a result of upward base effects and the phasing-out of past compensatory fiscal measures – before approaching the Governing Council’s target in 2025. Nonetheless, the strength of the ongoing disinflation process was reflected in the December projections: staff had revised down their projections for headline inflation by 0.2 percentage points to 5.4% for 2023 and by 0.5 percentage points to 2.7% for 2024. The 2025 projection was unchanged at 2.1%, while for 2026 inflation was projected to be 1.9%. Core inflation was projected to be 5.0% in 2023, 2.7% in 2024, 2.3% in 2025 and 2.1% in 2026.

Mr Lane focused on the fourth-quarter-over-fourth-quarter growth rates, as these were free from carry-over effects. Starting with HICP inflation, the December projections showed a growth rate of 2.8% in the fourth quarter of 2023 over the fourth quarter of 2022, which was expected to slow very gradually to 2.6% in the fourth quarter of 2024. Thus the evolution of inflation during 2024 would be fairly flat. However, the slowdown in core inflation, which was less affected by base effects, was projected to be faster – with the rate falling from 3.8% in the fourth quarter of 2023 to 2.7% in the fourth quarter of 2024.

Upside risks to inflation included the heightened geopolitical tensions, which could raise energy prices in the near term, and extreme weather events, which could drive up food prices. Inflation could also turn out higher than anticipated if inflation expectations were to move above the target, or if wages or profit margins increased by more than expected. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly, potentially owing in part to the recent rise in geopolitical risks.

Turning to economic activity in the euro area, in the third quarter real GDP had fallen marginally, as rising domestic demand had been offset by the further run-down of inventories. Survey indicators suggested that activity was set to weaken in the services sector and construction would contract again in the fourth quarter, while there were tentative signs that activity in the manufacturing sector was bottoming out.

Moving to demand components, private consumption had increased by 0.3% in the third quarter, driven by consumption of services and durable goods. While the consumption of services was still being supported by the remaining effects from the post-pandemic reopening of the economy, durable goods consumption was being boosted by the delivery of previously ordered motor vehicles, as supply bottlenecks were being resolved. Thus the upward movement in durable goods consumption observed in the third quarter was a lagging indicator of overall consumption.

As regards near-term expectations, demand for goods that were more sensitive to interest rate changes – chiefly durable goods – was declining, while the consumption of services was still being supported by the remaining reopening effects. The recovery in private consumption embedded in the December Eurosystem staff projections was predicated on falling inflation and rising wages, which were expected to boost real disposable income.

Housing and business investment were set to remain weak in view of tight lending conditions. Business investment had been stronger than housing investment during 2023, largely owing to the reduction in the outstanding stock of orders. However, this factor would not support business investment in 2024, which would be increasingly affected by the monetary tightening.

Euro area goods export growth had remained negative in September and the growth of import volumes had declined further. Export prospects remained subdued amid increasing competitiveness challenges. According to the European Commission’s business survey, European firms perceived themselves to have become less competitive in the global market, owing to both price factors and, increasingly, non-price factors.

Employment had so far been resilient. The unemployment rate had stood at 6.5% in October and employment had increased by 0.2% in the third quarter. However, short-term indicators pointed to a cooling of the labour market and weaker economic activity was dampening the demand for workers, with firms advertising fewer vacancies in recent months. Moreover, the total number of hours worked had edged down by 0.1% in the third quarter.

The sequence of subdued growth followed by the expected recovery based on rising real incomes and improving foreign demand was reflected in the new staff projections. Staff expected annual real GDP growth to be 0.6% in 2023, rising to 0.8% in 2024 and 1.5% in both 2025 and 2026. Compared with the September staff projections, real GDP growth had been revised down by 0.1 percentage points for 2023 and 0.2 percentage points for 2024, while it was unchanged for 2025.

The risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia’s unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This could result in firms and households becoming less confident about the future. Conversely, growth could be higher if rising real incomes led to spending increasing by more than anticipated or the world economy grew more strongly than expected.

As regards fiscal policies, the December staff projections entailed relatively small revisions to the main fiscal balances compared with the September projections. For 2024, the budget deficit was expected to decline to 2.8% of GDP and the fiscal stance was expected to tighten. It was important to continue monitoring whether governments would stick to their budgetary plans.

Turning to the monetary and financial analysis, market interest rates had fallen markedly since the October Governing Council meeting, more than reversing the significant increases observed earlier in the autumn. Initially, the declines had mainly affected medium to longer maturities, amid spillovers from other major economies. More recently, shorter-term market rates had also declined measurably, mostly in response to inflation falling faster than expected in November. This had resulted in a market forward curve that embedded an earlier and stronger easing of the monetary policy stance than incorporated in the staff projections.

Monetary policy transmission remained exceptionally strong. Bank lending to firms and households continued to be weak. The decline in the annual growth rate of bank lending to firms reflected both weaker credit demand and tighter credit standards. The softening of loan demand was mostly due to higher interest rates and slowing nominal fixed investment. For its part, the slowing pace of lending to households was driven by mortgage loans, consistent with the weakness in the housing market and tighter credit conditions.

Bank composite funding costs had risen further. The deposit base available to banks continued to contract, with the annual growth rates of M3 (the broad monetary aggregate) and M1 (currency in circulation and overnight deposits) in October standing at -1.0% and -10.0% respectively, close to their recent historical lows.

An important question was to what extent pressures from the transmission of monetary policy were still in the pipeline. ECB staff analysis showed that a sizeable increase in policy rates over a short period of time tended to lead to a stronger and faster transmission to credit volumes, and the impact of the tightening cycle on credit growth tended to peak earlier than implied by standard relationships. Such non-linearities seemed to be relevant in the current setting, with a substantial part of the extra interest rate effect attributable to a greater strength of the policy rate adjustments relative to historical regularities. Mr Lane also showed that, from a historical perspective, financing conditions had tightened very strongly over the current hiking cycle.

Monetary policy considerations and policy options

On the basis of the assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, Mr Lane proposed keeping the three key ECB interest rates unchanged.

Notwithstanding the recent downside surprises in inflation and the substantial downward revision of projected inflation for 2024, headline inflation was set to return to target only by the second half of 2025. The remaining distance of inflation from the ECB's target, the waning of disinflationary supply-side tailwinds and, overall, still-high levels of domestic inflation continued to call for maintaining a sufficiently restrictive stance.

The Governing Council should therefore maintain its current strategic orientation, namely that its future decisions should ensure that the key ECB interest rates would be set at sufficiently restrictive levels for as long as necessary, and that it would continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, the Governing Council's interest rate decisions should continue to be based on its assessment of the inflation outlook in light of incoming economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

It was an appropriate time to review the schedule of PEPP reinvestments. With the fading impact of the pandemic and the reduction in fragmentation risks, Mr Lane proposed advancing the normalisation of the Eurosystem's balance sheet at a measured and predictable pace. In particular, while full reinvestments should be maintained in the first half of 2024, the PEPP portfolio should be allowed to run off by €7.5 billion per month on average in the second half, with reinvestments fully discontinued at the end of the year. This proposal was broadly in line with market expectations, as reflected in the Survey of Monetary Analysts, and would be in line with the Governing Council's guidance that any "future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance". For the partial reinvestments until the end of 2024, operational modalities similar to those used during the partial reinvestments of the APP could be applied.

Furthermore, preserving the option to apply flexibility in reinvesting redemptions coming due in the PEPP portfolio, with a view to countering risks to the monetary policy transmission mechanism related to the pandemic, continued to be warranted.

Finally, in line with the ECB’s monetary policy strategy, it was again time for the Governing Council to thoroughly assess the links between monetary policy and financial stability. Euro area banks had demonstrated their resilience. They had high capital ratios and had become significantly more profitable over the past year. However, the outlook for financial stability remained fragile in the current environment of tightening financing conditions, weak growth and geopolitical tensions. In particular, the situation could worsen if banks’ funding costs were to increase by more than expected and if more borrowers were to struggle to repay loans. At the same time, the overall impact on the economy of such a scenario should be contained if financial markets reacted in an orderly fashion. Macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities, and the measures in place contributed to preserving the resilience of the financial system.

2. Governing Council’s discussion and monetary policy decisions

Economic, monetary and financial analyses

As regards the external environment, members took note of the assessment provided by Mr Lane that euro area foreign demand had generally remained weak in 2023, despite an upward revision in the December staff projections compared with September. One important reason for this was the post-pandemic normalisation of demand away from more trade-intensive goods and towards less trade-intensive services. The fallout from the heightened geopolitical risks had so far remained contained and energy prices had come down from their recent elevated levels. The prices of both oil and gas had declined significantly since the Governing Council’s previous monetary policy meeting.

With regard to economic activity in the euro area, members concurred with Mr Lane that tighter financing conditions and subdued foreign demand were likely to continue weighing on economic activity in the near term. Members widely acknowledged the weaker than expected growth in the short term. Survey indicators suggested, however, that the economy might have hit its trough, both globally and in the euro area. The Purchasing Managers’ Indices (PMIs) were bottoming out and even showing a small uptick, supporting the prospect of a soft landing. At the same time, it was argued that it would be premature to think that the weakness in activity had run its course. There were several drivers of growth that were unlikely to sustain the euro area economy in the near term. First, there were no clear signals of an upcoming improvement in global trade, while geopolitical risks might be adding to the global weakness, at least in manufacturing. Second, the cash buffers of firms and households had so far delayed the impact of monetary policy on aggregate demand, but as these buffers declined, in tandem with the contraction of the balance sheet of the Eurosystem, the impact of tighter financing conditions was likely to become stronger. As corporate profitability was an important driver of business investment, declining corporate profitability was also seen as a downward risk for investment. Third, a generalised tightening of the fiscal stance was to be expected, possibly in part related to the EU economic governance review, which would put further downward pressure on the economy. Finally, the exceptionally strong monetary policy transmission to lending to firms and households risked having a stronger negative impact on growth and inflation than had been incorporated in the December baseline projection by Eurosystem staff.

On this basis, it was argued that the December staff projections for growth in the near term might be too optimistic overall, also considering that mechanical nowcasting tools continued to point to slower economic activity and the possibility of a technical recession. While it was also recalled that there had recently been a disconnect between hard and soft data – such as PMIs – the Consensus Economics forecast for GDP growth was also significantly lower for 2024 than the equivalent staff projection. Most of the expected growth in 2024 hinged on an increase in consumption, which in turn was dependent on the dynamics of labour income. While productivity growth was currently weak, the strong growth in labour income in the staff projections was seen to be simultaneously driven by continued strength in employment and the catching-up of real wages. Moreover, the removal of fiscal measures implemented to support households in response to increases in energy prices would have a distributional effect and be borne more by low-income households, which had the highest propensity to consume. This would further weigh on consumption. Finally, the recent increase in real interest rates for maturities shorter than one year should also have a negative impact on private consumption.

At the same time, it was underlined that the evidence that monetary policy transmission was working was to be welcomed and remained consistent with a soft landing. The impact of monetary policy tightening was increasingly visible and was broadly proceeding as intended: financing and credit conditions had tightened, lending had been slowing, aggregate demand had been weakening and underlying inflation had been easing. Since inflation was coming down, the euro area economy was set to recover gradually in 2024 owing to rising real incomes, stronger consumption and higher foreign demand. Investment had remained resilient thus far in 2023 and was now projected to stagnate in 2024. However, it could perform better than projected if financial conditions loosened and business confidence improved. Especially in jurisdictions with a high prevalence of adjustable interest rates, mortgage interest rates had already started to decline, which could soon support housing investment again, as this was one of the demand components that had also been the first to react in response to higher interest rates.

More broadly, owing to the variability in the lags and strength of the transmission process, there were several reasons why the transmission of monetary policy remained uncertain and might be less powerful than suggested by historical patterns and models. While the first leg in the transmission of monetary policy, to financing conditions, had been rapid and strong, transmission to the real economy was more uncertain and might be weaker. Several factors played a role here: the strong labour market, the relatively strong balance sheets of firms, households and banks, and the greater weight of less interest-sensitive sectors, such as services, in overall value added. The staff projections therefore remained subject to significant uncertainty with respect to the medium-term outlook for economic activity and prices. This also reflected the lack of clarity about the interplay between cyclical factors and structural changes in the wake of the pandemic and other supply shocks, as well as the possibility of new shocks hitting the economy.

Turning to the labour market, it was noted that employment had remained resilient and had even edged up further, while hours worked was more subdued. At the same time, current levels of indicators should not lead to complacency about the strength of the labour market, which could change abruptly and had to be monitored carefully. Reference was made to potential non-linear changes in macroeconomic conditions if firms were to adjust employment in a synchronised way or if the present high degree of labour hoarding should become more costly, particularly at a time when profits were weakening, albeit from high levels. As the labour market was the main mechanism supporting the projected economic recovery in the period ahead, a potential non-linear response of the labour market posed downside risks to the economic outlook.

A broader question was raised regarding the extent to which the economic slowdown was cyclical or structural in nature. It was highlighted that, on the basis of the regular annual review of the supply side undertaken by staff, potential output had been revised down in the staff projections, albeit moderately, partly reflecting structurally higher energy prices and weaker capital formation. Many euro area corporations found it hard to compete internationally, owing to the high energy costs in Europe. As investment in renewables was running into capacity problems, the energy transition was not going to provide much relief from high energy prices in the near term. The downward revision to potential output also had implications for the implied output gap and for inflationary dynamics. Overall, the outlook for both productivity growth and potential output growth was seen as weak.

Regarding fiscal and structural policies, members reiterated that, as the energy crisis faded, governments should continue to roll back the related support measures. This was essential to avoid driving up medium-term inflationary pressures, which would otherwise call for even tighter monetary policy. Fiscal policies should be designed to make the economy more productive and to gradually bring down high public debt. Structural reforms and investments to enhance the euro area’s supply capacity could help reduce price pressures in the medium term, while supporting the green and digital transitions.

It was argued that the fiscal stance was likely to become tighter overall in the years ahead, which would imply a drag on economic activity. However, automatic stabilisers working in the opposite direction in a context of lower growth and lower inflation were likely to impede any meaningful improvement in the fiscal balance, thus complicating the fiscal outlook. It was stressed that a well-functioning monetary union with a stability-oriented monetary policy required a set of clear and simple fiscal rules.

Against this background, members assessed the risks to economic growth as remaining tilted to the downside. Growth could be lower if the effects of monetary policy turned out to be stronger than expected. A weaker world economy or a further slowdown in global trade would also weigh on euro area growth. Russia's unjustified war against Ukraine and the tragic conflict in the Middle East were key sources of geopolitical risk. This could result in firms and households becoming less confident about the future. Conversely, growth could be higher if rising real incomes led to spending increasing by more than anticipated or the world economy grew more strongly than expected.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. They underlined that the recent decline in inflation was good news, as it suggested a faster than anticipated disinflationary process. The decline was not just driven by the fading out of the energy shocks but was broad-based and also reflected developments in core components. In the short run, however, inflation was expected to pick up again in the coming months, mainly owing to energy-related base effects. Inflation numbers also remained affected by the unwinding of past shocks to the food and non-energy industrial goods components, as well as by the reversal of fiscal measures, which made it harder to discern an underlying trend. The latest inflation numbers were therefore to be treated with caution, and it was too early to be fully confident that inflation would return to target. More data were needed to confirm the decline, in particular data on wage growth, which were only expected in the spring of next year. In this context, it was also highlighted that market-based measures of inflation expectations had only started to decline significantly after inflation data had come in lower than expected. This underscored the importance of inflation outturns over the coming months as drivers of inflation expectations, particularly given that household expectations had remained sticky.

At the same time, measures of inflation momentum – namely seasonally adjusted three-month-on-three-month growth rates – suggested that both headline and core inflation had essentially been back at target in November. While such measures were volatile, it was argued that these were often better predictors of future inflation than annual growth rates. However, it was also pointed out that price adjustments were typically more frequent at the start of the year and therefore at the end of the year the signals from such measures on future inflation had to be interpreted with particular caution, in part owing to statistical difficulties with seasonal adjustments in the present conditions.

More broadly, it was pointed out that the envisaged decline in inflation also interacted with the strength of economic activity, which in turn determined the scale and speed at which price-setters were able to pass on their costs to final prices. On the one hand, as the outlook for economic activity in the staff projections seemed too optimistic, it was argued that the strength of disinflation was likely to be underestimated. This concern seemed to be confirmed by recent market expectations, which embodied a notably lower inflation path than the staff projections – for 2024 in particular. On the other hand, scepticism was expressed about whether the recent downward trend in inflation would be confirmed in the coming quarters, particularly as fiscal policy would probably remain loose for some time and a tight labour market would keep pushing up wages and, indirectly, services inflation. Moreover, renewed stronger price increases for energy and food could not be ruled out.

Turning to wage developments, members recalled that the wage outlook was key in understanding medium-term inflation pressures. Labour remained scarce and wage growth was still strong, with compensation per employee growing at an elevated rate and only limited signals of stabilisation coming from negotiated wages and the ECB wage trackers. Coupled with falling productivity growth, unit labour costs had been growing at a record pace of 6.6% in the third quarter, which was contributing to persistence in domestic inflation at levels not consistent with medium-term price stability. This called for remaining vigilant. Moreover, the projected strong pick-up in productivity growth might not materialise if part of its decline proved to be structural or if labour hoarding persisted for longer. It would therefore be important to monitor future rounds of wage negotiations. As negotiations on many wage agreements would only be concluded early next year, members did not expect substantial hard evidence corroborating the projected moderation of wage growth to be available before the middle of the year. While stronger wage growth therefore constituted an upward risk to the staff inflation projections, it was also acknowledged that the recently observed – and projected – further drop in inflation should lead to lower wage demands. If inflation continued to be particularly low, this might also make second-round effects less likely. At the same time, it was pointed out that lower inflation was so far not fully reflected in the perceptions of firms and the general public, so it should not be taken for granted that lower inflation figures would immediately translate into lower wage demands.

One of the reasons why domestic inflation had started to stabilise recently, in spite of the continued rapid increase in wages, might be that firms were moderating their markups. While already embedded in previous staff projections, an important assumption in the December projections had been a declining contribution from unit profits to the GDP deflator measure of inflation. This underpinned the convergence of medium-term inflation trends back towards the target. The significant downward adjustment in the contribution of unit profits seen in the latest national accounts data for the third quarter had lent support to these expectations. It appeared consistent with the return of unit profits to their previous trend, as assumed in the projections. This return to trend was partly of a cyclical nature, but it could well proceed more or less quickly than currently projected, which underlined the particularly high uncertainty surrounding this component of the ongoing and projected disinflation.

As regards longer-term inflation expectations, members took note of the assessments by Ms Schnabel and Mr Lane of the latest developments in market-based measures of inflation compensation and survey-based indicators. Market-based inflation expectations remained broadly anchored at 2% and had come down recently, reflecting the market view that inflation would fall rapidly and stabilise at 2%. At the same time, professional forecasters continued to be more cautious. It was also underlined that the inflation expectations of households and firms remained sticky and well above the ECB’s target. More broadly, it was felt that the exceptionally large gap that had formed between the interest rate path derived from financial market prices and the interest rate assumptions embodied in the staff projections pointed to upside risks to the inflation path projected by staff. However, it was hard to establish to what extent the equally substantial fall in the price of energy since the cut-off date for the projections would provide further downward impetus to inflation in the months to come.

Against this background, members highlighted a number of risks to the medium-term inflation outlook, going in both directions. Upside risks to inflation included the heightened geopolitical tensions, which could push energy prices higher in the near term, and extreme weather events, which could drive up food prices. Inflation could also turn out higher than anticipated if inflation expectations were to move above the target, or if wages or profit margins increased by more than expected. By contrast, inflation could surprise on the downside if monetary policy dampened demand by more than expected or the economic environment in the rest of the world worsened unexpectedly, potentially owing in part to the recent rise in geopolitical risks. Overall, risks were mostly seen as broadly balanced, with some members assessing risks as pointing to the upside and other members judging them as having shifted to the downside, consistent with prevailing downside risks to economic activity.

In this context, members debated the notion of the “last mile” in the disinflation trajectory being the hardest to cover. On the one hand, it was argued that the notion was a useful way to summarise the challenges facing the Governing Council in determining the persistence of inflation pressures and the required duration of monetary policy restriction. From the beginning, it had been understood that bringing inflation all the way down from levels exceeding 10% to 2% would hardly be possible without incurring side effects, such as lower employment and lower output. Surprisingly, so far, progress on the inflation front was advancing at a relatively mild cost in terms of economic activity, with the prospect of a soft landing remaining in place. Therefore, with services inflation still running at 4% and continued strong wage growth, a potentially challenging “last mile” was still looming. In this respect, it was reiterated that the staff projections were predicated on a moderation of wage growth, a buffering of wage growth by lower unit profits and a sustained rebound in productivity growth helping to bring down the growth rate of unit labour costs. Further progress in disinflation thus rested on a number of benign assumptions and on inflation expectations remaining well anchored. In addition, potential rigidities in prices and wages – stemming for example from backward-looking features of wage negotiations – and the impact of structural shocks on the economy and inflation dynamics could well contribute to "last mile"-type delays in disinflation. There was also a risk of new shocks, such as further energy or food price shocks, and effects of climate change on food prices, as well as climate-related measures such as higher carbon taxes, which could render inflation more persistent and more easily unanchor inflation expectations after a long period of above-target inflation.

On the other hand, the view was expressed that the notion of a difficult "last mile" might undermine confidence in the ECB's inflation target being achieved in a timely manner. More fundamentally, it was not clear why the nature of the disinflationary process would change as the target drew closer. Looking at the annual inflation data for the last few years, it appeared that disinflation to date had actually been faster than the previous surge in inflation, questioning the empirical relevance of the "last mile" narrative. It was argued that inflation depended on the state of the economy and on monetary policy. With a weaker economy, tighter monetary policy and the world economy losing momentum, it should not be surprising to see inflation falling rapidly. Finally, it was argued that the main condition that would make inflation more persistent in the proximity of the inflation target was if inflation expectations became unanchored, which ultimately depended on the credibility of monetary policy.

Turning to the monetary and financial analysis, members largely concurred with the assessment provided by Mr Lane in his introduction. The most significant development since the Governing Council's previous monetary policy meeting had been the marked fall in market interest rates, which had intensified following the FOMC's policy decisions and press conference on 13 December, as evident in the update on market developments provided by Ms Schnabel. Market-based measures of inflation expectations had also declined considerably across horizons, to approach 2%, reflecting the view of market participants that inflation would fall rapidly and stabilise at that level. Nevertheless, real interest rates had fallen significantly beyond the near term because nominal interest rates had dropped by more than the corresponding inflation expectations embedded in market prices. Overall, the decline in market interest rates and the rise in risk asset prices had led to looser financial conditions according to most measures. However, the recent appreciation of the euro was going in the opposite direction.

Members generally agreed that this repricing in financial markets could, at least partially, be attributed to recent good news on the broad-based slowdown in inflation in the euro area and other major advanced economies. However, it was widely felt that market expectations reflected significant optimism and were inconsistent with the outlook in the staff projections, with respect to both the inflation outlook and the rate path embodied in the technical assumptions. Reflecting the forward curve at the time of the cut-off date, the projections had incorporated only about 75 basis points of rate cuts for 2024. In addition, it was recalled that analysts, including those participating in the Survey of Monetary Analysts, remained much more cautious. It was also recalled that market expectations were volatile. Market perceptions and narratives had shifted dramatically since the Governing Council's last monetary policy meeting, more than reversing the earlier move which, between September and October, had pushed rates higher on the back of a high-for-longer narrative. This suggested that there might well be another reversal in sentiment over the coming months.

Concern was expressed that the sharp market repricing threatened to loosen financial conditions excessively, which could derail the disinflationary process. Against this background, it was widely regarded as important not to accommodate market expectations in the post-meeting communication.

Overall, some humility was advised with respect to judging market expectations given prevailing uncertainties, including the uncertainty surrounding the outlook for growth and inflation. It was also noted that, if and when inflation fell further, the current level of interest rates would become increasingly tight over time.

Members agreed that, thus far, monetary policy had continued to be transmitted strongly into broader financing conditions. The average interest rates for business loans and mortgages had risen again in October. Higher borrowing rates, subdued loan demand and tighter loan supply had further weakened credit dynamics. With weaker lending and the reduction in the Eurosystem balance sheet, broad money – as measured by annual growth in M3 – had continued to contract for the fourth consecutive month and M1 growth had remained negative for the tenth consecutive month. At the same time, it was noted that the recent financial market repricing had already started to translate into lower interest rates on new mortgage lending and that, in some jurisdictions with a greater prevalence of floating rate mortgages, the average rate on the outstanding stock of housing loans could start to decline within the coming quarter.

The overall transmission of monetary policy to loan growth remained very strong. The annual growth rate of bank loans to non-financial corporations had fallen into negative territory for the first time since July 2015 and growth in loans to households also remained subdued. It was contended that there were signs of "over-tightening" in the banking sector, reflecting the dual effect of higher policy rates and lower deposits amid a declining supply of liquidity, although it was also argued that there was no serious risk in the present environment in which excess liquidity was still abundant. Furthermore, it was recalled that the decline in liquidity in the system had had a limited impact and banks had continued to repay the TLTROs voluntarily.

The Governing Council held its biannual structured exchange on the links between monetary policy and financial stability. Members concurred that euro area banks had demonstrated their resilience, had high capital ratios and had become significantly more profitable over the past year. However, the situation could worsen if banks' funding costs or credit risk were to increase by more than expected, but these risks were assessed to be contained if the market reaction to such scenarios were orderly. It was reiterated that macroprudential policy remained the first line of defence against the build-up of financial vulnerabilities, and that the measures in place contributed to preserving the resilience of the financial system.

Monetary policy stance and policy considerations

Turning to the assessment of the monetary policy stance, members highlighted that, if maintained for a sufficiently long duration, the current monetary policy stance was sufficiently restrictive to bring inflation back to target in a timely manner. Based on the interest rates embedded in the staff projections – which lay above market interest rates – the projections suggested that the rate path was in line with reaching the inflation target in the second half of 2025.

Against this background, members assessed the data that had become available since the last monetary policy meeting in accordance with the three main elements of the "reaction function" that the Governing Council had communicated earlier in 2023. These comprised the implications of the incoming economic and financial data for the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Overall, the view was held that all three elements of the reaction function were moving in the right direction, providing clear evidence that monetary policy was working as intended.

Starting with the inflation outlook, members broadly concurred with the assessment presented by Mr Lane in his introduction. Overall, the process of disinflation seemed to be proceeding well and probably more strongly than had been anticipated, with the November flash estimates coming in significantly lower than expected. The fall in inflation was encouraging and had been broad-based, spanning all main components, including core items. This was indicative of weak demand and reflected the impact of monetary policy as well as diminishing effects from other factors that had been pushing inflation up. It gave grounds for increased confidence that inflation would be brought back to target in a timely manner. But it was highlighted that inflation would likely pick up in the very near term on account of an upward base effect for the cost of energy and would decline only slowly in the course of 2024.

Furthermore, projected inflation for 2025 was largely unchanged in the December projections from the September round and remained slightly above target, especially for core inflation. However, it was noted that services inflation had started to ease and that, more generally, inflationary pressures were receding in all components. This was indicative of weak demand, affected in part by monetary policy. It was underlined that future wage dynamics remained highly uncertain, with many new agreements to be negotiated early in 2024. Convincing evidence of a sustained turnaround in wages had yet to emerge, and this was necessary for sufficient confidence to be gained that inflation would continue to fall back to the ECB's 2% target. At the same time, it was noted that quarter-on-quarter inflation rates had plunged over the past year and the new Eurosystem staff projections contained a large downward revision in inflation for 2024. Moreover, there were some signs of wage growth stabilising or coming down, and it was argued that wages were a lagging indicator. However, it was stressed that the projection for 2025 had been broadly unchanged in the December round, and core inflation remained above 2% at that horizon. Upside risks to inflation from the outlook for fiscal policy, including higher carbon taxes, and for energy and food prices were also seen as elevated, as were the prevailing geopolitical risks. If such upside risks to inflation materialised or clearer adverse structural changes were to emerge, inflation pressures might become more persistent.

Members agreed that indicators of underlying inflation appeared to have passed their peak and continued to decline. However, the dynamics of underlying inflation remained strong from a historical perspective, including when looking at the measures adjusted for energy shocks and supply bottlenecks. In particular, domestic inflation remained elevated and was edging lower at a slow pace, with sticky wage growth and services inflation in particular reflecting the still strong labour market. It was also pointed out that base effects and fiscal measures made it more challenging to ascertain the true dynamics of underlying inflation.

Turning to the assessment of monetary policy transmission, members generally agreed that transmission was proceeding strongly and helping to dampen inflationary pressures for both goods and services. Moreover, it was argued that a significant part of the interest rate pass-through was still pending, with the overall peak impact on activity seen in early 2024 and the bulk of the impact on inflation still expected over the next two years. The view was expressed that transmission to financing conditions and lending activity was working more strongly than initially expected and non-linearities or financial amplification could be at work. Such effects were typically not included in standard models and the projection baseline and could bolster the strength of transmission to economic activity and prices.

Reference was made to the wide range of estimates for the impact of monetary policy normalisation since December 2021, with large differences as to the extent and persistence of the effects depending on the various models used for policy analysis and in the projections as well as on different underlying assumptions. In this context, the argument was made that the observed disinflation did not validate the notion that the surge in inflation had been transitory but rather supported the view that decisive policy action by the ECB had been instrumental in achieving this outcome.

Looking ahead, it was also emphasised, however, that further transmission was still in the pipeline and that firms' cash buffers and households' excess savings, which had to some extent limited the impact of monetary policy on aggregate demand, could decline alongside the contraction of the Eurosystem balance sheet. This was seen as suggesting that the impact of tight financing conditions might be stronger than expected in the coming quarters. However, it was argued that there was limited evidence of the effects of policy tightening having strengthened, since economic activity was developing broadly according to expectations, the labour market remained tight and downward adjustments in inflation expectations appeared to follow downward inflation surprises more than weakness in the economy.

All in all, on the basis of the December Eurosystem staff projections, members expressed increased confidence that inflation would be brought back towards the 2% target in 2025, although there were different views as to whether there were grounds for sufficient confidence that the target would be reached in a timely manner. Hence a need was seen for continued vigilance and patience, and for the maintenance of a restrictive stance for some time.

It was stressed that there was no room for complacency and that it was not the time for the Governing Council to lower its guard. Caution was warranted, as inflation would probably pick up in the near term and there were continued uncertainties in relation to wages and underlying inflation dynamics. This suggested that it was still too early to be confident that the task had been accomplished.

Monetary policy decisions and communication

Against this background, all members agreed with the proposal by Mr Lane to maintain the three key ECB interest rates at their current level. All three elements of the Governing Council's reaction function were considered to support the case for this decision. Confidence was expressed that the monetary policy stance continued to be sufficiently restrictive, which gave the Governing Council the opportunity to hold rates at current levels and take time to assess the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission. Restating the Governing Council's data-dependent approach was seen to be important, with a focus on the three elements of the reaction function, which provided a structured approach to monetary policy decision-making and communication. This also was seen as an integral part of the Governing Council's meeting-by-meeting orientation and offered the necessary flexibility.

Turning to the policies affecting the size and composition of the Eurosystem's balance sheet, a very large majority of members agreed with Mr Lane's proposal to advance the normalisation of the balance sheet at a measured and predictable pace.

This was viewed as a proportionate response in view of the initial objectives of the PEPP, which was an instrument designed to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the pandemic. As the pandemic, or at least its emergency dimension, was over, maintaining full reinvestments was no longer appropriate. In addition, markets were currently functioning smoothly and fragmentation concerns were limited. This meant that the risks from ending full reinvestments were contained, especially since moving to partial reinvestments still allowed flexible reinvestments if necessary. Hence it was an opportune time to take this decision, which would be another logical step in the normalisation of the Eurosystem balance sheet.

The proposal was also broadly in line with market expectations, so it would not surprise market participants. Moreover, the approach would allow a smooth adjustment, in particular since redemptions in the PEPP portfolio were very small relative to other sources of balance sheet shrinkage in 2024. At the same time, it was seen as crucial that any decision to end full reinvestments earlier than originally planned should be fully delinked from monetary policy stance decisions relating to level of the policy interest rates. This meant it was important to stress that interest rate decisions were the main instrument of the Governing Council's monetary policy.

While some members favoured an earlier end to full reinvestments than had been proposed, suggesting that tapering could start earlier and be more gradual, other members argued that full reinvestments should continue until the end of 2024. In this context, it was argued that the difference between starting tapering or ending reinvestments a couple of quarters sooner or later would not affect the proportionality assessment.

Members unanimously agreed with Mr Lane's proposal to continue applying flexibility in reinvesting redemptions falling due in the PEPP portfolio.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the monetary policy press release. The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

[Monetary policy statement for the press conference of 14 December 2023]

Press release

Monetary policy decisions

Meeting of the ECB’s Governing Council, 13-14 December 2023

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Cipollone
- 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 Reinesch*
- Ms Schnabel
- Mr Scicluna*
- Mr Šimkus*
- Mr Stournaras
- Mr Välimäki, temporarily replacing Mr Rehn
- Mr Vasle
- Mr Villeroy de Galhau
- Mr Vujčić
- Mr Wunsch

* Members not holding a voting right in December 2023 under Article 10.2 of the ESCB Statute.

Other attendees

- Mr Dombrovskis, Commission Executive Vice-President**
- Ms Senkovic, Secretary, Director General Secretariat
- Mr Rostagno, Secretary for monetary policy, Director General Monetary Policy
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

** In accordance with Article 284 of the Treaty on the Functioning of the European Union.

Accompanying persons

- Mr Dabušinskas
- Mr Demarco
- Mr Garnier
- Mr Gavilán

- Mr Gilbert
- Mr Haber
- Mr Horváth
- Mr Kaasik
- Mr Kelly
- Mr Koukoularides
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Pösö
- Mr Rutkaste
- Mr Šošić
- Mr Tavlas
- Mr Ulbrich
- 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 22 February 2024.