

Meeting of 2-3 February 2022

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 2-3 February 2022

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

Financial market developments

Ms Schnabel reviewed financial market developments since the Governing Council's previous monetary policy meeting on 15-16 December 2021. Markets had digested well the Governing Council's decisions in December 2021 to discontinue net asset purchases under the pandemic emergency purchase programme (PEPP) in March 2022 and to adjust the future path of purchases under the asset purchase programme (APP). The day after that meeting, ten-year overnight index swap (OIS) rates and euro area GDP-weighted sovereign yields had been lower than before the meeting. Nevertheless, long-term real and nominal interest rates had increased globally from the exceptionally low levels that had prevailed after the discovery of the Omicron variant of the coronavirus (COVID-19) in late November last year.

A model-based breakdown of the recent increase in ten-year euro area risk-free rates suggested that it had been mainly driven by two factors. The first was a change in investors' assessment of the economic impact of the Omicron variant. Developments over the past few weeks had reinforced the impression that the Omicron wave might be sharp but short-lived, and the drag it exerted on economic growth weaker than initially feared. The second factor pushing interest rates higher in recent weeks had been a reappraisal of the global monetary policy outlook. In the United States, investors had brought forward the expected time of "lift-off", with the first hike currently expected in March. They had also priced in more tightening over the next two years, and were now expecting balance sheet runoff to start sooner.

In the euro area, rising inflation compensation had added to the upward pressure from higher real rates, as markets had revised up their expectations of the future path of inflation in response to the renewed upside surprises to inflation in December and January. Recent energy price developments

had added to perceptions in the market that inflation risks were rising. Brent crude oil prices had increased to about USD 90 per barrel, the highest level since 2014 and about 25% higher compared with mid-December. According to futures curves, oil prices were expected to remain high over the medium term. Gas spot and futures prices, too, were higher than before the Governing Council's previous monetary policy meeting, reflecting the growing tensions between Russia and Ukraine as well as low inventories.

These developments had contributed to a continued reappraisal of the medium-term inflation outlook for the euro area. First, respondents to the Survey of Monetary Analysts (SMA) saw upside risks to inflation over the entire horizon covered by the SMA. Second, survey-based indicators of long-run inflation expectations had been revised up. In the SMA, in particular, they had risen to 2% from 1.8% in December. This was the highest they had ever been since the start of the SMA. Likewise, in January long-term inflation expectations from Consensus Economics had reached 2% for the first time since 2015. Market-based measures of longer-term inflation compensation had remained at around 2%. Furthermore, in the inflation options market, investors were pricing in a probability of around 30% that inflation over the next five years would, on average, be above 2.5% and a probability of around 50% that it would be above 2%.

In this environment, markets had significantly revised their expectations about the monetary policy outlook in the euro area. Compared with December, the OIS forward curve had steepened visibly for short-term maturities. Markets were pricing in a cumulative 50 basis point hike in the deposit facility rate (DFR) by mid-2023, which would raise the DFR to 0%. As usual, these dates had to be treated with caution because the market rates included term premia. Allowing for such premia, market pricing implied that the DFR would actually rise above zero somewhat later. SMA participants, too, were now expecting the first DFR increase to be one quarter earlier, in the third quarter of 2023, with a much steeper path after lift-off than they had anticipated in December.

Developments in options markets suggested that investors had revised not only their expectations about the central future path of short-term interest rates, but also their expectations about the distribution of risks around this path. This distribution had become more skewed to the upside. Nevertheless, monetary policy in the euro area was still expected to normalise at a measurably slower pace than in many other economies, as could be seen from the developments in foreign exchange markets. The euro had temporarily fallen against the US dollar to the lowest level since June 2020. At the time of the meeting, the euro was still down against the US dollar by more than 6% compared with a year ago and was trading close to its 2019 average. In nominal effective terms, the euro was down by around 3% compared with a year ago.

With investors preparing for faster policy normalisation globally, risk assets that had benefited from the long period of very low interest rates might have been expected to come under pressure. However, risk assets had in fact remained resilient overall, in particular in the euro area. According to market

intelligence, real interest rates currently remained at levels that were supportive for growth and risk assets.

In euro area sovereign bond markets, yield spreads over German ten-year Bunds had remained around their December levels with few exceptions. The resilience of these spreads was noteworthy in the current environment. The change in the expected future policy path – by the logic of the ECB’s sequencing – implied a significant reduction in the amount of assets expected to be bought under the APP. The picture was very similar in the euro area corporate bond markets, where spreads had only increased marginally. Thus, financing conditions for euro area firms had remained highly favourable.

As regards developments in global equity markets, stocks had first declined visibly in the United States, but had then recovered a good part of their losses. In the euro area, stock markets had suffered only very moderate losses compared with December 2021. Here the impact of higher discount rates had been offset by continued upward revisions to longer-term earnings expectations and improved risk sentiment. All in all, therefore, the rise in real and nominal interest rates had so far been absorbed well by financial markets, as real financing conditions remained favourable amid high inflation and expectations of continued buoyant global growth in the coming years.

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

In his review of global developments Mr Lane noted that the Omicron variant had led to a sharp rise in global coronavirus cases in January. Although these cases appeared milder than in previous waves, many parts of the world had strengthened their containment measures. Whereas previous waves had seen a rotation between advanced economies and emerging markets, in the recent wave a lot of countries across the globe had found themselves in a similar situation. This could imply a stronger, more synchronised rebound compared with earlier waves. The most recent loosening of containment measures in some countries was confirming the expectation that Omicron case numbers could fall quickly once a sufficient level of immunity had been reached.

The Purchasing Managers’ Index (PMI) for both manufacturing and services at the global level continued to point to an ongoing recovery at the turn of the year. But there were signals of a slowdown in the near term, especially in manufacturing. Supply bottlenecks continued to restrain global activity. While these bottlenecks seemed to be levelling off according to various indicators, they remained substantial.

The euro exchange rate had depreciated since the December meeting of the Governing Council, both against the US dollar (-0.9%) and in nominal effective terms (-1.2%). Taking a longer-term perspective, the exchange rate appreciation observed in 2020 had largely been reversed, bringing the exchange rate closer to its pre-pandemic level. Oil prices had increased sharply (+28%) since the

December meeting, with the oil futures curve shifting upward until the end of 2024. Most of the oil price increase since the December meeting could be attributed to supply factors and the recent failure of some OPEC+ members to step up production.

In contrast to oil prices, gas prices had declined by 33% since the December 2021 Governing Council meeting. This was due to the relatively mild winter in Europe and the redirection of imports of liquified natural gas from Asia to Europe, which had more than offset the large drop in gas imports from Russia. Concerning the outlook for gas prices, it was important to recognise that supply shocks tended to have a more persistent effect on gas prices when inventories were low, which was currently the case. Global food prices had increased by 6% since the December meeting following poor harvests, rises in shipping costs and higher fertiliser prices as a result of rising energy costs.

Turning to developments in activity in the euro area, Mr Lane noted that after a strong performance in the middle of last year there had been a significant slowdown at the end of the year. Real GDP had grown by 0.3%, quarter on quarter, in the fourth quarter of 2021 (according to Eurostat's flash estimate) following a growth rate of 2.3%, quarter on quarter, in the third quarter. In the fourth quarter of 2021 euro area GDP had reached its pre-pandemic level. The slowdown in GDP growth reflected the intensification of the pandemic, persisting bottlenecks and still high energy prices.

In Europe, COVID-19 cases had risen more than tenfold since mid-November, but with the emergence of the Omicron variant the number of intensive care admissions was no longer rising in line with the number of infections. Nevertheless, health concerns among consumers had increased. The European Commission survey of December 2021 showed that households had become less optimistic about their near-term spending, especially in sectors providing contact-intensive consumer services.

Turning to production, pressures exerted by supply bottlenecks had levelled off, but there was no evidence so far of a significant decline in those bottlenecks. Production of transport equipment continued to be dampened by shortages of semiconductors and by logistical problems. As a result, capacity utilisation had fallen and stocks of almost finished and finished goods had risen in the sector. Production of other capital goods remained robust.

Turning to trade in goods and services, the accumulated level of export orders remained higher than before the pandemic, but the flow of new orders was diminishing, most likely owing to the still acute bottlenecks.

The recovery in the labour market continued to be strong. Unemployment had declined to 7.0% in December, which was the lowest unemployment rate since the creation of the euro area. The December 2021 Eurosystem staff macroeconomic projections foresaw a significant improvement in labour market conditions and the latest data were in line with that prediction.

The number of people employed, which included workers in job retention schemes, was basically back to its pre-pandemic level in the third quarter of 2021. However, total hours worked were still below the

pre-pandemic level, with the gap between the two measures mainly being explained by job retention schemes. Across sectors, the recovery in hours worked in services had accelerated more in the second and third quarters of 2021 than in the manufacturing sector.

To assess how tight the labour market was, it was useful to look at the ratio between the vacancy rate and the unemployment rate and to compare this ratio across the euro area and the United States. In the United States, even before the pandemic there had been more jobs available than people unemployed, i.e. the ratio had been above one. While the ratio had fallen to below 0.5 in mid-2020, it had climbed back up to 1.5 at the end of 2021. By contrast, in the euro area although a pick-up could be observed in this ratio at the end of 2021, the number of vacancies posted was only around 30% of the number of people unemployed. Thus, the situation in the euro area was very different from that in the United States. Still, the outlook for employment in the euro area continued to be positive and to improve, with all euro area PMI employment indicators standing above the expansion threshold of 50.

Turning to inflation, Eurostat's HICP flash estimate for January had been released on the first day of the Governing Council meeting and had only been reflected in the analysis to a limited extent. The latest inflation data would be integrated more fully in the analysis for the March meeting. In recent months around half of the headline inflation rate had resulted directly from energy inflation, but the contribution of food prices had increased.

According to Eurostat's flash release, headline inflation had increased slightly further to 5.1% in January 2021 – from 5.0% in December and 4.9% in November. This was substantially higher than foreseen in the December projections. Energy inflation had been very high in January, at 28.6%, with fuel prices accounting for the largest share of this figure. The rise in energy inflation could increasingly be explained both by higher electricity prices, which had been affected by various policies, and by higher gas prices.

Prices for unprocessed food had exceeded their projected price increase by more than than prices for processed food. The latter mainly reflected increases in prices within the EU's internal market amid global rises in both energy costs and prices for international commodities.

With respect to non-energy industrial goods (NEIG) inflation, the contribution of durable goods had continued to increase, which could be attributed to supply bottlenecks as well as to the energy price rise. However, price dynamics for the other components of NEIG indicated that the increase in NEIG inflation was broad-based across items. The indirect contribution of energy to non-energy inflation items was relevant in this context, since all non-energy sectors used energy as an input. Typically, the energy input was less than 10% of overall costs, but energy price increases as high as 28.6% were going to affect many individual categories of goods.

Further up the pricing chain, pipeline pressures for NEIG inflation continued to build up, partly reflecting the rise in energy production costs. Import prices for intermediate goods remained at

unusually high levels and domestic producer price inflation for non-food consumer goods had increased further to stand at a new historical high. The annual rate of change in import prices for final non-food consumer goods, which had been negative for most of 2020 and had a dampening effect on NEIG inflation, had increased further and added to pipeline pressures for NEIG. This reflected both the higher goods prices that euro area importers had to pay but also the effect of the depreciation of the euro.

A range of indicators of underlying inflation had moved up to levels above 2%. However, there were important temporary factors behind this, in particular the effects of bottlenecks and high energy prices. A rise in the price of energy increased the price level for other goods in the input-output matrix across the board. However, this did not necessarily imply that high inflation was going to persist. Historically, measures of underlying inflation were good predictors of future inflation, as they were to some extent designed to reflect persisting developments. But temporary factors were clearly also playing a role in the present situation.

Comparing recent headline inflation developments in the euro area and the United States, many issues were similar in qualitative terms. However, in quantitative terms HICP inflation excluding food and energy (HICPX) stood at 2.6% in December in the euro area, while in the United States the CPI less food and energy was 5.5%. While part of the higher inflation in the United States could be explained by the higher increases in rents and their larger weight in the CPI, the biggest difference related to the effects on core inflation of supply disruptions, bottlenecks and the reopening of the economy. These effects had so far been much more evident in the US data.

Turning to indicators of wage developments in the euro area, growth in negotiated wages had remained low in recent months, although the labour market was “hotter” in some countries than in others. Overall, however, there was no evidence of any big structural change in the behaviour of negotiated wages. Nor did expectations of labour costs point to any evidence so far of significant second-round effects from the current high level of inflation.

Regarding sources of domestic inflation, it was noteworthy that in the euro area most energy was imported and import prices for energy had increased by almost 50% in the second half of 2021. This had led to a big drop in the terms of trade. This drop was essentially a tax on Europe paid to the rest of the world. The income effect of the deterioration in the terms of trade was estimated at around 2.5% of GDP. According to another calculation, the most recent balance of payments data showed that payments by EU countries for energy imports had risen from €200 billion in the first 11 months of 2020 to €335 billion in the first 11 months of 2021. This was a 66% increase.

Thus the high energy price increases constituted a collective negative wealth effect on the European economy. Although the negative effect could be alleviated via taxes and subsidies, it would certainly affect macroeconomic dynamics. While the euro area was cushioned by the accumulated household

savings, forecasters needed to take this negative wealth effect into account in the analysis of future spending and production decisions.

Turning to longer-term inflation expectations, available survey indicators of longer-term inflation expectations had recently become re-anchored at 2% after they had dipped at the start of 2020. This was a success story and the strategy review had helped to achieve this. Anchoring inflation expectations at 2% was the foundation stone for meeting the ECB's inflation target.

Looking at the ECB Survey of Professional Forecasters, the distribution of expectations for the first quarter of 2022 compared with the results of the survey a year ago showed that the mode (the most frequent answer) had increased to 2%, reflecting the centre of the distribution. Furthermore, of the forecasters who were still not expecting 2% inflation, most expected a figure below 2%. The share of forecasters expecting inflation above 2% remained relatively small, indicating that the risk of an upside unanchoring was hard to see. Thus there had been a convergence of longer-term inflation expectations to the ECB's target.

In the SMA the fraction of respondents expecting longer-term inflation to be below 2% was still sizeable, but had come down measurably over the last few survey rounds. Meanwhile, the proportion of participants expecting longer-term inflation to equal 2% had risen significantly, and there had been little movement in terms of the share who thought that inflation would be above 2% in the longer term. Market-based measures of medium to longer-term inflation compensation had been broadly stable at just below 2%, with the measures adjusted for risk premia being somewhat lower.

With regard to financing conditions, these had overall remained favourable for all sectors. Although bank bond yields were rising in line with the wider bond market movement, there was little impact from this on overall bank funding costs. One reason was the continued application of negative interest rates to corporate and household deposits, while the targeted longer-term refinancing operations (TLTROs) also played a role. Overall, the borrowing rates facing firms and households remained low.

The recovery in the volume of loans had continued, with the growth rate of loans to euro area firms increasing to 4.2% in December. Euro area banks had a generally benign view of the credit risk related to lending to firms. Credit standards remained largely unchanged (with the bank lending survey for the fourth quarter of 2021 indicating a slight tightening for loans to firms). The growth of loans to households continued to be supported by dynamic lending for house purchase, and credit standards for housing loans had remained unchanged in the fourth quarter of 2021.

As regards monetary developments, the annual growth rate of M3 had slowed to 6.9% in December, which was partly related to base effects. Nonetheless, the short-term dynamics of money growth remained broadly stable. Household deposit inflows had moderated since April 2021, in the context of recovering consumption, lower real returns and the possible use of deposits to fund the purchase of property.

Turning to fiscal policy, additional fiscal support had been agreed in response to the Omicron variant and energy price increases, leading to slightly weaker fiscal tightening in 2022 than expected in the December staff projections. The additional euro area sovereign financing needs were estimated to be less in 2022 than in 2021 and 2020, and less pressure was expected on the supply of bonds this year.

Monetary policy considerations and policy options

Summing up, Mr Lane stressed that the euro area economy continued to recover, although it was likely to remain subdued in the first quarter of 2022. While the current pandemic wave was weighing on economic activity, especially contact-intensive consumer services, it appeared less damaging to economic activity than previous waves. Although shortages of equipment, materials and labour in some sectors continued to hamper production of manufactured goods, delay construction and hold back the recovery in parts of the services sector, there were early signs, including in the January flash PMI release, that supply bottlenecks might be starting to ease. However, the substantial negative terms-of-trade shock generated by higher energy prices was reducing the purchasing power of households and the earnings of businesses, which restrained consumption and investment. At the same time, the labour market was improving further with unemployment coming down, which should support incomes. In overall terms, a strong pick-up in activity later in the year was still expected.

The risks to the growth outlook remained broadly balanced over the medium term. Uncertainties related to the pandemic had abated, in view of the milder impact of the Omicron variant than had been feared. Growth could be stronger than expected if households became more confident and saved less than foreseen in the December projections. However, geopolitical tensions had increased, and a prolonged phase of high energy costs constituted a material downside risk to consumer spending and investment, while also increasing cost pressures in energy-intensive sectors and elevating the risk of second-round inflation effects through higher nominal wage settlements. Moreover, if supply bottlenecks failed to resolve at the pace envisaged in the December staff projections, growth could be negatively affected. A sharper than expected tightening in global financial conditions and a sharp slowdown in China related to property market developments constituted external risk factors that warranted monitoring.

Inflation had surprised to the upside in both December and January, increasing to 5.0% and 5.1% respectively. Energy prices remained by far the most important factor for HICP inflation, with the direct impact accounting for over half of headline inflation in January and energy costs also pushing up prices across many sectors. Moreover, the indicators based on futures markets signalled a more prolonged phase of elevated energy prices during most of 2022. Food prices had also increased, reflecting unfavourable weather and harvest conditions, but also high transportation costs and the rising costs of fertilisers, which were both associated with the surge in the prices of commodities. The

HICPX stood at 2.3% in January, down from 2.6% in December. The lower rate was mainly due to weaker dynamics in the NEIG component, as services price inflation remained unchanged.

Overall, price gains had become more widespread, with the prices of a large number of goods and services having increased markedly. In this context, most measures of underlying inflation had risen, although the role of temporary pandemic factors and energy input costs meant that the persistence of these increases remained uncertain. According to a purely mechanical update of the latest short-term inflation projections, in the near term inflation was expected to be higher than projected in December and would likely remain above 2% for the rest of the year. At the same time, it was still expected that energy price dynamics would slow and the price pressures stemming from global supply bottlenecks would recede in the course of 2022. In addition, while labour market conditions were improving further, wage growth remained muted overall. Market and survey-based measures of inflation expectations saw a sharp decline in inflation in 2023 and 2024 relative to 2022, while measures of longer-term inflation expectations had continued to converge to the 2% target. Importantly, these indicators did not suggest that there were signs of inflation expectations becoming unanchored to the upside.

Compared with the December staff projections, risks to the inflation outlook were tilted to the upside, particularly in the near term. Inflation could be higher than anticipated over the next few months if the surge in energy prices intensified, especially if geopolitical tensions were to escalate further, if oil supply remained persistently sluggish, or if the bottlenecks in production and international commerce were to extend through the end of the year. Looking beyond the near term, inflation could be higher than foreseen if current price pressures fed through into higher than anticipated wage rises, or if the economy returned more quickly to full capacity than considered likely at present. But inflation could be lower than expected if the higher prices of energy and food were to exert a stronger than expected drag on consumption and investment, and thus suppress underlying inflation, or if downside risks to the world economic outlook materialised.

Market interest rates had increased since the Governing Council's December meeting, reflecting mainly firming expectations of monetary policy tightening at a global level. As a result, the date for a first interest rate hike implied in the forward curve had been brought forward, and markets were now pricing in a faster pace of interest rate normalisation after lift-off. Notwithstanding, bank lending rates for firms and households continued to stand at historically low levels, reflecting contained bank funding costs, helped by the terms of TLTRO funding. Overall, financing conditions for the economy remained supportive.

Pending the March staff projection round, which would help in reassessing the implications for medium-term inflation of the new data accrued since December, Mr Lane proposed to maintain a steady course and reconfirm the December monetary policy stance. This would mean that, in view of the economic recovery and the reduction in downside risks to the medium-term inflation target, the Governing Council would discontinue net purchases under the PEPP at the end of March and would

continue reducing the pace of asset purchases step by step over the coming quarters. But monetary support was still needed for the economy to advance further and for inflation to stabilise durably at the 2% target. In view of the many uncertainties that clouded the outlook, there was a need to maintain flexibility and optionality in the conduct of monetary policy. The Governing Council should therefore stand ready to adjust all of its instruments as appropriate to ensure that inflation stabilised at the 2% target over the medium term.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members expressed broad agreement with the assessment of the economic situation in the euro area and the risks to the outlook provided by Mr Lane in his introduction. As regards the external environment, the recovery of the world economy was continuing but faced a slowdown in the near term. This was especially the case in manufacturing, where suppliers' delivery times had not shortened substantially. The main news since the Governing Council's previous monetary policy meeting was considered to be the significant movement in energy commodity prices, which was, to a large extent, due to supply factors. These were associated in turn with the impact of geopolitical tensions.

Given Europe's dependence on energy imports and the need to replenish relatively low storage levels, it was argued that, looking ahead, a rise in geopolitical uncertainty might bring with it even higher and more persistent inflation. More generally, it was underlined that inflation was to a large extent a global phenomenon. At the same time, it was recalled that there were important differences between the inflation developments in the United States and those in the euro area. The notion was put forward that in the euro area inflation essentially reflected a more persistent external supply shock, while in the United States it largely reflected domestic demand that had been fuelled by the more substantial fiscal stimulus, which was already feeding into higher wage growth.

Turning to euro area developments, output had reached its pre-pandemic level at the end of 2021 despite a weakening of quarter-on-quarter growth to 0.3% in the final quarter of the year. Economic activity and demand were likely to remain muted in the early part of 2022 as pandemic containment measures were affecting activity in consumer services, and high energy costs were constraining consumption and investment. Supply bottlenecks continued to hamper production and were holding back the recovery in some sectors, and while there were signs that these might be starting to ease,

they would nonetheless persist for some time. Looking beyond the near term, growth was likely to rebound strongly over the course of 2022, driven by robust domestic demand, the global recovery and the ongoing fiscal and monetary policy support.

Members agreed that the economic recovery was continuing despite the bumpiness induced by the COVID-19 waves. It was argued that the spread of the Omicron variant did not constitute a major risk to economic developments, and it was observed that some countries were lifting protective measures, as hospitalisation and death rates were falling despite elevated infection rates. This allowed for more sustained growth dynamics and more normal business cycle dynamics in the period ahead. At the same time, it was pointed out that businesses saw supply chain bottlenecks lasting into 2023, which was longer than previously expected, despite some recent signs of attenuation.

Looking through short-term volatility, it was argued that pent-up consumer demand was materialising, with the saving ratio receding from the high levels reached during the pandemic. However, it was pointed out that according to the latest available data, which were for the third quarter of 2021, the euro area saving ratio remained well above pre-pandemic levels and it might well have risen again since then, given the renewed pandemic restrictions in the winter. It was suggested that the decline was not necessarily being driven by a lower propensity to save income but by a drawdown of net financial assets and hence a temporarily higher propensity to consume out of wealth. In this respect, the savings that households and firms had accumulated were seen to be buffering consumption and investment against the impact of the adverse energy and terms-of-trade shock. Reference was made in particular to the strong rebound in corporate profits, which might allow firms to absorb part of the shocks via compression of margins. At the same time, pent-up demand pressures allowed some cost increases to be passed through more easily into consumer prices. However, it was also underlined that the terms-of-trade shock induced by the rise in energy prices was equivalent to a tax and a loss of disposable income which had to be borne by euro area households and firms. While many countries had introduced compensatory measures, it was pointed out that this loss was offset to only a very limited extent by fiscal measures, and, looking ahead, was likely to weigh on consumption and investment.

It was widely noted that the labour market recovery had been robust and that unemployment had fallen to a historically low rate more quickly than expected. At the same time, job retention schemes were still being used. Shortages of skilled labour were becoming increasingly acute and less and less tied to specific sectors, although there were differences across euro area countries. Employment had recovered to pre-pandemic levels in terms of headcount, and survey data pointed to further strong employment growth ahead. In terms of total hours worked, however, the recovery was less advanced. This was seen as partly a consequence of the widely used government support measures aimed at retaining employment in the euro area. More generally, it was suggested that some aspects of labour market adjustments in the euro area, such as those associated with immigration and the rate at which

workers change jobs, remained incomplete and uncertain. On the one hand, it was argued that there was no evidence of a significant reduction in labour supply. On the other hand, it was cautioned that some of the acute labour shortages could prove more lasting and in some segments it was not clear whether and when workers who had withdrawn from the labour force would return.

Regarding economic policies, it was reiterated that targeted and productivity-enhancing fiscal measures and structural reforms, attuned to the conditions in different euro area countries, were essential to complement monetary policy effectively. The pandemic crisis had demonstrated that monetary and fiscal policy working in concert could be very efficient. With regard to the fiscal side, reference was made to the compensatory measures that governments had recently introduced to buffer the impact of high energy costs on the purchasing power and real incomes of households. This was a clear manifestation of the important role of fiscal policy at this stage, as had been highlighted in Mr Lane's introduction. It was widely remarked that further fiscal measures could be expected to be adopted, and that in some jurisdictions the fiscal measures were having a direct downward effect on measured headline inflation. A concern was expressed that a change in the monetary policy stance in this context could be seen to run counter to the additional accommodation provided by fiscal policy and hence weaken the "policy mix" at a time when fiscal policy was providing the targeted support to demand that was needed in the short term.

Against this background, members assessed the risks to the economic outlook as broadly balanced over the medium term. The economy could perform more strongly than expected if households became more confident and saved less than expected. Although uncertainties related to the pandemic had abated somewhat, geopolitical tensions had increased. Furthermore, persistently high energy costs could exert a stronger than expected drag on consumption and investment. The pace at which supply bottlenecks were resolved was a further risk to the outlook for growth and inflation.

With regard to price developments, members largely concurred with the assessment presented by Mr Lane in his introduction, while underlining that the inflation picture had changed considerably since the Governing Council's December assessment. Inflation had continued to be higher than projected and had increased both in December and in January, when it had reached 5.1%. In the near term inflation was likely to remain higher than previously anticipated. Energy prices continued to be the main reason for the elevated rate of inflation, with energy costs also pushing up prices of goods and services across many sectors. At the same time, price rises had become more widespread and most measures of underlying inflation had risen over recent months, although the role of temporary factors related to the pandemic meant that the persistence of these increases was uncertain.

The December and January inflation releases were assessed in terms of magnitude, direction and surprise component. It was highlighted that for the euro area as a whole and for many countries, the January figure was the highest level reached since the introduction of the euro. Reference was made to double-digit or close to double-digit rates in some smaller economies. In one large euro area

economy, a much lower inflation figure relative to that of the euro area as a whole was partly explained by government measures to contain energy price increases. In another case, a substantial increase in tariffs for electricity had caused a much higher outturn than expected. It was also noted that in a number of countries inflation had actually declined compared with December.

Regardless of the magnitude and direction of the change, it was acknowledged that the January figures were significantly higher than had been expected for the euro area as well as for all countries across the forecasting community. This could be gauged from the reaction of markets to the release. It was stressed that a large part of the upward surprise was explained by energy inflation and it was argued that it thus stemmed from factors that did not reflect developments in the euro area domestic economy. However, it was noted that for the euro area as a whole all of the main HICP components had surprised on the upside, thus indicating broader price pressures than just those stemming from the energy component.

It was observed that the surprise for January was the latest in a succession of underestimated outcomes and that it had occurred in spite of a large upward revision to the inflation outlook in the December staff projections. On the one hand, the exceptional size of the recent projection errors was seen to be a testament to the uncertainty that forecasters were currently facing. On the other hand, it was acknowledged that inflation could now be expected to be higher in the short run and that it would take longer for the inflation hump to recede. Reference was made to the mechanical update of the short-term projections incorporating the January figures, which suggested that inflation could remain well above 2% for the entire year. This implied inflation above 2% for an extended period of time and raised the question of whether the deviations from the inflation target could still be described as “moderate” and “transitory”. Such persistent deviations raised the risk that inflation could become entrenched in inflation expectations.

Looking further ahead, it was suggested that increases in energy costs and other production costs had yet to pass fully through to consumer prices in large parts of the euro area and that the effect would then only show in the data for 2023. Doubts were expressed as to whether inflation in 2023 would be below 2% as anticipated in the December staff projections. It was argued that it had become increasingly likely that inflation would converge to 2% in the medium term, but from above the target rather than from below.

Reference was made to the average error in the staff projections for projected inflation two years ahead, which was around three-quarters of a percentage point, and the fact that the recent downward bias in the projections followed a period of upward bias. This raised the questions of whether the underlying models were performing sufficiently well and whether the historical relationships underpinning the models and projections still held. Moreover, it was argued that the projected decline in inflation over the medium term was at odds with the fast absorption of labour market slack and strong demand in the coming years embedded in the December staff projections. This argued for

putting more weight on other sources of information, such as surveys, expert judgement and incoming data, in assessing the medium-term outlook.

It was recalled that a major element in the expected decline of inflation to below 2% over the medium term was the assumption included in the staff projections that energy commodity prices would evolve along their downward-sloping futures curves. Alternative technical assumptions, such as those derived from a “random walk” forecast, would result in inflation above 2% in 2023 and 2024. It was also remarked that the projections might underestimate the structural upward pressure on energy prices stemming from the green transition. In addition, it was argued that, although not yet part of the official HICP, the unprecedented rise in the costs of owner-occupied housing warranted consideration in the medium-term outlook. In the third quarter of 2021 these costs would have added 0.3 percentage points to HICP inflation and 0.6 percentage points to HICP inflation excluding energy and food.

All members expressed concern over the latest upside surprises in the inflation figures, which were also apparent when looking at seasonally adjusted month-on-month price developments. It was remarked that the most vulnerable segments of the population were being hit hardest by high energy costs and inflation. At the same time, the point was made that what mattered for monetary policy was the nature of the underlying economic forces and the implications of those forces for the medium-term outlook. In addition, monetary policy needed to be forward-looking and not react mechanically to data releases related to past periods, such as the recent inflation figures.

It was argued that a distinction between supply and demand, as well as between global and domestic influences, was more meaningful than simple dichotomies contrasting temporary and persistent shocks. In this respect, it was important to assess to what extent the latest inflation increases reflected the pass-through of past increases in global energy prices or instead pointed to changes in the domestic inflation process. It was observed that almost all of the upward revisions to euro area headline and core inflation between the September and December projection rounds could be explained by the energy price shock, when both direct and indirect effects were taken into account. This amounted to a large terms-of-trade shock to the euro area economy that implied substantial declines in real household incomes and corporate earnings which could translate into lower consumption and investment in the period ahead, in turn suggesting a downward impact on the medium-term inflation outlook.

In this context, it was reiterated that there were no incipient signs of sustained domestically generated inflation, as that would require higher wage growth and further upward moves in inflation expectations. In this respect, the lack of evidence of stronger contractual wage growth and the fact that inflation expectations remained well anchored were seen as the key missing elements in the inflation picture. Data on past wage growth, however, were a lagging indicator and did not provide timely signals about future inflation. This was especially true at present, when the available data related to a period in which the pandemic was still raging. More prominence should therefore be given to forward-looking

indicators, such as those based on surveys. Reference was made to the results of the ECB's Corporate Telephone Survey, which pointed to expectations of significantly higher wage growth compared with last year, as well as significant labour shortages and a strong pass-through of input prices to final consumer prices, possibly pointing to a steepening of the Phillips curve. At the same time, it was recalled that the December staff projections had already anticipated wage growth of around 3% for all the years of the projection horizon and that this had been judged to be compatible with inflation projections of around 2%. The latest available data saw negotiated wages in the euro area growing by substantially less than 2%.

While it was pointed out that there was no evidence so far of second-round effects associated with the current high inflation rates, members widely referred to an increased risk should inflation remain higher for longer. Inflation was outpacing wage growth in many countries. This eroded households' purchasing power and was likely to trigger stronger wage increases over time. The view was expressed that for such second-round effects to emerge it did not matter whether the underlying drivers of inflation were supply or demand factors. Given the lagged nature of wage data, it would take some time before second-round effects could be observed in actual wage growth. At the same time, it was pointed out that the backward-looking inflation component in the wage-setting process was a "stylised fact" and thus part of forecasting models predicated on historical relationships. Therefore, the prevailing high inflation rates would be incorporated into the upcoming March staff projections, although this would not imply per se an upward revision to the medium-term inflation outlook, given that the impact of the energy price shock and the terms-of-trade shock would likely influence projected inflation in the opposite direction.

Against this background, compared with the expectations at the time of the December 2021 Governing Council meeting, risks to the inflation outlook were tilted to the upside, particularly in the near term. If price pressures fed through into higher than anticipated wage rises or the economy returned more quickly to full capacity, inflation could turn out to be higher. Overall, it was seen as important to await the outcome of the March staff projections for a more integrated and holistic assessment of the outlook, rather than jumping to conclusions based on partial analysis.

As regards inflation expectations, members took note that market-based measures of longer-term inflation compensation had remained just below 2% and survey-based indicators had increased to 2% in the latest rounds of the Survey of Professional Forecasters and Consensus Economics. This was seen as a welcome development and suggested that longer-term inflation expectations were well anchored at the 2% target, while there were no signs of unanchoring on the upside. At the same time, the rise in longer-term expectations and their surrounding probability distributions also indicated that there was no longer a risk of a downward unanchoring. The anchoring of inflation expectations was seen as a key element in the inflation outlook. It was reiterated that, in very uncertain times, more

focus should be on the expectations of firms and households so as to assess whether high actual inflation implied a risk of unanchoring.

Turning to the monetary and financial analysis, members widely concurred with the assessment provided by Mr Lane in his introduction that, overall, financing conditions for the euro area economy had remained favourable. While market interest rates had increased since the Governing Council's December meeting, bank lending rates for firms and households had remained at historically low levels. Lending to firms had picked up across all maturities and robust demand for mortgages was sustaining lending to households. It was underlined that credit appeared to be flowing freely in the economy with no signs that firms and households with sound balance sheets were facing restrictions on their access to finance. Bank profitability had recovered and bank balance sheets remained solid. It was noted in this respect that ECB Banking Supervision had recently completed the 2021 Supervisory Review and Evaluation Process (SREP) cycle, confirming the overall resilience of the euro area banking sector, with significant institutions having maintained solid capital and liquidity positions in 2021 well in excess of regulatory requirements. Banks were thus well placed to cope with the gradual removal of remaining supervisory support measures.

Monetary policy stance and policy considerations

Regarding the monetary policy stance, members underlined that financing conditions remained favourable for all sectors of the economy. However, it was remarked that there had been considerable interest rate spillovers from developments in the United States to market rates in the euro area. It was noted that the combination of expectations of monetary tightening at the global level, improved growth prospects, tightening labour markets, renewed upside surprises in inflation figures and rising inflation expectations had led markets to bring forward the expected date for a first ECB rate hike and to price in a faster normalisation after lift-off. This implied an endogenous tightening of financing conditions, although real interest rates remained deeply in negative territory.

With respect to the implications for the monetary policy stance stemming from the inflation outlook, members concurred that the latest figures suggested that inflation was likely to remain elevated for longer than had been expected in December, with risks to the outlook remaining tilted to the upside, particularly in the near term. Accordingly, there was broad agreement that the situation had changed and that the inflation narrative needed to be adjusted, putting emphasis on optionality in the use of all instruments in the period ahead. The view was widely shared that convergence to the ECB's medium-term inflation target was no longer a distant prospect, thus making the fulfilment of the forward guidance criteria more likely within a shorter time span.

Some members argued that the likelihood that inflation would settle at around 2% over the medium term had already increased significantly, with the outlook coming close to satisfying the conditions

established in the forward guidance on interest rates. This was seen as requiring a timely adjustment of the still highly accommodative monetary policy stance. Net asset purchases and negative policy rates were no longer seen as consistent with the incoming data, as it was regarded as unlikely that inflation would drop below the target in the medium term. In this context it was underlined that any conclusion on whether the conditions in the forward guidance on interest rates had been met was not predicated on the staff projections but was up to the judgement of the Governing Council based on its assessment of all relevant information, with the staff macroeconomic projections being only one element. The remark was made that the performance of the projections models might be challenged by the prevailing high uncertainty, which was seen as a further reason for putting less weight on the projections relative to other sources of information. It was recalled that the current formulation of the Governing Council's forward guidance on interest rates had been derived from the monetary policy strategy, which called for forceful and persistent monetary policy action in the presence of the effective lower bound on interest rates. However, it was remarked that the inflation outlook had evolved in the meantime and, at the present stage, the Governing Council should be careful not to introduce additional policy inertia (i.e. a slower pace of adjustment) when assessing the fulfilment of the forward guidance criteria.

A scaling-back of monetary accommodation should commence, in line with the established forward guidance on sequencing (i.e. the order in which the different policy instruments operated). It was recalled that the Eurosystem was currently on track to buy a significant share of new issuances of euro area sovereign bonds, and this implied adding further policy accommodation at a time when inflation could be expected to be higher for longer than previously anticipated. It was also stressed that monetary policy needed to be forward-looking and that the longer the period of elevated inflation lasted, the higher the risk of material second-round effects would become. It was argued that the task of monetary policy in this environment was to ensure that inflation expectations remained firmly anchored and to avoid the risk of the prevailing high inflation becoming entrenched. Caution was expressed about basing the Governing Council's assessment on wage data which were only available with a lag. In this environment, the main risk was no longer of tightening monetary policy too early but too late. An earlier monetary policy normalisation would reduce the risk of abrupt tightening later on, which could potentially be associated with high economic and social costs. Against this background, a number of these members were of the view that the forward guidance conditions were already broadly satisfied and expressed a preference for adjusting the forward guidance on the phasing-out of the APP at the present meeting.

Other members, however, stressed that there were no signs of an upside unanchoring of inflation expectations in the euro area. The increase in inflation expectations towards 2% observed since the previous summer had to be considered a welcome development. While downside risks to price stability had clearly receded, it was regarded as premature to draw conclusions as to whether the

conditions in the forward guidance on interest rates had already been met without a full assessment of the implications of the energy price shock for the medium-term inflation outlook that would only become available with the March ECB staff macroeconomic projections. It was also stressed that it remained an open question whether the outcome of the March projections would show inflation reaching the ECB's target durably within the projection horizon, which was a key condition for considering a rate increase under the forward guidance. Moreover, it was underlined that such a scenario was conditional on financing conditions remaining favourable.

With respect to the staff projections, it was emphasised that the exceptional uncertainty around the duration of the inflation spike needed to be explained, including the role of the energy price assumptions in determining the inflation outlook. It was recalled that the Governing Council's credibility was above all founded on its ability to maintain price stability, which contributed to the well-being of the European people. Against this background, it was maintained that the Governing Council should avoid an overreaction to inflation developments that were assessed as being short-lived. Changing the stance and the related communication at the current meeting was seen as premature and could jeopardise the recovery, as the December Eurosystem staff projections still showed inflation remaining below the Governing Council's target in the medium term without any visible signs of an unanchoring of inflation expectations or any sound evidence of emerging second-round effects on wages.

All in all, members widely agreed that the March ECB staff macroeconomic projections would allow the Governing Council to assess in greater depth the implications for the medium-term inflation outlook of the new data accrued since December. It was noted that in view of the limited time until the Governing Council's March meeting, incoming information was unlikely to lead to a substantially different or more benign inflation assessment but might instead imply another upward revision to the inflation outlook for the coming quarters. It was also cautioned, however, that, despite the latest higher than expected inflation outcomes, the extent of possible revisions in the March projections, in particular for the medium-term outlook, remained an open issue. A structured and quantitative evaluation of all relevant factors forming the basis of the projection exercise would provide the Governing Council with important information that would help to put the evolution of the monetary policy stance on more solid ground.

Monetary policy decisions and communication

Overall, there was broad agreement that a gradual normalisation of the monetary policy stance continued to be appropriate. It was recalled that at the December meeting the Governing Council had already started this normalisation process by announcing the discontinuation of net asset purchases under the PEPP and the step-by-step reduction of its asset purchases, as well as its expectation that the special interest rate period of the third series of targeted longer-term refinancing operations

(TLTRO III) would end in June. In this context, it was recalled that a clear distinction needed to be made between the interest rate forward guidance and the guidance for APP net purchases, which was based on a different criterion, namely the need to reinforce the accommodative impact of the ECB's policy rates.

A gradual and flexible conduct of monetary policy was seen as critical. To this end, there was a need to maintain sufficient optionality with respect to the time horizon for adjusting the Governing Council's policy instruments in a data-driven manner. In addition, heightened geopolitical risks were seen as calling for a very prudent approach to normalisation. In this context, the Governing Council needed to recognise that the elevated inflation figures were partly a result of global shocks and were neither caused by monetary policy nor could they be addressed by monetary policy without causing a sharp fall in domestic demand at a time when the economy was still recovering from the pandemic shock. It was generally deemed important for the Governing Council to emphasise that it would maintain a clear and predictable path for its policy actions, based on its careful and regular assessment of the outlook for the economy and for inflation.

Against this background, members widely agreed that the Governing Council should confirm its forward guidance on the sequence of its different policy measures, which would entail ending net asset purchases under the APP before raising the key ECB policy rates and finally phasing out reinvestments. It needed to be recalled that the Governing Council's forward guidance and forward-looking communication was always data-dependant, reflecting an expectation or a probability assessment that was conditional on the medium-term inflation outlook. Overall, the Governing Council should use optionality to fine-tune the timing of the different milestones of its forward guidance in such a way that the medium-term inflation outlook converged to the ECB's target of 2%. In this context it was recalled that the Governing Council had a wide range of instruments at its disposal to ensure sufficient flexibility in gradually normalising the monetary policy stance in line with the evolving situation.

Members also widely agreed with Mr Lane's proposal to confirm the decisions taken at the Governing Council's December meeting, namely to discontinue net asset purchases under the PEPP at the end of March and to continue reducing the pace of net purchases step by step over the coming quarters. In adapting the inflation narrative and communication, it had to be acknowledged that inflation had continued to turn out higher than anticipated and was expected to remain elevated for some time, which could augment risks of second-round effects in the period ahead. Compared with the assessment in December, upside risks to the inflation outlook had increased, particularly in the near term.

Regarding communication, it was emphasised that the inflation narrative and communication needed to be adapted in order to retain or increase optionality in the period ahead. As the increase in inflation was becoming longer-lasting than initially expected, it was remarked that the Governing Council

should avoid characterising inflation developments as temporary or transitory and instead stress its assessment that inflation was expected to decline in the course of the year. Compared with December the outlook had changed and the likelihood of seeing inflation rates below 2% in 2023 had decreased significantly. At the same time, communication had to highlight the gradual, data-driven approach to monetary policy normalisation to ensure that inflation stabilised at the 2% target over the medium term.

In the light of the increased uncertainty and the heightened upside risks to the inflation outlook, the general view prevailed that the Governing Council should convey its increased alertness and should monitor incoming information carefully, in particular regarding second-round effects. Communicating the possibility of faster progress on the path of policy normalisation – should such a decision be warranted by an updated medium-term outlook for inflation – was seen as a means to ensure that the Governing Council had at its disposal sufficient policy flexibility at its upcoming meetings on the basis of data that would become available. It was underlined that the Governing Council had to reaffirm its determination to adjust all of its instruments, maintaining more than ever flexibility and optionality in a situation of exceptionally high uncertainty.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council confirmed the decisions taken at its monetary policy meeting last December and as set out in the dedicated press release published after the meeting.

The members of the Governing Council subsequently finalised the monetary policy statement, which the President and the Vice-President would, as usual, deliver at the press conference following the Governing Council meeting.

Monetary policy statement

[Monetary policy statement to the press conference of 3 February 2022](#)

Press release

[Monetary policy decisions](#)

Meeting of the ECB's Governing Council, 2-3 February 2022

Members

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

* Members not holding a voting right in February 2022 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 Buch
Mr Demarco
Ms Donnery
Mr Goulard
Mr Haber
Mr Jurkšas
Mr Kaasik
Mr Kuodis
Mr Kyriacou
Mr Lünemann
Mr Nicoletti Altimari
Mr Novo
Mr Ódor
Mr Rutkaste
Mr Sleijpen
Mr Tavlás
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 Thursday, 7 April 2022.