

Meeting of 27-28 October 2021

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 27-28 October 2021

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

Financial market developments

Ms Schnabel reviewed the financial market developments since the Governing Council's previous monetary policy meeting on 8-9 September 2021.

Market-based measures of inflation compensation in the euro area had surged to their highest levels in over seven years, pushing long-term nominal sovereign bond yields back to levels seen earlier in the year. In the euro area, ten-year inflation swap rates were more than 30 basis points higher than in September 2021 and a full percentage point higher than in December 2020, when the Governing Council had pledged to preserve favourable financing conditions. The five-year forward inflation-linked swap rate five years ahead had, for the first time in more than seven years, risen above the ECB's target of 2%. By contrast, ten-year real rates had fallen further. They were now almost 50 basis points below their December 2020 levels.

This pattern of yield changes suggested that rising long-term rates were not primarily the result of adverse spillovers, which would typically have manifested themselves in rising real rates. Rather they were seen as a reappraisal of the global inflation outlook, mainly reflecting the repercussions of the global energy shock and growing evidence of more persistent supply-side bottlenecks. While at short to medium-term horizons most of the increase in inflation compensation reflected higher genuine inflation expectations, at longer horizons the increase mostly reflected higher inflation risk premia. The fact that long-term inflation risk premia had increased so strongly in previous weeks suggested that market participants were increasingly worried about inflation outcomes above – rather than below – expected inflation, even once the prevailing shocks were expected to fade. Exceptionally high

uncertainty surrounding the nature and structure of the post-pandemic global economy was likely to have contributed to rising risk premia.

Although markets had significantly repriced both the baseline inflation outlook and the risks around it, there was no evidence that changes in expectations about asset purchases – either in the euro area or globally – had affected euro area sovereign bond yields. Contrary to developments in the spring, the spread between the ten-year German Bund and overnight index swaps (OIS) had remained highly resilient over recent weeks. Spreads between euro area sovereign bonds and the Bund had also remained resilient and, since the September monetary policy meeting, had even continued to fall to new post-2008 lows in most countries.

Developments in euro area credit and stock markets suggested that higher nominal long-term yields and the prevailing supply shocks were not expected to derail the recovery. Investment grade corporate bond spreads remained close to record low levels. Even though higher yields had weighed on euro area equity markets in previous weeks, the downward pressure had been fully offset by further upgrades of firms' longer-term earnings expectations and a diminishing equity risk premium.

Short-term and money market rates had risen in the euro area but by significantly less than in other major economies. The time of a rate lift-off had been brought forward from mid-2024 to late 2022. Since a non-negligible part of the recent rise in short and long-term rates reflected term premia, the actual time of lift-off priced by investors was likely to be later. This was consistent with the reading of survey-based expectations. Although the latest survey of monetary analysts also pointed to respondents anticipating an earlier lift-off, a first rate hike was only expected in the second quarter of 2024.

Option-implied probabilities for the expected path of short-term interest rates pointed to a significant widening of the distribution of possible future outcomes, which was now clearly skewed to the upside. Such an increase in uncertainty was to be expected when the market attached an increasing probability to expected inflation meeting the conditions for lift-off.

Medium-term inflation expectations, as proxied by the one-year swap rate three years ahead, had stood at 1.99% the day before the Governing Council meeting – their highest level since early 2013. Over the next five years, inflation was expected to be visibly above the Governing Council's target of 2% on average. The rise in measures of inflation compensation had been consistent with a marked shift in the distribution of expected inflation outcomes, as priced in by inflation options markets. The market was now putting the lowest weight on inflation being below 1% over the next five years within the available data sample, which started in 2010, and the highest weight on inflation being above 2% in more than a decade, i.e. a weight of more than 50%.

Conditional on the future path of inflation as embedded at present in inflation swap rates, current market pricing could therefore be consistent with the ECB's state-contingent forward guidance. That

the forward guidance remained credible was also supported by the behaviour of forward OIS rates. These continued to react less sensitively to expected inflation than before the pandemic, even if the sensitivity had increased somewhat in previous weeks owing to the strong acceleration in measures of inflation compensation. With short-term nominal rates less sensitive to inflation, the real yield curve in the euro area had fallen to unprecedented levels, while the euro continued to depreciate against the US dollar as expected policy rate differentials widened further. For the first time since the start of the pandemic, investors were no longer holding net euro long positions, implying that they did not expect the euro to reverse recent losses in the near term. Thus, continued policy divergence remained the central scenario for investors, even as markets had brought forward lift-off expectations in response to growing expectations that prevailing inflationary pressures would ultimately prove more persistent than previously anticipated.

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

Mr Lane reviewed the global environment and the recent economic and monetary developments in the euro area.

Regarding the external environment, global activity was still in a solid expansionary phase, with the global composite output Purchasing Managers' Index (PMI) remaining above 50 in September. However, there was some natural deceleration compared with the most intense reopening phase a few months earlier. World trade had initially shown a strong recovery to well above pre-pandemic levels but had flatlined since March. The impact of bottlenecks – visible in suppliers' delivery times and the ratio of new orders to inventories – on global exports and industrial production was estimated to have increased lately.

Since the Governing Council's September monetary policy meeting, the euro had declined significantly in both nominal effective terms (-1%) and against the US dollar (-1.9%). Oil prices had increased sharply (+17% in US dollar terms), reflecting both demand and supply effects. The oil price futures curve stood at levels that were much higher than foreseen in the September ECB staff macroeconomic projections, also for 2022 and 2023. Gas prices had increased even more strongly than oil prices over previous months, reflecting both strong global demand related to the economic recovery and supply-side effects.

As at the global level, the euro area outlook was clouded by supply bottlenecks and input price pressures. Industrial production had been fluctuating around the level of pre-pandemic activity, declining again to some extent in August. PMI indicators for manufacturing and services were standing firmly above 50. In particular, PMI data for accommodation and for food and beverages pointed to a significant recovery throughout the third quarter. Nevertheless, there was some variation across

industrial sectors. The automotive sector, in particular, was severely affected by semiconductor shortages, also in the context of adjustments in production processes towards electric vehicles.

Looking more closely at manufacturing, supply bottlenecks, together with the rapid recovery in demand, had led to a significant decline in inventories. At the same time, deliveries had slowed. The ECB's Corporate Telephone Survey indicated that well over half the respondents expected supply constraints and high input price pressures to last for at least six more months. A large number of respondents expected the supply constraints and elevated input prices to last even for another full year or longer.

As regards investment, housing investment growth likely moderated in the third quarter of 2021 owing mainly to tightening supply constraints, such as labour and material shortages, in an environment of strong demand. Business investment growth was expected to have remained in positive territory in the third quarter but not to have performed as strongly as previously envisaged on account of supply-side disruptions. Lately, also the PMI for new orders of capital goods, which was still at quite a high level, had been declining.

Turning to trade, the recovery continued at two speeds, with goods exports subdued and services trade rebounding somewhat. The historically large discrepancy between buoyant export orders and weak export volumes illustrated the impact of supply bottlenecks on exports. This shortfall was higher for the euro area than for the rest of the world, as euro area exports required relatively complex supply chains. Services exports had started to recover in the summer and indicators continued to signal a slight rebound.

Regarding labour market developments, the unemployment rate stood at 7.5% in August, similar to the pre-pandemic period. Nevertheless, a significant number of people were still in job retention schemes and the labour participation rate remained well below the pre-pandemic level. Thus, overall, the labour market continued to be weaker than before the pandemic. The PMI composite indicator for employment suggested further strong growth in the third quarter of 2021, with signs of stabilisation in September and October. The job vacancy rate for the total economy had risen in the second quarter of 2021 to the same level as in the corresponding quarter of 2019.

Turning to nominal developments, headline inflation in the Harmonised Index of Consumer Prices (HICP) had increased from 2.2% in July to 3.0% in August and to 3.4% in September. A longer-term perspective revealed that inflation was currently extraordinarily high, with large contributions from energy and goods inflation. Goods inflation was currently much higher than its long-term average of 0.6%, while services inflation could be seen as normalising. Oil price developments and their direct impact on fuel prices had been the main factor in the energy price surge. However, more recently, energy inflation had been driven also by strong upward movements in gas and electricity prices.

Services inflation had increased to 1.7% in September with the reopening of the economy, while non-energy industrial goods inflation had eased to 2.1%.

Most indicators of underlying inflation had increased. Prices in contact-intensive sectors continued to drive the current pick-up in the HICP excluding food and energy (HICPX), as demand was returning to those sectors most hit by the pandemic with an upward short-term effect on prices. The model-based Persistent and Common Component of Inflation (PCCI), which was less affected by temporary factors, stood at 1.6% in September, while Supercore, which included only the cyclically sensitive components of the HICPX, had increased from 1.3% in August to 1.6% in September.

Turning to pipeline pressures, producer prices had continued to rise very dynamically. Increases in producer prices were expected to lead to continuing upward pressure on consumer prices for non-energy industrial goods. Growth in negotiated wages had remained low of late, and it remained uncertain whether the upward impact of recent increases in consumer price inflation would pass through to wages. Evidence from the latest Corporate Telephone Survey indicated that a majority of the respondent firms expected wages to rise somewhat more strongly in 2022 than they did in 2021. That wage growth had so far remained muted was a very important element of the overall inflation dynamics for the medium term.

PMI input and output price developments indicated that profit margins continued to be under pressure, and increasingly so in services. Input prices were currently outpacing output prices, not only in intermediate goods industries but also in consumer goods industries and services.

Turning to housing costs, the ECB's residential property price index had increased strongly, by 7.3%, year on year, while the experimental owner-occupied housing price index had also increased strongly, by 4.5%, year on year in the second quarter of 2021. Overall, the costs of owning a house were growing considerably more strongly than the costs of renting a house, which had increased by around 1.3% in the second quarter of 2021.

Longer-term survey-based indicators of inflation expectations and market-based measures of inflation compensation had ticked up, moving closer to 2%. In the latest ECB Survey of Professional Forecasters, five-year ahead inflation expectations had been revised up from 1.8% to 1.9%. Fewer respondents were expecting very low inflation and more respondents were expecting rates of between 1.8% and 2.0%.

Turning to financial and monetary developments, nominal risk-free rates stood markedly higher than at the time of the September monetary policy meeting. Sovereign bond spreads were slightly narrower. Corporate bond spreads had narrowed in view of a positive credit outlook. With risk-free interest rates going up and spreads stable or slightly narrower, there was evidence of an overall tightening of nominal financing conditions. After some volatility, equity prices were at a level similar to at the time of the September meeting.

With respect to monetary developments, lending to firms had remained moderate but had seen an uptick in September. This was consistent with the slight net increase in loan demand reported by banks in the October round of the bank lending survey. Fixed investment had made a positive contribution to loan demand for the second consecutive quarter, which was a positive sign for the economic recovery. Firms' borrowing costs remained below the levels seen at the start of the pandemic and were still insulated from the upward trend in risk-free rates.

Lending to households remained strong, with annual growth in loans much higher than in the period after the 2007-08 Great Financial Crisis, supported by dynamic lending for house purchase. The borrowing costs of households for house purchase remained substantially below their level at the start of the pandemic, as did borrowing costs for consumer lending.

Following sharper net tightening earlier in the pandemic, the latest round of the bank lending survey showed that credit standards for loans to firms remained broadly unchanged in the third quarter of 2021, for the second consecutive quarter. Despite the supply bottlenecks, banks maintained a balanced view of their credit risks, in line with the economic recovery and continued support from the authorities.

Focusing on developments in money creation, the annual growth rate of M3 had stood at 7.4% in September, after 7.9% in August. Monthly household deposit flows had returned to their pre-pandemic average, reflecting the recovery in consumer confidence and spending. By contrast, corporate deposit flows remained strong and above the pre-pandemic average, pointing to a further strengthening of liquidity buffers.

On fiscal policies there was only limited news. The fiscal tightening in 2022 was likely to be less pronounced than had been assumed in the September ECB staff projections, as some new fiscal measures had already been announced and the latest draft budgetary plans indicated a more expansionary fiscal stance. Looking further ahead, budget balances in 2023 were expected to still be more negative than prior to the pandemic in most countries.

Monetary policy considerations and policy options

Summing up, Mr Lane remarked that the euro area economy continued to recover, although momentum had moderated to some extent. The impact of the pandemic on economic activity had declined, with the gradual lifting of restrictions supporting consumer spending, especially on those services most affected by lockdowns – such as tourism and hospitality. The manufacturing sector continued to expand, but at a slower pace owing to ongoing supply chain disruptions. This could be seen in the hard data: industrial production had fallen by 1.6% in August and was 1.2% lower than at the start of the pandemic. It was also visible in the PMI manufacturing output index, which had

declined from 55.6 in September to 53.2 in October – a 16-month low. Shortages in the supply of labour, materials and equipment were clouding the outlook for the coming quarters. After the rapid rebound in the earlier stages of reopening, the rate of expansion in the PMI services component had moderated. Accordingly, while the composite PMI for the euro area remained firmly in expansionary territory it had slowed markedly, falling from 59.0 in August to 56.2 in September and subsequently to 54.3 in October – a six-month low.

HICP inflation had increased from 3.0% in August to 3.4% in September. In September energy inflation accounted for about half of overall inflation. Inflation had continued to surprise to the upside, driven by three broad – and intertwined – factors associated with the current energy price shock and the reopening of the economy. First, the surge in energy prices reflected both supply-side and demand-side developments. Part of the increase in gas and electricity prices reflected spillovers from global developments. However, the rise in European gas prices had outpaced global price movements on account of Europe-specific factors, such as the substitution of gas for other fuels, low inventories and higher carbon prices. Second, the recovery in demand linked to the reopening of the economy, combined with pandemic-related factors and global supply-side impediments, was putting upward pressure on prices. These dynamics were especially visible in relation to consumer services and those goods most affected by global supply shortages.

Higher demand for services and supply frictions were pushing up HICPX inflation, which had risen from 1.6% in August to 1.9% in September. Similarly, pipeline price pressures continued to build up for a wide range of goods and had become more visible at later stages of the pricing chain. Accordingly, non-energy industrial goods inflation had stood at 2.1% in September, well above its long-term average. Third, special factors associated with the pandemic – namely base effects related to the drop in oil prices last year and the end of the temporary VAT cut in Germany – were still contributing to higher inflation.

Headline inflation appeared likely to rise further during the year and to peak in the fourth quarter. Although inflation would take longer to decline than previously expected, it was foreseen to diminish in the course of 2022 as the influence of these three factors driving near-term inflation developments eased or fell out of the year-on-year inflation calculation. Looking further ahead, a tightening in the labour market should push up wages, supporting a gradual increase in underlying inflation pressures. However, Mr Lane mentioned that inflation was still expected to fall below the ECB's target in the medium term. That said, the duration of the supply shortages and higher energy prices remained uncertain, constituting a source of upside risk to the near-term inflation outlook. Measures of longer-term inflation expectations had moved closer to 2%, although these generally remained below the target, especially on a risk-adjusted basis.

The recovery continued to depend on the course of the pandemic and further progress with vaccination campaigns. The risks to the economic outlook were still seen as broadly balanced. A

faster than anticipated drawdown of accumulated savings for investment and consumption still constituted an upside risk. However, a prolongation of supply chain disruptions could slow down the recovery, while persistently high energy prices could hamper economic activity and dent disposable income, thereby weighing on consumption and investment. In particular, if these factors persisted for longer than expected, the upward shift in the price level could feed through into higher than anticipated wage increases. The latest data still pointed to extensive labour market slack, and wage dynamics remained subdued. Moreover, the negative terms-of-trade shock generated by the surge in energy prices was also denting profitability, reducing the scope for granting wage increases. In monitoring wage developments, it would be essential to differentiate between, on the one hand, wage adjustments that were simply a response to the unexpectedly high current inflation rate or a shift in the expected level of inflation towards the target and, on the other hand, a self-reinforcing process whereby employers accommodated demands for higher pay in expectation of persistent excess inflation in the future.

While financing conditions for firms, households and the public sector remained supportive in broad terms, market interest rates had increased markedly since the September meeting. The increase in longer-term yields had outstripped the improvement in longer-term inflation expectations, as captured by the surveys of professional forecasters and monetary analysts, as well as by risk-adjusted market-based measures of inflation compensation. Similarly, the significant increase in term premia could be related to a shift in inflation risk premia. Over time, a persistent increase in market interest rates would feed into a tightening of financing conditions. Euro area sovereign spreads remained stable, with no indication of a weakening in the transmission from risk-free to sovereign debt markets. Market-based and bank-based financing conditions for firms and households currently remained at supportive levels, despite a slight increase in bank and corporate bond yields. The euro had depreciated noticeably against the US dollar, reflecting expectations of relatively tighter monetary policy in the United States.

Overall, the latest developments broadly confirmed the previous assessment made at the September meeting, suggesting no change to the pace of purchases under the pandemic emergency purchase programme (PEPP). Accordingly, Mr Lane proposed continuing to conduct net asset purchases under the PEPP at a moderately lower pace during the final quarter of the year than the previous two quarters.

Some indicators of market expectations for the future path of the short-term money market interest rate were difficult to reconcile with the ECB's forward guidance on its policy rates. The increase in near-term rates likely reflected higher compensation for bearing a perceived increase in inflation risk, while some market participants might also put more weight on the likelihood of the lift-off conditions being met earlier than envisaged in the ECB staff's assessment. However, current market pricing may have also reflected, in part, an incomplete understanding of the three conditions laid out in the Governing Council's forward guidance that had to be satisfied before lifting the policy rates, especially

in view of the ECB staff's assessment that inflation would decline over the course of next year and that inflation was foreseen to settle below the target over the projection horizon.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members generally agreed with the assessment of the current economic situation in the euro area and the risks to the outlook provided by Mr Lane in his introduction. The euro area economy continued to recover strongly, although momentum had moderated to some extent. Consumers continued to be confident and their spending remained strong. But shortages of materials, equipment and labour were holding back production in some sectors. Inflation was rising, primarily because of the surge in energy prices but also as the recovery in demand was outpacing constrained supply. Inflation was expected to rise further in the near term but to decline in the course of next year.

As regards the external environment, members shared the assessment provided by Mr Lane in his introduction: the bigger picture was still that of a solid global recovery although with some slowing of momentum. While some deceleration was natural, some was connected to the persistence of bottlenecks and supply constraints. Reference was made to increased congestion in ports. The outlook for global oil and gas markets remained surrounded by uncertainty. It was underlined that rising prices were reflecting a confluence of factors related to demand, supply and inventories. It was argued that capacity bottlenecks in energy supply might be longer lasting if the green energy agenda reduced incentives for exploring and maintaining oil extraction. Some concern was also expressed more generally about uncertainties related to the global economic outlook and the implications this would have for euro area foreign demand.

Turning to euro area developments, the economy had continued to grow strongly in the third quarter of 2021. While momentum had moderated to some extent, output was still expected to exceed its pre-pandemic level by the end of the year. The lifting of pandemic restrictions was supporting consumer spending, although higher energy prices might reduce purchasing power in the months to come. At the same time, the labour market continued to improve, supporting the prospect of higher incomes and increased spending. The recovery in domestic and global demand was supporting production and business investment, although various shortages and cost pressures were clouding the outlook for the coming quarters. It was argued that the December 2021 Eurosystem staff projections were likely to see a downward revision to real GDP growth for 2021, given the latest evidence for some euro area

countries. Yet this might just be part of a change in the profile over time, with lower growth in the second half of 2021 but higher growth in 2022. It was suggested that, looking beyond certain temporary setbacks, the losses caused by the pandemic had largely been reversed. Accordingly, the focus should shift towards more normal business cycle dynamics and a longer-term perspective.

Members widely acknowledged that supply bottlenecks were lasting longer than initially thought. This was also the view emerging from contacts with firms in the ECB's Corporate Telephone Survey. At the same time, it appeared that there were differences between countries concerning the degree to which bottlenecks were affecting the economy. Firms operating in integrated value chains were likely to be more affected than others. It was observed that this went hand in hand with a strong reliance on "just-in-time" delivery systems, raising the question of whether future systems would return to relying more on inventories and buffers. It was also suggested that, as a result of current experiences, there could be some reversal of the past globalisation of manufacturing. The point was made that the bottlenecks not only reflected the reopening of the economy but also structural forces, with the shift to electric vehicles in car manufacturing being an example. Overall, however, it was stressed that supply bottlenecks would gradually fade away as supply reconnected with demand, even though this was taking longer than expected.

Members assessed the risks to the economic outlook as broadly balanced. Supply bottlenecks and rising energy prices were considered the main near-term risks to the pace of the recovery and the outlook for inflation. If supply shortages and higher energy prices lasted longer, these could slow down the recovery. At the same time, if persistent bottlenecks were to feed through into higher than anticipated wage rises, or if the economy returned more quickly to full capacity, price pressures could become stronger. However, economic activity could outperform expectations if consumers became more confident and saved less than currently expected. More generally, the recovery continued to depend on the course of the pandemic and further progress with vaccination campaigns.

In their exchange of views, members discussed the notion of "stagflation" in relation to risks to the economic outlook. It was recalled that a terms-of-trade shock – as implied by the rise in energy prices – normally came with upward impacts on inflation but downward impacts on economic growth, via lower real disposable income and higher costs. With the economy just coming out of the pandemic crisis, the negative terms-of-trade shock was also seen as increasing the likelihood of "scarring effects" that could hamper future growth. At the same time, it was cautioned that temporary movements in prices and output in different directions should not be labelled as stagflation. It was quite normal for the latter stages of a recovery to be accompanied by lower growth, and most of the recent upward pressure on prices was coming from base effects. It was stressed that the current outlook clearly lacked the stagnation element. Growth momentum was declining, but within a still strong recovery and with robust rates of growth in activity – well above potential growth. Reference was made to the unprecedented wedge between industrial orders and industrial production, which

suggested significant potential for a rebound once the supply problems receded, limiting the likelihood of stagflation. Stock markets pricing in higher and rising earnings was also seen as a factor that did not square with stagflation. The same held with regard to the support from fiscal and monetary policy and anchored inflation expectations. In this context, it was recalled that stagflation experiences in the 1970s occurred in a different environment, in which indexation allowed wages to react to energy prices and thus sustained both stagnation and inflation.

With regard to price developments, members broadly agreed with the assessment presented by Mr Lane in his introduction. Inflation had increased to 3.4% in September and was expected to rise further in 2021. While the current phase of higher inflation would last longer than originally anticipated, inflation was expected to decline in the course of 2022. The upswing in inflation largely reflected a combination of three factors: the sharp rise in energy prices, a reopening-driven recovery in demand outpacing supply and base effects related to the end of the VAT cut in Germany. The influence of all three factors was expected to ease or fall out of the year-on-year inflation calculation in the course of 2022. As the recovery continued, the gradual return of the economy to full capacity was expected to underpin a rise in wages over time. Market-based measures and survey-based indicators of longer-term inflation expectations had moved closer to 2%. In addition, options markets had, by and large, priced out low inflation outcomes over the following five years. These factors were expected to support underlying inflation and the return of inflation to target over the medium term.

Members widely agreed on the expected hump-shaped pattern in the shorter-term inflation outlook. Confidence was expressed that the effects of higher energy prices and of supply bottlenecks would be temporary, although the decline in inflation in 2022 would now take longer than previously expected. Reference was made to the recurrent underestimation of the latest outcomes for both headline and underlying inflation, corroborating earlier conjectures that the risks around the September 2021 ECB staff projections had been tilted to the upside. Against this background, it was seen as likely that in the December 2021 Eurosystem staff projections the shorter-term inflation outlook for the euro area would once again be revised upwards.

There was broad agreement among members that the key question at the current juncture was what the latest developments implied for the medium-term inflation outlook. It was pointed out that the medium-term inflation outlook remained surrounded by elevated uncertainty and it was suggested that this warranted an open mind with respect to different scenarios that might unfold. It was recalled that, while mechanical updates of projections pointed to upward revision for 2022, for 2023 these updates also implied a significant effect from downward-sloping oil price assumptions. At the same time, it was suggested that the current surge in market prices for gas would only be reflected in consumer price inflation with some delay, owing largely to administered price-setting.

Looking beyond mechanical updates, it was stressed that more persistent bottlenecks and the increases in energy costs could have repercussions that would ultimately have a dampening effect on

underlying inflation and therefore on the medium-term inflation outlook. This would be the case if, for instance, bottlenecks slowed the economic recovery. Similarly, the effect of higher energy prices on the terms of trade implied a “tax” that would need to be absorbed by workers and firms in the domestic economy. This could delay the return of economic activity to pre-pandemic levels, which was consistent with conjunctural indicators that suggested that economic momentum was weakening. It was argued that supply-side shocks would only lead to a self-sustained inflationary process if they hit when the resources in the economy were fully utilised, which was not yet the case in the euro area. Both the number of people in the labour force and the hours worked in the economy remained below their pre-pandemic levels, and those levels had led only to modest inflationary pressures before the pandemic. In addition, the unemployment rate was still being compressed by the impact of job retention schemes. At the same time, the point was made that the strong pent-up demand, together with a greater readiness to pay implied by the very high accumulated savings of households, could allow for a greater pass-through of the current supply-side shocks to inflation.

Members considered that an increase in inflation in the medium term required higher wage growth and inflation expectations. It was argued that such wage growth needed to reflect a persistent shift in the growth rate rather than a one-off shift in the level. The view was widely shared that negotiated wage growth had remained subdued and there were no signs as yet of second-round effects on wages stemming from the higher energy prices. At the same time, it was cautioned that one could not take much reassurance from the few wage negotiations seen in the most recent past, as these had not taken place against the background of the prevailing very high inflation rates. Second-round effects might thus still be observed after some delay and it would only be possible to identify them once the next round of wage negotiations had been completed. The more protracted high inflation proved to be, the more pressure trade unions would face to push through higher wage demands. Reference was also made to the indications of potential second-round effects in the results of the Corporate Telephone Survey.

At the same time, caution was counselled in the current situation so as not to associate any observed increases in wage growth with unwelcome second-round effects. Some catching-up was to be expected and, coming after a long period of low inflation, a pick-up in wage growth driven by tightening labour markets – even if sustained – should be considered a healthy development. Moreover, in terms of the consequences for labour costs, any rise in wage growth would have to be weighed against productivity growth. Generally, the materialisation of second-round effects in response to a terms-of-trade shock depended on the competitive situation and the relative bargaining power of workers and employers. It was argued that the mechanism whereby prices were raised to restore profitability in response to higher wage demands was unlikely to be in operation at this time, owing to the risk of losing market share. Moreover, in comparison with the 1970s and 1980s, there had been a shift in the relative importance of pay and job security in wage bargaining. In this respect, the labour market was

seen still to contain a substantial amount of hidden slack, which was related to employees in job retention schemes and to restraints on mobility and migration. While the possibility of second-round effects was considered to be limited in the presence of labour market slack, it was argued that price effects could be greater than currently estimated if labour force participation did not return to pre-crisis levels. Moreover, with infection rates still high and subsidies still generous under job retention schemes, workers' reservation wages might have increased, although this effect was likely to vanish as the labour market normalised after the pandemic. While there was agreement that the bargaining power of trade unions and the scope for wage indexation had decreased over time, it was pointed out that wage negotiations were now taking place against the background of high inflation rates well above the ECB's target.

In their discussion, members also recalled other factors that were relevant for the medium-term inflation outlook. It was argued that, thus far, the projections did not include the rise in carbon prices that would be needed to reach the objectives set in the Paris Agreement. It was acknowledged that energy prices needed to rise in order to affect the behaviour of consumers and enterprises through relative price changes (*vis-à-vis* non-energy components), but the question was raised as to whether the ultimate effects of higher energy prices on economic activity and inflation would be positive or negative. Related to this, doubts were expressed about the use of typically downward-sloping oil price futures curves as projection assumptions, when fossil fuel prices were bound to remain elevated or rise further. Additionally, growth of owner-occupied housing costs, which at present were not included in the HICP, had accelerated to a rate of 4.5%, year on year, in the second quarter of 2021. This was a source of concern at a time when the latest estimates suggested that owner-occupied housing would have contributed 0.4-0.5 percentage points to inflation in the second quarter of the year according to an experimental HICP (while the difference between such an experimentally augmented HICP and the official HICP would have amounted to 0.2-0.3 percentage points). At the same time, it was cautioned that this supplementary cost indicator should not always be expected to make a positive contribution to inflation, as it partly reflected developments in house prices that could be subject to strong mean reversion over time. Finally, it was recalled that some of the models used in the macroeconomic projections might not adequately capture prevailing inflation dynamics, as these were based on mean reversion to the low historical trend seen over the past few years.

As regards inflation expectations, members took note of the further increase in longer-term survey-based indicators and market-based measures of inflation expectations that Ms Schnabel and Mr Lane had reported in their introductions. Expectations were now seen as being close to or having already reached the 2% target. It was pointed out that this was only a gradual move towards levels more in line with the new inflation target and that such re-anchoring should not be confused with an unanchoring on the upside. It was acknowledged that the individual expectations measures all had some methodological shortcomings, such as a risk premium component or outliers, but that it was

useful to have a wide range of information, which qualitatively all pointed in the same direction. The view was expressed that the longer the inflation spike lasted, the more it would become entrenched in longer-term inflation expectations. It was also suggested that, as indicated by the results of household surveys, the way households and firms experienced inflation was quite different from the reading of macro data by market analysts and central banks.

Turning to the monetary and financial analysis, members widely concurred with the assessment provided by Mr Lane in his introduction. Bank lending rates for firms and households remained at historically low levels. The growth of loans to non-financial corporations remained moderate, despite picking up in September. The most recent bank lending survey showed that credit conditions for firms had stabilised and were supported – for the first time since 2018 – by a reduction in banks' risk perceptions. It was remarked that the growth rate of lending to households for house purchase stood above 5% – the highest level since 2008. At the same time, bank balance sheets continued to be supported by favourable funding conditions and remained solid.

Monetary policy stance and policy considerations

Members widely concurred with the view that, at the current juncture, the accommodative monetary policy stance had to be reconfirmed and remained appropriate to support the convergence of inflation to the Governing Council's symmetric 2% target over the medium term. In line with the Governing Council's new strategy, monetary policy had to be patient in the light of the elevated uncertainty, in order to support a self-sustained re-anchoring of inflation expectations at the target. Since the monetary policy space was constrained by the effective lower bound on interest rates, the increase in the inflation rate was seen as an opportunity to re-anchor inflation expectations solidly at the Governing Council's 2% target over the medium term. A continued accommodative monetary policy stance would also be in line with the Governing Council's new monetary policy strategy, which called for policy to be persistent when interest rates were at the lower bound and explicitly allowed for inflation to moderately exceed the target for a transitory period. Moreover, it was conjectured that there had been no fundamental changes in the underlying causes of the low growth and low inflation environment prevailing prior to the pandemic.

However, it was also noted that, despite the increase in nominal rates, short-term real interest rates had decreased. The remark was made that, at some point in the future, the very generous monetary policy support to the economy would need to be reassessed in view of the improved inflation outlook and be brought towards a more neutral configuration over time. Contrary to the situation in the past decade, the Governing Council was now increasingly facing a macroeconomic backdrop of deficient supply rather than deficient demand, in an environment of rising inflation expectations and a fast

improving labour market. At the same time, it was recalled that the current macroeconomic outlook depended heavily on the monetary policy support that was in place.

With regard to financing conditions, it was noted that, overall, financial and financing conditions had remained favourable, although market interest rates such as the ten-year OIS rate and euro area sovereign bond yields had increased markedly since the Governing Council's previous quarterly assessment in September. The increase in the ten-year OIS rate reflected exclusively an increase in measures of inflation compensation. A substantial part of the increase in inflation compensation, in turn, was attributed to an increase in the term premium related to spillovers from abroad. At the same time, real interest rates had fallen and government and corporate bond spreads had remained contained. Market-based and bank-based financing conditions for firms and households remained at, or close to, historically supportive levels, despite an increase in bank and corporate bond yields.

Concerns were voiced that expectations regarding the future path of short-term money market interest rates were difficult to reconcile with the Governing Council's forward guidance on interest rates, with market participants anticipating a much earlier date for the first rate increase than at the time of the Governing Council's September meeting. The question was raised as to whether market participants might misunderstand the three conditions laid out in the Governing Council's forward guidance that had to be satisfied before the first increase in policy rates. These conditions were that the Governing Council should see inflation reaching 2% (i) well ahead of the end of its projection horizon and (ii) durably for the rest of the projection horizon, and that (iii) in the Governing Council's judgement realised progress in underlying inflation was sufficiently advanced to be consistent with inflation stabilising at 2% over the medium term. It was recalled that – in contrast to survey-based indicators – market-based measures of inflation compensation and future interest rates contained term premia, which had to be disentangled from the pure expectations component. The increase in term premia on account of the elevated uncertainty could potentially offer one explanation for the discrepancy between market-based measures and survey-based indicators, although both metrics had shifted significantly since the September meeting.

Two main reasons for this shift were discussed. On the one hand, the significant increase in market-based measures of inflation compensation across the maturity spectrum, including over the medium term, suggested that market participants judged that the interest rate lift-off conditions would be met earlier than the Governing Council anticipated. Consistent with the automatic stabiliser function inherent in the Governing Council's forward guidance, it was reasonable to expect changes in the expected time to lift-off as inflation expectations rose. This suggested that the forward guidance remained credible and that it had contributed to a further easing of financing conditions by lowering real short and medium-term interest rates. In this context, it was noted that there was now a gap between the future path of inflation implied by inflation swap markets and the September 2021 ECB

staff projections, and attention was drawn to the recent persistent underestimation of inflation in recent staff macroeconomic projections.

On the other hand, market participants were possibly questioning the credibility of the Governing Council's forward guidance. In this context, it was stressed that the Governing Council had to reaffirm all three conditions of its forward guidance and its determination to act forcefully and persistently, in line with its revised monetary policy strategy, in order to anchor inflation expectations solidly at its 2% target. Equally, the Governing Council had to reaffirm its assessment that inflation would decline in the course of next year and could still be expected to settle below the ECB's 2% target over the projection horizon. It was underlined that, by explicitly stressing the need for durability of the underlying inflation developments, the Governing Council's forward guidance was particularly well suited to looking through "cost-push" shocks such as the ones being experienced.

Members concurred that the current and near-term increase in inflation was driven largely by temporary factors that would fade in the medium term. At the same time, members agreed that price pressures were more persistent than had been foreseen in the September ECB staff projections. Although it was judged that second-round effects were not visible so far, medium-term price pressures needed to be monitored closely. In this context, it was noted that medium-term inflation expectations – not just those of market participants but also those of economic agents in general – remained well anchored and generally below the 2% target. Overall, it was acknowledged that the medium-term inflation outlook had improved.

Although the Governing Council's focus on the medium-term inflation outlook suggested looking through the projected hump-shaped path for inflation that resulted from the temporary nature of the current factors affecting the inflation outlook, the uncertainty around the medium-term prospects was seen as elevated. While an increase in the upside risks to inflation had to be acknowledged, it was deemed important for the Governing Council to avoid an overreaction as well as unwarranted inaction, and to keep sufficient optionality in calibrating its monetary policy measures to address all inflation scenarios that might unfold.

Based on the joint assessment of financing conditions and the inflation outlook, all members agreed with Mr Lane's proposal to continue conducting net asset purchases under the PEPP at a moderately lower pace during the final quarter of the year compared with the previous two quarters, while confirming all other monetary policy measures, namely the level of the key ECB interest rates, the Governing Council's forward guidance on their likely future evolution, the purchases under the asset purchase programme (APP), the reinvestment policies and the longer-term refinancing operations.

With regard to the upcoming Governing Council meeting in December, the view was held that, judging on the basis of the current developments, net purchases under the PEPP could be expected to come to an end by March 2022, in line with the date that the Governing Council had announced in its

previous communication. At the same time, it was highlighted that monetary policy decisions needed to be data-driven and all incoming data during the coming months needed to be taken into account. While the Governing Council would benefit from new staff macroeconomic projections at its December meeting, it was cautioned that the data available in December would not resolve all the uncertainties around the medium-term inflation outlook. It was seen as important that the Governing Council should keep sufficient optionality to allow for future monetary policy actions, including beyond its December meeting.

Monetary policy decisions and communication

Regarding communication, it was stressed that, in view of the significant shift in the path of short-term money market rates, the Governing Council had to reaffirm its forward guidance and its assessment that, while inflation would take longer to decline than previously expected, in the medium term it was foreseen as remaining below the 2% target. In this context, it was necessary to stress the medium-term inflation outlook and the Governing Council's determination to act forcefully and persistently, in line with its revised monetary policy strategy, to anchor inflation expectations solidly at its 2% target. At the same time, it had to be acknowledged that some of the upside risks to the September 2021 staff projections had materialised and that the recent uptick in inflation was expected to be more persistent than previously anticipated.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the following monetary policy decisions, which are set out in more detail in the corresponding ECB press release.

The Governing Council continued to judge that favourable financing conditions could be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) than in the second and third quarters of the year.

The Governing Council also confirmed its other measures, namely the level of the key ECB interest rates, its forward guidance on their likely future evolution, its purchases under the asset purchase programme (APP), its reinvestment policies and its longer-term refinancing operations.

The Governing Council reiterated that it stood ready to adjust all of its instruments, as appropriate, to ensure that inflation stabilised at its 2% target over the medium term.

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 28 October 2021](#)

Press release

[Monetary policy decisions](#)

Meeting of the ECB's Governing Council, 27-28 October 2021

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 Panetta

Mr Rehn*

Mr Reinesch

Ms Schnabel

Mr Scicluna

Mr Stournaras

Mr Šimkus

Mr Vasle

Mr Villeroy de Galhau*

Mr Visco

Mr Weidmann

Mr Wunsch*

* Members not holding a voting right in October 2021 under Article 10.2 of the ESCB Statute.

Other attendees

Mr Dombrovskis, Commission Executive Vice-President**

Ms Senkovic, Secretary, Director General Secretariat
Mr Smets, Secretary for monetary policy, Director General Economics
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 Arce
Mr Bitans
Ms Buch
Mr Demarco
Ms Donnery
Mr Gaiotti
Ms Goulard
Mr Haber
Mr Kuodis
Mr Kyriacou
Mr Luikmel
Mr Lünemann
Mr Novo
Mr Ódor
Mr Sleijpen
Mr Tavlás
Mr Vanackere
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 Rostagno, Director General Monetary Policy
Mr Sousa, Deputy Director General Economics

Release of the next monetary policy account foreseen on Thursday, 20 January 2021.