EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

Christine LAGARDE
President

Mr Rasmus Andresen
Mr Ernest Urtasun
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 16 September 2022

L/CL/22/204

Re: Your letter (QZ-022)

Honourable Members of the European Parliament, dear Mr Andresen and Mr Urtasun,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 13 July 2022.

On aggregate, national accounts data point to a relatively large contribution of unit profits to GDP deflator inflation (a measure of changes in the prices of goods and services produced in the euro area) after the coronavirus (COVID-19) recession. The average quarterly contribution stood at 1.5 p.p. in 2021, compared with 0.25 p.p. in 2018, 0.5 p.p. in 2019 and 0.4 p.p. in 2020. After a considerable slowdown in 2022Q1, unit profit growth picked up again in 2022Q2.[1] Looking ahead, the September 2022 ECB staff projections expect profit margins to buffer some of the anticipated higher wage costs in 2023, but to then recoup some losses in 2024.

The resilience in profit developments in the available data has been especially visible in sectors with high input price pressures alongside reduced competition among suppliers due to supply bottlenecks, such as agriculture, industry (excluding construction) and construction. In services, unit profit developments have been strong in areas where a strong pick-up in activity was observed as the economy reopened following the pandemic-related lockdowns, such as trade, transportation, accommodation and food services. Overall, the strength of

[1] See also slide 9 in "The globalisation of inflation", *keynote speech*, ECB, 11 May 2022, available at: https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp220511_1_annex.en.pdf.

unit profits suggests that companies in some sectors have been able to take advantage of temporarily limited competition in an environment of supply chain bottlenecks and strongly rebounding demand, thereby recouping real income losses more strongly by raising selling prices than would normally be seen in the presence of strong input cost pressures. In any case, the extraordinary circumstances that have surrounded the global economic environment, including the euro area, over the last two years currently make it extremely difficult to draw firm conclusions on the nature and persistence of the recent oscillations in profit margins across different sectors. In particular, determining whether these oscillations reflect mainly temporary or more persistent shifts in supply-side conditions (e.g. the level of competition) or in the demand for different categories of goods and services will require more complete and granular evidence at the firm and sector levels.

The Governing Council's choice and calibration of monetary policy instruments is geared towards its primary objective of preserving price stability. In the current conditions of undesirably high inflation, this orientation has led us to implement a process of normalising monetary policy. As part of this process that has started since December last year, we raised our three key ECB interest rates by 50 basis points in July and by 75 basis points in September. Moreover, we communicated that, based on the Governing Council's current assessment, further increases in interest rates to levels that support a timely return of inflation to the 2% target will be appropriate over the next several meetings.

The normalisation process will interact with our previous measures taken in response to the adverse economic consequences of the pandemic for the euro area. These measures include the targeted longer-term refinancing operations (TLTRO III), whose conditions we changed during the pandemic. These changes were designed and intended to encourage banks to continue lending to firms and households in an environment of unprecedented risks to the macroeconomy. The targeted nature of these operations succeeded in protecting the flow of credit to the economy.

During the normalisation phase, a robust bank-based transmission mechanism remains essential for the Governing Council to ensure an adequate pass-through of its monetary policy stance to credit conditions. In this context, we will continue to monitor bank funding conditions and regularly assess how targeted lending operations are contributing to the monetary policy stance.

At its July monetary policy meeting the Governing Council also stated that, in the context of our policy normalisation, we will evaluate options for remunerating excess liquidity holdings. At its September meeting, at which the deposit facility rate was raised above zero, the Governing Council decided that the two-tier system for the remuneration of excess reserves is no longer necessary. We therefore decided to suspend the two-tier system by setting its multiplier to zero. Further deliberations will take place in the context of our policy normalisation process.

Yours sincerely,

[signed]

Christine Lagarde