EUROPEAN CENTRAL BANK

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Christine LAGARDE
President

Mr Manu Pineda
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 23 June 2023

L/CL/23/137

Re: Your letter (QZ-014)

Honourable Member of the European Parliament, dear Mr Pineda,

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 11 May 2023.

The coronavirus (COVID-19) pandemic and Russia’s war in Ukraine triggered strong imbalances between demand and supply and caused sizeable cost increases for companies. These shocks especially affected energy-related input costs, which have often been passed through to selling prices, as firms had an incentive to protect their profit margins. In some sectors, firms were even able to increase their profit margins, with the pass-through of higher costs to final prices having been unusually strong on aggregate. The pass-through of higher input costs to this extent may, among other things, be a reflection of firms having taken advantage of supply-demand imbalances and less transparency – that goes along with any stronger volatility in inflation – to test consumer demand with large price increases that exceed the related increase in cost. In such an environment, maintaining or expanding profit margins can come with a lower loss of market share or none at all.

As regards monetary policy, overall inflation is projected to remain too high for too long and we are determined to ensure that inflation returns to our 2% medium-term target in a timely manner. Higher policy rates increase the cost of borrowing for all economic actors, which reduces the amount that people, businesses and governments spend and invest. The resulting dampening demand will, over time, reduce inflation and protect against the risk of a persistent upward shift in inflation expectations. The firm anchoring of inflation expectations at our target in turn reduces the economic cost of disinflation. At this stage, we are seeing that the first leg of transmission of our monetary policy – from our interest rate decisions to broad financing conditions – is working forcefully. The second leg of transmission – from tighter financing conditions to real activity and, in turn, to inflation – is also gradually underway, but subject to uncertainty in terms of time lags and strength of transmission. Looking ahead, profit margins are expected to weaken owing to the monetary policy-induced easing of demand pressures, a catch-up in real wages and further improvements in supply constraints.

Regarding your questions on “surgical” measures to control prices and measures to tackle profit margins specifically, please note that the European Central Bank (ECB) does not have any direct means of controlling individual prices or of addressing isolated causes of high inflation. As I explained in my hearing before the Committee on Economic and Monetary Affairs (ECON) Committee on 20 March, the recent cost and price shocks should be absorbed in a way that ensures they do not lead to an upward spiral of price and wage adjustments, endangering price stability.[1] However, the details of burden-sharing between wages and profits are the responsibility of the social partners. Insofar as increasing profits have been facilitated by insufficient competition in certain sectors, it is for the competent competition authorities to assess the need for action to enforce prohibitions on the abuse of dominant positions and ensure the removal of undue entry barriers.

The best contribution monetary policy can make to economic growth and job creation in the euro area on a sustainable basis is by ensuring price stability over the medium term. At the same time, the ECB supports the investment and structural reform objectives of the Recovery and Resilience Facility. Any inflationary effect of additional public expenditure will be offset, at least to some degree, by the disinflationary effect of greater productive capacity resulting from the planned supply-side measures and particularly from front-loaded structural reforms. We would welcome their timely and efficient implementation.

Yours sincerely,

[signed]

Christine Lagarde

[1] See transcript of the ECB President’s ECON Committee hearing, 20 March 2023, available at: https://www.ecb.europa.eu/press/key/date/2023/html/ecb.sp230320%7E8cfe38e846.en.html.

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