Meeting of 9-10 December 2020

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 9-10 December 2020

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 28-29 October 2020.

Developments in global financial markets had been driven by a strong improvement in risk sentiment. The main catalyst had been the news on the effectiveness and imminent roll-out of multiple coronavirus (COVID-19) vaccines. Two additional factors had reinforced and amplified the improvement in risk sentiment. First, there were growing signs of a forthcoming bipartisan fiscal stimulus programme in the United States in the wake of the formal commencement of the presidential transition process. Second, the communication by the ECB's Governing Council that it would recalibrate its instruments at its December meeting had strengthened confidence in the ECB's commitment to monetary policy remaining a reliable source of support. This commitment had supported a broad-based easing of financial conditions.

In stock markets, those sectors and countries that had been hit hardest by the pandemic had benefited the most from hopes that a vaccine would restore economic and social activity more rapidly. This group included many large euro area countries. However, despite the recent strong rally, stock valuations of firms in many crisis-hit sectors in the euro area remained well below their pre-pandemic levels.

In euro area government bond markets, improving risk sentiment had supported a further decline in spreads of lower-rated sovereigns in recent weeks. All euro area countries could now fund long-term borrowing at, or below, rates equivalent to the GDP-weighted average of the rates on bonds of non-euro area advanced economies. This highlighted the extent of the monetary stimulus that the ECB was currently providing, and was expected to provide in the future, to mitigate the social and economic costs of the pandemic.

Monetary policy had likely also been a key factor mitigating the increase in euro area risk-free yields in response to positive macroeconomic shocks. Real long-term rates and inflation expectations had moved in opposite directions in recent weeks. Ten-year inflation swaps had increased by more than 25 basis points since the Governing Council's meeting on hopes of a faster recovery than previously expected, while real rates had steadily moved lower. In addition, the spread of the ten-year German Bund over the corresponding overnight index swap (OIS) rate had started trending lower from mid-September 2020 as German Bund yields had fallen more sharply than the equivalent OIS rates. Such developments typically reflected expectations of a change in the net supply of bonds, which was consistent with investors anticipating a recalibration of the pandemic emergency purchase programme (PEPP).

As a result, the degree of monetary policy accommodation currently embedded in euro area sovereign bond markets was practically unprecedented in the period since the global financial crisis, both in its scale and in its breadth across countries. The entire euro area GDP-weighted sovereign yield curve was significantly below its pre-pandemic level and firmly in negative territory. The dispersion across euro area ten-year sovereign yields had reached a new post-2008 low.

Benign conditions in sovereign bond markets and increased risk appetite had also left their mark on euro credit markets. Spreads of financial and non-financial issuers had fallen further and were now approaching

their pre-COVID-19-crisis levels.

As regards exchange rate developments, with the year-end approaching, risks of a no-deal Brexit had increased considerably over the past few days. While market participants both in the United Kingdom and in the euro area seemed to be prepared for a no-deal Brexit scenario, the implied volatility of the GBP/EUR exchange rate had increased sharply in recent days, especially for short-term maturities.

In addition, optimism about medical breakthroughs and a faster global recovery had fuelled further US dollar weakness. The nominal effective US dollar exchange rate had depreciated by more than 3.5% over the course of November 2020. There was model-based evidence that the improvement in risk sentiment, reflecting prospects of a faster global recovery, had been the major factor driving the recent appreciation of the euro. A comparison of the stock market performance of export-oriented euro area firms with the performance of firms whose business models depended more on domestic demand suggested that there was no clear evidence, so far at least, that negative competitiveness effects were perceived by investors to significantly counteract the positive global demand effects implied by a weaker US dollar.

Overall, financial conditions at the global level and in the euro area were highly accommodative. ECB staff analysis suggested that monetary policy had played an important part in restoring and easing financial conditions at the global level. It had added substantially to the positive effects stemming from receding risk aversion among market participants.

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

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

As regards the global economy, growth momentum had weakened amid rising cases of infection and stricter containment policies, while the vaccine news had lifted prospects for the future. Global GDP and global trade had suffered a massive blow in 2020 and the deep contraction in world demand had had major effects on exports of euro area firms. Large fiscal support packages had preserved jobs and boosted disposable incomes, especially in advanced economies, and private consumption had recovered robustly in the third quarter. However, the outlook for the fourth quarter had weakened substantially owing to the resurgence of COVID-19 infections, coupled with the assumption of a no-deal Brexit and a faltering fiscal stimulus in many countries. The Purchasing Managers' Index (PMI) had deteriorated markedly in November across major advanced economies with the exception of the United States. There had been a significant recovery in world trade in the third quarter. Based on forward-looking PMI data on new export orders, world trade was expected to continue to grow in the fourth quarter.

Global financial conditions had loosened further, driven by higher equity prices and declining spreads.

Brent crude oil prices had climbed above USD 48 per barrel on the back of the improving global risk sentiment, implying an increase of 20% since the October monetary policy meeting of the Governing Council. The euro had appreciated markedly against the US dollar (3.2%) but had remained broadly stable in nominal effective terms (0.3%).

Turning to the euro area, the December 2020 Eurosystem staff macroeconomic projections entailed a deterioration in the short-term outlook, followed by a robust rebound with real GDP expected to return to its pre-crisis level by mid-2022 in the baseline scenario, which was broadly within the range of forecasts by other institutions and the private sector. Regarding the latest developments, real GDP had expanded by 12.5%, quarter on quarter, in the third quarter of 2020, according to Eurostat. Manufacturing production had been broadly unchanged between July and September. Meanwhile, the recovery in services was lagging that in manufacturing, but was also slowing, and there was considerable divergence in activity levels across the services sector. The short-term outlook was dominated by the effect of the new containment measures introduced to stem the resurgence of coronavirus infections.

Focusing on demand components, private consumption had rebounded strongly in the third quarter but remained well below its pre-pandemic level. A contributing factor to the rebound had been strong demand for durable goods, including some consumption that had been postponed from the second quarter, although it remained uncertain to what extent "lockdown-induced pent-up demand" had been satisfied. Regarding the fourth quarter, retail sales had been resilient in October, while data on credit card payments, by contrast, pointed to a notable drop in spending in the last week of October and during November, although this was much smaller than the reduction in footfall in retail outlets and recreational establishments. With spending in decline and incomes still supported by government short-term work schemes, the saving ratio was expected to rise again in the fourth quarter.

Business investment, which was closely related to developments in output, had also rebounded in the third quarter. But the outlook for business investment remained subdued in the light of reduced revenues, low rates of capacity utilisation and fragile corporate balance sheets. Euro area trade had rebounded strongly in the third quarter of 2020 (driven by trade in goods) and had provided a positive contribution to GDP growth. However, renewed lockdown restrictions were likely to interrupt the pattern of the recovery in trade.

Looking at the euro area labour market, the unemployment rate had increased by only around 1.2 percentage points since February 2020 and stood at 8.4% in October 2020, as a result of special government support measures, especially in the form of job retention schemes including short-time work schemes. In the third quarter labour force growth had been recovering after the sharp declines recorded during the first few months of the pandemic. At the same time, high-frequency indicators suggested that job creation was being particularly hard hit during the pandemic.

Turning to nominal developments, the December 2020 Eurosystem staff projections included downward revisions to HICP inflation and HICP inflation excluding energy and food (HICPX). These projections, which foresaw HICP inflation rebounding from 0.2% in 2020 to 1.0% in 2021 and gradually increasing further, to stand at 1.4% in 2023, were at broadly similar levels to forecasts by other international institutions and the private sector over the medium-term horizon.

Headline inflation had remained at -0.3% in November according to Eurostat's flash estimate – unchanged for the third month in a row. HICPX inflation had also been broadly unchanged, at 0.2%, while energy and food inflation had declined marginally.

Much of the observed decline in services inflation was related to travel and hence a lot of this decline could be expected to be reversed in the future. Headline inflation was likely to remain negative in December 2020, but was expected to return to positive rates at the beginning of 2021. Special factors, including temporary changes in indirect taxes, had continued to play an important role in recent developments in headline inflation and in the short-term inflation outlook.

Negotiated wage growth had decreased to 1.6%, year on year, in the third quarter of 2020, continuing a slight downward trend from the level of 2.0% recorded in the first quarter of 2020. Nonetheless, the persistence in wage developments had given some support to inflation over the course of 2020. The growth rate of the GDP deflator had declined to 1.0% in the third quarter of 2020, from 2.4% in the second quarter, narrowing the gap vis-à-vis HICPX inflation. As activity had rebounded in the third quarter, profit margins had also improved, but remained below the pre-crisis level. An important stabilising factor for profit margins in the current crisis seemed to have been the more widespread use of public support schemes.

As regards inflation expectations, market and survey-based indicators of longer-term inflation expectations remained subdued. Participants in the ECB's Survey of Professional Forecasters (SPF) also continued to see higher risks of low inflation in the longer term. For example, the probability of HICP inflation of less than 1% had doubled from around 10% in 2013 to about 20% recently.

In terms of financial conditions in the euro area, the inversion of the EONIA forward curve had receded and there were no expectations of a cut in the deposit facility rate. Monetary policy expectations had contributed to keeping long-term risk-free rates low. Equity prices had increased since the last Governing Council meeting, largely driven by positive sentiment, but were not yet underpinned by strengthening earnings growth expectations. Corporate bond spreads had declined. The easing in financial conditions reflected higher pricing of risky assets after vaccine news as well as expectations of additional policy support.

As regards monetary developments, money growth was buoyant, as ample credit had been provided to non-financial firms since the start of 2020. There was evidence that bank credit had reached those parts of the economy where it was needed most. Following the introduction of the various policy support measures, bank lending to small and medium-sized enterprises (SMEs) had been much stronger than lending to other firms in the second quarter of 2020, in terms of both annual growth rates and the absolute size of loan flows. While nominal lending rates were favourable, real bank lending rates stood significantly higher than their pre-pandemic levels, owing to the lower level of near-term inflation expectations.

So far banks had maintained the robust capital position prevailing at the start of the crisis and the regulatory and government support measures had supported both the average risk weights and the size of banks' capital base. The increase in banks' provisioning costs for expected loan losses had thus far been absorbed by banks through lower profits. This suggested that there might be mounting pressure on banks to bring about a recovery in their margins by increasing lending rates and tightening financing conditions for firms and households.

Turning to fiscal policies, the euro area fiscal stance had been strongly expansionary in 2020 and the December 2020 Eurosystem staff projections included a significantly larger stimulus over the period 2021-22 than assumed previously. The Next Generation EU (NGEU) programme was projected to provide substantial support for growth, although uncertainty with respect to the actual use of the fund and its impact remained high.

Monetary policy considerations and policy options

Summing up, Mr Lane remarked that while the prospects for the roll-out of vaccines were encouraging, the pandemic continued to pose serious risks to public health and to the euro area and global economies. The December Eurosystem staff macroeconomic projections indicated a more pronounced impact of the pandemic on the economy in the short term.

Headline inflation had remained unchanged at -0.3% in November and measures of underlying inflation had generally stabilised after the downward trend seen previously, but they continued to point to a broad-based weakness in price pressures and wage dynamics, while the euro's appreciation also constituted a headwind to inflation. Market-based measures of longer-term inflation expectations remained at very subdued levels, after a slight improvement in response to the positive vaccine news.

The December projections pointed to a more protracted weakness in inflation than previously envisaged. The economic disruptions associated with the second wave of the pandemic implied a further delay in the convergence of inflation towards the Governing Council's inflation aim, as reflected by the 0.2 percentage point downward revision to the headline inflation projection for 2022.

Sentiment in financial markets had benefited from optimism about the prospect of vaccine roll-outs. However, the level of financial conditions was also predicated on expectations of further monetary policy easing. With respect to financing conditions for firms and households, the latest surveys pointed to potential fragility in the transmission of monetary policy via banks. According to the Survey on the Access to Finance of Enterprises, the net percentage of firms reporting a positive assessment of their access to credit had declined over the past six months and a sharp deterioration in access to both bank loans and credit lines was expected over the next six months. Together with the October 2020 round of the bank

lending survey, which had indicated a tightening of credit standards and terms and conditions, the incoming information confirmed that the potential amplification of adverse real-financial feedback loops remained a material risk and needed to be closely monitored.

Overall, the incoming data and the Eurosystem staff projections suggested a more pronounced near-term impact of the pandemic on economic activity and inflation than previously envisaged. In turn, the protracted nature of the pandemic shock entailed another delay in the convergence of inflation to the Governing Council's aim, while further risks of an unanchoring of inflation expectations were salient.

In response to the economic fallout from the resurgence of the pandemic, Mr Lane proposed to take additional monetary policy measures. These were aimed at preserving favourable financing conditions over the pandemic period, thereby supporting the flow of credit to all sectors of the economy, underpinning economic activity and safeguarding medium-term price stability. Preserving favourable financing conditions for an extended period of time helped to support inflation developments via multiple channels. First, it reduced financing uncertainty for banks, corporations, households and governments alike, and bolstered confidence, thereby encouraging spending and investment, and ultimately underpinning the economic recovery and inflation. Second, the assurance that favourable financing conditions would be maintained helped to prevent an undue tightening of financing conditions in an improving macroeconomic landscape. Keeping favourable financing conditions in such an environment could even accelerate the dynamics of the recovery, since better economic prospects combined with attractive financing conditions could fast-track consumption and investment. Finally, an extended period of favourable financing conditions would underpin confidence in the recovery and in the eventual pick-up in inflation, which would support inflation expectations and thereby provide additional monetary stimulus through lower real rates. Overall, preserving favourable financing conditions helped to counter the negative pandemic shock to the inflation path and thereby supported the achievement of the price stability objective via a reduction in uncertainty (notably about funding costs in the economy), but also through stronger forward guidance about how the central bank might respond to a future tightening of financing conditions.

With these aims in mind, Mr Lane proposed to take the following decisions:

First, to expand the PEPP envelope by €500 billion to a total envelope of €1,850 billion and lengthen the net purchase horizon at least until the end of March 2022.

The expansion and extension of PEPP purchases was the most suitable tool for helping to ensure that the level of financing conditions remained favourable to absorb the current shock and it could provide greater certainty about the duration of favourable financing conditions. This would help to reduce uncertainty and bolster confidence, thereby encouraging higher spending and investment, ultimately underpinning the economic recovery and helping to offset the downward impact of the pandemic on the projected path of inflation. This implied conducting purchases flexibly according to market conditions, with a view to preventing a tightening of financing conditions that was inconsistent with countering the downward impact of the pandemic on the projected path of inflation. In addition, the commitment under the PEPP to purchase flexibly over time, across asset classes and among jurisdictions would continue to support the smooth transmission of monetary policy.

The recalibration of the PEPP was proportionate to the risks facing the fulfilment of the Governing Council's mandate. It continued to be more efficient than a rate cut in the current pandemic conditions characterised by high uncertainty. And the previous assessment that, on balance, the benefits of PEPP purchases outweighed the potential costs also continued to hold.

The extension of the horizon to March 2022 would take into account the expected timeline for the roll-out of vaccines and the updated macroeconomic projections that saw the return to 2019 GDP levels only during the course of 2022.

Second, to extend the reinvestment of the principal payments from maturing securities purchased under the PEPP until at least the end of 2023. In any case, the future roll-off of the PEPP portfolio would be

managed to avoid interference with the appropriate monetary policy stance.

Third, to recalibrate the conditions on operations under the third series of targeted longer-term refinancing operations (TLTRO III) by extending the lower interest rate period by 12 months to June 2022, adding three additional operations and increasing the borrowing allowance to 60% of the eligible loan stock. In order to create an incentive for banks to sustain the current level of bank lending, the recalibrated TLTRO III borrowing conditions could be made available only to banks that achieved a new lending performance target. The extension of the pandemic-related low interest rate period, the addition of more operations and the increase in the amount that could potentially be borrowed under TLTRO III would preserve the very attractive funding conditions that in the past few months had supported the flow of credit to the real economy, even at a time of high stress. This would help banks to secure the liquidity required to extend loans to households and firms on very favourable terms.

Fourth, to extend to June 2022 the duration of the set of collateral easing measures adopted by the Governing Council on 7 and 22 April 2020, in order to provide assurance that banks could make full use of the Eurosystem’s liquidity operations, most notably the recalibrated TLTROs.

Fifth, to offer four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021, which would continue to provide an effective liquidity backstop.

Sixth, as concerns the asset purchase programme (APP), to continue to conduct purchases at a monthly pace of €20 billion. The Governing Council needed to reiterate that it continued to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it started to raise the key ECB interest rates. In addition, the Governing Council needed to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it started raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Seventh, to extend the Eurosystem repo facility for central banks (EUREP) and all temporary swap and repo lines with non-euro area central banks until March 2022.

Finally, to continue conducting regular lending operations as fixed rate tender procedures with full allotment at the prevailing conditions for as long as necessary.

As regards external communication, the Governing Council needed to: (a) confirm that, while acknowledging the good news about the roll-out of vaccines, the resurgence in COVID-19 infections and the associated containment measures implied a more pronounced near-term impact of the pandemic on the economy and a more protracted weakness in inflation than previously envisaged; (b) emphasise that a recalibration of monetary policy instruments was needed to ensure that financing conditions remained favourable to underpin the economic recovery and to counteract the negative impact of the pandemic on the projected path of inflation; (c) stress that the recalibrated PEPP would be deployed to preserve favourable financing conditions over the pandemic period across all sectors; (d) underline that purchases would be conducted flexibly according to market conditions and with a view to preventing a tightening of financing conditions that would be inconsistent with countering the downward impact of the pandemic on the projected path of inflation; in particular, if favourable financing conditions could be maintained with asset purchase flows that did not exhaust the envelope over the net purchase horizon of the PEPP, the envelope would not need to be used in full; equally, the envelope could be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation; (e) explain that the recalibrated TLTROs would preserve the very attractive funding conditions for banks, which would help to ensure that they could continue to offer favourable lending conditions and had sufficient liquidity to extend loans to households and firms; and (f) reiterate that it would continue to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moved towards its aim in a sustained manner, in line with its commitment to symmetry.

2. Governing Council's discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, members generally agreed with the overall assessment of the current economic situation in the euro area and the risks for activity provided by Mr Lane in his introduction. While the rebound of economic activity in the third quarter had been stronger than expected and the prospects for the roll-out of vaccines were encouraging, the pandemic continued to pose serious risks to public health and to the euro area and global economies. The resurgence in COVID-19 cases and the associated containment measures were significantly restricting euro area economic activity, which was expected to contract in the fourth quarter of 2020. Inflation remained very low in the context of weak demand and significant slack in labour and product markets. Overall, the incoming data and the Eurosystem staff projections suggested a more pronounced near-term impact of the pandemic on the economy and a more protracted weakness in inflation than previously envisaged.

The baseline scenario of the December 2020 Eurosystem staff macroeconomic projections for the euro area saw real GDP growth at -7.3% in 2020, 3.9% in 2021, 4.2% in 2022 and 2.1% in 2023. Compared with the September 2020 ECB staff macroeconomic projections, the outlook for economic activity had been revised down in the short term, but was seen to broadly recover to the level projected in the September baseline scenario over the medium term. Compared with the September 2020 ECB staff macroeconomic projections, the outlook for inflation had been revised down for 2020 and 2022.

As regards the external environment, members broadly shared the assessment provided by Mr Lane in his introduction. In the third quarter of 2020 global activity had rebounded more strongly than previously expected, but weakening growth momentum was foreseen in the fourth quarter amid rising COVID-19 cases and stricter containment policies. The resurgence of COVID-19 infections, coupled with the assumption made in the December 2020 Eurosystem staff projections of a no-deal Brexit and a faltering fiscal stimulus in many countries, had led to a weaker outlook at the turn of the year 2020/2021. The projections implied a marginal downward revision to growth in global activity and trade for 2021. Members expressed the view that an EU-UK agreement avoiding a no-deal Brexit and an agreement in the United States on a renewal of the fiscal stimulus constituted upside risks to these projections, while downside risks remained, related to the further evolution of the pandemic and the possibility of more protracted scarring effects.

Turning to euro area developments, members acknowledged that, following a sharp contraction in the first half of 2020, euro area real GDP had rebounded strongly in the third quarter. It was noted that this rebound had been stronger than expected in the September 2020 ECB staff projections and, together with a less pronounced decline in the second quarter than previously anticipated, constituted upside surprises for two consecutive quarters. Looking ahead, this experience suggested that rebounds could again be fairly dynamic once restrictions were lifted. Economic agents had apparently learned to adapt to such restrictions, for instance by adjusting their consumption patterns, and the economy had demonstrated a strong capacity to bounce back rather quickly. At the same time, the role of policy support, which remained critical in cushioning the impact of the pandemic, was underlined. Members widely agreed that the second wave of the pandemic and the associated intensification of containment measures observed since mid-October could be expected to result in a renewed significant decline in activity in the fourth quarter of 2020, although to a much lesser extent than observed in the second quarter of the year. It was highlighted that the carry-over effect from the decline in the fourth quarter was the main factor behind the downward revision to expected real GDP growth in 2021 in the staff projections.

In their discussion of the outlook for economic activity, members welcomed the positive news about the prospective roll-out of vaccines and thus a gradual resolution of the health crisis. This represented a major difference compared with the situation at the time of the Governing Council's last monetary policy meeting in October, as could be seen from the clear improvement in financial market sentiment. It was argued that

the prospect of more effective and more quickly disseminated vaccines implied a more benign pandemic scenario than previously anticipated in the September ECB staff projections and thus had a substantial bearing on the medium-term economic outlook, which was predicated on the expected evolution of the pandemic.

Members considered that the impact of positive news regarding the availability of vaccines on the medium-term outlook needed to be weighed against the impact of the more negative latest news on infection rates and containment measures in the short term. In this respect, a key question was how temporary the effects of the renewed downward shock would be and how long it would take the economy to recover from a double-dip of activity into negative territory. In this context, it was recalled that the expected shape of the recovery now looked very different from the V- and U-shapes expected earlier in the year. It was possible that given the more positive starting point, the second wave of the pandemic would not make the crisis deeper as a whole, but would make it more drawn out than previously anticipated. It was felt that a protracted curtailment of activity might inflict more lasting damage on a number of sectors, with heightened risks of rising insolvencies and unemployment affecting the medium-term outlook and more protracted scarring effects owing to the delay in the recovery.

Against this background, there was broad agreement among members that pronounced uncertainty remained a key theme in the economic outlook and it was observed that this uncertainty could ultimately be resolved in different ways. Although fiscal policy measures were supporting households and firms, the uncertainty about the economic outlook was weighing on business investment and causing consumers to remain cautious. If health concerns rather than containment measures were behind this caution, consumer spending would only recover more fully once the pandemic faded away. The evolution of the elevated household saving ratio thus remained a critical element in the staff projections, as its expected renewed spike and subsequent gradual unwinding was an important factor determining the profile of consumption. As long as jobs were preserved, the experience of the third quarter of 2020 suggested that the significant amount of accumulated savings could lead to a stronger rebound in growth. However, it was also recalled that while there might be pent-up demand for durable goods, demand for services would possibly stay depressed for longer.

Overall, the risks surrounding the euro area growth outlook were seen to remain tilted to the downside, although they were less pronounced. While the news about vaccine roll-outs in the near future was encouraging, downside risks remained, related to the implications of the pandemic for economic and financial conditions.

Regarding fiscal policies, an ambitious and coordinated fiscal stance remained critical in view of the sharp contraction in the euro area economy. Fiscal measures in response to the pandemic emergency should, as far as possible, be targeted and temporary. At the same time, weak demand from firms and households and the heightened risk of a delayed recovery warranted continued support from fiscal policy at the national and European levels. The key role of the NGEU package and the importance of it becoming operational without delay were reiterated. Some comfort was drawn from recent signals that the package was now closer to being adopted. It was underlined that provided that the funds were deployed for productive public spending and accompanied by productivity-enhancing structural reforms, the NGEU would contribute to a faster, stronger and more uniform recovery. It would thereby enhance resilience and the growth potential of Member States' economies, supporting the effectiveness of monetary policy in the euro area. Such structural policies were particularly important for addressing long-standing structural and institutional weaknesses and accelerating the green and digital transitions.

With regard to price developments, there was also broad agreement with the assessment presented by Mr Lane in his introduction. According to Eurostat's flash estimate, euro area annual inflation had remained unchanged at -0.3% in November. On the basis of oil price dynamics and taking into account the temporary reduction in the German VAT rate, headline inflation was likely to remain negative until early 2021. It was then expected to increase owing to the end of the temporary VAT reduction in Germany and

upward base effects in energy price inflation. At the same time, underlying price pressures were expected to remain subdued owing to weak demand, notably in the tourism and travel-related sectors, as well as to low wage pressures and the appreciation of the euro. Once the impact of the pandemic faded, a recovery in demand, supported by accommodative fiscal and monetary policies, would put upward pressure on inflation over the medium term. Market-based indicators and survey-based measures of longer-term inflation expectations had remained at low levels.

In their discussion of the outlook for inflation in the December Eurosystem staff projections, members noted that because of the pandemic there was exceptionally high uncertainty at present regarding the measurement of economic slack and of inflation, as well as the relationship between them over time. This was probably also affecting the range of plausible inflation projections and, in the light of past projection errors for inflation, suggested the need to include a degree of caution in the projection baseline. The expected inflation profile in the December Eurosystem staff projections was low when compared with past projections, and it remained well below the Governing Council's inflation aim even at the end of the current projection horizon in 2023. The staff projections implied that by the end of the projection horizon, with the exception of the year 2018, euro area inflation would have remained below the inflation aim for around a decade. Given the repeated experience of subdued inflation outturns and protracted errors in inflation projections, the question was raised as to whether persistently subdued inflation could in part be ascribed to structural factors, such as digitalisation. A question was also raised about the extent to which recent projection errors could be due to developments in certain specific items, such as those related to travel, which likely had a very low actual weight in current consumption during the pandemic. Members also paid close attention to the role of the exchange rate in the inflation outlook. It was pointed out that the nominal effective exchange rate currently stood at an all-time high and that the recent appreciation could contribute significantly to the subdued inflation outlook. At the same time, it was recalled that the impact of the exchange rate on inflation depended on the nature and persistence of the shock driving the exchange rate movement.

As regards inflation expectations, members noted that since the end of 2019 longer-term inflation expectations in the SPF had remained relatively resilient and stood close to the longer-term downward trend in actual HICP inflation. The December 2020 Eurosystem staff projections did not imply a major reversal of this trend. Market-based measures of longer-term inflation expectations had increased to pre-pandemic levels on the news about the prospective roll-out of vaccines. However, they remained at very low levels.

On the monetary analysis, members broadly agreed with the assessment provided by Mr Lane in his introduction that strong broad money (M3) growth had been supported by the Eurosystem's ongoing asset purchases, which had become the largest source of money creation. The narrow monetary aggregate M1 continued to be the main contributor to broad money growth, reflecting a still heightened preference for liquidity in the money-holding sector and a low opportunity cost. The annual growth of bank loans to the private sector had plateaued, although at higher rates than prior to the COVID-19 pandemic. Meanwhile, monthly lending volumes had receded, which indicated diminishing emergency liquidity needs, weak investment and tighter conditions on loans to firms, as signalled by the ECB's bank lending survey for the third quarter of 2020.

The TLTRO III operations were seen to be providing continuous support to bank lending. Together with the liquidity buffers that firms had accumulated, the improved resilience of bank balance sheets at the beginning of the crisis and the recent extension of fiscal and macroprudential policy measures, TLTRO III was considered to be mitigating the risks of adverse real-financial feedback loops. At the same time, it was cautioned that credit risks and the probability of default of non-financial corporations were increasing as the crisis endured. Views were exchanged on the role of loan supply versus loan demand factors, with reference being made to elevated corporate savings and a possible satiation of precautionary liquidity needs among companies.

Monetary policy stance and policy considerations

With regard to financial conditions, members widely shared the assessments provided by Ms Schnabel and Mr Lane in their introductions. Namely, market sentiment had improved notably following the news of the successful development of vaccines and on account of expected monetary policy measures. Interest rate spreads of euro area sovereigns had fallen below their pre-crisis levels. It was cautioned, however, that uncertainty remained high and positive sentiment could erode quickly in the event of negative news. Concerns were voiced over risks related to developments in the exchange rate that might have negative consequences for the inflation outlook.

All members agreed that, in view of the economic fallout from the resurgence of the pandemic, the downward revision to the projected inflation path, and the resulting risks of an unanchoring of inflation expectations, additional monetary policy measures were necessary to preserve favourable financing conditions over the pandemic period, thereby supporting the flow of credit to all sectors of the economy and underpinning the economic recovery. It was observed that the December Eurosystem staff inflation projections were far below the Governing Council’s inflation aim. Against this background, decisive action to ensure that financing conditions remained favourable was deemed necessary.

It was recalled, however, that, although the medium-term inflation outlook was not in line with the Governing Council’s aim, the current circumstances differed in some respects from the emergency situation during which the PEPP had initially been decided upon. The current environment warranted a recalibration of policy instruments to safeguard favourable financing conditions, rather than the adoption of additional measures to combat the crisis. The remark was made that the Governing Council’s medium-term orientation called for patience and persistence on reaching its aim over time and that the PEPP horizon was therefore an important parameter. At the same time, the argument was made that a further lowering of yields from their already highly accommodative levels could be expected to have only marginal effects on growth and inflation, while increasing the risks of unintended side effects, in particular for financial stability. Overall, the Governing Council would need to monitor changes in the outlook for price stability carefully over the coming months.

Members expressed broad agreement with the monetary policy package proposed by Mr Lane in his introduction. It aimed at maintaining favourable financing conditions for an extended period during the pandemic and ensuring that the flow of credit to all sectors of the economy continued to be supported, thereby underpinning economic activity and safeguarding medium-term price stability. The expansion and extension of PEPP purchases and the recalibration of the TLTRO III conditions were widely seen as the most suitable tools to ensure that financing conditions remained favourable throughout the pandemic.

Given that the return to the Governing Council’s inflation aim was delayed by the pandemic, it was widely considered an appropriate and proportional response to the prevailing type of shock to increase the horizon of net purchases under the PEPP until March 2022, extend the reinvestments of the principal payments from maturing securities purchased under the PEPP until the end of 2023, and to add more TLTRO III operations, extending the pandemic-related low interest rate period to June 2022. Overall, it was agreed that the proposed longer horizon of the PEPP and TLTRO III was broadly in line with the expected duration of the pandemic crisis, the continued uncertainty about the roll-out of the vaccines, and the expected return of economic activity to its pre-pandemic level. It was also agreed that the assessment by Mr Lane that, on balance, the benefits of PEPP purchases and the TLTRO III outweighed the potential costs continued to hold.

The PEPP was seen as the cornerstone of the Governing Council’s monetary policy package, as thanks to its flexibility it had proven particularly effective in ensuring the Eurosystem maintained a stabilising presence in the markets, providing a backstop against a disorderly repricing of risk. The PEPP also contributed to easing the monetary policy stance in response to the downward impact of the pandemic on the path of inflation. An expansion of the PEPP envelope by €500 billion, in addition to the €20 billion of

monthly purchases under the APP, was generally seen as appropriate to underpin the Governing Council's commitment to maintaining favourable financing conditions over the extended pandemic period.

A more moderate increase in the PEPP envelope was advocated by a number of members based on the argument that significant space for purchases was still available from past decisions and that in an environment of high uncertainty it was worth "keeping some powder dry" by maintaining the option to further adjust the envelope in the future.

However, some arguments were also made in favour of a larger envelope. While the already accommodative level of current financing conditions was acknowledged, it was argued that the proposed increase in the PEPP envelope was insufficient to ease financing conditions further and bring inflation closer to the Governing Council's aim, also in the light of the fact that the additional envelope of €120 billion for the APP would run out by the end of 2020.

Members highlighted the flexibility embodied in the PEPP. It was argued that the focus on preserving favourable financing conditions implied a move away from a constant monthly pace of purchases towards adjusting the pace according to market conditions, with a view to preventing a tightening of financing conditions inconsistent with countering the downward impact of the pandemic on the projected path of inflation. This approach, combined with forceful communication, could allow the Governing Council to reduce the pace of purchases while having an equivalent effect on financing conditions. This could result in greater efficiency and in using less than the entire envelope over the duration of the programme. The flexibility in the allocation of the PEPP purchases over time was seen as being well aligned with the principle of proportionality and the Governing Council's monetary policy stance. At the same time, it was seen as essential for the Governing Council to state that it stood ready to increase the envelope further if needed.

Attention was drawn to possible constraints on and side effects of additional purchases, such as the risks of moral hazard, fiscal dominance and distorted market functioning. Safeguards to guarantee a sufficient distance from monetary financing concerns – such as the guidance for the allocation of the stock of asset purchases according to the capital key – were seen as important to maintain legitimacy and independence. It was emphasised that in the present environment fiscal policy remained the most appropriate response to the pandemic-driven crisis and monetary policy should play a secondary role.

Members also exchanged views on how to assess favourable financing conditions and felt that financing conditions should be considered in a holistic way, with their appropriate level also depending on the inflation outlook. It was deemed important to explain that maintaining favourable financing conditions allowed for some flexibility if the fundamentals changed or if conditions tightened endogenously in response to economic developments. In addition, the relevant financing conditions were seen to pertain to all private and public sectors of the economy, comprising interest rates as well as credit volumes and conditions.

With regard to the recalibration of the TLTRO III conditions, the three proposed changes – the extension of the pandemic-related low interest rate period, the addition of more operations and the increase in the amount that could potentially be borrowed – were seen as appropriate ways to preserve attractive funding conditions and to help banks to secure the liquidity required to keep extending loans to households and firms on favourable lending terms. The new lending performance target was considered an important element -giving banks an incentive to provide additional credit, whereas the current attractive pricing of TLTRO III seemed sufficient to provide ongoing backing for bank-based monetary policy transmission. The proposed increase in the amount that could potentially be borrowed under TLTRO III was seen as supporting the flow of credit to the real economy, allowing banks to secure liquidity on very favourable terms. It was recalled that this amount was defined in relation to euro area banks' stock of eligible loans, which amounted to just over half of their total loan book.

A number of reservations were expressed with regard to the proposed increase in the borrowing allowance to 60%, related, in particular, to concerns that it would make banks increasingly dependent on the

Eurosystem as their funding source and could induce banks to invest more in sovereign debt. Against this background, broad agreement was reached to raise the borrowing allowance to 55% of the stock of eligible loans.

As regards communication, members widely agreed with the elements proposed by Mr Lane in his introduction. Although uncertainty continued to be pronounced, it was deemed important to acknowledge the positive news that had emerged since the last meeting and its impact on the balance of risk. At the same time, it was felt that the Governing Council needed to stress that the medium-term inflation outlook was far from an inflation rate of below, but close to, 2%. The view was expressed that the Governing Council could not afford to be perceived as complacent about the inflation path embodied in the projections.

In addition, it needed to be stressed that the recalibration of the Governing Council’s policy measures provided sizable and flexible support in order to maintain favourable financing conditions over the extended pandemic period. An important shift in implementing the PEPP was to be highlighted and it should be underlined that if favourable financing conditions could be maintained with asset purchase flows that did not exhaust the full amount available under the PEPP, the envelope need not be used in full. At the same time, the Governing Council should also indicate its willingness to recalibrate the PEPP in the future, as needed, to ensure that overall financing conditions were sufficiently favourable to counteract the impact of the pandemic on the medium-term inflation outlook. In this context, it was noted that the important role that the reinvestment of principal payments played for the monetary policy stance had to be underlined as well.

Furthermore, the Governing Council needed to announce that it would carefully monitor whether its measures were sufficient to guarantee a return of inflation to its aim, and to reiterate that it stood ready to adjust all of its instruments, as appropriate, to ensure that inflation moved towards its aim in a sustained manner, in line with its commitment to symmetry. This could also include possibly cutting the deposit facility rate. The Governing Council would also continue to monitor the effects of the exchange rate on the inflation outlook.

Finally, the need for an ambitious and coordinated fiscal stance in view of the sharp contraction in the euro area economy was to be emphasised, underlining the key role of the NGEU package and the importance of it becoming operational without delay.

Monetary policy decisions and communication

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council decided to recalibrate its monetary policy instruments as follows:

First, the interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility would remain unchanged at 0.00%, 0.25% and -0.50% respectively. The Governing Council expected the key ECB interest rates to remain at their present or lower levels until it had seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence had been consistently reflected in underlying inflation dynamics.

Second, the Governing Council decided to increase the envelope of the pandemic emergency purchase programme (PEPP) by €500 billion to a total of €1,850 billion. It also extended the horizon for net purchases under the PEPP to at least the end of March 2022. In any case, the Governing Council would conduct net purchases until it judged that the coronavirus crisis phase was over.

The Governing Council also decided to extend the reinvestment of principal payments from maturing securities purchased under the PEPP until at least the end of 2023. In any case, the future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate monetary policy stance.

Third, the Governing Council decided to further recalibrate the conditions of the third series of targeted longer-term refinancing operations (TLTRO III). Specifically, it decided to extend the period over which

considerably more favourable terms would apply by twelve months, to June 2022. Three additional operations would also be conducted between June and December 2021. Moreover, the Governing Council decided to raise the total amount that counterparties would be entitled to borrow in TLTRO III operations from 50% to 55% of their stock of eligible loans. In order to provide an incentive for banks to sustain the current level of bank lending, the recalibrated TLTRO III borrowing conditions would be made available only to banks that achieved a new lending performance target.

Fourth, the Governing Council decided to extend to June 2022 the duration of the set of collateral easing measures adopted by the Governing Council on 7 and 22 April 2020. The extension of these measures would continue to ensure that banks could make full use of the Eurosystem’s liquidity operations, most notably the recalibrated TLTROs. The Governing Council would reassess the collateral easing measures before June 2022, ensuring that Eurosystem counterparties’ participation in TLTRO III operations was not adversely affected.

Fifth, the Governing Council also decided to offer four additional pandemic emergency longer-term refinancing operations (PELTROs) in 2021, which would continue to provide an effective liquidity backstop.

Sixth, net purchases under the asset purchase programme (APP) would continue at a monthly pace of €20 billion. The Governing Council continued to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it started raising the key ECB interest rates.

The Governing Council also intended to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it started raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Seventh, the Eurosystem repo facility for central banks (EUREP) and all temporary swap and repo lines with non-euro area central banks would be extended until March 2022.

Finally, the Governing Council decided to continue conducting its regular lending operations as fixed rate tender procedures with full allotment at the prevailing conditions for as long as necessary.

The monetary policy measures taken today would contribute to preserving favourable financing conditions over the pandemic period, thereby supporting the flow of credit to all sectors of the economy, underpinning economic activity and safeguarding medium-term price stability. At the same time, uncertainty remained high, including with regard to the dynamics of the pandemic and the timing of vaccine roll-outs. The Governing Council would also continue to monitor developments in the exchange rate with regard to their possible implications for the medium-term inflation outlook. The Council therefore continued to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moved towards its aim in a sustained manner, in line with its commitment to symmetry.

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

Introductory statement

Introductory statement to the press conference of 10 December 2020

Press releases

Monetary policy decisions
ECB extends pandemic emergency longer-term refinancing operations
ECB prolongs support via targeted lending operations for banks that lend to the real economy

Meeting of the ECB's Governing Council, 9-10 December 2020

Members

- Ms Lagarde, President
- Mr de Guindos, Vice-President
- Mr Centeno
- Mr Hernández de Cos
- Mr Herodotou*
- Mr Holzmann
- Mr Kazāks
- Mr Kažimír
- Mr Knot
- Mr Lane
- Mr Makhlouf*
- Mr Mersch
- Mr Müller
- Mr Panetta
- Mr Rehn
- Mr Reinesch
- Ms Schnabel
- Mr Stournaras*
- Mr Vasiliauskas
- Mr Vasle

- Mr Vella
- Mr Villeroy de Galhau*
- Mr Visco
- Mr Weidmann
- Mr Wunsch

* Members not holding a voting right in December 2020 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 Aucremanne
- Mr Bradeško
- Ms Buch
- Mr Demarco
- Ms Donnery
- Mr Gaiotti
- Ms Goulard
- Mr Haber

- Mr Kaasik
- Mr Kuodis
- Mr Kyriacou
- Mr Lünnemann
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Sleijpen
- Mr Tavlas
- Mr Välimäki

Other ECB staff

- Mr Bracke, Deputy 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, 18 February 2021.

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