EUROPEAN CENTRAL BANK
EUROSYSTEM

25 June 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, 3-4 June 2020

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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 monetary policy meeting on 29-30 April 2020. Three key conclusions could be drawn on the basis of recent market developments.

First, the ECB's monetary policy measures, together with the Franco-German recovery fund proposal which was subsequently broadly taken up in the package proposed by the European Commission, had reduced downside tail risks for the euro area. A drop in coronavirus (COVID-19) infection numbers and further large fiscal stimulus measures in other advanced economies had added to the improved sentiment.

Second, the broad-based decline in risk premia on the back of these developments had offset the tightening impact of a deterioration in macroeconomic fundamentals. While developments in euro area financial markets had, until recently, been broadly consistent with the prospect of a swift economic recovery, expectations were gradually being revised downwards.

Third, and as a consequence, the latest easing of financial conditions in the euro area in part hinged on the contribution of fiscal and monetary policy to mitigating fragmentation risks across markets and jurisdictions.

The ECB's composite indicator of systemic stress was consistent with these broad conclusions. It showed that systemic stress across a range of financial markets had continued to steadily recede, although it remained at an elevated level compared with the period before the coronavirus pandemic in both the euro area and the United States. Global volatility too had abated across various market segments, in part owing to the effective liquidity backstop provided by central banks worldwide.

In this environment, overall funding conditions in euro area sovereign bond markets had eased further, as reflected in a downward shift of the euro area GDP-weighted sovereign yield curve, which remained, however, above its pre-crisis level.

Empirical evidence suggested that monetary policy had contributed significantly to the fall in bond yields since the announcement of the pandemic emergency purchase programme (PEPP). The PEPP was offsetting upward pressure on bond yields that resulted from the crisis-induced increase in the free float ratio, i.e. the share of bonds held by price-sensitive investors relative to total bond supply. Prevailing market segmentation implied that monetary policy needed to act in a more targeted and flexible way to preserve policy transmission across the entire euro area. Fiscal developments, and in particular the news relating to a more ambitious European fiscal response to the crisis, had reinforced the effectiveness of the ECB's measures. As a result, fiscal and monetary policy in the euro area were starting to act as complements, thereby effectively containing tail risks.

Downward pressure on sovereign bond yields had also contributed to easing funding conditions in euro area corporate bond markets, although they too remained relatively tight compared with the pre-pandemic period.

The exceptionally high pace of gross issuance in the investment grade corporate bond market had not decelerated, highlighting the continued high financing needs of companies, even as lockdown measures were gradually being eased. The ECB's monetary policy was providing considerable support to corporate credit markets, including the commercial paper market, helping firms manage their cash flow needs. Financial investment grade commercial paper rates had come down notably in recent weeks from their peaks, while non-financial commercial paper rates had stabilised. The ECB's presence in the commercial paper market had helped firms reduce rollover risks, which in turn had also contributed to an increase in the issuance of longer-dated paper.

Improvements on the debt funding side for firms had been accompanied by improvements in equity markets. All the major global indices had posted substantial gains since the Governing Council's previous monetary policy meeting, further offsetting a large part of the losses recorded at the start of the coronavirus pandemic. The decline since the beginning of 2020 was still highest in the euro area, but the Euro Stoxx index had more recently been outperforming other markets following the Franco-German recovery fund proposal. Since its announcement on 18 May 2020, the Euro Stoxx index had risen by 13%, compared with 8% for the S&P 500 index, mainly reflecting a further decline in the equity risk premium. This easing had, however, been partially offset by deteriorating medium to long-term earnings growth expectations, consistent with a shift in expectations towards a more protracted impact of the crisis.

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.

The external environment was characterised by a sharp downturn in global activity and trade, which implied a reduction in foreign demand for the euro area. Incoming data confirmed that the global economy had fallen into an unprecedented recession in the first half of the year. The global (excluding the euro area) composite output Purchasing Managers' Index (PMI) had extended the losses registered in the first quarter, declining to a historical low in April before recovering somewhat in May. The downturn in global trade was expected to be even more severe than the contraction in output as a result of closed borders and disruptions to logistics. Moreover, trade developments tended to be procyclical, especially in downturns. Data on new export orders pointed to a sharp fall of global trade in the second quarter of the year.

Financial conditions had continued to ease in advanced and emerging market economies since the April monetary policy meeting, but remained substantially tighter than before the pandemic shock. Brent crude oil prices had increased by 62% since the April meeting, but continued to stand at low levels. The euro had appreciated somewhat against the US dollar even if it remained broadly unchanged in nominal effective terms.

In the euro area, the pandemic and the associated containment measures were taking a toll on productive capacity and domestic demand. In the first quarter of 2020, euro area real GDP had decreased by 3.8%, quarter on quarter, although strict containment measures were only in place from mid-March in most countries. At a sectoral level, both the manufacturing and services sectors had been severely hit by the pandemic. This had been reflected by PMI business expectations in the manufacturing and services sectors reaching record lows in March and April, before bouncing back somewhat in May.

The pandemic shock had also led to a sharp increase in household savings, as consumption had decreased more strongly than income. The exceptional degree of uncertainty had led to the postponement of consumption and investment with strongly negative effects on growth. Labour market conditions were rapidly deteriorating and a sizeable decline in euro area trade was expected for the second quarter of 2020.

Overall, the incoming data pointed to a further significant contraction of real GDP in the second quarter. While euro area activity was expected to rebound in the third quarter as the containment measures were eased further, the overall speed and scale of the rebound remained highly uncertain.

This assessment was broadly reflected in the June 2020 Eurosystem staff macroeconomic projections for the euro area. The June projections signalled that output would decline steeply (by 13.0%) in the second quarter of 2020, after having already declined by 3.8% in the first quarter. This was expected to be only partly reversed in the second half of the year, with quarterly growth rates of 8.3% and 3.2% projected for the third and fourth quarters respectively. Under this baseline, annual output was projected to shrink by 8.7% in 2020, followed by positive growth rates of 5.2% in 2021 and 3.3% in 2022. Compared with the March 2020 ECB staff macroeconomic projections, the outlook for real GDP growth had been revised substantially downwards by 9.5 percentage points in 2020 and revised upwards by 3.9 percentage points in 2021 and 1.9 percentage points in 2022.

In general, the extent of the contraction and the recovery was seen to depend crucially on the duration and the effectiveness of the containment measures, the success of policies to mitigate the adverse impact on incomes and employment, and the extent to which supply capacity and domestic demand would be permanently affected. The euro area fiscal stance provided a strong contribution to stabilising GDP growth, based on a combination of discretionary policy measures and the working of automatic stabilisers. However, this was resulting in large increases in deficit and debt. For 2020, the anticipated strong increase in the euro area government debt-to-GDP ratio was expected to be pushed higher by an unfavourable interest-growth differential.

Turning to price developments, headline inflation had dropped further from 0.3% in April to 0.1% in May (according to Eurostat's flash estimate). Energy inflation continued to push down headline inflation, while inflation for (especially unprocessed) food remained elevated and could affect consumers' inflation perceptions. The HICP excluding energy and food had remained at 0.9% in May, unchanged from April. Overall measures of underlying inflation had fallen somewhat since February, partly reversing the earlier gradual increases. Pipeline price pressures had weakened and wage negotiations remained on hold.

On the basis of current and futures prices for oil, headline inflation was likely to decline somewhat further over the coming months and to remain subdued until the end of the year. Over the medium term, weaker demand was expected to put downward pressure on inflation, which was expected to be only partially offset by upward pressures related to supply constraints. For the long term, survey-based measures of inflation expectations had mostly remained at historical lows, but stood considerably higher than market-based measures.

This assessment was also reflected in the June 2020 Eurosystem staff projections, which entailed a substantial downward revision of the inflation outlook in the baseline scenario, with headline inflation expected to average 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. The revisions to the outlook for core inflation indicated an even larger deterioration, with core inflation projected to reach only 0.9% in 2022. Compared with the March 2020 ECB staff macroeconomic projections, the outlook for HICP inflation had been revised downwards by 0.8 percentage points in 2020, 0.6 percentage points in 2021 and 0.3 percentage points in 2022. While to some extent related to the lower path of energy prices, the revisions also reflected lower price pressures on account of the sharp decline in real GDP and the associated significant increase in economic slack.

As regards euro area financial conditions, risk-free rates had changed little since the Governing Council's April monetary policy meeting. The latest EONIA forward curve had also remained largely unchanged, indicating no expectations of a rate cut in 2020. Sovereign bond market fragmentation had declined but spreads remained elevated. A partial recovery in risk asset prices was attributable to an improvement in risk sentiment. Meanwhile, corporate fundamentals continued to deteriorate. Overall, financial conditions had been broadly stable since the Governing Council's April meeting, but remained significantly tighter than before the pandemic crisis.

Turning to money and credit developments, broad money (M3) growth had increased to 8.3% in April 2020, from 7.5% in March. Strong money growth reflected bank credit creation, which was driven to a large extent by the acute liquidity needs in the economy. Moreover, high economic uncertainty was triggering a shift towards money holdings for precautionary reasons. In this environment, the narrow monetary aggregate M1, encompassing the most liquid forms of money, continued to be the main contributor to broad money growth. The annual growth rate of loans to non-financial corporations rose further to 6.6% in April 2020, up from 5.5% in March, reflecting firms' need to finance their ongoing expenditures and working capital in a context of rapidly declining revenues. At the same time, the annual growth rate of loans to households decreased to 3.0% in April, from 3.4% in March, amid containment measures, declining confidence and a deteriorating labour market.

Monetary policy considerations and policy options

Summing up, Mr Lane observed that the incoming information confirmed that the euro area economy was experiencing an unprecedented contraction. Survey data and real-time indicators for economic activity had shown some positive signs as the containment measures were gradually eased. Nonetheless, these readings indicated only a minor improvement compared with the speed at which the indicators had plummeted in the preceding two months. The steep decline of output in the second quarter that followed the decline in the first quarter was projected to be only partly reversed in the second half of the year. Under the baseline, which had been revised substantially downwards relative to the March projections, annual output was projected to shrink by 8.7% in 2020, followed by positive growth rates of 5.2% in 2021 and 3.3% in 2022. The baseline was surrounded by an exceptional degree of uncertainty. The June 2020 staff projections also entailed a substantial downward revision of the inflation outlook in the baseline scenario, with headline inflation expected to average 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. It was important to note that without the vigorous policy response (including an estimated 2.5 percentage point contribution to 2020 output from fiscal policy), the projected paths for output and inflation would be even lower.

The announcement of the PEPP on 18 March had arrested a sharp sell-off in bond and equity markets that was threatening to undermine the ECB's monetary policy stance and its effective transmission. Both the highly accommodative pricing of the targeted longer-term refinancing operations (TLTRO III) and the collateral easing measures were providing strong incentives for banks to maintain credit flows to the real economy. In addition, the unconditional refinancing operations together with the establishment of international swap lines were ensuring that liquidity in the banking system was protected. These measures had acted as a stabilising force during this exceptional period.

Nevertheless, financial conditions had tightened sharply since the escalation of the pandemic, as the downward shift in risk-free rates had not been fully transmitted to the broader set of asset prices and yields that set the financial conditions for the real economy. In particular, the upward pressure on average sovereign yields had contributed to higher corporate and bank bond yields and a decline in equity valuations, especially for bank stocks.

Against this background, Mr Lane emphasised that two main factors called for further policy action at the current meeting. First, the medium-term outlook for price stability was threatened by the fallout from the coronavirus crisis: in particular, the baseline in the new projections saw 0.3 and 0.6 percentage point downward revisions in the 2022 headline and core inflation rates respectively, with substantially larger revisions in the severe scenario. Second, financial conditions for the euro area as a whole were significantly tighter compared with the period before the pandemic, whereas the growth and inflation outlook called for easier financial conditions.

In order to counter these pandemic-related negative revisions to the inflation outlook, the appropriate policy response was to increase the size of the PEPP envelope. In March, the Governing Council had decided to launch the PEPP "to counter the serious risks to the transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus". As expressed in the preamble to the PEPP legal act: "It is also clear that this situation hampers the transmission of the monetary policy impulses and adds severe downside risks to the relevant inflation outlook. Against this background, the PEPP was a measure which was proportionate to counter the serious risks to price stability, the monetary policy transmission mechanism and the economic outlook in the euro area, which are posed by the outbreak and escalating diffusion of COVID-19."

Accordingly, the downward revision to the inflation outlook, together with the further downside risks captured in the severe scenario, called for a temporary phase of additional asset purchases, in order to deliver the monetary conditions that could support a return to the pre-crisis inflation trajectory within the projection horizon.

In terms of timing, the lags in the transmission of monetary policy to inflation dynamics meant that it was important to take a significant step in addressing the increase in the inflation shortfall. Furthermore, the value of a timely response was compounded by the importance of avoiding a sustained unanchoring of inflation expectations, in view of the downside risks faced and the near-term prospect of a sustained phase of very low inflation outcomes.

In terms of the overall monetary stance, the PEPP provided a temporary additional source of accommodation, which operated alongside the more standard suite of policy instruments (the level of the ECB policy rates; the APP; forward guidance; and the TLTRO III programme). Before the pandemic shock, this set of measures had been configured to lift inflation towards the Governing Council's policy aim over the medium term. Given the scale and unique nature of the shock, it was better to tackle the substantial downward shift in the inflation outlook through a targeted and temporary programme (the PEPP), rather than a recalibration of the existing policy package. Moreover, an increase in the size of the PEPP envelope would also provide additional protection against the risks of fragmentation across market segments, which could potentially obstruct the smooth transmission of monetary policy. At the same time, the envelope should be understood as a ceiling, which implied that in the event of significant upside surprises to the outlook, the full envelope would not need to be used.

Looking ahead, incoming economic and financial data and subsequent projection rounds would provide essential guidance as to whether the pandemic-related negative shock to inflation dynamics had been sufficiently contained. Ongoing monetary accommodation would likely prove necessary in order to support the macro-financial conditions conducive to making further progress towards the Governing Council's inflation aim. Once the pandemic shock to the inflation path had subsided, the monetary stance could again be controlled by calibrating the Governing Council's pre-crisis suite of policy instruments.

In terms of the overall monetary policy strategy, purchases of government bonds under the PEPP and the APP were an effective tool for delivering on the Treaty-assigned price stability objective in the current environment. This was especially the case given the already low levels of the ECB's policy rates and the crucial role of sovereign yields in determining the financing conditions of firms and households. These measures were also efficient, especially in combination with other policy measures, since other instruments would require extraordinary adjustment to generate the same impact on inflation dynamics. The easing of credit conditions would help viable businesses continue to operate and retain as many workers as possible. In turn, preserving jobs was the most important factor in determining incomes and the financial security of individuals and families in the euro area. The Governing Council's measures played a key role in supporting credit intermediation through banks, not least since the business prospects of the banking system depended first and foremost on the macroeconomic outlook. Accordingly, the PEPP and the APP were proportionate measures under the current conditions for pursuing the price stability objective, with sufficient safeguards having been built into the design of these programmes to limit potential adverse side effects, including risks of fiscal dominance, and to address the monetary financing prohibition.

On the basis of this assessment, Mr Lane proposed that the Governing Council take the following decisions:

First, to increase the size of the PEPP by €600 billion. The size of the proposed envelope was calculated to make a significant contribution to offsetting the pandemic-related downward shift in the projected inflation path.

Second, to extend the net purchase horizon of the PEPP to at least the end of June 2021. This would align the Governing Council's minimum purchase horizon with the phase of the most severe pandemic-related restrictions on economic activity and the weakest inflation pressures. It was also broadly aligned with the horizons of the other monetary policy measures taken by the Governing Council in response to the pandemic. In any case, net asset purchases under the PEPP would be conducted until the Governing Council judged that the coronavirus crisis phase was over.

Third, to announce that maturing principal payments from securities purchased under the PEPP would be reinvested until at least the end of 2022 and that, in any case, the future roll-off of the PEPP portfolio would be managed to avoid interference with the desired monetary stance. This reinvestment strategy for the PEPP would avoid the risk of an unwarranted tightening of financial conditions at a time when the recovery from the pandemic shock was likely to remain incomplete. At the same time, a separate reinvestment strategy (distinct from the APP) was appropriate in view of the temporary and emergency nature of the PEPP.

Fourth, to continue net purchases under the APP at a monthly pace of €20 billion, together with the purchases under the additional €120 billion temporary envelope until the end of the year. The Governing Council would continue 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.

Fifth, 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.

Sixth, to keep the key ECB interest rates unchanged and to expect them to remain at their present or lower levels until the Governing Council 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.

In the current stressed market conditions, asset purchases (together with the TLTRO III programme) were the most effective and efficient tools for adding monetary accommodation. High uncertainty and heightened risk aversion would weaken the transmission of policy rate cuts to the market reference rates that mattered for the pricing of credit to households and firms, especially in the context of a temporary shock. In this environment, asset purchases were more efficient at easing funding conditions and thereby the lending rates that mattered for the real economy.

In its public communication, the Governing Council needed to confirm that the incoming information indicated an unprecedented contraction of the euro area economy; highlight that the projections entailed a substantial downward revision to both the level of economic activity and the inflation outlook over the whole projection horizon, while the baseline was surrounded by an exceptional degree of uncertainty; emphasise that additional monetary policy action had become necessary to ensure the necessary degree of monetary accommodation and a smooth transmission of monetary policy across sectors and jurisdictions, in order to safeguard medium-term price stability; explain that its decision to recalibrate the PEPP was in response to the pandemic-related negative revision to the projected inflation path and would further ease the general monetary policy stance, supporting the funding costs of the real economy; stress that the PEPP also allowed the Governing Council to counter risks to the smooth transmission of monetary policy through the flexible implementation of the purchases over time, across asset classes and among jurisdictions; and reiterate that the Governing Council would do everything necessary within its mandate and continued to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moved towards its aim in a sustained manner.

2. Governing Council's discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, members generally agreed with the assessment of the current economic situation in the euro area and the outlook provided by Mr Lane in his introduction. Incoming information confirmed that the euro area economy was experiencing an unprecedented contraction. In the first quarter of 2020, euro area real GDP had decreased by 3.8% quarter on quarter as a result of the coronavirus pandemic and the measures to contain it. Both the manufacturing and services sectors were severely affected, and the pandemic had taken a toll on the productive capacity of the euro area economy as well as on domestic demand. Information from surveys, high-frequency indicators and incoming hard data all pointed to a further significant contraction of real GDP in the second quarter. Most recent indicators suggested some bottoming-out of the downturn in May as parts of the economy gradually reopened. Accordingly, euro area activity was expected to rebound in the third quarter as the containment measures were eased further, supported by favourable financing conditions, an expansionary fiscal stance and a resumption of global activity. However, the overall speed and scale of the rebound remained highly uncertain. This assessment was also broadly reflected in the June 2020 Eurosystem staff macroeconomic projections for the euro area.

As regards the external environment, the outlook for global activity had been revised downwards significantly compared with the March 2020 ECB staff macroeconomic projections. The pandemic crisis was affecting not only activity in individual countries but also international trade, and downward revisions to foreign demand for the euro area were larger than those to global activity. Looking at this from a different perspective, it implied that at the current juncture the euro area could not rely on exports to offset weakness in domestic demand.

On euro area activity, members stressed the exceptional uncertainty surrounding the outlook for the euro area in the present circumstances. It was underlined that much of the uncertainty lay outside the economic sphere and related to the future course of the pandemic and its medical solution. The extent of the contraction and the recovery would depend crucially on the duration and the effectiveness of the containment measures, the success of policies to mitigate the adverse impact on incomes and employment, and the extent to which supply capacity and domestic demand were affected more permanently. The point was also made that economic outcomes were highly dependent on the success of policy interventions, for instance in preventing acute liquidity shortages among firms from turning into widespread insolvencies. More broadly, there was a link between the quality of the policy responses and the degree to which the supply side of the economy could be damaged more permanently.

Against this background, members widely acknowledged the difficulties of preparing projections in view of the high degree of uncertainty that presently surrounded economic developments and clouded the outlook. Overall, there was broad agreement that publishing a "mild" and a "severe" scenario alongside a most likely baseline projection was a reasonable way of reflecting the elevated risk and uncertainty. Some concern was expressed that the mild scenario might already be outdated. At the same time, it was argued that keeping a mild scenario was warranted, as the unlocking of the economy could give rise to more positive outcomes in the short term than envisaged in the baseline. Reference was also made to some positive signs from countries outside the euro area that were further ahead in the unlocking process.

In the exchange of views on the scenarios in the June 2020 Eurosystem staff projections, it was remarked that these broadly confirmed the range of outcomes in the scenarios that had been prepared by ECB staff in April and released on 1 May. At the same time, it was recalled that all scenarios assumed that an effective medical solution would become available by mid-2021. This implied that all scenarios might turn out to be too optimistic for the latter part of the projection horizon if that was not the case. Similarly, it was recalled that the baseline projection assumed that there would be no adverse real-financial feedback loops. Historical experience suggested that such loops would draw out the recovery and imply a worse outlook than that entailed in the baseline. In this context, it was observed that to date financial markets had remained fairly resilient and rebounded rather rapidly, also reflecting the swift and forceful monetary policy response so far. At the same time, it was stressed that, in view of the cut-off date, neither the positive impact of the European Commission's proposed recovery fund nor that of the additional fiscal stimulus announced in the largest euro area economy had been taken into account in the staff projections. Overall, the balance of risks around the baseline projection for growth was seen as to the downside.

Members underlined that the shape of the recovery would depend crucially on how consumption and investment evolved under the present uncertainties and whether the pandemic led to longer-lasting changes in the behaviour of economic agents. In particular, the expected pattern of the saving ratio was seen as a key issue, as was the extent to which a sharp spike owing to the lockdown would subsequently unwind as the economy gradually reopened. Some concern was expressed that expecting a full unwinding of higher savings might be too optimistic, as protracted uncertainty might keep the ratio higher for longer. In the services sector, in particular, workers and consumers might review not only their current but also their long-term income prospects, leaving consumption subdued for quite some time. Moreover, a rise in real interest rates and attempts to restore net wealth could be further factors encouraging saving. At the same time, it was argued that the unwinding could lead to a saving rate below the pre-crisis rate if the involuntary savings made during the lockdown and containment periods were spent to meet pent-up demand.

Regarding fiscal policies, an ambitious and coordinated fiscal stance remained critical, in view of the sharp contraction in the euro area economy. Members therefore strongly welcomed the European Commission's proposal for a recovery plan dedicated to supporting the regions and sectors most severely hit by the pandemic, to strengthening the Single Market and to building a lasting and prosperous recovery.

With regard to price developments, there was broad agreement with the assessment presented by Mr Lane in his introduction. According to Eurostat's flash estimate, euro area annual HICP inflation had decreased to 0.1% in May, down from 0.3% in April, mainly on account of lower energy price inflation. On the basis of spot and futures prices for oil, headline inflation was likely to decline somewhat further over the coming months and to remain subdued until the end of the year. Over the medium term, weaker demand would put downward pressure on inflation, which would only be partially offset by upward pressures related to supply constraints.

This assessment was also reflected in the June 2020 Eurosystem staff macroeconomic projections for the euro area, which foresaw annual HICP inflation in the baseline scenario at 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. Some concern was expressed that that model-based estimates of deflation risks surrounding the baseline scenario in the June 2020 projections had reached their highest levels since the December 2008 projections. The point was made that while deflation was not a likely outcome for now, it was also no longer a low probability event and warranted careful monitoring.

In their exchange of views on the inflation outlook, members recalled the considerable uncertainty about the net effect of rising slack and lower demand on the one side, and the possible longer-term adverse impact on aggregate supply capacity on the other side. It was argued that the pandemic could influence potential output in either direction. For instance, notwithstanding increased production and distribution costs associated with public health and safety measures, total factor productivity could increase, for example due to the improvements in digitalisation prompted by the crisis. It was acknowledged that the uncertainty about the impact of the pandemic crisis on potential output made real-time estimates of output gaps even more uncertain than in normal times. In this context, it was stressed that while the output gap might overstate the amount of slack, the unemployment gap would understate it, as statistically recorded unemployment was being kept artificially low by temporary employment schemes. The concern was raised that the lagged nature of the labour market response would eventually lead to a period of higher unemployment. This would put downward pressure on wage growth that would come on top of the deceleration that had already started before the pandemic crisis. Overall these arguments pointed to protracted weakness in the inflation outlook.

However, the point was also made that, while the balance of demand and supply effects was disinflationary in the shorter term, the medium term might see rising inflationary pressures. These could stem from factors including disruptions in supply chains, de-globalisation tendencies and regulatory restrictions in the context of containing the pandemic. It was argued that there remained considerable uncertainty about how the negative supply effects would affect pricing, but that some goods and services would have to become more expensive, if only to keep businesses viable.

It was also recalled that price measurement issues could be an additional source of uncertainty in the current environment. This related to difficulties with collecting price data and increased recourse to imputations. In addition, the goods and services actually purchased during the lockdown and containment periods likely deviated from the expenditure weights assumed in the consumption baskets used in the HICP compilation. It was argued that, as a result, consumers' perceptions could deviate substantially from what was recorded in the official statistics. Reference was made to the strong increase in food prices, which suggested that perceived inflation could currently be higher than measured inflation, possibly feeding through to expectations.

In discussing recent developments in inflation expectations, members broadly shared the assessment provided by Mr Lane in his introduction that market-based indicators of longer-term inflation expectations had remained at depressed levels. While survey-based indicators of inflation expectations had declined somewhat over the short and medium term, longer-term expectations had been less affected (despite remaining near historical lows). It was argued that the elevated probability of inflation remaining below 1% according to market-based indicators suggested that market participants' inflation expectations might have become less well anchored.

With regard to the monetary analysis, members widely agreed with the assessment provided by Mr Lane in his introduction that strong growth in broad money (M3) reflected a shift towards money holdings for precautionary reasons in the context of elevated uncertainty. Strong money growth also reflected bank credit creation, which was driven to a large extent by acute liquidity needs in the economy. At the same time, a question was raised on the impact of the ongoing, large-scale accumulation of monetary liquidity on risks to price stability over the medium term.

It was remarked that the bank lending channel continued to perform well, which was important for monetary policy transmission given that the bulk of financial intermediation in the euro area operated through banks. The annual growth in loans to non-financial corporations had picked up further in April, reflecting firms' need to finance their ongoing expenditures and working capital in the context of rapidly declining revenues. The upcoming TLTRO allotments at very favourable conditions should further encourage banks to continue extending loans to all private sector entities. Moreover, attention was drawn to complementary support provided on the prudential side aimed at easing conditions in the banking system. However, it was still uncertain whether the funds provided by the ECB's lending operations would reach those sectors of the euro area economy where liquidity was most urgently needed, such as small and medium-sized enterprises.

Monetary policy stance and policy considerations

With regard to financial conditions and the monetary policy stance, members shared the assessment provided by Ms Schnabel and Mr Lane in their introductions. While sentiment in financial markets had improved since the previous monetary policy meeting in late April, financial conditions had tightened overall since the escalation of the pandemic. More recently, euro area bond spreads had declined and equity prices, which were one driver of overall financial conditions, had rebounded. The easing in financial conditions and improvement in sentiment since the previous monetary policy meeting were attributed to a number of factors: the gradual relaxation of containment measures; the support provided by the ECB's monetary policy decisions; national fiscal policy measures; and the Franco-German recovery fund proposal, as broadly taken up in the comprehensive recovery package subsequently proposed by the European Commission.

At the same time, it was emphasised that improved sentiment in financial markets should not lead to complacency. While the ECB's set of monetary policy measures, most notably the PEPP, had contributed to calming financial markets, real interest rates in the euro area had increased, thereby contributing to a tightening in the stance of monetary policy in the context of a subdued outlook for inflation. With regard to the monetary policy transmission mechanism, it was noted that the decline in risk-free rates had not been transmitted in full to the broader set of asset prices and yields affecting the financial conditions faced by the real economy. In particular, the upward pressure on average sovereign bond yields, which was in part related to the increased issuance of government debt, had contributed to higher corporate and bank bond yields and a decline in equity valuations, especially for banks. Looking ahead, this could trigger an increase in the price of credit to households and businesses.

The tighter financial conditions compared with pre-coronavirus levels, the unprecedented magnitude of the economic contraction, and the notable downward revisions to the outlook for growth and inflation entailed in the June projections were highlighted. In addition, there were downside risks to the outlook, as well as rising risks of disinflation and even deflation. Against this background, all members agreed that further monetary policy action was needed, in accordance with the Governing Council's price stability objective.

At the same time, some reservations were expressed about the precise timing and proposed scale of the expansion of the PEPP envelope to further boost monetary policy accommodation at the current meeting. Prevailing uncertainties and some indications of a bottoming-out of economic and financial conditions were seen to argue for a more cautious approach.

However, it was generally felt that not acting at the present meeting could trigger a further tightening of financial conditions, to the detriment of the economic recovery. Continued exceptionally high levels of uncertainty were not seen as a valid reason to postpone a response that was required by the ECB's price stability objective, but rather as calling all the more for decisive action. It was seen as particularly important in the current environment that monetary policy and fiscal action should act as complements in combating the economic fallout from the pandemic crisis.

Members broadly agreed with the arguments put forward by Mr Lane in his introduction that the PEPP was the most effective and efficient tool for providing additional monetary accommodation in the current environment, reflecting its dual role in supporting both the monetary policy stance and the transmission of the stance to all parts of the euro area economy in the current stressed market conditions. In terms of the overall stance and given the scale and unique nature of the pandemic shock, the substantial downward shift in the inflation outlook would be better tackled through a targeted and temporary programme rather than a recalibration of the more standard policy tools. It was argued that the PEPP was the best available instrument for lowering the medium and long-term interest rates which mattered most for the real economy. Expanding the PEPP would help to bring the sovereign bond yield curve more closely into line with the risk-free curve. This in turn would support the transmission of monetary policy to the interest rates applicable to households and businesses, to the extent that sovereign bond yields acted as a benchmark for the pricing of loans and market-based credit instruments. It was also remarked that increasing the size and duration of asset purchases would contribute to containing overall uncertainty, thereby supporting the recovery of the euro area economy. In this vein, the PEPP could provide additional protection against the risks of fragmentation across market segments that might obstruct the smooth transmission of monetary policy. It was recalled that the PEPP had been rather successful in containing spread volatility in the European government bond markets and in averting risks of self-fulfilling adverse market dynamics. In this context, the importance of the flexible implementation of the PEPP was emphasised as a means to ensure the transmission of monetary policy across time, asset classes and jurisdictions. Such flexibility was seen as most effective and efficient during periods of market stress. At the same time, it was reiterated that, in line with the design features of the PEPP, the capital key remained the relevant benchmark for the allocation of purchases across jurisdictions.

On this basis, members broadly agreed with the proposal by Mr Lane to increase the size of the PEPP by €600 billion, to extend the horizon for net purchases under the PEPP to at least the end of June 2021, and to announce that principal payments from maturing securities purchased under the PEPP would be reinvested until at least the end of 2022 and that, in any case, the future roll-off of the PEPP portfolio would be managed so as to avoid interference with the desired monetary policy stance.

With regard to the calibration of the PEPP expansion, a range of preferences were expressed in favour of either a larger or smaller envelope. The case for a larger envelope was based on the significant downside risks to the June projections amid the exceptionally high degree of uncertainty surrounding the economic outlook, together with the subdued inflation outlook, with heightened risks of protracted disinflation or even deflation. In addition, the point was made that the June projections did not cover the possibility that the crisis could spill over to the financial sector: if this were to happen, it would trigger a further deterioration in financial conditions and necessitate an even stronger monetary policy response. At the same time, a number of arguments were made in favour of a smaller expansion of the PEPP, which would allow more time to assess the evolution of the economic situation and the medium-term outlook for price stability. The point was also made that the June projections did not take into account the Commission's recovery fund proposal or recently announced national fiscal measures, which could entail an upside risk to the economic outlook contained in the staff projections.

In the end, a broad consensus emerged among members around the proposal put forward by Mr Lane to expand the PEPP envelope by €600 billion in order to deliver the monetary conditions that could support a return to the pre-crisis inflation trajectory within the projection horizon. An expansion of this amount was seen as providing a clear signal that the Governing Council was not satisfied with the medium-term inflation outlook of 1.3%. It was also noted that expanding the size of the PEPP by €600 billion would help support the smooth transmission across all jurisdictions of the euro area.

With regard to the envisaged horizon of net purchases under the PEPP, members broadly concurred with the proposal put forward by Mr Lane to extend it until at least the end of June 2021, thus aligning it with the phase of the most severe impact of the pandemic-related restrictions on economic activity and the weakest inflation pressures in the period ahead. The purchase horizon would also be broadly aligned with the horizons of the other monetary policy measures taken by the ECB in response to the pandemic. It was underlined that the proposed extension of the PEPP was consistent with the Governing Council's communication that net asset purchases would continue until the coronavirus crisis phase was over. The more prolonged economic slowdown than previously anticipated thus warranted such an extension.

With regard to the reinvestment of principal payments, members broadly agreed with the proposal made by Mr Lane to announce a PEPP reinvestment horizon of until at least the end of 2022. This was seen to avoid the risk of an unwarranted tightening of financial conditions at a time when the recovery from the pandemic shock was likely to remain incomplete. These reinvestments were seen to enhance the effectiveness of the PEPP by reducing the amount of duration risk that investors needed to absorb in the future, thereby helping to limit upward pressure on longer-term interest rates. Announcing a minimum duration for the reinvestment horizon of until at least the end of 2022 was viewed as appropriate, given the temporary and emergency nature of the PEPP. It was argued that this would also allow time, in a manner that would not interfere with the broader monetary policy stance, to reduce possible deviations from the capital key that might arise during the net purchase phase.

Members also put forward some broader considerations with regard to the effectiveness and efficiency of using asset purchases as a monetary policy tool in the pursuit of the ECB's price stability objective, including in the light of the upcoming review of the monetary policy strategy and with a view to explaining the Governing Council's monetary policy deliberations in a more comprehensive way to the public. It was argued that the proportionality assessment of any monetary policy measure had to consider, among other things, the degree to which the measure contributed to achieving the monetary policy objective, on the one hand, and possible unintended side effects, on the other hand. It required a judgement as to whether other policy measures were available that were as effective and efficient while offering a better balance between intended and unintended effects.

It was highlighted that asset purchases were an essential tool with which monetary policy could affect macroeconomic developments and, ultimately, inflation outcomes, via a number of transmission channels. From the outset, purchases under the public sector purchase programme (PSPP) of securities with maturities of between two and thirty years had been aimed at lowering market interest rates that are relevant for the real economy and inflation developments. There was now ample evidence from an exhaustive literature showing that asset purchase programmes in general and the PSPP in particular had proven effective in achieving their intended effects on the euro area economy and thereby in maintaining price stability. Asset purchases had lowered relevant market interest rates throughout the euro area, which translated into lower bank lending rates and higher lending volumes and, ultimately, into higher growth and inflation outcomes. Although the quantitative estimates varied to some extent and were subject to the usual model uncertainty, the overall evidence underpinned the view that the PSPP had had a positive impact on macroeconomic outcomes, confirming the assessment that it was a policy measure that was effective in putting upward pressure on inflation and inflation expectations as intended.

It was recalled that the decision to implement a large-scale asset purchase programme in January 2015 had been taken in response to two major challenges, namely strong disinflationary headwinds in the aftermath of the financial and sovereign debt crises in the euro area and the global phenomenon of declining equilibrium (or“natural”) interest rates that ultimately determined the degree of accommodation that a given level of policy rates would deliver. There was vast empirical evidence documenting the decline in the level of equilibrium interest rates over the past three decades which was broadly related to a decrease in potential output growth in many industrial countries, reflecting factors such as demographic trends or low productivity growth. Therefore, with policy interest rates close to their effective lower bound, unconventional instruments were needed to provide the degree of monetary accommodation that was consistent with the ECB’s inflation aim.

At the same time, it was noted that the low interest rate environment in which central banks had to navigate was associated with a number of challenges. First, low interest rates might incentivise market participants to adopt excessive risk-taking behaviour, ultimately triggering risks to financial stability. Second, low interest rates prevailing over an extended period of time could strain the profitability, and hence the capitalisation, of banks. Third, the low interest environment might give rise to scenarios in which banks financed inefficient firms, which implied a misallocation of resources and could ultimately lead to a decrease in overall productivity in the economy. Moreover, low interest rates were also challenging for earnings on the savings of households and insurance companies that aimed for certain nominal yields. It had to be acknowledged, however, that the asset purchases under the PSPP had contributed to these potential issues, but only to the extent that they lowered interest rates below the natural interest rate. Hence, the challenges of a low interest rate environment mainly arose from the structural factors driving the decline of interest rates, while monetary policy had only contributed to these effects and was clearly not the main factor behind them.

In assessing the benefits and costs of asset purchases, the relevant benchmark was not the status quo, but a counterfactual situation in which policy accommodation through asset purchases had not been provided. There was ample evidence that the euro area economy would have fared much worse without the policy stimulus from asset purchases. The Eurosystem’s asset purchases had created financial conditions that countered disinflationary forces and helped to avert deflationary risks in the euro area. In overall macroeconomic terms, asset purchases had made a very significant positive contribution to both economic growth and inflation in the euro area. With respect to the earnings situation of banks, the low interest rate environment had reduced their interest rate margins, but the positive impact of asset purchases on the broader economy had in turn supported banks' balance sheets. In this context, it was also highlighted that so far there was no convincing evidence that the low interest rates had contributed to so-called zombie lending. The empirical evidence on the effects of the low interest rate environment on retirement provisions was also unclear. In this context, it was not only the nominal return on an individual asset that was relevant for overall retirement provisions, but also the overall real return on all assets that people held in their portfolios over their lifetime.

As regards the impact of the ECB's monetary policy measures on households, there was ample evidence from numerous studies on the impact of low interest rates and asset purchases on household income. Evidence derived from the European Household Finance and Consumption Survey showed that net borrowers had benefited from lower interest rates, whereas net savers had seen a decline in their interest income. It was also noted that the effects of lower interest rates arising from asset purchases were similar to the effects of using conventional monetary policy instruments. Moreover, to judge the overall effects of low interest rates on household income, all transmission channels, not just savings income, had to be taken into account. The significant macroeconomic effects of asset purchases contributed to higher wages and higher employment, and thereby positively affected households' disposable income and consumption.

With regard to the potential interactions between monetary policy and fiscal policy, a clear focus on the primary objective of maintaining price stability, combined with safeguards which ensure the respect of the prohibition of monetary financing, was viewed as essential to the lasting success and credibility of monetary policy, and ultimately to acceptance and trust in the euro as a common currency. In order to ensure sustainable public finances, the countries participating in the monetary union had adopted common budgetary rules and a budgetary surveillance procedure. Moreover, the institutional set-up also relied on market discipline for sound fiscal policies, while monetary policy needed to observe the prohibition of monetary financing. It was also recalled that the Treaty on the Functioning of the European Union had not only granted the ECB independence, assigned it the primary objective of price stability and prohibited monetary financing, it also required the ECB to adhere to the principle of an open market economy with free competition.

Against this background, it was underlined that allocating the Eurosystem's purchases of public sector securities across jurisdictions using the ECB's capital key as the benchmark was one of the safeguards helping to maintain incentives for sound fiscal policies. Moreover, it was also regarded as important to set issue and issuer limits ensuring that Member States continued to finance themselves primarily through the bond market. In this environment, markets played an important disciplining role, as bonds purchased in the primary market could not simply be passed on to the Eurosystem. However, the view was also expressed that, if the Eurosystem became the main holder of euro area government bonds, this could weaken the disciplining role of markets and their incentives to assess the fiscal soundness of euro area sovereigns. These aforementioned safeguards were supplemented by further operational constraints on the conduct of purchases, criteria on the eligibility of sovereign issuers and a risk-sharing mechanism, whereby the risks of the PSPP holdings of national debt securities were borne by the respective national central banks.

The point was also made that the combination of a very expansionary monetary policy with potentially unsound or unsustainable fiscal policies could undermine the foundation of a credible monetary policy. Risks of fiscal dominance could arise, in which monetary policy might be pressured to refrain from raising interest rates even if this was required to fulfil the monetary policy mandate. Likewise, with an increasing portfolio of public securities on the Eurosystem's balance sheet, financial risks could increase, which might – in adverse scenarios – hamper the effectiveness of monetary policy in the future. Therefore, it was viewed as essential to embed safeguards in the design of the Eurosystem's asset purchases, including a limits framework and the capital key as a benchmark, so as to mitigate the risk of monetary policy becoming dependent on countries' fiscal policies. Accordingly, these should constitute guiding principles. A remark was also made that in some situations in which misguided fiscal and structural policies threatened the transmission of monetary policy and the achievement of the ECB's price stability objective, the Governing Council also had other tools that could be activated in conjunction with an adjustment programme by the European Stability Mechanism.

Overall, there was broad agreement among members that while different weights might be attached to the benefits and side effects of asset purchases, the negative side effects had so far been clearly outweighed by the positive effects of asset purchases on the economy in the pursuit of price stability. However, it was also noted that it could not be ruled out that unintended effects could increase over time and eventually outweigh the overall positive effects. It was thus seen as important to continuously assess the effectiveness and efficiency of the monetary policy measures, their transmission channels and their benefits and costs. In this context, it was remarked that all expansionary monetary policy instruments contributed to a low interest rate environment. Therefore, the associated side effects of low rates were not a distinguishing feature of asset purchases, such as under the PSPP or the PEPP, but were a factor pertaining to all policy instruments that contributed to a low interest rate environment.

Monetary policy decisions and communication

With respect to communication on the outcome of the current Governing Council meeting, members broadly agreed with the proposals put forward by Mr Lane in his introduction.

Members also agreed to emphasise in the communication that two main factors called for further policy action: first, the pandemic-related downward revision to the inflation outlook on the back of lower energy prices and a significant increase in economic slack, which posed a threat to the Governing Council's medium-term price stability objective; and, second, the unwarranted tightening of financial conditions in an economic environment that instead required easier financial conditions. Accordingly, it had to be stressed that additional monetary policy action was needed to ensure the necessary degree of monetary accommodation and a smooth transmission of monetary policy across sectors and jurisdictions, in order to support the swift recovery of economic activity to pre-coronavirus levels and to safeguard medium-term price stability.

In this regard, recalibrating the PEPP was the most appropriate course of action, as expanding the PEPP and extending its horizon would be most effective for further easing the general monetary policy stance, maintaining favourable funding costs for the real economy and providing temporary support in response to the pandemic-related shock to the euro area economy and the path of inflation. In addition, it had to be stressed that conducting purchases in a flexible manner over time, across asset classes and among jurisdictions allowed the Governing Council to effectively stave off risks to the smooth transmission of monetary policy.

There was broad agreement among members to reiterate that the Governing Council would do everything necessary within its mandate and that it continued to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moved towards the Governing Council's aim in a sustained manner. While this included the possibility of further adjusting the size and composition of the PEPP, it needed to be highlighted that the Governing Council was ready to adjust the full range of its instruments, including the TLTROs, policy interest rates and forward guidance.

Finally, it needed to be highlighted that monetary and fiscal policies were increasingly complementing each other in the current situation, where the additional monetary policy stimulus went hand in hand with the measures taken by euro area governments and European institutions to ensure sufficient healthcare resources and to provide support to affected companies, workers and households. At the same time, a call was made for further strong and timely efforts to prepare and support the recovery. The Governing Council, therefore, strongly welcomed the European Commission's proposal for a recovery plan dedicated to supporting the regions and sectors most severely hit by the pandemic, to strengthening the Single Market and to building a lasting and prosperous recovery.

Taking into account the foregoing discussion, upon a proposal by the President, the Governing Council took the following monetary policy decisions:

(1) The envelope for the pandemic emergency purchase programme (PEPP) would be increased by €600 billion to a total of €1,350 billion. In response to the pandemic-related downward revision to inflation over the projection horizon, the PEPP expansion would further ease the general monetary policy stance, supporting funding conditions in the real economy, especially for businesses and households. The purchases would continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions. This allowed the Governing Council to effectively stave off risks to the smooth transmission of monetary policy.

(2) The horizon for net purchases under the PEPP would be extended to at least the end of June 2021. In any case, the Governing Council would conduct net asset purchases under the PEPP until it judged that the coronavirus crisis phase was over.

(3) The principal payments from maturing securities purchased under the PEPP would be reinvested until at least the end of 2022. In any case, the future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate monetary stance.

(4) Net purchases under the asset purchase programme (APP) would continue at a monthly pace of €20 billion, together with the purchases under the additional €120 billion temporary envelope until the end of the year. 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.

(5) Reinvestments of the principal payments from maturing securities purchased under the APP would continue, in full, for an extended period of time past the date when the Governing Council 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.

(6) 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.

The Governing Council 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 4 June 2020

Press release

Monetary policy decisions

Meeting of the ECB's Governing Council, 3-4 June 2020

Members

Ms Lagarde, President

Mr de Guindos, Vice-President

Mr Costa*

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 June 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 Alves

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 Odór

Mr Rutkaste

Mr Sleijpen

Mr Tavlas

Mr Välimäki

Other ECB staff

Ms Graeff, Director General Communications

Mr Straub, Counsellor to the President

Ms Rahmouni-Rousseau, Director General Market Operations

Mr Sousa, Deputy Director General Economics

Mr Rostagno, Director General Monetary Policy

Release of the next monetary policy account foreseen on Thursday, 20 August 2020.