EUROPEAN CENTRAL BANK

EUROSYSTEM

Account of the monetary policy meeting of the Governing Council of the European Central Bank

held in Frankfurt am Main

on Wednesday and Thursday, 2-3 September 2015

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Mario Draghi

President of the European Central Bank

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

Financial market developments

Mr Cœuré reviewed recent financial market developments.

Since the previous Governing Council monetary policy meeting on 15-16 July, events in China had been the main driver of global financial markets, with significant spillover effects in commodity markets. The decline in oil prices had also triggered a downward adjustment in market-based measures of inflation expectations in the euro area and had contributed to a decline in bond yields and significantly higher market volatility. Nevertheless, the implementation of the asset purchase programme (APP) had been in line with the pre-defined targets and had not been hampered by the global developments and lower market liquidity observed over the summer months. In the foreign exchange market, the euro had risen against most major currencies, including the US dollar, in part supported by expectations of a postponement of a first rise in official interest rates in the United States since 2006.

With regard to international markets, the main theme over the summer had been the decline in growth prospects in China, developments in the Chinese stock market, and the decision by the People's Bank of China to reform the daily fixing mechanism for the renminbi, announced on 11 August 2015. Accordingly, the new daily fixing would no longer be based on the previous day's central parity, but on the previous day's closing spot price, thereby moving closer to a market-determined mechanism.

The spillovers to international markets had been strong, with European, US and Japanese stock markets declining by 7% to 13%, after having traded sideways during the summer. However, these markets had subsequently rebounded somewhat following actions by the Chinese authorities and perceived accommodative comments from ECB and Federal Reserve officials. Most market analysts deemed the spillover to developed equity markets to be excessive and to have been exacerbated by one-sided positioning as well as thin liquidity during the summer months. The turmoil in Chinese equities had also had strong spillover effects on commodities markets. Oil and industrial metal prices had continued to decline to levels not seen since 2009 as a result of oversupply and expectations that demand would remain subdued owing to the slowdown in global growth. Accordingly, forward contracts up to two years ahead suggested that the market was expecting oil prices to stay lower for longer, as some forward prices had declined by up to USD 17 per barrel during the previous six months.

Regarding exchange rates, the euro had appreciated in terms of its nominal effective exchange rate against the currencies of major trading partners. It had also strengthened to an intraday high of 1.17 against the US dollar on 24 August before falling back to USD 1.125 on 1 September. The moves were attributed to the lower probability of an imminent rate hike by the Federal Open Market Committee in the light of international developments, as well as to the unwinding of carry trades funded in euro, as confirmed by the reduced short positions in the US Commodity Futures Trading Commission weekly data.

With respect to developments in euro area financial markets, the decline in oil prices had also triggered a decrease in market-based measures of inflation expectations and contributed to a decline in bond yields and higher market volatility. The fall in nominal yields had not been accompanied by a similar decline in real yields, given that market-implied inflation rates had also declined.

Looking at market conditions in the euro area fixed income markets in recent months, volumes in ten-year German Bund futures on Eurex had consistently been below their five-year seasonal average, with the exception of the high-volatility episodes in May 2015 and the recent uncertainty related to China. Investor activity in the cash bond market had been similarly subdued, with volumes in stressed jurisdictions having declined by less than those elsewhere.

Turning to the execution of the public sector purchase programme (PSPP), lower liquidity had become more apparent in some market segments, for example for supranational bonds or in smaller jurisdictions as well as at the very long end of the curve. With regard to the pace of purchases under the APP, the ECB had undertaken – as would be published on Monday, 7 September 2015 – purchases of €51.6 billion in August. Given the modest frontloading of purchases in previous months, the Eurosystem had now bought assets amounting to, on average, around €60 billion per month over the first six months of the APP. Purchases under the third covered bond purchase programme (CBPP3) had amounted to €7.5 billion in August, with the book value of CBPP3 holdings having stood at around €111.5 billion at the end of that month, and with primary market purchases amounting to a share of 17.9%. With regard to purchases of asset-backed securities (ABS), the Eurosystem had bought €1.3 billion of such securities in August, bringing the book value of holdings under the ABS purchase programme to €11.1 billion at the end of that month, with 27.2% purchased in the primary market.

From September to November 2015, purchases under the APP would again be somewhat frontloaded to prepare for the expected decline in market liquidity in December.

Finally, turning to money markets and liquidity, excess liquidity had been building up steadily. It had risen by €100 billion over the current maintenance period to reach €499 billion on 1 September 2015. Interbank market activity was declining somewhat overall, as a result of the high levels of excess liquidity and also banks' reluctance to trade in the money market at levels that were close to -20 basis points. In this context, money market rates had remained steady at low levels.

Increasing excess liquidity was reflected in short-term rate expectations. EONIA forward rates had decreased further in August. Three-month EURIBOR futures-implied rates had also turned negative for maturities up to and including September 2016, such that the whole EURIBOR curve was currently negative for the year ahead. In the cash market, new lows had been recorded for the three-month EURIBOR rates.

The impact on euro area money markets of the global market turbulence and developments in China had so far remained very muted. The ECB's actions, in the form of the Governing Council's forward guidance, the targeted longer-term refinancing operations (TLTROs) and the asset purchase programmes, had ensured that the money market curve had remained very stable and euro area money market conditions had been resilient to, and well protected from, global shocks.

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

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

Global growth had remained gradual and uneven across regions. The global manufacturing Purchasing Managers' Index (PMI) had dropped to 50.7 in August 2015, from 51.0 in the preceding two months. Global trade momentum had remained weak in the first half of 2015. The volume of world imports of goods had decreased by 0.9%, quarter on quarter, in the second quarter of 2015, after a decline of 1.7% in the first quarter. The global PMI for new export orders had remained below 50 in August, at 49.9, unchanged from July.

Global inflation had remained moderate. Annual headline inflation in the OECD area had been unchanged in July, at 0.6%, while inflation excluding food and energy had edged up slightly to 1.7%, from 1.6% in June, in a context of volatile oil prices and abundant spare capacity. Since the Governing Council's monetary policy meeting in mid-July 2015, Brent crude oil prices had fallen by 13% to stand at USD 50 per barrel on 1 September, and were 15% lower in euro terms, while non-oil commodity price declines could be observed in particular for metal and food prices. Over the same period, the euro exchange rate had appreciated by 1.8% against the US dollar and by 2.6% and 4.1% in nominal effective terms vis-à-vis 19 and 38 major trading partners respectively.

Turning to the euro area, according to the available flash estimate from Eurostat of 14 August 2015, real GDP had risen by 0.3%, quarter on quarter, in the second quarter of 2015, following growth of 0.4% in the first quarter. While no breakdown at the euro area level was as yet available, short-term indicators and available country data suggested that domestic demand and net exports had contributed positively, while the contribution of changes in inventories had been negative.

Industrial production excluding construction had declined by 0.2%, quarter on quarter, in the second quarter of 2015, while the ECB indicator on euro area industrial new orders had grown strongly in the second quarter. Both the composite output PMI and the European Commission's Economic Sentiment Indicator stood on average in July and August above their respective average levels in the second quarter of 2015. In addition, both indicators currently stood at levels above their respective long-term averages.

Looking ahead, private consumption expenditure should remain the key driver of the euro area economic recovery, while the modest recovery of business investment in the first half of 2015 was expected to continue, as capacity utilisation had returned to levels close to its long-term average, impediments to production had lessened and credit supply constraints had eased. Regarding slack in the euro area economy, a range of estimates and indicators suggested a large degree of uncertainty while in general pointing to significant levels of slack. Looking ahead, the negative output gap was expected to close gradually in the coming years.

Labour markets were still relatively weak, but conditions had been improving overall. Employment had risen further, by 0.1% quarter on quarter, in the first quarter of 2015. The unemployment rate for the euro area, which had started to decline in mid-2013, had fallen further between the first and second quarters of 2015 and stood at 10.9% in July. Available survey data pointed to continued moderate employment growth in the period ahead.

The September 2015 ECB staff macroeconomic projections foresaw euro area real GDP growth to be 1.4% in 2015, 1.7% in 2016 and 1.8% in 2017. This was somewhat lower than envisaged in the June 2015 Eurosystem staff projections. Downward revisions primarily reflected lower external demand owing to weaker growth in emerging markets and a lower import content of global growth. Since the cut-off date of 12 August for the technical assumptions underlying the projections, the effective exchange rate of the euro had appreciated and oil prices had declined. On balance, this pointed to somewhat higher downside risks to the euro area growth outlook.

Turning to price developments in the euro area, according to Eurostat's flash estimate, annual HICP inflation was 0.2% in August, unchanged from July and June. The unchanged headline rate had resulted from a further decline in energy price inflation that had been compensated for by increases in the annual rates of change of the unprocessed food and non-energy industrial goods components. HICP inflation excluding food and energy was also unchanged from July, standing at 1.0% in August.

Overall, looking at a broad range of measures of underlying inflation and at the evolution of individual HICP components, it remained premature to conclude with certainty that a turning point in inflation dynamics had been reached earlier in the year. As regards a number of other price indicators, the latest price survey data had shown a dampening of the upward trend observed since the start of the year. Euro area PMI survey indices for input prices had declined in August, while those for output prices had remained broadly stable. Their levels were nevertheless still higher than at the start of the year. The European Commission survey data on selling prices for the retail and services sectors of the euro area economy had also declined in July. In August they had rebounded slightly for the retail sector, remained stable for the services sector and fallen further for the industry sector.

Import prices remained the main source of upward pipeline price pressure for consumer goods. While import prices stood at elevated levels for non-food consumer goods and, to a lesser extent, for food, domestic sources of pipeline price pressures were still weak. Producer price indices for June and July, which had become available since the Governing Council meeting on 15-16 July, indicated that producer prices for non-food consumer goods had started to increase slightly, standing at 0.2% in July. Although producer prices for non-food consumer goods had been subdued, historical regularities suggested that an upturn was likely, as soon as the pass-through of the strong past depreciation of the euro started to gain traction.

The September 2015 ECB staff macroeconomic projections foresaw HICP inflation to average 0.1% in 2015 and to pick up to 1.1% in 2016 and 1.7% in 2017. In comparison with the June 2015 Eurosystem staff projections, the outlook for HICP inflation had been revised down, largely owing to lower oil prices. Also taking into account the developments in oil prices and exchange rates after the cut-off date for the technical assumptions of 12 August, there were downside risks to the September staff inflation projections.

As regards longer-term inflation expectations, market-based measures had declined again over the summer, following the recovery from their troughs in mid-January. For example, the five-year forward inflation-linked swap rate five years ahead stood at 1.7% on 1 September 2015, after 1.8% in mid-July 2015. No new release of the ECB Survey of Professional Forecasters had become available since the last monetary policy meeting.

Turning to financial and monetary conditions, the EONIA forward curve had slightly steepened at longer maturities. Despite the recent financial market repricing, and reflecting the lag in the pass-through of monetary policy rates to bank lending rates, the composite lending rate for non-financial corporations (NFCs) had declined between end-2014 and July 2015. Rates on loans to households for house purchases had declined overall in the second quarter of 2015 but had started to increase in June and July.

The overall nominal cost of external financing for euro area NFCs was estimated to have increased modestly in August, after declining marginally in July. The increase in August reflected mainly a higher equity risk premium resulting from a decline in stock prices. In July and August, the cost of equity and market-based debt for NFCs stood on average around 45 basis points higher than in February 2015. Monthly data showed that the net issuance of debt securities by NFCs had moderated in May and June 2015. This development followed the surge in issuance activity in the first quarter of 2015, associated with the launch of the expanded APP. Turning to other stock market indicators, the price-to-earnings ratios of both financial and non-financial corporations had recovered from their trough in late 2011, but had been declining again sharply since May. Price-to-book ratios had diverged since 2012, with the ratio of financial corporations having increased less than that of non-financial corporations.

Regarding money and credit developments, the data for July pointed to robust growth in broad money, skewed towards its most liquid components. In July the annual growth rate of M3 had increased to 5.3%, up from 4.9% in June. M3 growth had continued to be driven by M1 (with annual growth picking up further in July to stand at 12.1%, after 11.7% in June), reflecting the low opportunity costs of holding the most liquid instruments as well as sales of public sector bonds and covered bonds by the money-holding sector in the context of the APP. Among the counterparts of M3, shifts away from longer-term financial liabilities – partly linked to the attractiveness of the TLTROs – towards instruments included in M3 and increased credit from MFIs (including the Eurosystem) to general government, reflecting purchases under the PSPP, had been the main contributors to annual money growth in recent months, while the contribution from credit to the private sector had turned marginally positive.

MFI lending to the non-financial private sector had continued to recover until July, but MFI loan dynamics remained weak overall. The annual growth rate of loans to NFCs had recovered further in most euro area countries. MFI loan growth to households had also recovered further in the second quarter of 2015.

Specifically, the annual rate of change of loans to NFCs (adjusted for loan sales and securitisation) increased to 0.9% in July, up from 0.2% in June, continuing its gradual recovery since the beginning of 2014. The annual growth rate of loans to households (adjusted for loan sales and securitisation) increased to 1.9% in July 2015, after 1.7% in June.

As regards fiscal policies, the government deficit and debt ratios were expected to decline over the projection horizon. The projected decline in the general government deficit-to-GDP ratio was due to the cyclical improvement in the euro area economy and declining interest expenditure. At the same time, the average euro area fiscal stance, measured as the change in the cyclically adjusted primary balance, was expected to remain broadly neutral over the projection horizon.

Monetary policy considerations and policy options

Summing up, Mr Praet noted that the euro area economic recovery was expected to continue at a somewhat slower pace than previously anticipated, largely reflecting the slowdown in emerging market economies. Although it was still premature to conclude whether these developments could have a lasting impact on euro area output and HICP inflation, downside risks had intensified. Challenges facing emerging market economies were clouding the global outlook and were unlikely to recede quickly, while lower oil prices were expected to support domestic demand in the euro area, but not to fully compensate for the impact of weaker global demand and a stronger euro exchange rate.

Overall, lower than expected commodity prices, the recent euro exchange rate appreciation and somewhat lower than expected economic growth had increased the downside risk to achieving a sustainable path of inflation towards 2%. This was reflected in the downward revisions in the latest ECB staff projections and had been reinforced by the most recent economic and financial developments. At the same time, monetary and financial conditions remained supportive, largely due to the accommodative monetary policy stance – even though sharp fluctuations in asset prices were having an impact on financial conditions and risk premia.

Cross-checking the results of the economic analysis with those of the monetary analysis indicated the need to firmly implement the Governing Council’s monetary policy decisions and to monitor closely all relevant incoming information as concerned their impact on the medium-term outlook for price stability.

In the light of these developments and the new sources of uncertainty, there was no need to act at the present meeting, but it was very important that the Governing Council found the right balance between, on the one hand, not drawing premature conclusions on the lasting impact of the latest economic and financial developments and, on the other hand, recognising that downward risks had clearly increased.

Against this background, appropriate monetary policy communication remained essential. The Governing Council could communicate that it assessed that the downside risks to the growth and inflation outlook had increased and that it would closely monitor the risks to the outlook for euro area price developments over the medium term. The Governing Council could also forcefully underline its willingness and ability to act, if warranted, by using all the instruments available within its mandate, and stress that its asset purchase programme provided sufficient flexibility.

Mr Cœuré introduced the operational details regarding the proposed increase of the PSPP issue share limit from the current 25% to 33%, which was put forward for two reasons. First, Article 5 of Decision ECB/2015/10 adopted on 4 March 2015 foresaw a review of the limit after the initial six months of purchases. Second, increasing the limit would benefit the implementation of the expanded asset purchase programme, safeguarding sufficient flexibility in the implementation of the PSPP.

An important consideration when adopting the issue share limit had been to avoid a situation whereby the Eurosystem could acquire a blocking minority for the purposes of collective action clauses in a potential debt restructuring. In some cases, the Eurosystem could therefore not buy more than 25% of the issue, but these cases represented a small share of the overall outstanding amount of the PSPP-eligible universe.

Against this background, it was proposed to increase the issue share limit to 33% for all PSPP-eligible bonds but, for any bond where a blocking minority could arise below 33%, purchases would be limited to 25%. Bonds for which the blocking minority was below 33% would accordingly have to be checked on a case-by-case basis.

2. Governing Council's discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, members broadly shared the assessment of the outlook and risks for economic activity in the euro area provided by Mr Praet in his introduction. Real GDP growth in the second quarter of 2015 had been weaker than expected, while recent economic data, including survey evidence available up to August, were seen as broadly consistent with a continued moderate economic recovery in the euro area. However, the recovery was now expected to proceed at a somewhat weaker pace than previously anticipated. While domestic demand in the euro area appeared to be relatively resilient, since the Governing Council meeting in mid-July some further weakness had been evident in the international environment. The slowdown in activity in emerging market economies, in particular, was weighing on global growth and trade, leading to lower growth in foreign demand for euro area exports. This assessment was broadly reflected in the September 2015 ECB staff projections, which incorporated a downward revision to the outlook for growth compared with the June 2015 Eurosystem staff macroeconomic projections.

Members discussed the outlook and the risks for the international environment. It was noted that a slowdown in the growth of world trade had been observed for some time, with signs of a lower trade elasticity of global growth possibly pointing to a structural change since the onset of the financial crisis. It was therefore likely that the recent slowdown reflected a combination of both structural and cyclical factors. In addition, uncertainty arising from developments in economic and financial conditions in emerging market economies, particularly China, had clearly increased. It was emphasised that the interpretation of the latest developments in China was very challenging, and more time and analysis were needed to better understand these developments and their implications for the euro area from a medium-term perspective. Although the possible impact of slower growth in China on euro area growth should not be overestimated, it had to be acknowledged that China had been an important driver of global growth over the past 20 years, with an increasing role in global value chains. Moreover, the slowdown in demand in China could contribute to greater global uncertainty and a possible loss of confidence, which could have a more substantial impact on global growth.

The recent volatility in global markets was overall judged to clearly indicate that the economic outlook was subject to increased risk and heightened uncertainty. However, it was seen as premature to gauge whether a reassessment of fundamentals was warranted, namely with respect to lower growth prospects in China and other emerging market economies, or whether other factors were behind the recent high level of volatility in global markets, including reversals in trading behaviour and changes in the regulatory environment. All in all, it was considered too early to say whether recent external developments would have a material effect on the euro area, but the downside risks had clearly increased and there was a need to carefully monitor developments and policies outside the euro area.

With regard to recent developments in the euro exchange rate, since the Governing Council meeting in mid-July the euro had appreciated somewhat both against the US dollar and in nominal effective terms, particularly when considering the broader measure of the nominal effective exchange rate based on a basket of 38 currencies. While recent developments might have been driven in part by the unwinding of carry trades funded in euro in an environment of heightened risk aversion, changes in the outlook and associated market expectations about monetary policy in other currency areas – comprising both advanced and emerging economies – were also seen to have played a role.

While the external environment was challenging and volatility had increased, there were a number of factors pointing to the resilience of the euro area. Looking ahead, the cyclical recovery in the euro area was expected to proceed in the second half of the year, with moderate real GDP growth continuing and the output gap gradually narrowing over the projection horizon. The latest economic sentiment data and purchasing managers' surveys pointed to some robustness of the euro area to external developments, with no significant effects on activity apparent thus far. Among the main factors mentioned, low oil and commodity prices were seen to support purchasing power and the domestic side of the recovery. The steady decline in the euro area's unemployment rate was another positive signal. Furthermore, it appeared that the process of internal devaluation within the euro area, involving adjustments in prices and costs in individual Member States, was largely complete, which implied diminishing downward short-term pressure on demand and prices in the respective economies, even if different views could be taken on the extent to which further rebalancing was still needed. Finally, fiscal consolidation was also no longer weighing on growth, while the extent of further balance sheet adjustments needed in the private sector was less clear.

At the same time, the growth performance of the global economy and, in particular, of the euro area could be considered disappointing from a longer-term perspective. It was recalled that economic activity in the euro area had still not recovered to the level seen in 2008, and that investment was still far below its pre-crisis level. Recent developments pointed to the fragility of the growth model of the euro area, which appeared too reliant on external demand. Against this background, more active support for domestic demand was needed from other policy areas to underpin confidence – via structural reforms, the provision of an adequate public infrastructure and growth-supporting tax reforms – which would also provide greater insurance against external shocks.

Members underlined that the role of investment was critical, both for the short-run outlook and in the medium term, as it was an important determinant of potential growth. It was observed that investment had remained very subdued in the wake of the crisis, with the current heightened uncertainty possibly weighing further on the investment outlook, beyond what was embodied in the September 2015 ECB staff projections, which showed investment picking up in 2015 and 2016, with a small downward revision in 2016. Attention was also drawn to the apparent disconnect between survey indicators and real economic performance in recent months, and the question was raised as to whether this could be due in part to insufficient progress with structural reforms needed to unlock growth and investment. Against this background, an improvement in the conditions for both public and private investment was called for and support was expressed again in this context for the European Commission's investment plan and the growth-supportive role of a well-functioning public infrastructure.

As on previous occasions, members also referred to the assessment of the degree of slack in the economy. While the output gap was expected to close gradually, there was a need to continue to analyse a wide range of indicators of slack. It was recalled that while a number of estimates, including those reported by international institutions, estimated the output gap in the euro area to be around 2½%, slack was very difficult to measure and was subject to a high degree of uncertainty. If the degree of slack was analysed jointly with inflation and with other variables, this could yield much larger estimates of the output gap. Such analysis could also account for the high level of unemployment, but would be difficult to reconcile with commonly used estimates of the level of structural unemployment, which, however, also varied when different methodologies were used.

Overall, while the moderate recovery in the euro area economy was expected to continue, the risks to the outlook remained on the downside. This reflected, in particular, the heightened uncertainties related to the external environment. Notably, it was possible that recent developments in emerging market economies could have further adverse effects on global growth via both trade and confidence channels.

In the exchange of views about fiscal developments it was noted that one of the key features of the current ECB staff projections – and one of the factors supporting economic growth – was that the fiscal stance was now broadly neutral, following the fiscal consolidation that had taken place in recent years. In this context, scope was seen for fiscal policy to further support the recovery by rebalancing the composition of expenditure towards more public investment and other growth-friendly measures geared to enhancing the quality of public finances, notwithstanding the fact that the degree of fiscal space was very limited for most euro area countries, taking into account the rules of the Stability and Growth Pact and current fiscal positions.

With regard to price developments, members generally shared the assessment of the outlook and risks presented by Mr Praet in his introduction. According to Eurostat's flash estimate, euro area inflation was 0.2% in August 2015, unchanged from the two previous months, with the annual rate of HICP inflation excluding food and energy also remaining stable in August, at 1.0%. Inflation was expected to remain very low in the near term before increasing towards the end of the year and rising further in 2016 and 2017. However, inflation was now expected to pick up more slowly than previously expected, due to lower commodity prices, the appreciation of the euro and the weaker outlook for growth. Recent oil price developments implied that the increase in headline inflation in the remainder of the year would be weaker than previously expected, as the upward impact of base effects would be smaller. This assessment was reflected in the September 2015 ECB staff macroeconomic projections, where the inflation profile had been revised downwards in comparison with the June 2015 Eurosystem staff projections.

Given the recent sharp fluctuations in oil prices, members discussed the factors underlying these developments. Overall, it appeared that the more recent downward movement in oil prices had mainly been driven by supply-side factors, such as increases in OPEC production and resilience in US shale oil production growth, while demand factors related to weaker global growth were also seen to have played a role, with crude oil demand picking up less than supply growth, resulting in further accumulation in inventories.

Taking into account the most recent developments in oil prices and the euro exchange rate, there were downside risks to the September 2015 ECB staff projections for inflation. The magnitude of the changes to some of the technical assumptions underlying the projections since the cut-off date had been exceptional, reflecting the high level of market volatility. Depending on the exact cut-off dates and averaging procedures used, in most cases a mechanical update resulted in further downward revisions to the growth and inflation outlook. Hence, the latest developments and the impact of monetary policy measures, as well as geopolitical, energy price and exchange rate developments, warranted close monitoring.

One conclusion that could be drawn from the high sensitivity of the outlook to the assumptions used, in particular the oil price, was that the Governing Council should be cautious in extrapolating from recent developments and not place too much weight on the latest data, as in the context of such high short-term volatility every update of the assumptions provided only a temporary snapshot of the economic environment. It would be unwise to draw premature conclusions from any short-term developments which might vary from one day to the next. By contrast, domestic price pressures, as captured for instance by measures of underlying inflation, were rising over the projection horizon and had largely developed in line with earlier expectations, although they had also been revised down slightly in the projections for 2017.

At the same time, it was clear that the fall in oil prices affected the outlook for inflation via direct and indirect effects through a number of channels. It was also underlined that, while the revision to the inflation outlook had been driven mainly by oil prices and, to some extent, by the euro exchange rate and the external environment, the risk of second-round effects needed to be monitored closely in the period ahead. Moreover, the impact of lower inflation on inflation expectations and real debt burdens also needed to be taken into account.

A number of comments were made by members on the importance of examining closely developments in measures of underlying inflation. Such measures were considered a useful analytical tool to give a broader and more complete picture of the underlying trend in inflation. Looking more closely at specific components of inflation, services price inflation had been relatively stable at just above 1% in recent months, while non-energy industrial goods price inflation had steadily increased over the past six months. The rise in the durables component was consistent with the increase in the consumption of durable goods observed over recent quarters and the sharp increase in import prices for non-food consumer goods, following the depreciation of the euro. This increase in non-energy goods price inflation could be a sign that firms were regaining pricing power. It was also an indication that the low underlying inflation rates in countries most affected by the crisis were converging with those recorded in other countries, so that inflation developments across the euro area were becoming more homogeneous. This implied that deflationary risks were receding for a greater part of the euro area. Compared with the turn of the year, the risk of broad-based deflation pressures was low and had decreased. At the same time, while it was necessary to look further into measures of underlying inflation, it was also recalled that in the euro area measures of underlying inflation, or core inflation, were not a very good predictor of future headline inflation.

In their discussion of inflation expectations, members noted that market-based measures of inflation expectations had stopped increasing from the troughs reached at the beginning of the year and had declined somewhat since the last monetary policy meeting. With reference to evidence for both the euro area and the United States, which pointed to an increased correlation between current oil prices and inflation expectations, such as the five-year forward inflation-linked swap rate five years ahead, it was puzzling that current oil prices should strongly affect inflation so far into the future. It was noted that the correlation between oil prices and inflation expectations had existed for some time, but in the past year and a half the link between current inflation and inflation expectations appeared to have strengthened considerably. This could be seen as a sign of an unanchoring of inflation expectations which required careful monitoring, while also pointing to possible shortcomings in the market-based indicators and in the functioning of the underlying market segments. Against this background, the need for the Governing Council to continue to conduct a broad-based analysis of all factors driving developments in inflation expectations was emphasised, together with the need for close monitoring of any possible signals of an unanchoring of inflation expectations.

Overall, members shared the view that, while euro area inflation was expected to pick up, there had been a recent deterioration in the outlook for inflation which needed to be assessed further to distinguish between temporary and more persistent factors that were relevant for the medium term. In their assessment of the risks surrounding the inflation outlook, there was also broad agreement that the risks were tilted to the downside, given lower commodity prices, a stronger euro exchange rate and a somewhat lower growth outlook.

With regard to the monetary analysis, members broadly agreed with the assessment presented by Mr Praet in his introduction that money and credit dynamics had continued their recovery, supported by the monetary policy measures in place. While exhibiting subdued growth for most of the period since 2010, recent data had confirmed a robust expansion in broad money (M3), with a further acceleration in July 2015. This expansion continued to be driven by the most liquid components of broad money.

Encouraging signals were seen to come from recent loan dynamics, which had continued their gradual recovery since the beginning of 2014. The latest data on loans had shown continued improvements in lending conditions, with lending to both households and firms accelerating in July 2015, in part supported by the accommodative monetary policy stance. This positive trend was broad-based, pointing to diminishing fragmentation and heterogeneity across the euro area. The recovery in loan dynamics had been supported by the widespread decline in lending rates since the announcement of the credit easing measures in the summer of 2014, as well as by favourable funding conditions for banks. This provided evidence that the ECB’s policy measures were effective, also considering that banks appeared to be beginning to rebalance their portfolios towards private sector assets.

Overall, loan growth was considered to remain subdued, still standing well below the growth rates recorded during the previous, short-lived recovery in lending during 2010-11 and below the growth rates of the monetary aggregates. Subdued loan growth was seen in part to be still related to the ongoing adjustment of financial and non-financial sector balance sheets, particularly in some euro area countries in the wake of balance sheet recessions that were holding back more vigorous credit expansion by banks. In this context, reference was also made to the price-to-book ratios of listed financial companies, which remained low and had recently fallen again, notwithstanding the comprehensive assessment completed in 2014, the start of euro area-wide supervision by the SSM and the monetary policy measures in place. This suggested that the adjustment in the banking sector was far from complete, although more favourable price-to-book dynamics were visible when one considered only a sample of the largest euro area banks, which might benefit more from capital market activity.

Monetary policy stance and policy considerations

Members widely shared the assessment and policy considerations put forward by Mr Praet in his introduction. There was broad agreement that the overall economic situation in the euro area had become more challenging since before the summer. At the same time, the revisions to the outlook had not fundamentally changed the picture of an ongoing moderate recovery of the euro area economy and a gradual increase in inflation rates over the coming years. However, in the light of recent developments in the global economy – particularly in emerging market economies – and in financial, commodity and foreign exchange markets, the downside risks to the outlook for euro area growth and inflation had clearly increased.

Against this background, there was wide agreement that, while recent market volatility was a sign of increased risk and heightened uncertainty over the economic outlook, it was too early to form a sound judgement on whether such developments would have a lasting impact on euro area economic developments and, in particular, the medium-term outlook for inflation. It was felt that more time was needed to gain a better understanding of the underlying driving forces and to analyse the factors behind the recent volatility in financial and commodity markets in greater depth. In particular, it was necessary to further assess whether these developments reflected changing macroeconomic fundamentals, such as a more durable shift in the growth prospects of the world economy, or whether increased volatility might be related to changes in financial market functioning and trading behaviour, for instance due to changes in the regulatory environment, with an impact on market liquidity and the role of banks as market-makers.

Broad agreement was expressed with Mr Praet's policy considerations, namely the need to find the right balance between recognising increased downside risks in the light of recent developments and new sources of uncertainty, while avoiding drawing premature conclusions regarding a possible longer-lasting impact on the euro area outlook and policy implications.

In line with this overall assessment it was recalled, on the one hand, that the ECB's monetary policy remained, overall, accommodative and provided support to the economic recovery and a gradual increase in inflation. It was stressed that the recent weakness in the growth momentum and the renewed risks to the inflation outlook were mainly related to external factors, which were outside the control of monetary policy but whose effects were likely buffered by the monetary policy measures in place. Additionally, since the decision to embark on a monetary easing programme at the beginning of the year, the euro area economy appeared to have evolved on a firmer footing, driven by domestic forces and with a modest cyclical recovery set to continue. Accordingly, deflation risks had diminished compared with the beginning of the year and more patience was needed to see inflation pick up more strongly, while money and credit growth already provided evidence of the impact of the monetary policy measures.

Also in line with the overall assessment it was recalled, on the other hand, that financial conditions had tightened, which was evident from higher real interest rates, lower equity prices and a stronger euro exchange rate. Inflation expectations had also recently declined, despite the significant monetary easing in place. Moreover, it appeared that the liquidity injected through the Eurosystem's policy measures had not been distributed evenly across the euro area and was feeding only very slowly into higher demand and activity.

Against this background, there was a need to monitor closely all relevant incoming information with respect to potential implications for the monetary policy stance and for the outlook for price stability. Particular attention needed to be paid to the risks stemming from the external environment and possible signs of emerging second-round effects in the context of a pronounced and lasting fall in oil prices. While, overall, there was a need to await greater clarity as regards the medium-term implications of recent events, there was broad agreement that downside risks to the outlook for inflation had increased. Therefore, it was important to communicate the Governing Council's willingness and ability to act, if needed, emphasising the flexibility embedded in the design of the APP in terms of its size, composition and duration. At the same time, it had to be affirmed that the APP would be implemented in full and would run until the end of September 2016, and beyond, if necessary, to ensure a sustained return of inflation rates towards levels below, but close to, 2%.

It was also felt that confidence should be placed in the effectiveness of the existing monetary policy measures, which required time to pass through to the euro area economy. It needed to be stressed, in this context, that the APP stood at only one-third of the trajectory that had been set out by the Governing Council, implying that a substantial degree of accommodation was still in the pipeline.

Finally, a call was made to strengthen communication on the need for other policy areas to contribute decisively to supporting the euro area recovery with appropriate measures. In particular in the current environment, other policy areas besides monetary policy should stand ready to buffer possible external shocks to the euro area economy. Accordingly, it was considered important that fiscal policies should support the economic recovery while remaining in compliance with the Stability and Growth Pact. Moreover, further product and labour market reforms, and particularly actions to improve the business environment, including an adequate public infrastructure, were seen as vital to increase productive investment, boost job creation and raise productivity. The swift and effective implementation of such reforms, in an environment of accommodative monetary policy, would not only lead to higher sustainable economic growth in the euro area but would also raise expectations of permanently higher incomes and accelerate the benefits of reforms, thereby making the euro area more resilient to global shocks.

As regards implementation aspects of the APP, members generally concurred with Mr Cœuré that sufficient experience in implementing the PSPP had been gained, which allowed an upward adjustment of the issue share limit in the context of the pre-announced review of this limit after the first six months of purchases. Increasing the issue share limit to 33% was seen to reduce implementation risks in the future and to permit purchases in line with the principle of market neutrality. At the same time, there was agreement that an increased issue share limit should not lead to a blocking minority of the Eurosystem in the event of a debt restructuring event. In this context it was noted that some uncertainty remained about the applicable threshold and the prevailing debt restructuring mechanism.

It was highlighted that while at present there appeared to be no specific bottlenecks in the sourcing of bonds, it was generally regarded as important to act pre-emptively by adjusting the issue share limit in a timely and forward-looking fashion. Lifting the issue share limit at the present time, reflecting a technical adjustment in the PSPP parameters, was seen to contribute best to the continued smooth implementation of the APP, supporting the effectiveness of the programme as announced in January, and would also underline that the APP parameters could be flexibly adjusted.

Monetary policy decisions and communication

Taking into account the views expressed by the Governing Council, the President concluded that it remained premature to judge whether recent developments would have a lasting impact on the medium-term outlook for price stability. Accordingly, close monitoring of all relevant information was warranted. At the same time, the Governing Council remained willing and able to act, if necessary, by using all available tools within its mandate, including the flexibility of its asset purchase programmes in terms of adjusting their size, composition and duration. There was also wide agreement for stressing that the monthly asset purchases of €60 billion would be fully implemented until the end of September 2016, and beyond, if necessary, and, in any case, until a sustained adjustment in the path of inflation, consistent with the Governing Council's aim of achieving inflation rates below, but close to, 2% over the medium term, was visible.

Taking into account the foregoing discussion among the members and on a proposal from the President, the Governing Council decided that 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 0.05%, 0.30% and -0.20% respectively.

Regarding non-standard monetary policy measures, the Governing Council furthermore decided to increase the issue share limit from the initial limit of 25% to 33%, subject to a case-by-case verification that this would not create a situation whereby the Eurosystem would have blocking minority power, in which case the issue share limit would remain at 25%.

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
http://www.ecb.europa.eu/press/pressconf/2015/html/is150903.en.html
Press release
http://www.ecb.europa.eu/press/pr/date/2015/html/pr150903.en.html

Meeting of the ECB's Governing Council, 2-3 September 2015

Members

Mr Draghi, President

Mr Constâncio, Vice-President

Mr Bonnici

Mr Cœuré

Ms Georghadji

Mr Hansson

Mr Honohan

Mr Jazbec*[1]

Mr Knot*

Ms Lautenschläger

Mr Liikanen

Mr Linde

Mr Makúch

Mr Mersch

Mr Nowotny*

Mr Noyer

Mr Praet

Mr Reinesch

Mr Rimšēvičs

Mr Smets

Mr Stournaras

Mr Vasiliauskas

Mr Visco

Mr Weidmann

* Members not holding a voting right in September 2015 under Article 10.2 of the ESCB Statute.

[1] Not for the part of the meeting held on 2 September 2015.

Other attendees

Mr Van der Haegen, Secretary, Director General Secretariat

Mr Schill, Secretary for monetary policy, Director General Economics

Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

Accompanying persons

Mr Beau

Mr Bitāns

Mr Bohnec[2], Alternate to Mr Jazbec*

Ms Buch

Mr Dewatripont

Mr Gerlach

Mr Kuodis

Mr Leal Faria

Mr Malo de Molina

Mr Mifsud

Mr Mooslechner

Mr Panetta

Mr Ramalho, Alternate to Mr Costa*

Mr Randveer

Mr Schoder

Mr Stavrou

Mr Swank

Mr Tavlas

Mr Tóth

Mr Välimäki

[2] Only for the part of the meeting held on 2 September 2015.

Other ECB staff

Ms Graeff, Director General Communications

Mr Smets, Counsellor to the President

Release of the next monetary policy account foreseen on Thursday, 19 November 2015.