EUROPEAN CENTRAL BANK

EUROSYSTEM

14 January 2016

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 December 2015

…………………………………………..…….

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 Governing Council's previous monetary policy meeting on 22 October in Malta, markets had mainly focused on the prospect of increased policy divergence between the Federal Reserve System and the ECB, as illustrated by several indicators; for instance, the spread between the euro and US dollar one-year forward overnight index swap (OIS) rates one year ahead had reached 140 basis points, a seven-year high. Furthermore, there had been a downward shift in the option-implied probabilities for the EUR/USD exchange rate for the end of the first quarter of 2016 following the Governing Council's 22 October meeting. The shift in these option-implied probabilities also suggested that a further easing by the ECB had been priced into interest rate markets. In the very short term, however, the market had priced in the risk of a significant reversal of the recent sharp depreciation of the euro against the US dollar, if the ECB or the Federal Reserve were to act differently from prevailing market expectations. This risk was illustrated by the absolute level of one-month implied volatility for the EUR/USD exchange rate, which, at the end of November, was near its highest level since 2011.

In the United States, market expectations of an increase in the target range for the federal funds rate by the Federal Reserve in December 2015 had been reinforced following the October statement by the Federal Open Market Committee (FOMC), along with subsequent remarks by FOMC members and a strong US labour market report for October. Moreover, the focus of analysts had already shifted to the expected path of the federal funds rate after an initial increase. While communication by Federal Reserve officials suggested a gradual path, the market – as indicated by the federal funds futures-implied curve – was pricing in a slower pace of rate increases by comparison with the path currently projected by FOMC members and with that observed in previous rate hike cycles.

In the euro area, the EONIA forward curve had fully priced in a 10 basis point cut in the deposit facility rate at the current Governing Council meeting and an additional cut of 10 basis points (to -0.40%) by September 2016. While the 12-month EURIBOR remained positive, the six-month rate had now fallen into negative territory. The EURIBOR futures curve had priced in further declines in euro money market rates, with the three-month rate expected to reach its lowest level, at -28 basis points, in September 2016.

In the euro area bond markets, government bond yields had declined since the previous Governing Council meeting. The German two-year benchmark government bond yield was now trading slightly below -40 basis points, around 20 basis points below the level before the Governing Council meeting on 22 October 2015. Meanwhile, ten-year German government bond yields had fallen by only 12 basis points, from 57 basis points to 45 basis points. According to some analysts, the steepening of the yield curve indicated that expectations of

a deposit facility rate cut outweighed those of an enlarged asset purchase programme (APP). A second possible explanation was that some investors appeared reluctant to engage in purchases of longer-dated bonds at current low yields.

Some market participants considered that the relationship between market-implied future inflation rates and current energy prices, displayed over previous months, might have loosened. Since early October, there had been an increase in the five-year forward inflation-linked swap rate five years ahead, despite continued declines in fuel prices. This new feature suggested that market participants were recalibrating their longer-term inflation expectations in view of the expected monetary easing by the ECB.

With regard to the execution of the APP, market liquidity had remained broadly steady, although some deterioration had been reported in certain market segments, such as agency bonds and covered bonds. No declining trend was observed in the trading volumes of German government bond futures, which, despite a brief dip at the end of November, had remained reasonably steady. In view of the expected decline in market liquidity around the year-end, there had been a frontloading of asset purchases since September 2015 to allow for lower purchases in December 2015.

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.

The world economy continued to recover at a moderate though uneven pace. The global composite output Purchasing Managers' Index (PMI) had risen slightly to 53.4 in October, from 52.8 in September. Global trade seemed to have stabilised at low levels, following weak data in the first half of 2015. The volume of world imports of goods had increased by 1.6%, quarter on quarter, in the third quarter of 2015, from -1.1% in the second quarter. At the same time, the global PMI for new export orders had declined slightly to 51.0 in November, from 51.2 in October.

Global inflation had remained moderate. Annual consumer price inflation in the OECD area had risen to 0.6% in October, from 0.4% in September. Excluding food and energy, OECD inflation had been unchanged at 1.8%. Since the 22 October meeting of the Governing Council, Brent crude oil prices had fallen by 9% to USD 45 per barrel. Analysis of the recent behaviour of oil prices, taking into account the drivers of supply and demand as well as record global inventories, suggested that lower oil prices could prevail for a longer period of time. Non-energy commodity prices had weakened by 6% in US dollar terms, on the back of lower prices for industrial raw materials. Over the same period, the euro exchange rate had depreciated by 4% in nominal effective terms vis-à-vis the currencies of 38 major trading partners.

Turning to the euro area, real GDP had increased, quarter on quarter, by 0.3% in the third quarter of 2015. While no breakdown was available as yet, existing information pointed to a continued positive contribution from domestic demand, with private consumption growth as the main driver. Industrial production (excluding construction) had declined further in September, by 0.3% month on month. By contrast, the Economic Sentiment Indicator (ESI) and the composite output PMI had improved in October. In November, the PMI had

also improved further, while the ESI had remained unchanged. Looking ahead, private consumption should remain the key driver of the economic recovery, on the back of higher disposable income growth, while investment growth should also gain momentum, in line with available survey-based information.

Labour market conditions had continued to improve gradually. Employment had risen by 0.3%, quarter on quarter, in the second quarter of 2015. The unemployment rate had declined further to 10.7% in October, around 1½ percentage points below its 12.1% peak in May 2013.

The December 2015 Eurosystem staff macroeconomic projections expected euro area real GDP to grow by 1.5% in 2015, 1.7% in 2016 and 1.9% in 2017. This was broadly unchanged from the September 2015 ECB staff projections. However, compared with the March 2015 projections, at the time when the expanded APP started to be implemented, real GDP growth had been revised down for both 2016 and 2017.

Turning to price developments, euro area headline HICP inflation had stood at 0.1% in November, according to Eurostat's flash estimate, unchanged from October, mainly owing to higher annual rates of change in the energy and, to a lesser extent, the processed food components, which had been offset by lower inflation in other components. Underlying inflation, as measured by the HICP excluding food and energy, had declined to 0.9% in November, from 1.1% in October. Import prices remained the main source of upward pipeline pressures, while domestic producer prices continued to be weak and nominal wages subdued.

The December 2015 Eurosystem staff projections foresaw euro area annual HICP inflation at 0.1% in 2015, 1.0% in 2016 and 1.6% in 2017. In comparison with the September 2015 ECB staff projections, the outlook for HICP inflation had been revised down slightly. Compared with forecasts by other international institutions and the private sector, the December 2015 projection for euro area HICP inflation remained at the higher end of the range for 2017, while for 2016 it was broadly in line with the forecasts of other international organisations. Risks to this outlook remained on the downside.

Since the 22 October meeting, market-based measures of longer-term inflation expectations had continued to increase. On 1 December, the five-year forward inflation-linked swap rate five years ahead stood at 1.8%, some 10 basis points higher than at the time of the Governing Council meeting of 22 October. The price of deflation protection, as derived from options, had decreased.

Turning to financial and monetary conditions, the euro area yield curve had become somewhat steeper since the previous monetary policy meeting, with short-term EONIA forward rates declining to historical lows, while long-term rates had moved only a little. Moreover, the cost of external financing for non-financial corporations had decreased slightly in both October and November, and small and medium-sized enterprises (SMEs) had reported, on balance, an improvement in the availability of bank loans. According to the results of the latest survey on the access to finance of enterprises (SAFE), which had been conducted between 21 September and 26 October 2015, euro area SMEs had become less concerned about access to finance as an impediment to their business compared with other factors relating to their business activity.

Regarding money and credit, broad money growth was robust, supported by low interest rates as well as the impact of the APP and the targeted longer-term refinancing operations (TLTROs). Annual M3 growth had

increased to 5.3% in October, from 4.9% in September, mainly driven by strong M1 growth. The annual growth rate of MFI loans to the private sector (adjusted for sales and securitisation) had increased to 0.8% in October, from 0.4% in September. The gradual improvement in loan dynamics had been visible for both firms and households. The annual growth rate of loans to non-financial corporations had increased to 0.6%, up from 0.1% in September. The annual growth rate of loans to households had increased further to 1.2%, after 1.1% in September. These developments were supported by improvements in both credit supply and demand factors as well as by favourable bank financing conditions. According to the October 2015 bank lending survey, banks in the euro area had reported an overall neutral effect of the APP on their profitability, with capital gains offsetting the adverse impact of the flattening of the yield curve on net interest margins. Furthermore, the positive effects on credit quality due to the improvement of economic conditions related to the APP also needed to be taken into account.

As regards fiscal policies, the government deficit and debt-to-GDP ratios, on average for the euro area, were expected to decline over the projection horizon, on account of the cyclical improvement in the euro area economy and declining interest expenditure. However, the euro area fiscal stance, as measured by the change in the cyclically adjusted primary balance, was currently expected to be mildly expansionary over 2015-16, partly owing to refugee-related government expenditure, before becoming broadly neutral again in 2017.

Monetary policy considerations and policy options

Summing up, Mr Praet recalled that, at its 22 October 2015 monetary policy meeting, the Governing Council had concluded that, in view of the persistence of weak price pressures and continued downside risks to growth and inflation, the degree of monetary policy accommodation would need to be re-examined in December.

This assessment had shown that the monetary policy measures put in place since June 2014 had been critical in arresting a process of an unanchoring of inflation expectations and were an important factor supporting the economic recovery observed since then. At the same time, the December 2015 Eurosystem staff projections, which incorporated the favourable financial market developments following the 22 October Governing Council meeting, confirmed a moderate ongoing euro area recovery while indicating continuing weak price pressures, with slightly weaker inflation dynamics than previously expected, following downside revisions to both growth and inflation in earlier projection rounds.

The most recent data had also confirmed earlier concerns that the adjustment of inflation to rates closer to 2% would take longer than envisaged in March 2015, when the expanded APP had been implemented. Moreover, while tail risks related to the international environment had receded, downside risks to both the growth and inflation outlook continued to prevail.

Cross-checking the outcome of the economic analysis with the signals coming from the monetary analysis confirmed the need for a recalibration of the ECB's monetary policy accommodation in order to secure a return of inflation rates towards levels that were below, but close to, 2%.

Against this background, a recalibration of the Governing Council's monetary policy stance was warranted. Accordingly, the following measures could be foreseen:

First, to cut the interest rate on the deposit facility by 10 basis points to -0.30%. This would further strengthen the effect of the APP by reinforcing the portfolio-rebalancing effects of the ongoing purchases, as the more negative returns on central bank deposits increased the incentives to buy other assets in place of the securities purchased by the Eurosystem.

Second, to announce an extension of the intended horizon of the APP until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council saw a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term.

Third, to reinvest the principal payments on the securities purchased under the APP as they matured, for as long as necessary. This would contribute both to favourable liquidity conditions and to an appropriate monetary policy stance. ECB staff and Eurosystem committees could be mandated to conduct related technical work.

Fourth, to include euro-denominated marketable debt instruments issued by regional and local governments located in the euro area in the list of assets that were eligible for regular purchases.

Fifth, to continue conducting the main refinancing operations and three-month longer-term refinancing operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2017.

Finally, to indicate that a general review of the technical parameters of the APP could take place in spring 2016.

Regarding external communication, the Governing Council could underline that these changes would ensure accommodative financial conditions and further strengthen the substantial easing impact of the measures taken since June 2014. They would also reinforce the momentum of the euro area's economic recovery and strengthen its resilience against recent global economic shocks. The Governing Council could also reiterate that it would closely monitor the evolution in the outlook for price stability and, if warranted, was willing and able to act by using all the instruments available within its mandate in order to maintain an appropriate degree of monetary accommodation. Furthermore, also in line with past communication, the Governing Council could recall that the APP provided sufficient flexibility in terms of adjusting its size, composition and duration.

2. Governing Council's discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, there was broad agreement among the members with the assessment of the outlook and risks for economic activity in the euro area presented by Mr Praet in his introduction. Recent

data releases provided confirmation of the ongoing cyclical recovery in the euro area. Real GDP had continued to grow in the third quarter, while other incoming information, including the latest survey evidence available up to November 2015, remained consistent with a continued moderate economic recovery. The recovery was expected to proceed broadly in line with the somewhat weaker pace anticipated in the September 2015 ECB staff projections.

This assessment was reflected in the outlook for growth in the December 2015 Eurosystem staff projections, which was broadly unchanged compared with the September 2015 projections. While there was more evidence that domestic demand in the euro area appeared to be relatively resilient, supported also by lower oil prices and a slightly looser fiscal stance, some further weakness had been evident in the international environment. In particular, the slowdown in activity in emerging market economies was weighing on global growth and trade, leading to lower growth in foreign demand for euro area exports.

Regarding the external environment, it was stressed that the December 2015 projections had incorporated a further downward revision to global activity and trade, thereby continuing a sequence of downward revisions to the outlook for the external environment, which also underlined the importance for euro area exports of developments in emerging market economies. There was broad agreement that the outlook for the external environment continued to be uncertain and subject to downside risks, largely related to vulnerabilities in emerging markets.

At the same time, it was mentioned that some indicators in the latest data suggested that the slowdown in emerging market economies was bottoming out and that world trade was starting to improve. Earlier concerns about developments in China in particular, following the stock market fall in August 2015, had not been borne out. Thus, a case could be made that the balance of risks had not deteriorated and had perhaps even become less negative. However, it was also argued that, even if the downside risk of developments in China was no longer considered to be acute, downside risks related to emerging markets more generally still needed to be taken seriously, both from a more medium-term perspective of the global financial and credit cycle and also in view of the vulnerability of some countries to increasing interest rates in the United States and related spillovers. All in all, external risks were therefore assessed to remain on the downside, and it was seen as necessary to continue to carefully monitor developments outside the euro area, including geopolitical risks with repercussions for the euro area.

Members generally concurred with the assessment presented by Mr Praet in his introduction that, while the moderate recovery in the euro area economy was expected to continue, the risks to the growth outlook were seen as remaining on the downside, in particular stemming from the external environment and broader geopolitical risks. These risks had the potential to weigh on global growth and foreign demand for euro area exports and on confidence more widely.

It was underlined that the ongoing recovery in the euro area economy remained fragile as well as moderate. Although the December 2015 Eurosystem staff projections were broadly in line with those of the September exercise, it also had to be kept in mind that the technical assumptions that underpinned the December projections had been positively influenced by favourable financial market developments since the 22 October

meeting of the Governing Council, which were in turn related to expectations of further monetary policy measures by the ECB. However, it was also mentioned that, apart from expectations regarding monetary policy in the euro area, the projections were also influenced by the anticipation of monetary policy tightening in the United States, as well as other exogenous variables. Overall, it was difficult to disentangle the effects of these different factors.

It was also remarked that the Governing Council's assessment had been evolving over a number of monetary policy meetings. Notably, the communication after the October monetary policy meeting had been motivated by the view that the outlook embedded in the ECB staff projections in September was already disappointing. Moreover, the recovery in the euro area was expected to be weaker than anticipated earlier in the year, in particular when compared with the March 2015 ECB staff projections, which had been the first to incorporate the impact of the monetary policy measures announced in January 2015.

Members also referred to the large amount of slack that was estimated to remain in the euro area economy. The December 2015 Eurosystem staff projections pointed to the output gap not being fully closed over the projection horizon. They also indicated that the rate of unemployment would not fall below 10% even by the end of the projection horizon in 2017. Moreover, it was noted that – in contrast to consumption – investment remained very weak and had again disappointed recently, with the December projections showing a downward revision. This pointed to continued uncertainty and lack of confidence, which might be exacerbated by the ramifications of broader (geo)political risks both inside and outside the euro area. These risks were important because confidence was a key ingredient for growth, especially for business investment. The risk that business confidence might not improve in the coming months was thus a cause for concern.

Some remarks were also made, however, which interpreted more positively the fact that the cyclical recovery was proceeding broadly in line with earlier expectations and that the December 2015 staff projections for activity were materially unchanged from those of September. This line of reasoning emphasised the resilience of euro area growth to weaknesses and uncertainty related to the external environment. Recent news, such as the latest surveys, was on balance either neutral or slightly positive, signalling confidence in the ongoing recovery despite worries about emerging market economies. In the third quarter of 2015 real GDP had recorded the tenth consecutive quarter of positive growth, with actual growth exceeding estimates of potential growth for the last five quarters. The recovery, although modest but still with growth rates above potential, remained intact. It was underpinned by lower oil prices and improvements in the labour market – both supporting disposable income – and by the lagged effects of the monetary policy measures taken in 2014 and 2015. Remaining impediments to more sustained growth, such as the ongoing adjustment processes and high levels of non-performing loans in a number of countries, required action in other policy domains, with an emphasis on structural measures to raise potential growth rates and on addressing the debt overhang and bank restructuring in some countries.

Notwithstanding some differences in the business cycle assessment, there was broad agreement among members on the need for structural reforms and for action in other policy areas to support the economic recovery, also to avoid overburdening monetary policy. Monetary policy could not solve all of the problems

holding back growth and unemployment in the euro area economy. There was an urgent need both for structural reforms by Member States and for institutional progress at the EU level. There was a risk that, amid other domestic priorities, the appetite for economic reform would diminish. Progress in structural reforms was also considered important for the banking sector. More generally, the point was made that the institutional and political framework of the euro area had so far not produced the kind of supply-side incentives that would be needed to spark private consumption and business investment in a significant way.

In an exchange of views about fiscal policy, it was considered important to highlight the need to comply with the existing rules of the Stability and Growth Pact and to maintain fiscal goals and consolidation, while pursuing a more growth-friendly composition of fiscal policies. As a result of mistakes made in the past, there had been a failure to create the overall fiscal space that would be necessary at the current juncture to alleviate the burden on monetary policy. Further reflection was called for on the appropriate fiscal stance for individual Member States and for the euro area as a whole, bearing in mind the institutional setting, the disparity in cyclical positions and available fiscal space, as well as economic conditions and recent events, such as the large influx of refugees. Reference was also made in this context to the existence of large current account surpluses in some countries and to the importance of considering the influence of monetary policy on the fiscal stance in the Member States.

With regard to price developments, members generally concurred with the assessment of the outlook and risks presented by Mr Praet in his introduction. Annual euro area headline inflation was 0.1% in November 2015, according to Eurostat's flash estimate, unchanged from the previous month, while the annual rate of HICP inflation excluding food and energy had fallen to 0.9%, 0.2 percentage point below the rate recorded in October. In the coming months, past volatility in oil prices would have a significant impact on energy prices and on overall inflation. In the short term, base effects linked to past developments in oil prices were expected to lead to an increase in headline inflation. Thereafter, energy-related base effects could lead to a renewed temporary decline in inflation in spring 2016 before inflation was expected to rise again. Owing to lower commodity prices and the past appreciation of the euro exchange rate, inflation was now expected to pick up more slowly than previously expected. This assessment was reflected in the December 2015 Eurosystem staff projections, in which the inflation outlook had been revised slightly down compared with the September ECB staff projections.

Taking a longer perspective, the December 2015 projections also had to be compared with what had been expected in the March 2015 projection exercise, when the impact of the expanded APP had first been incorporated in the projection baseline. Compared with the March projections, inflation had been revised down by 0.5 percentage point for 2016 and by 0.2 percentage point for 2017. The latest staff projections thus constituted one of a series of downward revisions to the inflation outlook. Even if it was difficult to be precise, this downward revision would have been larger were it not for the fact that the December 2015 projections already incorporated some anticipated effects of monetary policy on interest rates and the exchange rate following the Governing Council's monetary policy meeting on 22 October.

Attention was drawn, in particular, to the prospect that, according to the latest projections, it would take longer to reach the inflation aim than previously expected. In successive projection rounds, the time horizon over which staff expected inflation to reach a level close to 2% had been progressively pushed back.

A further concern expressed by members was that downside risks to the outlook for inflation continued to prevail, in spite of the December 2015 projections having already incorporated financial market expectations of further measures. The prevalence of downside risks to inflation was supported by a number of arguments. First, it was noted that the December 2015 projections did not include the latest release of HICP inflation for November, which was lower than expected. Second, a downside risk to the pick-up in headline inflation to 1.6% in 2017 was seen to derive from the experience of previous projection errors; it was recalled that, since 2008, the inflation projections had often shown a rise in inflation that had subsequently failed to materialise. In this context, the possibility was mentioned that oil prices could turn out to be lower than expected. Third, an analysis of the risks to inflation based on a wide range of alternative specifications of the Phillips curve showed the mass of the distribution skewed to the downside. Fourth, measures of market-based inflation expectations were currently pointing to a rate of inflation of only around 1% in 2017, suggesting that markets doubted inflation would be close to the ECB's inflation aim by then, even if it had to be taken into account that market-based measures were affected by risk and liquidity premia. Fifth, the longer inflation rates remained at low levels, the harder it would become for monetary policy to anchor inflation expectations. The longer inflation remained below the ECB's inflation aim, the greater the challenge for monetary policy.

At the same time, some remarks were made suggesting that there were encouraging developments in the inflation outlook that should not be overlooked, notably on the basis of measures of underlying inflation. It was pointed out that the December 2015 projections saw underlying inflation developing broadly in line with expectations in the September 2015 projections. Core inflation was now even a little stronger at the end of the projection horizon than in the September exercise. Moreover, despite the latest disappointment in Eurostat's flash release for inflation in November, which extended also to the HICP excluding energy and food (following an upside surprise in the October release), the underlying inflation rate was nevertheless on the whole still creeping up gradually, and if this rate of increase were to be maintained over the coming year and a half, the underlying inflation rate would reach around 1.5%, which would be in line with its historical average.

Some positive signs could also be observed with respect to the risk of deflation and the anchoring of inflation expectations. The argument was advanced that, as the cyclical recovery proceeded, the likelihood of extreme developments, such as outright deflation, diminished. This was supported by survey-based evidence on the distribution of inflation expectations. It was also remarked that, while market-based expectations for inflation were below the ECB's inflation aim, this need not signal an unanchoring of expectations. It could also be due to the existence of negative and time-varying inflation risk premia, which could also explain the discrepancies between survey-based measures of longer-term inflation expectations, which were stable at around 1.9%, and corresponding market-based measures, which were lower. This suggested that some caution was necessary in the interpretation of market-based measures of inflation expectations. Reservations were expressed, in particular about the five-year forward inflation-linked swap rate five years ahead, given market focus on this specific measure for gauging ECB policy, which might in turn undermine its information content. It was also

remarked that the sensitivity of inflation expectations to short-run inflation developments or to macroeconomic surprises had not significantly increased during the third quarter of 2015. Finally, it remained to be seen whether the impact of base effects on headline inflation in the next few months would have any consequences for market expectations of inflation.

Overall, taking into account all views expressed, there was broad agreement that, while euro area inflation was expected to pick up, there had been a further deterioration in the outlook for inflation, so that the return to inflation rates below, but close to, 2% would likely take longer than previously expected. The risks surrounding the outlook for HICP inflation were also assessed, on balance, to remain on the downside.

With regard to the monetary analysis, members concurred with the assessment presented by Mr Praet in his introduction that money and credit dynamics had continued their recovery, supported by low returns on other assets and the monetary policy measures in place, in line with a gradually recovering economy and showing that monetary transmission was gaining traction. With regard to the impact of the APP on monetary aggregates, it was noted that the bulk of purchases to date seemed to have been from non-residents, suggesting that the impact on money creation within the euro area was muted while the exchange rate channel was relatively stronger. A remark was also made that in cases of low confidence among borrowers and lenders the interest elasticity of money demand tended to be very high, limiting the effectiveness of monetary transmission and calling for supplementary action in other policy domains.

Loan dynamics had continued the gradual recovery observed since the beginning of 2014, with credit to both firms and households continuing to expand. This was supported by the prevailing accommodative monetary policy stance and the pass-through of the monetary policy measures in place since June 2014, which had contributed to favourable borrowing conditions and credit standards for firms and households. Credit supply constraints had receded on the part of banks. Reference was made to the survey on the access to finance of enterprises (SAFE) in the euro area, in which SMEs had signalled an improvement in the availability of external sources of finance and the willingness of banks to provide credit. This was also reflected in more favourable terms and conditions applied by banks when granting loans. Nonetheless, despite these improvements, bank lending developments continued to reflect still sluggish demand for credit, credit risk and a continued need for adjustments in financial and non-financial sector balance sheets, related in particular to still sizeable levels of non-performing loans.

Monetary policy stance and policy considerations

With regard to the monetary policy stance, members generally shared the assessment provided by Mr Praet in his introduction that the latest Eurosystem staff projections, which incorporated the favourable financial market developments following the previous monetary policy meeting in October, confirmed the moderate recovery, but still indicated continued downside risks to the inflation outlook and slightly weaker inflation dynamics than previously expected, also following the downward revisions in earlier projection exercises. Against this background, policy action was widely seen as warranted in order to recalibrate the monetary policy stance to support a return of inflation rates towards levels that were below, but close to, 2% and thereby to anchor

medium-term inflation expectations. The set of proposed measures was widely seen to consolidate the prevailing accommodative financial conditions and add further to the substantial easing impact of the measures taken since June 2014 and, thereby, to reinforce the momentum of the euro area's economic recovery and to strengthen its resilience against recent global economic shocks.

In the context of the re-examination of the degree of monetary accommodation, there was broad agreement on the effectiveness of the monetary policy measures put in place since June 2014, which had had a significant easing impact on financing conditions and supported credit developments and the real economy. The monetary policy measures appeared to be gradually working their way through the transmission chain, as the pass-through to intermediate variables had been gaining traction. This was evidenced by the compression of very short-term interest rates due to increasing levels of excess liquidity, by improvements in financing conditions faced by firms – including SMEs – and households, as well as by favourable developments in money and credit.

The impact of the measures was also visible in broader financial market variables, namely in bond and stock markets, where prices had risen since the introduction of the policy measures in June 2014, as well as in exchange rate developments. While more time was needed for the full pass-through of the policy measures, their impact was also already visible in final variables such as growth and inflation. The monetary policy stimulus that had been introduced was generally seen as a major factor behind the ongoing recovery and had helped to arrest further disinflation and stabilise inflation expectations.

The view was widely shared that, in the presence of continued weak price pressures and a still moderate recovery, the prevailing degree of monetary accommodation was not sufficient to bring inflation back to levels below, but close to, 2%, over the medium term with sufficient confidence. It was recalled that, at the monetary policy meetings in early September and late October, the Governing Council had already expressed concerns about a slower increase in inflation rates and increased downside risks to both the growth and inflation outlook compared with earlier expectations in March 2015, when the APP had been launched. While, at the time, it had been concluded that it was premature to draw firm conclusions as to whether these developments would have a lasting impact on the medium-term price stability outlook and it had been agreed to re-examine the degree of monetary accommodation at the present meeting, the evidence accumulated since then indicated that inflation dynamics continued to be weaker than previously expected, with in particular sizeable economic slack and headwinds from the external environment still weighing on price pressures in an environment where inflation was close to zero and far from the Governing Council's inflation aim. The December 2015 Eurosystem staff projections confirmed a somewhat weaker than expected continuation of the economic recovery and showed a further slowdown in the increase in inflation rates, constituting overall a sizeable revision of the inflation outlook compared with the outlook envisaged at the start of the APP, with continued downside risks.

Against this background, most members were of the view that a recalibration of the prevailing monetary policy stance was warranted to secure the return of inflation rates to levels below, but close to, 2% and thereby to anchor medium-term inflation expectations. The renewed deterioration in the inflation outlook had further prolonged the period over which inflation remained distant from the ECB's inflation aim and, hence, had further

pushed back the horizon over which this was expected to be achieved. Reinforcing monetary policy at the current meeting was therefore warranted to firmly reassert the Governing Council's forward guidance and its symmetric commitment to do what was necessary to achieve its price stability objective.

It was also argued that at the current juncture the risk of policy inaction clearly outweighed the risk of action. In particular, a possible downward drift in inflation expectations could prove difficult to reverse and a lack of policy action at the current meeting could instil doubts about the Governing Council's determination to implement the APP until a sustainable adjustment in the path of inflation was achieved. At the same time, it was underlined that taking policy action was not to be misunderstood as being unduly influenced by prevailing market expectations. Instead, it was seen to be in line with recent communication by the Governing Council and with its reaction function in response to the inflation outlook.

Some members did not see sufficient evidence in support of a recalibration of monetary policy at the current meeting, as proposed by Mr Praet, particularly when assessing the need for further accommodation on the basis of the incoming data, its potential effectiveness and its possible side effects. The balance of risks had not deteriorated materially compared with the Governing Council's monetary policy meeting in October and no marked shift in the inflation outlook was visible that would warrant urgent policy action. Recent data on sentiment, employment and unemployment had provided more positive than negative news, on the whole, pointing to a continued and resilient cyclical recovery. While inflation was indeed low and set to rise only gradually, indicators of underlying inflation were on a steady upward trend, while inflation expectations had stabilised.

Against this background, it was argued that the existing policy measures were working in the right direction and more time should be given for them to unfold their full effect, considering the usual long and variable lags of monetary policy transmission which may not have been fully captured by the December 2015 Eurosystem staff projections, before adopting further monetary policy measures. While policy inaction carried the risk of disappointing market expectations, in part financial conditions also reflected expectations of policy tightening in the United States and care needed to be taken to avoid circularity between monetary policy actions and expectations by the market. A material further extension of asset purchases at the present time appeared premature and could be reconsidered at a later stage, allowing for additional analysis and assessment still well ahead of the currently intended end of the programme in September 2016.

Some of these members also cautioned that the judgement on the need to act could not be separated from the nature of the remaining available instruments. In particular, purchases of sovereign debt, while considered to be a legitimate monetary policy tool, were seen to be associated with significant risks and side effects, and should therefore be kept in reserve as a contingency measure in case of extremely adverse developments, such as deflation, and should not be used as a means to fine-tune the inflation outlook. Therefore, the effectiveness of further monetary policy action had to be weighed against its potential costs and side effects. While the benefits of non-standard monetary policy action were seen to be subject to decreasing returns, this was not true for its side effects, including the impact on incentives for appropriate fiscal, financial and structural reforms. In this context, it was recalled that the decision to engage in asset purchases in January 2015 had

been accompanied by a strong call for complementary action in other policy domains. It appeared that such policy support had so far not materialised sufficiently.

In sum, most members supported the set of policy measures proposed by Mr Praet, while some members did not, on balance, see a sufficient case for further policy action or were only prepared to support some of the elements put forward. Among the latter, a few members expressed a preference, if further accommodation was seen as warranted, for limiting policy action at the current meeting to a cut in the deposit facility rate, possibly going beyond the 10 basis point reduction that had been proposed and possibly also including the prolongation of fixed rate full allotment tender procedures.

As regards the instruments of further monetary policy action, most members agreed that the set of policy measures put forward by Mr Praet in his introduction constituted an appropriate recalibration of the degree of monetary policy accommodation needed to secure a return of inflation rates to levels below, but close to, 2% over the medium term. The proposed set of policy measures was considered to be well balanced and, while at the lower end of market expectations, it was generally felt that the measures were adequately calibrated to achieve the ECB's price stability objective.

There was broad agreement that a further cut in the deposit facility rate by 10 basis points, to -0.30%, would provide a significant enhancement to the APP by reinforcing portfolio rebalancing effects, as lowering the rate further into negative territory, in conjunction with the ongoing increase in excess liquidity, should increase incentives to buy other assets in place of the securities purchased by the Eurosystem. A further cut could also support banks' willingness to lend without causing any undue adverse impact on their lending margins. There was agreement to leave the interest rates on the marginal lending facility rate and on the main refinancing operations unchanged.

A cut in the deposit facility rate of 10 basis points was seen as unlikely to trigger material negative side effects and was also seen as having the advantage of leaving some room for further downward adjustments, should the need arise. However, the further cut into negative territory would need to be accompanied by close monitoring of the transmission to financial markets, banks and the overall economy, also with regard to possible adverse effects on banks' liquidity management and their demand for central bank reserves.

Going beyond the proposed 10 basis point cut would, in the view of some members, raise issues about increasing side effects over time. In this context, the experience of other central banks in smaller jurisdictions would only partially apply. It would, in particular, raise issues regarding the profitability of banks and other financial institutions, whereby banks could try to recoup possible losses by increasing lending margins, leading to a tightening instead of a further easing in financing conditions – as well as issues regarding the implementation of the APP and the TLTROs.

At the same time, some members expressed a preference for a 20 basis point cut in the deposit facility rate at the current meeting, mainly with a view to strengthening the easing impact of this measure and reflecting the view that, to date, no material negative side effects on bank margins and financial stability had emerged.

With respect to the proposed extension of the APP, there was broad support for shifting the intended end date of the purchases from September 2016 to March 2017. This extension was regarded as an appropriate measure for additional monetary policy stimulus, as measures directly affecting the yield curve provided strong potential for monetary easing, when operating at the lower bound. Such an extension of the horizon of the APP would be firmly in line with the Governing Council's forward guidance, as previous communication had made this horizon conditional on the achievement of a sustained adjustment in inflation consistent with its inflation aim, which, on the basis of the available evidence, was not in sight by the intended end date of September 2016. When extending the programme, it was viewed as important to retain both the calendar-based and contingency-based elements of forward guidance, which included not only extending the intended end date to March 2017 but also reaffirming that the Governing Council would continue to add monetary accommodation via continued purchases for as long as needed to achieve a sustained adjustment in inflation.

The possibility was also raised of expanding the monthly volume of purchases or, alternatively, of frontloading purchases within the envisaged envelope so as to strengthen the impact in the short term. Moreover, the option was raised of extending the horizon beyond the suggested six months, so as to increase the overall volume of purchases above the level suggested by Mr Praet. However, there was broad agreement that such measures would not be warranted at this juncture, while a reassessment could be made in future.

It was widely agreed to announce the reinvestment of the principal payments of the securities purchased under the APP as they matured, for as long as necessary, which was seen to contribute to favourable liquidity conditions and an appropriate monetary policy stance. This measure was taken without prejudice to the modalities for phasing out the programme, which was not warranted at present but needed to be considered at a later date. Announcing a reinvestment policy at the current meeting would provide an important element of forward guidance regarding the envisaged amount of purchases and the size of the APP portfolio in the future, whereby the bonds purchased under the APP would remain on the balance sheet of the Eurosystem and the size of the portfolio would be kept at the level that would be reached at the end of the programme for as long as the reinvestment policy was in place.

There was also broad agreement on including regional and local government bonds in the list of assets eligible to be purchased by the national central bank of the country in which the respective regional or local government was located. It was felt that this measure would contribute to avoiding any possible strains on the availability of securities, especially in view of the extension of the programme beyond September 2016. The eligibility of these bonds would be subject to the usual credit rating floor foreseen for bond purchases. It was remarked that the implementation of this measure would not require a long lead time and the purchase of regional and local government bonds could start early in 2016 after the amendment of the relevant legal acts. It was envisaged that the Governing Council could review the technical parameters of the APP again in spring 2016, as had been suggested by Mr Praet in his introduction.

Finally, it was agreed to extend the fixed rate tender procedures with full allotment at least until the end of the last maintenance period in 2017, as a further element of forward guidance and in order to facilitate the implementation of the interest rate policies in conditions of abundant excess liquidity. A remark was made,

however, that further extending the provision of full funding insurance to counterparties, which had already been in place for a protracted period, would further prolong the suspension of market discipline and contribute to preserving the status quo in the banking system.

Monetary policy decisions and communication

Turning to communication, there was wide agreement among the members that additional monetary policy measures were warranted, as the latest information had confirmed concerns raised in September 2015 that the adjustment in inflation to rates closer to 2% would take longer than had been envisaged in March 2015 and that downside risks to both growth and inflation continued to prevail. At the same time, it was viewed as important to recognise the ongoing improvements in the economic and monetary environment, which also argued against a more pronounced change in the course of monetary policy. The proposed set of policy measures would ensure appropriate monetary policy accommodation and further strengthen the substantial easing impact of the measures taken since June 2014, consistent with the achievement of price stability. It would thus reinforce the momentum of the euro area's economic recovery and, ultimately, secure a return of inflation rates to levels that were below, but close to, 2% over the medium term and anchor inflation expectations accordingly.

It was also felt that confidence needed to be placed in the effectiveness of the existing monetary policy measures. It needed to be stressed that the policy measures taken since June 2014 had shown a number of tangible benefits, most notably in terms of the cost and availability of credit for firms and households, supporting the recovery of growth and inflation in the euro area. However, the current degree of monetary accommodation, which had been calibrated on the macroeconomic conditions prevailing at the start of 2015, was overall judged insufficient in view of the deterioration in the outlook for inflation and the prevailing downside risks to the ECB's price stability objective.

There was broad agreement that communication needed to underline that the monetary policy measures taken were adequate at the current juncture. It also needed to be reaffirmed that the monetary policy stance would remain accommodative for as long as necessary to ensure a sustained return of inflation rates towards levels below, but close to, 2%. The Governing Council would continue to closely monitor the evolution of the outlook for price stability and, if warranted, continued to be willing and able to act by using all the instruments available within its mandate in order to maintain an appropriate degree of monetary accommodation. In particular, the Governing Council recalled that the APP provided sufficient flexibility in terms of adjusting its size, composition and duration.

Finally, a call was made to remind governments forcefully about their responsibility to contribute decisively to rebalancing the euro area economy and to supporting the euro area recovery with appropriate measures. The concern was raised that the euro area growth strategy relied excessively on accommodative monetary policy transmitted, inter alia, via the exchange rate channel. In this environment, it was viewed as important that fiscal policies should support the economic recovery where possible, while remaining in compliance with the Stability and Growth Pact. The swift and effective implementation of structural 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.

Taking into account the views expressed by the Governing Council, the President concluded that a large majority of voting members supported a decision to recalibrate the degree of monetary accommodation in view of the ECB's price stability objective, with the proposed set of measures, and had decided:

First, as regards the key ECB interest rates, to lower the interest rate on the deposit facility by 10 basis points to -0.30%. The interest rate on the main refinancing operations and the rate on the marginal lending facility would remain unchanged at their current levels of 0.05% and 0.30% respectively.

Second, as regards non-standard monetary policy measures, to extend the APP. The monthly purchases of €60 billion under the APP were now intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council saw a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term.

Third, to reinvest the principal payments on the securities purchased under the APP as they matured, for as long as necessary. This would contribute both to favourable liquidity conditions and to an appropriate monetary policy stance. The technical details would be communicated in due time.

Fourth, to include, in the public sector purchase programme, euro-denominated marketable debt instruments issued by regional and local governments located in the euro area in the list of assets that are eligible for regular purchases by the respective national central banks.

Fifth, to continue conducting the main refinancing operations and three-month longer-term refinancing operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2017.

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/is151203.en.html

Press release

http://www.ecb.europa.eu/press/pr/date/2015/html/pr151203.en.html

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

Members

Mr Draghi, President

Mr Constâncio, Vice-President

Mr Bonnici

Mr Cœuré

Ms Georghadji

Mr Hansson

Mr Jazbec

Mr Knot

Mr Lane

Ms Lautenschläger

Mr Liikanen*

Mr Linde

Mr Makúch*

Mr Mersch

Mr Nowotny[1]

Mr Praet

Mr Reinesch

Mr Rimšēvičs

Mr Smets*

Mr Stournaras

Mr Vasiliauskas

Mr Villeroy de Galhau*

Mr Visco

Mr Weidmann

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

Other attendees

Mr Dombrovskis**, Commission Vice-President

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

** In accordance with Article 284 of the Treaty on the Functioning of the European Union.

[1] Not for the part of the meeting held on 3 December 2015.

Accompanying persons

Ms Buch

Mr Bohnec

Mr Carvalho

Mr Fagan

Mr Hernández de Cos

Mr Kaasik

Mr Kuodis

Ms Le Lorier

Mr Mifsud

Mr Mooslechner, Alternate to Mr Nowotny[2]

Mr Panetta

Mr Pattipeilohy

Mr Ramalho, Alternate to Mr Costa

Mr Rutkaste

Mr Schoder

Mr Stavrou

Mr Swank

Mr Tavlas

Mr Tóth

Mr Välimäki

Mr Wunsch

[2] Only for the part of the meeting held on 3 December 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, 18 February 2016.