26 August 2021

Meeting of 21-22 July 2021

Account of the monetary policy meeting of the Governing Council of the European Central Bank held in Frankfurt am Main on Wednesday and Thursday, 21-22 July 2021

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

Financial market developments

Ms Schnabel reviewed the financial market developments since the Governing Council's previous monetary policy meeting on 9-10 June 2021.

Long-term government bond yields had declined notably across advanced economies, including in the euro area, despite the ongoing strong recovery from the shock of the coronavirus (COVID-19) pandemic. Model-based evidence on the drivers of euro area yields suggested that a very large share of the recent decline in euro area risk-free rates reflected foreign spillovers, mainly in the form of an increase in global risk aversion. The fast spread of the Delta variant of the coronavirus and rising infection rates across many countries had likely been the main reason behind the increase in global risk aversion, as also reflected in the ratio of value to growth stocks having fallen markedly in recent weeks. Although the experience of the United Kingdom suggested that, so far at least, progress in vaccination campaigns had succeeded in weakening the link between the number of infections and hospitalisation rates, the Delta variant had instilled new uncertainties about the path to economic normalisation, thereby weighing on yields in recent weeks.

Long-term sovereign yields had declined more markedly in the United States, where investors had continued to reverse a large part of the rise in long-term real interest rates seen earlier this year, a move possibly linked to changes in market expectations about monetary policy. A model-based decomposition of the ten-year US Treasury yield suggested that term premia had declined considerably in recent weeks, while revisions to the expected future path of short-term rates had been more limited. This suggested that the sharp rise in US real rates earlier this year may have largely reflected increased uncertainty around the outlook for monetary policy, and that this uncertainty may have diminished in recent weeks.

By comparison, in the euro area, real risk-free rates had been much more stable than in the United States, although they had also started to grind lower in recent weeks. Real ten-year risk-free rates in the euro area were currently almost 20 basis points below the level prevailing at the Governing Council meeting on 9-10 December 2020. In addition, market-based measures of inflation compensation had resisted broad downward pressure in the euro area, suggesting that investors remained fundamentally positioned for a sustained recovery from the pandemic crisis.

As government bond spreads had remained resilient, the nominal euro area ten-year GDP-weighted sovereign bond yield had declined further since the Governing Council's previous monetary policy meeting on 9-10 June 2021 and was currently again in negative territory. Yields had fallen by more than 30 basis points since mid-May when changes in market expectations about the likely future path of asset purchases had put upward pressure on yields.

The EONIA forward curve had also flattened considerably in recent weeks, although this likely mirrored the decline in term premia related to the increased risk from the spreading of the Delta variant and did not necessarily reflect a genuine change in interest rate expectations. This was consistent with the unchanged expectations for a lift-off reported in the latest ECB Survey of Monetary Analysts (SMA). At the same time, the flattening of the forward curve could also in part reflect an adjustment in policy rate expectations in response to the outcome of the ECB's strategy review, though immediate market reactions had been muted.

As markets now expected an earlier lift-off of interest rates in the United States, the euro had depreciated markedly against the US dollar, reinforced by a flight to safety. Indeed, since the start of the year there had been a close correlation between the EUR/USD exchange rate and the short-term interest rate differential, implying that movements at the long end of the curve did not seem to have mattered much for foreign exchange markets, which had instead focused on the timing of the interest rate lift-off.

Despite the notable increase in global risk aversion, so far there had been little adjustment of credit risk premia in euro area fixed income markets. Corporate bond spreads had weathered the recent flight to safety well. Investment-grade credit spreads had declined further, while high-yield bond spreads had increased somewhat, but remained below their pre-pandemic levels despite the strong issuance of high-yield bonds in the year to date. ECB data showed that the strong issuance by high-yield issuers had been to a large extent absorbed by investment funds, thereby further raising the risk profile of non-banks.

The increase in global risk aversion had, however, weighed on equity prices. The EuroStoxx had declined, with larger losses in countries that were more heavily exposed to potential and actual travel restrictions imposed in the wake of the fast spread of the Delta variant. The events of recent days had also illustrated how current elevated stock market valuations could be prone to sudden corrections as cyclically adjusted price-earnings ratios were at, or close to, record highs. Price corrections, if sudden and sizeable, could have tangible effects on investors' balance sheets, as inflows into equity funds had continued to increase since the Governing Council's previous monetary policy meeting on 9-10 June 2021 and were several times higher than inflows seen in previous years.

Overall, financial conditions in the euro area had remained broadly stable at highly accommodative levels. Taking a snapshot across indicators, those that put a large weight on the exchange rate showed an easing of financial conditions and those that stressed stock markets showed a tightening.

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

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

As regards the external environment, incoming data had confirmed that the general recovery was proceeding, but with increasing evidence of supply constraints. At the same time, the spread of new COVID-19 variants continued to be a major concern for the global and euro area economic recovery. The Purchasing Managers' Index (PMI) data for June gave historically high readings for the second quarter of 2021 as a whole – but this was before the Delta variant had led to a sharp increase in cases of infection. Trade in goods remained on the strong upward trend observed since the middle of last year – even though it had flattened slightly according to the most recent data.

Since the June monetary policy meeting of the Governing Council, the euro had depreciated markedly against the US dollar (-3.6%) and less so in nominal effective terms (-0.9%). Oil prices had decreased by 3.9% in the same period (remaining broadly in line with the technical assumptions for the June projections), amid heightened volatility in the oil market. The upward trend in non-oil commodity prices had stopped and, overall, prices of metals and food had remained broadly unchanged since the June Governing Council meeting.

Turning to the euro area, GDP had decreased by 0.3%, quarter on quarter, in the first quarter of 2021, especially owing to the implications of the lockdowns in many euro area countries for private consumption. Supply-side bottlenecks continued to dampen manufacturing activity, with supplier delivery times remaining close to the record high recorded in June, both globally and in the euro area, and the ratio of new orders to stocks of finished goods reaching a record high. The intensification of supply constraints was weighing on manufacturing and investment and had led to a fall in industrial production in May. In the latest ECB Corporate Telephone Survey, firms had reported that it was probably going to take until somtime next year before these supply constraints would no longer be an issue.

Recent survey indicators, such as the PMIs for manufacturing output and services business activity, had suggested a strong rebound in activity in the second quarter, particularly in services, with continued growth in manufacturing. Retail sales volumes up to May, together with the increased availability of certain services, were consistent with robust consumption growth in the second quarter. Business confidence indicators pointed to a big recovery, with industrial confidence at very high levels in June – well above its pre-pandemic level – while other indicators were just about returning to pre-pandemic levels.

Consumer confidence had increased, mainly reflecting a marked improvement in the assessment of the general economic situation over the next 12 months, while confidence in consumers' personal financial situation, which tended be the main factor in purchasing decisions, had improved far less strongly.

For business investment, survey indicators up to June suggested a strengthening in the second quarter of 2021, although the decline in capital goods production in May reflected the constraints posed by supply-side bottlenecks. Construction firms had also flagged shortages of materials and labour close to historical highs in June, amid strong demand conditions and confidence indicators.

Turning to trade, the April data reflected continuing momentum, especially in goods exports to the United States and Asia, but the local contribution had weakened. In particular, exports of vehicles and electronics had been affected by supply constraints, while the delivery delays had also extended to machinery. Forward-looking indicators for tourism pointed to a recovery but were still very far from levels consistent with a complete normalisation.

Looking at the labour market, the unemployment rate had declined in May to stand at 7.9%, which was 0.2 percentage points lower than in April 2021 but 0.6 percentage points higher than in February 2020. The number of workers in job retention schemes had been reduced but still amounted to around 5% of the labour force. Overall, the labour market continued to be substantially affected by the pandemic, but high-frequency indicators and survey data pointed to robust employment growth in the period ahead.

Turning to nominal developments, inflation in the Harmonised Index of Consumer Prices (HICP) had decreased slightly from 2.0% in May to 1.9% in June. HICP energy inflation had remained high (12.6%), contributing the lion’s share (1.1 percentage points) to headline inflation in June. HICP inflation excluding energy and food had decreased slightly from 1.0% in May to 0.9% in June, driven by a decrease in services price inflation. While non-energy industrial goods (NEIG) price inflation had increased further from 0.6% in May to 1.2% in June, services price inflation, which historically had been an important driver of overall inflation, remained below 1%. In particular, prices in the tourism and hospitality sectors had not yet fully recovered. The change in HICP weights for 2021 had started to become a drag again on HICP inflation in June, a factor which was expected to increase over the summer.

Developments in measures of underlying inflation remained subdued overall, with special factors playing an important role for many measures. The Persistent and Common Component of Inflation index had increased because the common component in this measure also captured the persistent part of energy price developments. For measures of core inflation, developments depended on whether volatile items such as travel-related services or clothing and footwear were included and also whether the effects of changes in value added taxes were netted out. In general, it continued to be important to assess developments in underlying inflation on the basis of a broad range of indicators.

Pipeline pressures for NEIG inflation had increased further over recent months, mainly at the earlier stages of the pricing chain, and additional upward pressure on NEIG inflation from recent input cost developments was likely over the coming months.

Wage developments had been subdued overall. Many wage settlements had been low, which reflected the difficulty entailed in negogiating higher wages amid the current level of economic slack and high uncertainty. The latest data gave no indication that rising inflation rates were leading to higher wage agreements.

Increases in input costs continued to put profit margins under pressure. Looking ahead, it was important to assess whether the pass-through of higher input costs would strengthen.

In the latest ECB Survey of Professional Forecasters, longer-term expectations for headline inflation had been revised up to 1.8% (for 2026) from 1.7% (for 2025) in the previous round. The distribution of longer-term inflation expectations had moved to the right as many more respondents had revised their longer-term inflation expectations upwards than downwards. At the same time, market-based measures of inflation compensation and option-implied risk-neutral inflation probabilities had remained broadly unchanged since the June monetary policy meeting.

Turning to financial and monetary developments, nominal risk-free rates and sovereign yields had declined since the June policy meeting. Looking at the downstream indicators, interest rates for households and firms remained low and financial and financing conditions were broadly unchanged overall. Long-term GDP-weighted sovereign yields had fallen in parallel with risk-free rates since the June monetary policy meeting of the Governing Council, but they were still far above the levels recorded last December.

The annual growth of M3 had declined further in May, suggesting a normalisation of monetary flows compared with the peak of the crisis, with households and firms returning to accumulating deposits at a pace similar to the rate prevailing before the pandemic. The annual growth rate of loans to firms had declined in May as a result of the improvement in economic activity and confidence indicators. The real cost of bank financing had moved back towards pre-pandemic levels, supported by the recent rebound in inflation expectations.

In the July bank lending survey, euro area banks had reported a moderate net increase in demand for loans to firms in the second quarter of 2021, after two quarters of significant declines. Financing needs of firms for fixed investment were seen as making a positive contribution to loan demand for the first time since the third quarter of 2019. The reported change in the composition of lending hence reflected a normalisation. It was also reassuring that banks had reported broadly unchanged credit standards for loans to enterprises in the second quarter of 2021, following a significant net tightening in the second half of 2020 and a moderate tightening in the first quarter of 2021. Some companies seemed to have replaced bank loans with market-based financing, taking advantage of the attractive bond yields. The annual growth rate of loans to households had edged up in May and continued to be driven by lending for house purchase. Credit standards for housing loans had remained broadly unchanged in the second quarter of 2021.

Turning to fiscal policies, strong fiscal support was expected for 2021, including from the Next Generation EU (NGEU) programme. Since the June staff projections were prepared, additional fiscal measures of around 0.25% of GDP had been announced for the current year.

Monetary policy considerations and policy options

Summing up, Mr Lane noted that, in implementing the new monetary policy strategy, it was important to update the Governing Council's forward guidance on the key ECB interest rates. A commitment to maintain monetary accommodation on a persistent basis was essential in view of the effective lower bound constraint and the shortfall in the medium-term inflation outlook relative to the two per cent target.

The new strategy incorporated two key innovations which should be reflected in the ECB's forward guidance on interest rates: first, the redefinition of the ECB's price stability objective as a two per cent inflation target over the medium term; and, second, a conditional commitment to take into account the implications of the effective lower bound when conducting monetary policy in an environment of structurally low nominal interest rates.

Under the current conditions, forward guidance would reinforce the commitment to attaining the inflation target by clarifying that the policy rates would be raised only if the evidence was sufficiently robust to allow the Governing Council to expect with a high degree of confidence that the inflation rate would reach two per cent on a durable basis. In practice, the proposed new forward guidance would serve two distinct purposes: first, it would provide a concrete operationalisation of the concept of robust convergence of inflation to the new target; and, second, it would reflect the clear need for the ECB's policy reaction to be especially persistent in conditions, such as at present, in which nominal interest rates had been close to their lower bound for some time and the outlook for inflation was still well below the target.

A recalibrated forward guidance should contain three key conditions that should be met before interest rates were raised: first, inflation should reach the target well in advance of the end of the projection horizon, in order to ensure that the lift-off decision was based on firm foundations and not exposed to the volatility of longer-horizon projection errors; second, the Governing Council should be confident that the target would be reached on a durable basis; and, third, the Governing Council should not consider raising rates unless underlying inflation was also judged to have made satisfactory progress towards two per cent. This was an extra safeguard against a policy tightening in the face of cost-push shocks that might elevate headline inflation temporarily but fade quickly. Finally, a preamble should make clear that the new guidance was in the service of ensuring robust convergence to the target over the medium term.

In line with these principles, Mr Lane proposed the following reformulation: "In order to ensure robust convergence to the two per cent inflation target over the medium term, the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we see inflation reaching two per cent well ahead of the end of our projection horizon and on a durable basis and we judge that realised progress in underlying inflation towards two per cent is sufficiently advanced". First, by stipulating that inflation should be expected to reach the target "well ahead of the end of our projection horizon", the new forward guidance would give reassurance that the rise in inflation to two per cent at the time of a rate lift-off should not be expected to occur only at the end point of the horizon. This earlier convergence to the target also helped to hedge monetary policy against the risk of reacting to forecast errors, which tended to be larger at longer horizons. Second, by stating that the inflation target should be reached on a durable basis, the Governing Council would signal that the target would be attained on a lasting basis, rather than as the result of short-lived forces that led to one-off price increases but were unlikely to lead to persistently higher year-on-year inflation. For that purpose, the Governing Council needed to look beyond the initial threshold of "well ahead of the end of the projection horizon" to see whether the inflation target was expected to be reached on a durable basis. In both dimensions, the forward guidance was formulated as an expectation of the Governing Council, rather than being mechanically linked to staff projections.

This formulation would also keep an element of the focus on current developments by retaining the reference to underlying inflation. Specifically, the third condition would imply that the "realised progress in underlying inflation towards two per cent is sufficiently advanced" at the time of a rate hike. This additional condition would provide added insurance against a premature policy reaction to transitory, and possibly contractionary, price shocks. It was important to keep in mind that "underlying inflation" was a broad concept – it was the persistent component of inflation that provided the best guide to future inflation developments and was not proxied by any single indicator, in view of the state-contingent nature of the forces shaping underlying inflation trends.

Some other elements of the new forward guidance were important to note. First, the forward guidance remained state-contingent and would continue to provide a powerful automatic stabilisation mechanism. In one direction, if the inflation outlook were to improve by more than anticipated as the recovery proceeded, the time horizon to the first increase in interest rates would automatically shorten and financing conditions tighten. In the other direction, if there were setbacks to the inflation outlook, the time to lift-off would automatically lengthen, leading to easier financing conditions that would help support the economy and the inflation outlook. Second, specifying a condition in terms of a relatively earlier convergence within the projection horizon did not mean altering the Governing Council's concept of the medium term. The condition was meant to act as a signpost to orientate monetary policy at a time when acting too pre-emptively would risk exposing policy to "false signals" and when longer-term inflation expectations remained well below the Governing Council's inflation target. The orientation, as stated in the preamble to the new forward guidance, remained resolutely focused on "ensuring robust convergence to the two per cent inflation target over the medium term". Third, the formulation provided ex ante guideposts, rather than requirements that needed to be met ex post. In particular, the preamble limited the validity and scope of the new forward guidance to a situation in which robust convergence was not yet assured. Once robust convergence to the two per cent target had been achieved, revised forward guidance would be necessary.

Given that the reformulation of forward guidance constituted a revision to the policy stance that might prolong the horizon over which the key interest rates were expected to remain at their present or lower levels, a proportionality assessment was warranted. The proposed revision to the forward guidance was indeed judged a proportionate response to the risks to the ECB's price stability mandate. Since the Governing Council had first introduced forward guidance on interest rates in 2013, it had gained substantial experience with this instrument: there was little doubt that it was an effective tool to steer interest rate expectations. There was abundant evidence that it had contributed to bringing inflation closer to the Governing Council's objective, and the proposed new guidance was expected to be similarly effective. The proposed reformulation was also efficient compared with alternative policy options. Other tools, while also effective, would be less efficient in the medium-term segment of the term structure: in order to provide the same additional inflation impulse with different instruments, the Governing Council would need to either lower policy rates substantially deeper into negative territory or significantly scale up its asset purchase programmes. Moreover, any unintended consequences of the current low level of interest rates for financial intermediation and the wider economy were unlikely to be strongly amplified by the limited delay in the lift-off date to which this reformulation could give rise, and in any case would be outweighed by the benefits of low interest rates for employment and economic activity. Of course, the Governing Council would continue monitoring the potential side effects – positive or negative – if it extended the period over which negative or low interest rates were applied. In this respect it was also important to note that the support which the new strategy and the proposed forward guidance provided for the re-anchoring of inflation expectations reduced the risk of possible side effects, since it should help to shorten the time spent at very low interest rates and, all else being equal, lower the required volume of asset purchases.

Turning to the assessment of the economic outlook, the recovery of the euro area economy was gaining momentum. While the Delta variant was a source of concern, the advance of the vaccination campaigns over recent weeks had allowed containment measures to be rolled back in most euro area countries. The improvement in the economic outlook was reflected in forward-looking activity and sentiment data for all sectors of the economy and was also starting to show through in indicators of realised economic activity. The composite manufacturing PMI had hit a new record in June, retail sales had improved significantly in May, and trade was showing robust momentum. However, the increasing spread of the Delta variant could dampen the recovery, especially in services such as tourism and hospitality. Moreover, supply constraints continued to restrain production in some sectors. The intensification of global supply chain disruptions that was becoming evident, for example in longer delivery times or shortages of computer chips, had led to a decline in industrial production in the three largest euro area economies in May.

Risks to the outlook remained broadly balanced. Downside risks were primarily related to the possibility of a renewed intensification of the pandemic owing to the spread of more aggressive virus variants or more persistent supply bottlenecks. The strong incoming forward-looking data and the possibility of a faster than anticipated draw-down of savings represented some upside risks to the outlook.

HICP inflation had decreased slightly, from 2.0% in May to 1.9% in June. While, the latest data implied some upward revision to the short-term profile for headline and core inflation on account of stronger than envisaged inflation for the NEIG and energy components, the profile envisaged in the June staff projections was broadly confirmed. Survey-based measures of inflation now also indicated a small rise in longer-term inflation expectations, although to levels that were still some distance below the inflation target.

Although long-term benchmark interest rates remained above the levels observed in the first months of the year, these had fallen since the June monetary policy meeting, influenced by movements in US bond yields and renewed uncertainty about the future evolution of the pandemic. The market reaction to the Federal Open Market Committee’s meeting in June had been a key driver of international financial markets, but interest rate expectations in the euro area had remained mostly unaffected.

Since the incoming information was broadly in line with the joint assessment of financing conditions and the inflation outlook carried out at the June monetary policy meeting, Mr Lane proposed to continue to conduct net asset purchases under the pandemic emergency purchase programme in the third quarter at a significantly higher pace than during the first months of the year.

2. Governing Council’s discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, members generally agreed with the assessment of the current economic situation in the euro area and the risks to the outlook provided by Mr Lane in his introduction. The recovery in the euro area economy was widely seen as on track. More and more people were being vaccinated, and lockdown restrictions had been eased in most euro area countries. But the pandemic continued to cast a shadow, especially as the Delta variant constituted a source of growing uncertainty. Inflation had picked up, although the increase was expected to be mostly temporary. The outlook for inflation over the medium term remained subdued.

With respect to the external environment, members broadly shared the assessment provided by Mr Lane in his introduction that global economic activity and trade had continued to improve, despite the fourth wave of the coronavirus spreading across the world. It was generally believed that less stringent measures would be adopted by authorities and that the link between widely used lockdown indices and economic activity should be substantially weaker than in earlier waves. At the same time, concern was expressed about the situation in emerging economies, where vaccination campaigns were much less advanced. Moreover, trade continued to be heavily affected by supply bottlenecks and rising shipping costs, and was still dependent on the future evolution of the pandemic. In this environment, the outlook for global trade was seen as highly uncertain.

The outlook for economic activity and inflation in the United States was regarded as difficult to interpret in the light of recent financial market developments, with US bond yields having declined considerably at a time when inflation in the United States had clearly risen. While market participants might have become more pessimistic about the growth outlook in view of the recent spread of the Delta variant, they had also become more receptive to the Federal Reserve System’s argument that the ongoing bout of inflation would be temporary. However, it was also argued that a number of indicators pointed to risks of a more protracted rise in inflation in the United States, not least against the background of substantial fiscal policy support.

In discussing the euro area’s economic outlook, members generally concurred that the June baseline staff projections remained broadly valid, despite some changes in the likely quarterly pattern. It was underlined that the euro area economy was rebounding strongly and economic sentiment had improved notably. If anything, recent indicators seemed to have become more favourable than previously expected and were confirming that the recovery was gaining ground. Generally, they now pointed to a somewhat stronger outcome for economic activity in the second quarter, while growth in the third quarter might fall short of the ambitious figure contained in the June projections. Taking both quarters together, growth seemed to be well on track overall.

Manufacturing was expected to perform strongly, even though supply bottlenecks were holding back production in the near term. The reopening of large parts of the economy was supporting a vigorous bounce-back in the services sector. However, the Delta variant of the coronavirus could dampen the recovery in services, especially in tourism and hospitality.

As people returned to shops and restaurants and resumed travelling, consumer spending was rising. Better job prospects, increasing confidence and continued government support were reinforcing spending.

The ongoing recovery in domestic and global demand was boosting optimism among businesses. While the spread of the Delta variant had led to renewed uncertainty, as also reflected in financial markets, the economy was holding up. Households and firms continued to adapt rapidly to living with the presence of the coronavirus. The assessment was broadly shared that a fourth wave of the coronavirus would have a more limited health impact owing to rising vaccination rates, for example in terms of hospitalisation and pressure on intensive care units. Hence a fourth wave was also likely to result in less stringent containment measures and have a more limited economic impact overall. In this context, it was pointed out that the correlation between containment measures and the economic cost of the pandemic was changing over time.

Overall, economic activity could be expected to return to its pre-crisis level in the first quarter of next year. However, there was still a long way to go before the damage to the economy caused by the pandemic was overcome. For example, the number of people in job retention schemes had been declining but remained high.

Members assessed the risks to the economic outlook as broadly balanced. On the upside, economic activity could outperform expectations if consumers spent more than currently expected and drew more rapidly on the savings they had built up during the pandemic. Attention was drawn to the fact that the recovery was gaining momentum, with a strong rebound in consumption and qualitative indicators pointing to a fall in the household saving rate. A faster improvement in the pandemic situation could also lead to a stronger expansion than currently envisaged. In addition, the approval of the NGEU programmes for the individual countries was moving in a favourable direction, even if implementation risks remained. Previously identified risks of a wave of bankruptcies in the corporate sector appeared to be receding.

Regarding possible downside risks, growth could underperform expectations if the pandemic intensified or if supply shortages turned out to be more persistent and held back production more than previously anticipated. Concerns were expressed that much about the virus was still poorly understood and a sequence of further mutations was not unlikely, with consequences that were hard to predict despite progress with vaccination campaigns. It was also argued that tail risks in the non-financial corporate sector, and notably for small and medium-sized enterprises, were still accumulating in a recovery that was very asymmetric and uneven from a sectoral perspective. Moreover, it was underlined that the benign evidence of limited bankruptcies so far had to be ascribed to the massive and timely responses of fiscal and monetary policy. Finally, rising oil and commodity prices could weigh on consumption, while economic slack remained substantial in a fragile recovery.

Looking at a comparison with the June staff projections, it was pointed out that the risk of the Delta variant spreading had clearly materialised but with less immediate economic impact than might have been feared. Overall, the balance of risks for economic activity as expressed in the June projections was judged to be still valid.

Against this background, members agreed that ambitious, targeted and coordinated fiscal policy should continue to complement monetary policy in supporting the recovery. In this context, the NGEU programme had a key role to play. It would contribute to a stronger and uniform recovery across euro area countries. It would also accelerate the green and digital transitions and support necessary structural reforms that lifted long-term growth.

Turning to price developments, headline HICP inflation had stood at 1.9 per cent in June. Inflation was expected to rise over the coming months and to decline again in 2022. The current increase was largely being driven by higher energy prices and by base effects from the sharp fall in oil prices at the start of the pandemic and from the impact of the temporary VAT reduction in Germany last year. By early 2022 these factors would fade as they dropped out of the year-on-year inflation calculation.

Members highlighted that recent inflation numbers had clearly been higher than previously expected, for both headline inflation and core inflation excluding food and energy, continuing a persistent string of upside surprises. They were driven, in particular, by unexpectedly strong developments in NEIG prices. However, the picture of a mostly transitory increase in inflation was still widely seen to hold true. While the increases in inflation were expected to continue in the near term, in part owing to temporary cost pressures in supply chains, most measures of underlying price pressures had remained subdued. Significant slack in the economy, weak wage growth and the past appreciation of the euro meant that underlying price pressures would likely remain subdued for some time.

Attention was drawn to indications that profit margins were falling rapidly, implying that cost increases were being absorbed by businesses rather than being passed through to prices. Moreover, available data on wage agreements for the first few months of the current year pointed to growth in negotiated wages that remained relatively low in an environment in which inflation was relatively high. Subtracting reasonable estimates of trend productivity growth from wage growth showed subdued unit labour costs. It was argued that, taken together, this evidence suggested a subdued medium-term outlook for inflation. It was also argued that, so far, evidence of second-round or indirect effects of higher inflation was limited, with a contained pass-through from non-energy input costs to consumer prices.

However, it was also stressed that profit margins had already been squeezed for some time during the pandemic and, based on past experience, such a continuous decline in margins was not sustainable and would likely reverse. This suggested that cost increases would increasingly be passed through to consumers in the future. This was all the more likely in the current environment, since households appeared ready to spend part of their accumulated savings. Reference was also made in this context to upward revisions to earnings expectations for listed companies. In addition, supply bottlenecks now seemed to be more severe and persisting for longer than previously expected, although they were clearly expected to remain transitory. Moreover, labour market developments had been getting stronger in recent months, with reduced recourse to government support schemes.

The new package of climate policies recently proposed by the European Commission was seen as likely to lead to sustained upward pressures on energy prices and some other price components in the period ahead. However, it was also argued that such cost and price pressures linked to the climate transition might be offset by efficiency gains from technological change, by the replacement of fossil fuels with renewables in the energy mix and by an intended downward impact on energy consumption. The point was made, however, that the direct effect of climate policies on energy prices should dominate initially and that any substitution effect was likely to kick in only later. With respect to public investment and the impact on aggregate demand, and hence on economic slack, the net effect of the climate package would clearly be to stimulate the economy for the next decade.

In line with the conclusions of the ECB's strategy review, a discussion of the costs of owner-occupied housing was welcomed. Residential property prices in the euro area were increasing at their fastest pace since 2007, and experience at the country level suggested that the underlying trends were rather persistent. The available experimental owner-occupied housing cost data related to the first quarter of 2021, and the contribution they would have made to headline inflation for the euro area as a whole had been estimated at around 0.2-0.3 percentage points.

In this context, it was underlined that the existing HICP remained the relevant measure of inflation for the ECB, with owner-occupied housing an auxiliary consideration and the available experimental indicator lagging the HICP. In the past there had also been earlier periods, such as between 2011 and 2014 – i.e. during the sovereign debt crisis – when the contribution from owner-occupied housing would have been significantly negative, at around 30 basis points. Mapping the property price index to the owner-occupied housing component in consumer prices remained experimental and required further work. So far, a distinction had not been made between the consumption and the investment element.

Considering recent developments in inflation expectations, members noted that longer-term inflation expectations had edged up to 1.8 per cent, from 1.7 per cent, according to the ECB's Survey of Professional Forecasters, while market-based indicators of inflation expectations had remained broadly stable. The survey had been carried out before the ECB's announcement of its revised strategy but possibly reflected some anticipation of the Governing Council's new framework. While no significant market impact had been observed around the day on which the new strategy was announced, it might take some time until the markets and the public had fully digested the changes. Confidence was expressed that inflation expectations were starting to move in the right direction. However, it was also cautioned that inflation expectations for the coming five years as reflected in option market prices continued to show a much higher probability of euro area inflation falling short of two per cent than exceeding it.

Members broadly concurred that, while the inflation outlook had improved, it remained some distance from the ECB's target level. The Governing Council would consider the outlook again in more detail at its September meeting, once the new staff projections were available. At the same time, risks to the inflation outlook, as embodied in the June Eurosystem staff projections, were widely regarded as increasingly tilted to the upside. This was clearly seen to be the case over the short term. It was also seen to be the case to a lesser extent in the assessment of the medium-term outlook, although this was more uncertain.

Turning to the monetary and financial analysis, members broadly concurred that incoming data suggested monetary flows were normalising as the pandemic situation improved. The annual rate of growth in broad money (M3) had declined further in May, reflecting a strong negative base effect. Deposit flows of households and firms had returned to pre-pandemic levels as liquidity needs subsided. The annual growth rate of bank loans to the private sector had declined in May, reflecting a negative base effect and net loan redemptions. At the same time, it was noted that in the July bank lending survey euro area banks had reported a moderate net increase in firms' demand for loans in the second quarter of 2021.

Credit conditions were judged to have remained supportive against the backdrop of a generally improving economic situation and continued policy support from monetary, fiscal and supervisory authorities. Interest rates on bank loans had so far been insulated from the upward trend in risk-free interest rates since the end of 2020 and remained near historical lows.

Members agreed that, overall, financial and financing conditions had remained broadly unchanged at highly favourable levels. Euro area risk-free interest rates and sovereign yields had fallen in both nominal and real terms since the June monetary policy meeting, with the euro area GDP-weighted ten-year bond yield falling back into negative territory. It was remarked that real interest rates stood at historical lows. The decline in euro area market interest rates was seen to largely reflect renewed risk aversion, owing to the rapid spread of the Delta variant of the coronavirus, as well as spillovers from the decline in US yields. Further downstream, bank lending rates for firms and households had remained near historical lows.

It was reiterated that preserving favourable financing conditions for all sectors of the economy throughout the pandemic crisis period remained essential for the current economic rebound to turn into a lasting expansion and to offset the negative impact of the pandemic on inflation.

Monetary policy stance and policy considerations

With regard to the proposed policy measures, members agreed that it was necessary to align the forward guidance on interest rates with the revised formulation of the price stability objective in the ECB's new monetary policy strategy. Given that the conclusion of the strategy review had been announced only two weeks prior to the current monetary policy meeting, it was highlighted that changes in the forward guidance would shape market participants' understanding of the new strategy and could be seen as a first test of the revised strategy itself. It was underlined that the new strategy had been agreed unanimously and provided the Governing Council with a shared framework.

The strategy incorporated two key innovations, which needed to be reflected in the forward guidance. First, it provided a numerical clarification of the price stability objective by specifying an explicit two per cent symmetric inflation target. Second, it included a "conditional commitment" to take into account the implications of the effective lower bound when setting monetary policy in an environment of structurally low nominal interest rates, including through the adoption of more forceful or persistent policy measures.

The need to revise the forward guidance on interest rates was emphasised, in order to provide a credible commitment to bringing inflation up to the new target. It was also seen as essential to provide safeguards against a premature tightening of monetary policy in the current environment.

It was also recalled that forward guidance was a state-contingent instrument that expressed monetary policy intentions, rather than being a fixed commitment to a pre-determined policy path. The forward guidance was always based on the Governing Council's current assessment of the outlook for price stability. Hence, the Governing Council retained discretion and judgement, and the guidance could change as circumstances evolved. Moreover, as the forward guidance was not mechanically linked to the staff projections, the Governing Council retained flexibility to exercise its own judgement regarding the inflation outlook. The reformulated forward guidance was best understood as a set of conditions that would help guide the ECB's actions in pursuit of its inflation target, as defined in the new strategy. It did not necessarily imply "lower for longer" interest rates if it ultimately succeeded in anchoring inflation expectations at the target, as intended. Accordingly, it was remarked that forward guidance on interest rates, if credible, should reduce the extent to which other instruments needed to be deployed.

Against this background, the new formulation of the forward guidance proposed by Mr Lane was widely seen as finely balanced. It reflected the new symmetric inflation target of two per cent and the conditional commitment to take into account the implications of the effective lower bound when conducting policy in an environment of structurally low nominal interest rates. In particular, by stipulating more specific outlook-based and outcome-based conditions to be met before interest rates were raised, it underlined the need for persistence in the accommodative policy stance. This would help avoid a premature tightening of the stance and ensure a robust convergence of inflation to the target in the medium term. In this regard, it was noted that the forward guidance language should clearly dispel the notion that two per cent was a ceiling for inflation, given that the new strategy explicitly allowed for a moderate and transitory overshooting.

In the discussion, members put forward a number of considerations. On the one hand, the case was made for strengthening the forward guidance on interest rates even further. First, policy rates remained constrained by the lower bound. Second, medium-term inflation expectations continued to stand below the inflation target. Third, markets were pricing in a lift-off of the key ECB policy rates at a time when inflation over the medium term was still expected to be well below two per cent. This could be interpreted as a sign that the current forward guidance was insufficient to guide market expectations. From this perspective, it was felt that the forward guidance could be strengthened by formulating the lift-off conditions in terms of realised inflation rather than expected inflation. The point was made that stepping up the forward guidance now and scaling it back later, when necessary, would be better for credibility than having to scale up the guidance later.

On the other hand, it was cautioned that requiring inflation to durably reach two per cent at an earlier point in time would risk undermining the medium-term orientation of monetary policy. In addition, given the significant lags with which monetary policy was transmitted to the real economy, it would amount to intentionally overshooting the inflation target. In this regard, it was recalled that other instruments were continuing to provide strong monetary policy support at the lower bound. The point was made that some loosening of the monetary policy stance would occur automatically, without substantial changes to the forward guidance, because the somewhat higher inflation target in the new strategy would in any case likely imply a postponement of the lift-off date.

The credibility of the Governing Council's forward guidance was seen as key to its success. It was noted that the further into the future forward guidance extended, the less credible the commitment was likely to be. Under the forward guidance in place at the time of the meeting, markets were not expecting the lift-off until 2024 and were pricing in negative policy rates until 2028. Moreover, the argument was made that the proposed formulation could prove too ambitious and hence jeopardise credibility by risking a break with the stipulated conditions later on. A suggestion was made to include “knock-out” clauses in the forward guidance as a possible means to enhance credibility, mitigate financial stability risks and underscore that the Governing Council was just as concerned about inflation being too high as it was about inflation being too low. At the same time, it was underlined that the strategy itself provided a safeguard by stipulating that only temporary and moderate overshoots of inflation would be consistent with price stability over the medium term.

Against this background, members exchanged views on how to formulate the three conditions in the recalibrated forward guidance set out in the proposal by Mr Lane. With regard to the first condition, it was remarked that the phrase “well ahead” was essential in order to avoid referring only to the end of the projection horizon, which was seen as subject to greater uncertainty than shorter-term forecasts. Given projection errors, preferences were expressed to formulate the first condition in terms of realised inflation rather than projected inflation. This might help avoid a premature tightening of the monetary policy stance, strengthen the credibility of the guidance and provide greater clarity to markets. At the same time, concerns were raised that the phrase “well ahead” could be perceived as deviating from the medium-term orientation of the monetary policy strategy. However, it was clarified that specifying a condition in terms of a relatively earlier convergence within the projection horizon did not mean altering the concept of the medium term.

With regard to the second condition outlined by Mr Lane, the phrase “on a durable basis” was seen to provide flexibility by allowing for small oscillations around the target level. However, concerns were raised that the phrase was too vague to sufficiently anchor expectations, as suggested by experience with the current formulation of forward guidance. It was argued that the notion of durability could be reinforced by referring explicitly to the level of inflation over the remainder of the projection horizon. In this regard, and in view of the symmetric nature of the inflation target, it was suggested that reference could be made, for example, to inflation not falling below or staying above two per cent over the forecast horizon. It was acknowledged that such a reformulation of interest rate forward guidance would imply an almost certain overshoot of the two per cent inflation target. Such overshooting, if temporary and moderate, could however be seen as fully in line with the new strategy.

At the same time, it was argued that requiring inflation not to fall below the target would effectively amount to intentionally overshooting, which was viewed as inconsistent with the strategy. It was also remarked that, because there was no explicit safeguard ensuring that any potential overshoot would be moderate, maintaining price stability could give rise to the need for a rapid increase in policy rates once the conditions of the interest rate forward guidance had been met. Such a swift tightening of policy rates at a later stage might then not prove easy to pursue or might give rise to financial stability risks, exacerbating the initial overshoot. This needed to be taken into account in the proportionality analysis. Against this background, there was broad support for including an explicit reference to the ECB’s agreed monetary policy strategy statement on overshooting in the communication on forward guidance, in order to address potential misunderstandings.

With regard to the third condition, referring to underlying inflation was seen as an effective means to safeguard against a premature tightening of monetary policy in response to forecast errors or to supply-side shocks that might affect headline inflation only temporarily. However, a concern was expressed that the phrase "realised progress in underlying inflation towards two per cent is sufficiently advanced" could be misinterpreted as suggesting that the Governing Council had a separate two per cent target for underlying inflation. Moreover, the point was made that such a perceived target for underlying inflation would effectively render the guidance rather ambitious because standard measures of underlying inflation, in particular core inflation excluding food and energy, had typically been well below headline inflation in the euro area historically. It was also remarked that there were multiple measures of underlying inflation and therefore the reference might be viewed as ambiguous and leaving ample room for discretion.

Reflecting the balance of the arguments, overwhelming support emerged around an amended version of the forward guidance proposal by Mr Lane. The notion of "robust" convergence was further clarified by the inclusion of the phrase "durably for the rest of the projection horizon" with reference to inflation reaching two per cent. The inclusion of language from the new strategy statement – namely a reference to the target being symmetric and the possibility of a transitory period in which inflation could be moderately above target – would place the forward guidance firmly within the strategy framework. It would also act as a safeguard against persistent or pronounced overshooting. The phrase "underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent" made it clear that the target was headline inflation, not underlying inflation.

Turning to proportionality considerations, the proposed revisions to the forward guidance on interest rates were generally assessed to be a proportionate response to the risks to the Governing Council's price stability mandate. Experience with forward guidance suggested that it had been an effective tool for steering market expectations regarding interest rates, thereby helping to bring inflation closer to the Governing Council's target. The proposed reformulation was also viewed as efficient compared with alternative policy options. While forward guidance could, in part, substitute for the use of other instruments that might have more pronounced side effects, it was remarked that a recalibration of the interest rate forward guidance could be erroneously perceived by market participants as necessarily implying a longer period of net asset purchases owing to the link between rate guidance and forward guidance on the asset purchase programme (APP). There was general agreement to defer the discussion on the APP forward guidance to a future meeting. The Governing Council continued to assess the benefits of negative policy rates as outweighing their costs, although the longer negative rates remained in place the greater the likelihood of the balance of risks shifting to the downside.

Against this background, a large majority of members indicated that they could support the revised forward guidance proposal. The proposal was widely seen as providing a fine balance between greater emphasis on outcome-based elements in the forward guidance and a more flexible, forward-looking perspective. After the unanimous agreement on the new strategy, broad consensus on forward guidance was generally regarded as of great importance. At the same time, a few members upheld their reservations, as the amended formulation did not sufficiently address their concerns. These related in particular to the implied likelihood and persistence of overshooting, and being seen as promising to keep interest rates at their present or lower levels for a very long time period without an explicit escape clause.

Turning to other elements of the stance assessment, members concurred with Mr Lane that incoming information had broadly confirmed the joint assessment of financing conditions and the inflation outlook carried out at the June monetary policy meeting. Accordingly, it was agreed to continue to conduct net asset purchases under the pandemic emergency purchase programme in the third quarter at a significantly higher pace than during the first months of the year.

Monetary policy decisions and communication

On communication, it was regarded as important to explain that the forward guidance on interest rates reflected the new strategy and the need for persistent monetary policy measures in the face of the lower bound. The forward guidance underscored the Governing Council's commitment to achieving its new inflation target and indicated that it would wait until it was confident about the path of inflation before raising the key policy rates. The guidance was not a rule but rather provided an indication to financial markets and the broader public so they could better align their inflation expectations with the Governing Council's target.

It was essential to emphasise that the forward guidance remained consistent with the medium-term orientation of monetary policy, which remained distinct from the projection horizon. In this regard, it was nonetheless seen as helpful to clarify the notion of "well ahead", which could be specified as referring to the mid-point of the projection horizon for practical purposes.

It was noted that only the forward guidance on interest rates had been adjusted, and that the forward guidance on asset purchases remained unchanged for the time being. The point was made that the Governing Council had already been reacting forcefully for some time to the challenges posed by the effective lower bound, using a range of instruments. Highlighting this could help to dispel any notions that the reformulation of the forward guidance was a novel or delayed reaction to the lower bound problem calling for imminent deployment of further policy measures.

Taking into account the foregoing discussion among the members, upon a proposal by the President, the Governing Council took the monetary policy decisions as set out in the press release that would be published after the conclusion of the meeting.

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

Monetary policy statement

Monetary policy statement **English**

Press release

Monetary policy decisions

Meeting of the ECB’s Governing Council, 21-22 July 2021

Members

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

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

* Members not holding a voting right in July 2021 under Article 10.2 of the ESCB Statute.

Other attendees

- Ms Senkovic, Secretary, Director General Secretariat
- Mr Smets, Secretary for monetary policy, Director General Economics
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

Accompanying persons

- Mr Arce
- Mr Bradeško
- Ms Buch
- Mr Demarco
- Ms Donnery
- Mr Gaiotti
- Ms Goulard
- Mr Haber
- Mr Kaasik
- Mr Kuodis
- Mr Kyriacou

- Ms Lacerda
- Mr Lünnemann
- Mr Ódor
- Mr Rutkaste
- Mr Sleijpen
- Mr Tavlas
- Mr Vanackere
- Mr Välimäki

Other ECB staff

- Mr Proissl, Director General Communications
- Mr Straub, Counsellor to the President
- Ms Rahmouni-Rousseau, Director General Market Operations
- Mr Rostagno, Director General Monetary Policy
- Mr Sousa, Deputy Director General Economics

Release of the next monetary policy account foreseen on Thursday, 7 October 2021.

CONTACT

European Central Bank

Directorate General Communications

- Sonnemannstrasse 20
- 60314 Frankfurt am Main, Germany
- +49 69 1344 7455
- media@ecb.europa.eu

Media contacts