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

held in Frankfurt am Main on Wednesday and Thursday, 9-10 March 2016

7 April 2016

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

Financial market developments

Mr Cœuré reviewed financial market developments since the Governing Council's previous monetary policy meeting on 20-21 January 2016. The global economic outlook had deteriorated further, accompanied by bouts of market volatility, particularly in markets for bank liabilities. Oil prices had rebounded in February after having fallen to their lowest level since 2003. The outlook for oil prices remained uncertain, however, as the oil market was still experiencing over-supply and global oil inventories remained at very high levels. The potential for a lasting rebound in the oil market was unclear, according to market participants. Market-based indicators of inflation expectations had continued to broadly follow the price of petrol, but not the recent rebound in the price of crude oil, and the five-year forward inflation-linked swap rate five years ahead had reached a historical low of 1.36% on 29 February.

Against the background of concerns about global growth and continued risk-off sentiment in global markets, monetary policy expectations had been re-priced across all major currency areas, becoming more accommodative, with less divergent monetary policy expectations among the different monetary areas.

In the United States, market expectations for the next rate hike had been pushed back significantly, with a sharp re-pricing between January and February, followed by some correction in the light of recent better than expected indicators, in particular inflation. A 25 basis point rate hike in the United States was not fully priced in until December 2016, which was well beyond what had been expected at the beginning of the year. Similarly, in the United Kingdom, money market forward rates had shifted considerably lower, with the Sterling Overnight Index Average forward curve becoming inverted, fully pricing in a 10 basis point rate cut by the end of 2016. This was in stark contrast to what had been expected at the beginning of 2016.

The euro nominal effective exchange rate, measured against 19 major trading partners, had remained broadly unchanged since the previous monetary policy meeting, with a brief interim episode of a 2.5% appreciation of the euro. This temporary move had resulted from the depreciation of the currencies of the euro area's three main trading partners: the US dollar, the pound sterling and the Chinese renminbi. In the case of the pound sterling, the uncertainty surrounding the outcome of the UK referendum on EU membership, scheduled for 23 June, had risen and investors in the foreign exchange options market were increasing their purchases of downside protection on the currency.

The People's Bank of China had decided on 29 February 2016 to cut the reserve requirement ratio by 50 basis points to counter the slowdown in economic growth and improve liquidity conditions. This was the fifth consecutive cut since February 2015, amounting to a cumulative decrease of 300 basis points, from 20% to 17%.

The decision by the Bank of Japan on 29 January 2016 to adopt a negative deposit rate structure had reverberated through global financial markets, contributing to a sharp decline in global bank shares. Following the decision, the entire Japanese yield curve had shifted downwards by around 20 basis points.

Price volatility had negatively impacted market liquidity and funding activities in most euro area bond market segments since the Governing Council's previous monetary policy meeting. While liquidity for highly rated sovereign bonds had remained fairly stable, liquidity for the respective jurisdictions' covered bonds and agency bonds was currently rather reduced. With regard to private sector debt, a widening of spreads, for instance measured by the ITraxx series, had been observed in the period to mid-February 2016, not only for banks but also for non-financial corporations (NFCs), owing to concerns over growth and deteriorating liquidity in the corporate bond market; thereafter, some correction had taken place.

Supply in the corporate bond market had been very subdued, as NFCs had reduced their bond supply in spite of the low level of yields. Reportedly, corporations were cash rich and thus did not need to attempt to benefit from low yields, for instance by re-profiling their debt and extending maturities as sovereigns had done. At the same time, however, the overall debt supply was returning to higher levels, as covered bond issuers, sovereigns and agencies were again taking advantage of very attractive absolute low funding yield levels, in particular at the back end of the curve, to restructure their debt and issue bonds with longer maturities.

Since the Governing Council's previous monetary policy meeting on 20-21 January 2016, the EONIA forward curve had shifted downwards by between 7 and 10 basis points and had reached levels below those prevailing before the December 2015 meeting. The market was firmly pricing in at least a 10 basis point cut in the rate on the deposit facility at the current meeting. In addition, the one-year forward EONIA swap rate one year ahead had declined to a new all-time low, at -53 basis points (on 3 March), and the entire EURIBOR cash curve was now in negative territory for the first time ever.

Finally, Mr Cœuré concluded that market participants remained attentive to a number of risks in the foreseeable future: the risk of a re-emergence of bank and/or sovereign risk in the euro area, volatility in commodity prices and its consequences for emerging market economies, and the risk of a further depreciation of the pound sterling after the referendum.

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

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

Global growth remained subdued, with some weakening across regions. The global composite output Purchasing Managers' Index (PMI) had decreased to 50.6 in February, from 52.6 in January and 53.1 in the fourth quarter of 2015. Global trade had also weakened somewhat further. The volume of world imports of goods had grown by 0.9%, quarter on quarter, in the fourth quarter of 2015, down from 1.7% in the third quarter. The contraction in the PMI for new export orders in February suggested continued weakness early in 2016.

Global inflation had increased in January, with annual consumer price inflation in the OECD area standing at 1.2%, after 0.9% in December. Excluding food and energy, inflation had remained unchanged at 1.9%. Since the Governing Council's meeting on 21 January Brent crude oil prices had increased by 39%, to around USD 40 per barrel. Non-oil commodity prices had also bottomed out after sharp decreases in the period to end-January. Over the same period the euro had depreciated by 1% in nominal effective terms vis-à-vis the currencies of 38 major trading partners.

Turning to the euro area, real GDP had continued to grow in the fourth quarter of 2015, increasing by 0.3%, quarter on quarter, with domestic demand being the main driver. Incoming data since 21 January had been mixed overall. While euro area industrial production (excluding construction) had declined by 1%, month on month, in December, the volume of retail sales, taken together with new passenger car registrations, had risen in January to 1.3% above the average level recorded in the fourth quarter of 2015. At the same time, both the Economic Sentiment Indicator and the composite output PMI had declined in January and February to levels below their fourth-quarter averages, but still above their long-term averages.

Annual growth in households' real disposable income had decelerated to 1.7% in the third quarter of 2015, compared with 2.2% in the second quarter. At the same time, consumption growth had slowed to 1.5% in the fourth quarter, from 1.8% in the third quarter, while the savings rate had remained broadly unchanged. As regards investment, the stronger dynamics recorded in the fourth quarter of 2015 appeared to have been partly driven by construction investment, which had benefited from the mild winter. The PMI for construction had risen in January 2016 into positive growth territory for the first time since 2008, and the European Commission's construction confidence index had improved in February.

Euro area labour markets had continued to gradually improve. Employment had risen by 0.3%, quarter on quarter, in the third quarter of 2015. As a result, employment had been 1.1% higher than a year ago – the highest annual increase since the second quarter of 2008. The unemployment rate, which had been declining since mid-2013, had stood at 10.3% in January 2016 – the lowest rate since August 2011. Despite these improvements, labour market rigidities persisted and unemployment remained very high from a historical perspective.

The March 2016 ECB staff macroeconomic projections for the euro area foresaw annual real GDP increasing by 1.4% in 2016, 1.7% in 2017 and 1.8% in 2018. Compared with the December 2015 Eurosystem staff macroeconomic projections, the outlook for real GDP growth had been revised downwards, by 0.4 percentage point in 2016 and by 0.1 percentage point in 2017, mainly reflecting the weakened growth prospects for the global economy.

Turning to price developments in the euro area, according to the March staff projections the expected pick-up in HICP inflation had been delayed again, with the annual rate now reaching 1.6% only in 2018. Compared with the December projections, inflation had been revised down by 0.9 percentage point and 0.4 percentage point for 2016 and 2017 respectively. These downward revisions largely reflected considerably lower oil prices, the appreciation of the effective exchange rate of the euro and the weaker outlook for compensation per employee, as well as recent weaknesses in inflation in non-energy components of the HICP.

According to Eurostat's flash estimate, HICP inflation had been -0.2% in February 2016, down from 0.3% in January, owing to lower annual rates in all main components. Underlying inflation, as measured by the HICP excluding food and energy, had fallen to 0.7% in February, based on the flash estimate, after 1.0% in January. Import prices remained the main source of upward pipeline pressure, although they had been growing less strongly recently, while domestic pipeline pressures had remained subdued.

Looking at recent developments in long-term inflation expectations, market-based measures had fallen since December in a volatile market environment. By contrast, survey-based measures of long-term inflation expectations had been more stable.

Regarding financial and monetary conditions, the euro area yield curve had flattened substantially and was currently much lower than at the time of the December 2015 monetary policy meeting. In addition, following the sharp tightening in financial conditions after that meeting, on the back of the euro appreciation and the decline in equities, some reversal had taken place since the second half of February. Moreover, both the equity risk premium and non-financial corporate bond spreads had shown an increasing trend since spring and summer 2015 respectively. This differed from developments in the market for risk-free assets, where sovereign debt had become scarcer, as reflected by the decline in the risk-free rate. Since equity financing dominated the balance sheet of NFCs, the weighted average nominal cost of NFCs' external financing had not declined more sharply even though the cost of bank borrowing had been falling substantially since mid-2014. In January 2016 the composite MFI lending rates for NFCs and households had remained broadly stable at low levels.

Turning to money and credit, annual growth in broad money (M3) had remained robust at 5.0% in January, after 4.7% in December, supported by the low interest rates, as well as the impact of the targeted longer-term refinancing operations (TLTROs) and the asset purchase programme (APP). In addition to the most liquid components contained in M3, purchases under the APP had been a major contributor to M3 growth.

Euro area loan dynamics had continued to improve gradually in January, although growth rates remained subdued. The ongoing improvement was visible across countries and sectors. The annual growth rate of loans to NFCs (adjusted for sales and securitisation) had increased to 0.6% in January, after 0.1% in December and 0.7% in November. The annual growth rate of loans to households had remained at 1.4% in January, unchanged from December and November.

A re-pricing of subordinated bank bonds had taken place at the beginning of the year. While at present increases were at least partly linked to bank-specific problems in certain jurisdictions, they could have a non-negligible impact on bank funding conditions if market turbulence were to persist.

With regard to fiscal policies, the euro area fiscal stance, as measured by the change in the cyclically adjusted primary balance, was expected to be mildly expansionary in 2016 and 2017, before reverting to broadly neutral in 2018.

All in all, Mr Praet concluded that since the start of credit easing policies in June 2014 and their reinforcement through public sector asset purchases half a year later, the ECB's monetary policy measures had led to a substantial easing of financial conditions and improved access to finance in the euro area, thereby providing sizeable support to inflation and economic activity. The improvements not only pertained to overall financial conditions in the euro area, but also to reduced fragmentation. The dispersion of lending rates to borrowers domiciled in different jurisdictions had narrowed, remuneration of bank deposits had become much less diverse and, in most countries, NFCs were benefiting from more favourable conditions on loans. Furthermore, small and medium-sized enterprises (SMEs) currently faced fewer obstacles to access financing. Nevertheless, the prospects for a sustained adjustment in the path of inflation had deteriorated once more, owing to worsening external conditions, despite the adoption of additional monetary policy measures in December 2015.

Monetary policy considerations and policy options

Mr Praet recalled that at the January 2016 monetary policy meeting the Governing Council had communicated that "it will be necessary to review and possibly reconsider" its monetary policy stance in March, in particular when the new staff macroeconomic projections would become available.

Since then, the external environment had weakened and downside risks to the medium-term price stability objective had clearly increased. The economic recovery had been losing momentum and headline inflation had declined again into negative territory. Medium-term market-based measures of inflation expectations had also moved further down, increasing the risks of second-round effects. Moreover, the March 2016 ECB staff projections for inflation had been revised downwards substantially, implying yet another postponement of the date by which inflation was projected to come back into line with the ECB's objective.

Overall, and also cross-checking the outcome of the economic analysis with the signals coming from the monetary analysis, there was a strong case for the Governing Council to reconsider its monetary policy stance at the current meeting and provide further substantial monetary stimulus to counteract heightened risks to the ECB's price stability objective. In addition, it was important that public communication reiterated that the monetary policy measures put in place since June 2014 were critical in supporting the euro area recovery and in arresting even stronger disinflation.

A comprehensive package of measures that reinforced each other was hence proposed, calibrated to further ease financing conditions, stimulate new credit provision and thereby reinforce the momentum of the euro area's economic recovery and accelerate the return of inflation to levels below, but close to, 2% over the medium term. This package built on the following four complementary elements:

First, a reduction in the three policy rates on the main refinancing operations (MROs), the marginal lending facility and the deposit facility, to 0.00%, 0.25% and -0.40% respectively;

Second, an increase in the monthly pace of purchases under the APP from €60 billion at present to €80 billion, with an extension of the eligible asset universe to include investment-grade euro-denominated bonds issued by non-bank corporations, under a new corporate sector purchase programme (CSPP);

Third, a credit easing component (TLTRO II). New TLTROs would reinforce the accommodative stance and strengthen the transmission of monetary policy by providing further incentives for bank lending to the real economy;

Fourth, reinforcing the forward guidance on interest rates by communicating that, looking ahead, "taking into account the current outlook for price stability and the extra support that inflation and the economy will receive from today's measures, the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases", which would link the interest rate forward guidance to the conditionality that applied to the APP.

Mr Cœuré complemented Mr Praet's introduction with remarks on implementation issues.

Starting with the APP and the CSPP, a purchase target of €80 billion per month until March 2017 could be achieved with a reasonable degree of confidence with two parameter changes: first, an increase in the issuer limit and the issue share limit for eligible international organisations and multilateral development banks (henceforth "supranationals") from 33% to 50%, and, second, a reduction in the share of EU supranational securities from 12% to 10% of purchases under the public sector purchase programme (PSPP), starting in April 2016. Simultaneously, to keep the current 20% risk-sharing regime unchanged – in itself a key parameter of the programme – the ECB's share of monthly PSPP purchases would need to be increased from 8% to 10%. The Eurosystem would have to monitor the ability to source bonds and propose new parameter changes as needed. As regards the proposed new CSPP, this would be included under the umbrella of the APP and would start by the end of the second quarter of 2016. The list of eligible assets under the CSPP would comprise investment-grade euro-denominated marketable debt instruments issued by euro area non-bank corporations, with the exact definition still to be specified. A starting point for the eligible universe under the CSPP would be bonds eligible under the Eurosystem collateral framework, following the same principle as used for the other asset purchase programmes. The CSPP would be subject to full income and loss-sharing, and the portfolio would be valued at amortised cost subject to impairment.

With regard to the four TLTRO II operations to be launched at a quarterly frequency from June 2016 to March 2017, each operation would have a four-year maturity from the respective settlement date. Voluntary repayments would be possible two years after the settlement of each operation, at a quarterly frequency, and, in contrast to the first series of TLTROs, no mandatory early repayment was envisaged. Counterparties would participate individually or as part of a group in the same way as for the current TLTROs and with the same group definition, meaning that groups could be unchanged from the first series of TLTROs to the second. New groups could also be created for TLTRO II. Each participant could borrow an amount equivalent to 30% of its stock of eligible loans as at 31 January 2016, less any amount previously borrowed and still outstanding under the first two TLTRO operations conducted in 2014. The definition of eligible loans would be the same as for the first series of TLTROs. The applicable benchmark would be based on net lending in the 12-month period between 31 January 2015 and 31 January 2016.

Regarding the incentive scheme, banks exceeding the benchmark would be rewarded with lower borrowing rates that could be as low as the rate on the deposit facility. More specifically, the interest rate for counterparties below the benchmark would be fixed at the MRO rate prevailing at the date of the allotment. Banks exceeding their benchmark would be retroactively charged at a lower rate for the entire term of the operation and that rate would also be linked to the interest rate on the deposit facility at the date of allotment.

To encourage and facilitate the switch from the first series of TLTROs to the second series, an additional voluntary repayment option for all the current TLTROs would be introduced in June 2016, coinciding with the settlement of the first TLTRO II operation, so as to allow a roll-over from the first series of TLTROs.

Finally, Mr Cœuré indicated that the package did not contain a proposal for an exemption scheme for the deposit facility rate.

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, as provided by Mr Praet in his introduction. Real GDP had continued to expand in the fourth quarter of 2015 and recent data releases remained consistent with an ongoing moderate economic recovery. However, the recovery appeared to have lost some momentum. Domestic demand in the euro area was expected to remain relatively resilient, supported by lower oil prices and a more expansionary fiscal stance, as well as by the ECB's monetary policy measures, while a weaker international environment, with notably slower growth in emerging market economies, was weighing on global activity and trade, leading to more subdued foreign demand for euro area exports. This assessment was reflected in the outlook for growth in the March 2016 ECB staff macroeconomic projections. As expected, compared with the December 2015 Eurosystem staff projections, the growth outlook had been revised downwards. Members took note that the effects of the non-standard measures decided at the December 2015 monetary policy meeting had been incorporated into the March 2016 projections exercise. It was also recognised that the technical assumptions used in the March 2016 staff projections for growth and inflation had to some extent been positively influenced by expectations of additional monetary policy measures by the ECB, without which the downward revisions would have been larger.

Regarding the outlook and risks for the external environment, the latest staff projections contained further downward revisions in the short term to global activity and trade. It was remarked that the downward revisions could to some extent be considered as the materialisation of risks which had already been identified by the Governing Council in September 2015. In this context, it was highlighted that the baseline projection for the euro area was predicated on the assumption of a rather swift rebound in world trade. While the baseline was generally supported, caution was also expressed about the projected strengthening in global activity. Overall, despite some better economic news emanating recently from the United States, 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 market economies.

Turning to the euro area, there was broad agreement with the revised growth outlook in the ECB staff projections. The updated projections were generally viewed as confirmation that the ongoing recovery in the euro area economy remained weak and fragile. Against this background, it was observed that the euro area economy continued to be rather vulnerable to adverse shocks. At the same time, the importance of distinguishing between the baseline scenario and the risks surrounding this baseline was emphasised. Although the downward revisions to the outlook for growth were disappointing, the baseline scenario still incorporated a gradual acceleration in economic activity. Moreover, the downward revisions were mostly related to external, rather than domestic, adverse developments.

Private consumption was expected to remain robust, based on continued real income growth, supported by low energy prices and a further gradual improvement in euro area labour markets, and business investment was expected to pick up, in line with increasing demand. A number of positive indicators were also mentioned, which could provide a basis for more optimism about the current economic situation, including the January industrial production data for the two largest euro area countries and the continued improvement in labour markets, which reflected some positive effects of past structural reforms. The view was put forward that, taking these factors into account, the outlook for the euro area should not be regarded as overly pessimistic and conveying an unduly gloomy assessment should be avoided.

Commenting on the outlook for domestic demand in more detail, the balance of risks was mostly seen to be on the downside. While noting that wage dynamics were expected to be weaker than previously foreseen, members expressed the view that the outlook for income growth, as foreseen in the staff projections, might still be subject to downside risks given the past projection errors in wages, the degree of slack remaining in the labour market and the possible effects of past structural reforms. It was noted that labour market conditions in the euro area, although improving, were still far from those in other major economies, such as the United States and the United Kingdom.

Reference was also made to the continued existence of savings and investment imbalances across both sectors and countries. The view was put forward that these might be exacerbated by elevated uncertainty and the low level of interest rates, which might in some cases adversely affect confidence as well as the expected return on savings, possibly leading to higher savings and lower growth in household consumption, notably in countries where private pension plans and life insurance played a large role. In addition, members expressed concern about the outlook for private investment. It appeared that, despite low borrowing costs and the availability of ample internal financing, firms continued to be cautious about undertaking investments, perhaps owing to the perceived high level of uncertainty and the low potential growth rate. In this context, the argument was made that, for countries with available fiscal space, public investment could be increased, while at the European level there was a need to see more results from the European Commission's Investment Plan for Europe.

Overall, the recovery in the euro area economy was expected to continue at a more subdued pace, while the risks to the growth outlook were mostly seen to remain tilted to the downside. These risks related in particular to the heightened uncertainties regarding the external environment and to broader geopolitical risks.

Against this background, members reiterated the necessity for other policy areas to support sustained output growth and that monetary policy on its own was not sufficient. There was a need for both structural reforms and fiscal policy to also play their part. In particular, given the high level of structural unemployment in the euro area and the low growth in potential output, the ongoing cyclical recovery should be supported by effective structural policies regarding both labour and product markets. In addition to leading to higher sustainable economic growth, structural reforms would help to improve the resilience of the euro area to global shocks. As regards fiscal policy, members highlighted the need to comply with the rules of the Stability and Growth Pact, while at the same time stressing that existing elements of flexibility should be used. A more growth-friendly composition of fiscal policies could support the economic recovery, as could the use of fiscal space, where appropriate.

With regard to price developments in the euro area, there was broad agreement with the assessment of the outlook and risks presented by Mr Praet in his introduction. The return to negative headline inflation in February was due to lower annual rates in all the main components, including services and non-energy industrial goods. According to Eurostat's flash release, the annual rate of HICP inflation excluding food and energy had also fallen back unexpectedly. In the short term, on the basis of current oil futures prices, headline inflation was expected to remain in negative territory for a number of months, before rising later in the year, linked to strong upward base effects and the assumed oil price increases embedded in the futures curve. Over the medium term, inflation was expected to pick up in line with the economic recovery in the baseline projection.

A combination of factors, including lower energy prices and the appreciation of the effective exchange rate of the euro, were seen to be responsible for a substantial downward revision to the outlook for HICP inflation compared with late 2015. This assessment was reflected in the March 2016 ECB staff projections, where the HICP inflation outlook had been revised down significantly for 2016 and 2017 in comparison with the December 2015 Eurosystem staff projections. It was also noted that the downward revisions to inflation would have been larger were it not for the fact that the March projections already incorporated, via the technical assumptions, some expectations by financial markets of further monetary policy measures.

Members expressed concern about the prospect that it would now take longer to reach the inflation objective than previously expected. According to the latest ECB staff projections, which now incorporated projections for 2018 for the first time, headline inflation was expected to be only 1.6% in 2018, underpinning the assessment that the return of headline inflation to rates below, but close to, 2% would be further postponed. The sequence of downward revisions over time to both the growth and inflation projections was recalled. Against this background, it was felt that it had to be acknowledged that inflation would not return to the ECB's inflation aim for some time to come, while keeping in mind that the ECB's definition of price stability over the medium term was not tied to the horizon of the staff projections. In this context, attention was drawn to the fact that inflation had already been well below 2% for most of the period since 2012. The adverse implications of persistently low inflation for the process of debt deleveraging and also for financial stability were pointed out, by comparing this profile for inflation with a counterfactual one in which inflation was close to 2% over the same period.

Looking more closely at the evolution of the main components of inflation, it was noted that the dominant forces driving the headline inflation rate continued to be global factors, namely lower energy prices and the exchange rate. The volatility of oil prices and of exchange rates had increased recently. It was remarked that the importance of these factors in determining headline inflation could be illustrated by updating the projections with the higher oil price and weaker exchange rate developments after the cut-off date of 15 February 2016, which would result in somewhat higher inflation than in the baseline scenario. However, it was also mentioned that oil prices over the more recent past had been determined not only by supply factors but also by weaker demand, which, if persistent, would not be a positive signal for the outlook.

Members exchanged views about the implications of the latest developments in measures of underlying inflation. In particular, concern was expressed about the lower rate of HICP inflation excluding food and energy in the February flash release. It was noted that, if the reasons for the decline were permanent, this would dampen the outlook for underlying inflation still further. However, the reasons behind the decline in HICP inflation excluding food and energy in the latest release had not yet been fully explored, and it was possible that a significant part of this decline was due to temporary factors.

At the same time, it was mentioned that, although underlying inflation remained positive, the decline recorded in February was a new element, which raised questions about the outlook for inflation compared with the situation last year, when core inflation had been rising slowly, but steadily, by around 0.1 percentage point each quarter. On the one hand, the weakness in HICP inflation excluding food and energy could be read as a signal of the insufficient level of aggregate demand in the economy, which, it was argued, remained the main problem for the euro area. On the other hand, it was reasoned that there had also been deeper changes in the saving and spending behaviour of economic agents after the financial crisis, reflecting, among other things, rebalancing needs, including wage and price adjustments, and balance sheet repair in a number of sectors and countries. As a consequence of such, possibly structural, changes, past experience did not provide much guidance as regards the reaction of inflation to the closing of the output gap, which gave rise to increased uncertainty about the inflation outlook.

Recent developments in euro area inflation expectations were also scrutinised by members. The further decline in market-based measures since the Governing Council’s previous monetary policy meeting, and the risk of an unanchoring of inflation expectations, continued to be a key concern. The importance of halting the decline in inflation expectations was emphasised. Wage increases had already turned out much lower than previously expected, albeit for a range of different reasons, including windfall gains in households’ real disposable income, and concern was voiced that second-round effects might be larger than those incorporated into the staff projections. It was important to avoid a pattern of low wages and low prices becoming entrenched in the expectations and behaviour of economic agents. At the same time, some caution was again expressed regarding the reliability of the information content of market-based measures of inflation expectations, for a number of reasons, including liquidity effects associated with the ECB's APP. It was also noted that survey-based measures of longer-term inflation expectations, such as the ECB's Survey of Professional Forecasters, remained more benign. According to this view, while there was a danger that persistently low inflation outcomes might spill over into inflation expectations, the risk of an unanchoring of inflation expectations and of deflation could still be considered to be low.

Overall, there was broad agreement that, while euro area inflation was expected to pick up, there had been a further downward revision of the inflation outlook, mainly reflecting lower oil prices in recent months, so that the return to inflation rates below, but close to, 2% would take longer than previously expected. The risks surrounding the outlook for HICP inflation were also assessed to remain on the downside.

With regard to the monetary analysis, members concurred with the assessment presented by Mr Praet in his introduction that the recovery in money and credit dynamics had continued. M3 growth had remained robust in January 2016, mainly supported by the most liquid components and reflecting the impact of the monetary policy measures and the low opportunity cost of holding monetary instruments.

Loan dynamics had continued on the gradual recovery path observed since the beginning of 2014. Bank credit to both firms and households had continued to expand, with the annual rate of change of loans to NFCs (adjusted for loan sales and securitisation) rebounding in January. Developments in MFI loans to enterprises continued to mirror the lagged relationship with the business cycle and credit risk, as well as ongoing balance sheet adjustments, which reflected still high levels of non-performing loans. Loan dynamics were also supported by the accommodative monetary policy stance and the pass-through of monetary policy measures in place since June 2014, which had improved borrowing conditions and credit flows across the euro area. Notably, fragmentation across euro area countries had declined, with a significant compression of loan spreads. The ECB's monetary policy measures were thus seen to have contributed strongly to the turn in the credit cycle in the euro area since 2014.

From a global perspective, economies could be considered to be at different stages of the financial cycle, with the United States being more advanced than the euro area and perhaps having even completed the associated process of balance sheet correction, while in the euro area this was still under way. It was also noted that there could potentially be more positive news for the credit outlook from the regulatory side, with indications of a forthcoming clarification by the European Commission on the nature of Pillar 2 requirements under the Capital Requirements Directive, which could be reflected in the implementation of these requirements by the Single Supervisory Mechanism and could help reduce some of the regulatory uncertainty weighing on euro area banks.

Monetary policy stance and policy considerations

With regard to the monetary policy stance, members widely shared the assessment provided by Mr Praet in his introduction that, since the previous monetary policy meeting of the Governing Council in January, downside risks to the Governing Council's medium-term price stability objective had increased overall, as also indicated by the downward revisions for inflation and growth in the March 2016 staff macroeconomic projections. Against this background, members widely agreed that there was a need to reconsider the

Governing Council's monetary policy stance with a view to providing further substantial monetary stimulus to counteract heightened risks to the ECB's price stability objective. Accordingly, an adequately calibrated package of measures was seen as needed to secure the return of inflation towards levels below, but close to, 2% without undue delay.

Members widely agreed that, while the recovery of the euro area economy was expected to proceed, euro area growth momentum would be slower and inflation lower for longer than previously anticipated. This implied yet another postponement of the date by which inflation was expected to return to rates in line with the Governing Council's medium-term aim. While much of the downgrade in the inflation outlook was due to falling oil prices and their prevailing future path, measures of underlying inflation were also projected to be weaker than previously foreseen. Concerns were also voiced about the renewed decline in medium-term market-based measures of inflation expectations. Overall, risks of second-round effects appeared to have increased. Moreover, the prolonged volatility in financial markets, amid heightened uncertainty about the global environment and renewed concerns about the health of the euro area banking sector, was seen as a risk to the continued smooth transmission to the real economy of the monetary policy measures taken since June 2014.

There was thus broad agreement among members that a strong policy response was required, which was best achieved by a comprehensive package of measures that exploited the synergies and complementarities between its different components. This package needed to be adequately calibrated to further ease financing conditions, stimulate new credit provision and thereby reinforce the momentum of the euro area's economic recovery and accelerate the return of inflation to levels below, but close to, 2%. While, overall, members widely agreed on the need for comprehensive policy action, different views were expressed with regard to the individual components of the proposed package.

There was very broad agreement among members that the proposed policy package would benefit from strong credit easing components, namely with regard to the launch of new TLTROs to provide support for the bank lending channel. TLTRO II should enhance the bank-based transmission of the monetary policy stance by providing further incentives for bank lending to the real economy.

Very broad support was expressed for the view that TLTRO II would need to be equipped with strong price incentives to encourage new lending to the real economy. Attractive funding conditions for banks, in turn, were seen to further ease private sector credit conditions and to stimulate overall credit dynamics. Therefore, the proposed inbuilt price incentive scheme of TLTRO II, aimed at providing incentives for the creation of new credit to the private sector, was widely supported. It was argued that the pricing scheme of TLTRO II would also contribute to a further defragmentation in the money markets. While, in the current circumstances, some banks could already borrow at the EONIA rate, the TLTROs would ease funding conditions for a broader range of banks, provided they were able to increase lending to the real economy in excess of the respective benchmarks.

However, a few members expressed concerns about central bank operations continuing to replace the functioning of private markets and perpetuating banks' dependence on Eurosystem financing, as well as about the size of the proposed price incentive scheme. The price reduction of up to the level of the deposit facility rate seemed to be rather generous, could lead to market distortions and could contribute to the preservation of weak business models by some banks.

Regarding the applicable interest rate over the life of TLTRO II, members generally felt that it was appropriate to charge a fixed rate upon allotment of the operation. This would be simple and attractive, as banks could lock in their TLTRO funds at very favourable funding conditions for four years. With respect to the definition of eligible loans, on the basis of which the borrowing allowance would be calculated, it was agreed that the practice applied in the first series of TLTROs should be maintained, whereby eligible loans were defined as those of euro area NFCs and households, excluding loans to households for house purchase. The assessment was widely shared that lending for house purchase was best excluded from the TLTROs to avoid fuelling housing price bubbles by channelling savings into the housing sector.

On the calculation of the benchmark, there was broad support for maintaining the mechanism adopted for the first series of TLTROs. Accordingly, the benchmark net lending would be set at zero for those banks with positive net lending, while the benchmark would be set at a lower level for those banks that were undergoing deleveraging. For banks to fully reap the benefits of the attractive new conditions of TLTRO II, it was also agreed they should be given an extra repayment opportunity for the existing TLTROs, to allow them to switch to the more attractive conditions of TLTRO II.

Turning to the APP proposals, members widely agreed to the proposed expansion of the monthly purchases from €60 billion to €80 billion. A sizeable expansion in the monthly volume of purchases was seen as substantially strengthening the effectiveness of the asset purchases, mainly by reinforcing the portfolio rebalancing channel. Wealth effects and a further compression of long-term yields should foster the effective pass-through of the asset purchases, whereby lending rates to the real economy should also benefit further. As regards the parameters of the APP, with a view to ensuring the smooth implementation of future asset purchases, there was wide support for the proposal to increase the issuer limit and issue share limit for securities issued by eligible supranational institutions from their current level to 50%.

A few members restated their reservations concerning the APP, namely with respect to public sector bonds, and voiced concerns as on previous occasions about a further expansion of asset purchases, as purchases of sovereign securities were, more than other monetary policy instruments, associated with a number of specific challenges and side effects. The view was reiterated that recourse to broad-based asset purchases, including public sector paper, should therefore remain a contingency instrument, to be used only as an *ultima ratio* in an adverse scenario, such as a situation of imminent deflation, for which there was no evidence at present. In this regard, the costs and risks of engaging further in public sector asset purchases, particularly in the medium to long term, would outweigh their potential benefits, also considering diminishing returns of scale and taking into account that even deeper cuts in the deposit facility rate or strongly targeted lending operations could have more traction on the economy.

Broad support was expressed for the proposal to include investment-grade euro-denominated bonds issued by non-bank corporations as a new asset class in the eligible universe of purchasable assets under the APP. The inclusion of corporate bonds was seen as strengthening the credibility of the overall expansion of the monthly purchase volume and more directly signalling the support provided by the APP for the financing of the real economy. It was also noted that the purchases could have important spillover effects on the financing conditions of SMEs in the light of international evidence indicating that the banking sector redirected lending to SMEs when large companies' bond issuance substituted for bank borrowing.

Nonetheless, there were also cautionary remarks concerning the possible effectiveness of the purchases of corporate bonds. It was noted that, in the euro area, the market for these bonds was generally not very liquid or large, and purchases in such a market could therefore raise level playing field issues and lead to market distortions. Moreover, the direct impact on corporate financing conditions and investment behaviour appeared doubtful, as the Eurosystem would mainly purchase bonds from highly rated, cash-rich corporations, whose financing costs were already very low and whose investment behaviour, in any case, was not constrained by the cost or availability of funding.

Regarding some operational features of the corporate asset purchases to be established under the new CSPP, there was broad support for the inclusion of euro-denominated investment-grade bonds of corporations established in the euro area, while the more detailed features of the programme still had to be worked out. Robust and clear eligibility criteria needed to be spelt out further, also considering the treatment of smaller issuers and SMEs and fragmentation in the corporate bond market.

Turning to interest rates, broad support was expressed for the proposal to lower all the key ECB policy interest rates further, whereby the rate on the MROs and the rate on the marginal lending facility would be cut by 5 basis points to 0.00% and 0.25% respectively, and the rate on the deposit facility would be cut by 10 basis points to -0.40%. Nonetheless, different views were expressed about the costs and benefits of moving further into negative territory and the respective implications for the formulation of the Governing Council's forward guidance on policy interest rates.

On the one hand, concerns were raised about possible undesirable side effects that could arise from moving further into negative territory, particularly in combination with fast-growing excess liquidity. A further cut in the deposit facility rate could unduly increase the pressure on banks' profitability, which could have adverse effects on the stability of the banking sector. As rates on bank customers' deposits were typically constrained at zero, a further decline in rates charged on the asset side would lead to a compression in banks' margins. Moreover, the transmission of monetary policy via bank intermediation could be affected negatively, as banks could recoup part of the costs by increasing lending rates or increasing fees and other charges in their cross-selling activities. Cutting interest rates further, in a market environment where uncertainty about the impact of negative rates prevailed, could also further exacerbate financial market volatility and have direct, negative repercussions on the confidence of euro area households and firms, as well as weigh on the profitability of insurance companies and pension funds, including corporate pension schemes. Finally, caution was also expressed with regard to the effectiveness of further reductions in the deposit facility rate, both as regards domestic channels of transmission and the exchange rate channel.

On the other hand, a number of arguments were put forward pointing to the benefits of a further cut in the deposit facility rate. Lowering the rate further into negative territory was seen as an effective tool for providing additional monetary easing, which also reinforced the impact of the other monetary policy measures in place by stimulating the "velocity of reserves". Moreover, past cuts in the rate had not only led to lower short-term interest rates, but had compressed interest rates across the spectrum of the yield curve also at the longer end. As regards the possible impact on banks' profitability, a general equilibrium perspective was warranted that went beyond the direct effects of negative interest rates on the profit and loss account of banks. Taking a broader view, on balance, the combination of all monetary policy measures taken, including negative rates, appeared to have contributed positively to banks' profitability thus far. This was evidenced by overall increasing net interest income and banks' return on equity in the course of 2015, the first full year of negative rates, as well as by rising lending volumes. Banks appeared to benefit from the low interest rate environment, as a decline in interest revenues was more than compensated for by lower costs of funding and an expansion in credit volumes, together with possible holding gains on assets. With regard to the possible external dimension of a policy rate cut, it had to be stressed that further monetary easing was aimed at improving domestic financing conditions.

Against this background, overall, members broadly supported a further cut in the deposit facility rate. With respect to the envisaged size of such a cut, the importance of communication and the link to the formulation of forward guidance was underlined. On the one hand, a sharper rate cut could be considered, together with indications that the effective lower bound would have been reached for all practical purposes. On the other hand, the proposed limited rate cut could be judged as appropriate for now, given the current assessment, while it would also not rule out the possibility and prospect of further cuts if warranted by the outlook for price stability.

Most members favoured the proposed cut of 10 basis points, in conjunction with maintaining the formulation of "at present or lower levels" in the Governing Council's forward guidance. It was argued that, from today's perspective, and taking into account the support provided by the policy measures to growth and inflation, policy rates would be expected to remain at very low levels and that further rate reductions would not be anticipated at this stage. Nonetheless, the Governing Council would not rule out future cuts in policy rates, as new shocks could change the outlook for inflation, which might warrant further monetary policy action, with policy rates remaining part of the Governing Council's toolbox.

Members also exchanged views on the possibility of introducing an exemption scheme for the deposit facility rate applicable to banks' holdings of excess reserves. Such a scheme was, in principle, seen as an instrument for mitigating possible negative effects on bank profits and for ensuring the smooth transmission of monetary policy. However, doubts were expressed in view of the overall complexity of such a system from an operational perspective and considering that there was little evidence of negative side effects at the current juncture. Against this background, the introduction of an exemption scheme was not seen as warranted at this stage.

Finally, as regards forward guidance, broad support was expressed for linking the forward guidance on the likely future path of policy interest rates to the forward guidance on the asset purchases in a hierarchical and sequential manner by adding "and well past the horizon of the net asset purchases" to the existing formulation on forward guidance. This would anchor expectations about the relative sequencing, thereby providing greater clarity about the Governing Council's expectations with respect to the future path of policy interest rates. The envisaged formulation on policy rate forward guidance needed to be fully consistent with the ECB's monetary policy strategy, to reflect the current forward guidance on asset purchases and to ensure interdependence of the APP and the policy interest rates. However, a remark was also made that keeping interest rates low well past the horizon of the APP could be perceived by the public as allowing inflation to overshoot in the future.

In the overall assessment of the proposed policy package, some remarks were made on the effectiveness of the monetary policy measures taken previously and of the proposed policy package, also in view of recent market concerns about the limits of monetary policy. Members broadly agreed that the monetary policy measures taken since June 2014 had been critical in supporting the euro area recovery and in arresting even stronger disinflation. It was therefore seen as important to firmly reiterate that the monetary policy measures were working and had been delivering their intended effects, for which there was ample evidence. The combination of measures, such as the rate cuts, the forward guidance, the earlier credit easing measures and the APP, had led to a broad-based and significant easing in financing conditions for all sectors of the economy.

In particular, the monetary policy measures taken since June 2014 were seen as having been instrumental in contributing to a reversal in credit dynamics. The measures had also helped to reduce fragmentation, with the pass-through of the ECB's policy stance improving in countries most affected by the crisis, and declines in lending rates for NFCs following the ECB's monetary policy measures taken since June 2014 being substantially greater in these countries.

It needed to be emphasised that the monetary policy measures taken had proven to be effective and had delivered significant effects on growth in inflation. In a counterfactual scenario of the absence of monetary policy support, inflation would likely be significantly in negative territory and economic growth would be visibly lower. The current low inflation environment should not be attributed to ineffective monetary policy measures, rather it was largely the result of a succession of negative shocks stemming mainly from the external environment, but also from weaker than expected domestic price pressures. At the same time, it was highlighted that the possible risks and side effects of the monetary policy instruments in use, particularly with regard to financial stability risks, had to be better understood and required further careful analysis and assessment.

Members generally expressed confidence in the effectiveness of the envisaged policy package, even though nuanced views were put forward on the relative merits of the various elements of the package. Overall, it was highlighted that the agreed policy package consisted of a comprehensive set of measures that largely complemented and reinforced each other. While the cut in policy rates would impact the whole spectrum of the yield curve, the asset purchases further flattened the curve, with the portfolio rebalancing effects being reinforced by the negative interest rates. At the same time, the new series of TLTROs and the purchases of non-bank corporate bonds would further ease the funding conditions of banks and firms, boosting the pass-through of the monetary policy stance to the borrowing conditions faced by the private sector.

While monetary policy had to do whatever was needed to pursue its price stability objective, a strong call was reiterated for other policy areas to step up, decisively, their efforts to strengthen sustainable growth prospects in the euro area, also to avoid the risk of overburdening monetary policy.

Monetary policy decisions and communication

Against this overall background, and taking into account the views expressed by the members of the Governing Council, the President concluded that a large majority of voting members supported the proposed policy package, comprising a cut in the interest rates on the Eurosystem's MROs and on the marginal lending facility of 5 basis points to 0.00% and 0.25% respectively, a cut in the interest rate on the deposit facility of 10 basis points to -0.40%, an expansion of the monthly purchases under the APP to €80 billion, starting in April, the inclusion of investment-grade euro-denominated bonds issued by non-bank corporations established in the euro area in the list of assets eligible for regular purchases, and the launch of a new series of four targeted longer-term refinancing operations, each with a maturity of four years, starting in June 2016.

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/2016/html/is160310.en.html

Press releases

http://www.ecb.europa.eu/press/pr/date/2016/html/pr160310.en.html
http://www.ecb.europa.eu/press/pr/date/2016/html/pr160310_1.en.html
http://www.ecb.europa.eu/press/pr/date/2016/html/pr160310_2.en.html

Meeting of the ECB's Governing Council, 9-10 March 2016

Members

- Mr Draghi, President
- Mr Constâncio, Vice-President
- Mr Bonnici
- Mr Cœuré
- Mr Costa
- Ms Georghadji
- Mr Hansson*
- Mr Jazbec

- Mr Knot
- Mr Lane*
- Ms Lautenschläger
- Mr Liikanen
- Mr Linde
- Mr Makúch
- Mr Mersch
- Mr Nowotny
- 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 March 2016 under Article 10.2 of the ESCB Statute.

Other attendees

- Mr Dombrovskis**, Commission Vice-President
- Mr Teixeira, Secretary, Director General Secretariat
- Mr Winkler, Deputy Secretary for monetary policy, Senior Adviser, DG Economics

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

Accompanying persons

- Mr Fagan
- Mr Hernández de Cos
- Mr Kaasik
- Mr Kuodis
- Ms Le Lorier
- Mr Mifsud
- Mr Mooslechner
- Mr Mrva
- Mr Nagel
- Mr Panetta
- Mr Ramalho
- Mr Rutkaste
- Mr Schoder
- Mr Stavrou
- Mr Swank
- Mr Tavlas
- Mr Välimäki
- Mr Wunsch

Other ECB staff

- Ms Graeff, Director General Communications

- Mr Smets, Counsellor to the President
- Mr Bindseil, Director General Market Operations
- Mr Klöckers, Deputy Director General Economics
- Mr Rostagno, Director Monetary Policy, DG Economics

Release of the next monetary policy account foreseen on Thursday, 19 May 2016.

CONTACT

European Central Bank

Directorate General Communications

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

Media contacts