20 January 2022

Meeting of 15-16 December 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, 15-16 December 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 27-28 October 2021 and put these developments into the context of the broader financial stability landscape, in line with the outcome of the ECB's strategy review.

In response to the discovery of Omicron, stock markets worldwide had suffered marked losses. The volume of put options on the EURO STOXX 50 had hit its highest level since the outbreak of the coronavirus (COVID-19) pandemic in March 2020, as investors looked for protection against further losses. At the same time, the ten-year US Treasury and euro area GDP-weighted sovereign yields had almost fallen back to the lows seen over the summer. They stood well below the levels observed at the Governing Council's October meeting.

These financial market developments could be interpreted in two ways. The first was that the market expected Omicron to have a materially larger impact on economic activity than previous mutations. However, model-based evidence showing a shock-decomposition of the recent decline in ten-year euro area OIS yields assigned only a fraction of the decline in yields to a deterioration in the economic outlook. Similarly, less than a third of the recent marked decline in oil prices was likely to reflect a reappraisal of the global growth outlook.

The second interpretation of recent financial market developments related to the fragile market conditions that prevailed when the news about Omicron broke. Since mid-October 2021, volatility in bond markets had been rising sharply and liquidity conditions in derivative markets had deteriorated measurably, amplifying the market reaction to the news of Omicron.

Two factors had contributed to this fragile market environment. One was the growing conviction among investors that the period of low inflation was over and that globally monetary policy would have to be tightened sooner than had been anticipated earlier in 2021. The second was the sensitivity of financial markets to such changes in the policy outlook after years of significant monetary policy accommodation.

In the United States, markets now assessed the chance of a rate hike at the Federal Reserve's meeting in May 2022 as well over one in two. A one-in-three chance of a rise was seen as early as March 2022. In the euro area, by contrast, expectations of "lift-off" – a first rate hike – had been pushed back compared with the Governing Council's previous meeting on 27-28 October 2021. Nevertheless, lift-off expectations remained far closer than they had been at the Governing Council meeting on 8-9 September 2021, and they had also become less volatile. Moreover, the gap that had opened in the autumn between the lift-off expectations priced in by markets and those indicated by the participants in the Survey of Monetary Analysts (SMA) was closing. In the SMA, the median expectation for lift-off had been brought forward by another two quarters, from the second quarter of 2024 to the fourth quarter of 2023 – only three quarters later than priced in by markets compared with six quarters in October 2021.

The divergence in expected policy cycles had continued to put significant downward pressure on the euro-US dollar exchange rate. The euro had depreciated by nearly another 3% against the US dollar since the Governing Council's previous monetary policy meeting and was currently down by 8% from its peak in late May 2021. The ECB's forward guidance remained a key factor behind the divergence in expected policy cycles. Although the relationship between expected inflation and expected policy rates had strengthened somewhat since the Governing Council meeting on 8-9 September 2021, it remained significantly weaker than before the COVID-19 pandemic. Also, looking at the relationship between expected policy rates and inflation surprises across advanced economies, the euro area stood out as a clear exception, with significant cumulative upside surprises to inflation having a limited impact on policy rate expectations.

Nevertheless, uncertainty around the future path of policy rates had increased, also in the euro area, which had contributed to the rise in market volatility. The risk distribution around the three-month EURIBOR had narrowed somewhat compared with the Governing Council's previous meeting on 27-28 October 2021. However, it remained significantly larger than in July and clearly skewed to the upside. This risk distribution suggested investors were concerned that the high uncertainty about the inflation outlook could mean the conditions of the ECB's forward guidance might be met earlier than currently expected.

This view was corroborated when looking at inflation swap rates. Although these had come down from their multi-year highs in recent weeks, the current euro area forward inflation swap curve remained close to the 2% target. It stood well above the level that had been expected before the COVID-19 pandemic. Option markets, too, continued to price in a significant probability of inflation exceeding the ECB's target. They suggested around a 10% probability that inflation over the next five years would, on average, be above 3%, and about a 40% probability that inflation would be above 2%.

To understand how sensitive the market was to a shock like Omicron, it was important to look at the risk exposure that investors had previously built up in expectation that short-term rates and volatility would stay low for a long time. In equity markets, global equity funds had taken in more funds in 2021 than in the previous two decades combined, which had contributed to pushing equity valuation metrics to the tails of, or beyond, the 75th percentile of the historical distribution, in particular in the United States but also in the euro area. Vulnerabilities had risen substantially in the non-bank sector. For example, the liquidity, credit and duration risk of euro area investment funds had all increased notably since the start of the COVID-19 pandemic.

Similarly, in euro area sovereign and corporate bond markets, credit risk premia had been severely compressed over the past months despite much higher leverage. Prospects of higher risk-free rates had led to a decompression, albeit to varying degrees, with spreads generally remaining well below the levels observed before the pandemic. Moreover, with volatility elevated and safe assets in high demand, bond yields had actually fallen in almost all euro area Member States since the Governing Council's October meeting and had otherwise remained close to their October levels. Spreads had only increased due to a strong decline in German Bund yields, which themselves had fallen much more sharply than the OIS rate. The spread of the ten-year Bund yield over the equivalent OIS rate had declined below the extraordinary levels seen at the height of the pandemic in March 2020.

These developments highlighted the exceptional demand for safe assets as uncertainty about the policy outlook had increased. On the supply side, the available "free float" of bonds in the euro area had declined to very low levels. As a result, there had been a gradual and persistent deterioration in bond market liquidity across most euro area jurisdictions. Recently the Governing Council had decided to double the aggregate limit on the cash that counterparties could pledge under the Eurosystem securities lending programme. This had supported liquidity in the repo markets at a time when the demand for collateral had been rising and supply had been limited.

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.

Regarding the external environment, Purchasing Managers' Index (PMI) data had signalled some slowing down of the world economy in the third quarter of 2021, owing to COVID-19-related restrictions and supply chain disruptions. The latest PMI data signalled a renewed improvement for the fourth quarter – especially in services but less so for manufacturing. Supply bottlenecks continued to restrain global activity and trade. Since the October monetary policy meeting of the Governing Council oil prices had decreased sharply (-12%), reflecting demand and supply effects. The euro exchange rate had declined only modestly in nominal effective terms (-0.4%), but had fallen visibly against the US dollar (-3%). Gas prices had increased amid heightened volatility, while metal prices had continued their downward trend.

Turning to developments in activity in the euro area, during the lockdown in the first quarter of 2021 there had still been a substantial gap between GDP and its pre-crisis level. However, much of this gap – though not all – had been closed by the third quarter of 2021. A lot of the recovery during 2021 had been driven by private consumption, linked to the recovery in household spending on services that had followed the earlier recovery in manufacturing.

The nature of supply constraints had been shifting over time and these continued to weigh on activity. Manufacturing firms had been suffering from shortages of materials and equipment. According to the Industry Survey of the European Commission, these shortages had worsened in the fourth quarter of 2021. The lack of skilled labour had become a concern in parts of both the manufacturing and the services sectors.

Growth in disposable income had increased between the first and third quarters – reflecting a large recovery in real income. But in the fourth quarter real income was expected to drop, linked to the recent rise in energy prices. This implied a notable reduction in household real disposable income through a terms-of-trade effect, which was expected to dampen consumer spending in the short term.

As regards housing investment, confidence continued to be strong but constraints from the supply side were playing an increasing role. Investment in other machinery and equipment had exceeded pre-pandemic levels since the first quarter of 2021, while in the third quarter investment in transport equipment had still been substantially below pre-pandemic levels. According to the Survey on the Access to Finance of Enterprises (SAFE), the share of firms saying that they had obtained financing for fixed investment over the latest six-month period had continued to improve and had reached a level above the pre-pandemic average.

The recovery in the labour market continued to be strong. Although the unemployment rate had decreased further to the pre-crisis level of 7.3% in October, job retention schemes continued to support the labour market. Staff calculations indicated that the unemployment rate would be around 9% if workers in job retention schemes were added to the unemployed. In addition, the labour force continued to increase slightly but remained below pre-crisis levels. Employment and hours worked had been increasing in the third quarter but remained below pre-crisis levels, with some variation across countries. This signalled that the labour market was nowhere near back to normal. The job vacancy rate for the total economy had reached 2.6% in the third quarter, its highest level since the start of the data series. This increase was broad-based across sectors and reflected strong labour demand.

The December 2021 staff projections foresaw a strong recovery in economic activity despite some near-term downward revisions owing to supply bottlenecks and the new pandemic wave. Economic growth in 2021 was seen to equal 5.1%, compared with 3.9% in the December 2020 projections. Inflation was expected to remain higher for longer, owing to high energy prices as well as mismatches between supply and demand. But the narrative remained that bottleneck effects were expected to fade over time. Headline inflation was foreseen to fall below 2% as of the fourth quarter of 2022 and be equal to 1.8% in 2024. This reflected low energy inflation but robust core inflation, supported by the absorption of slack, increased labour costs and higher inflation expectations.

Looking at different forecasts over time, the June 2020 Eurosystem staff projections had foreseen only a partial recovery of the economy – whereas now in the December 2021 forecast the real GDP projection had returned to the pre-pandemic path. It was also very important to look at the labour market, where the December projections were returning to the pre-pandemic path. At 6.6% at the end of the projection horizon in 2024, the unemployment rate was forecast to be at a level not seen since the early 1980s. However, this was partly attributable to adverse demographic developments leading to a lack of workers and therefore stronger labour market pressures.

To address the high uncertainty surrounding the economic outlook, the December 2021 Eurosystem staff projections continued to include alternative pandemic scenarios.

Turning to developments in prices and costs, Harmonised Index of Consumer Prices (HICP) inflation had increased further from 3.4% in September to 4.1% in October and 4.9% in November (flash release), pushed up by another increase in energy inflation. Energy inflation had reached an all-time high in November – predominantly driven by oil and fuel prices – while gas and electricity had also played an important role. But there had also been a substantial rise in HICPX inflation, i.e. HICP inflation excluding energy and food, based on higher inflation for goods and services.

Price pressures had spread to more of the goods and services included in the HICP. The range of inflation rates across HICP items was currently very wide. Most indicators of underlying inflation had picked up quite a bit recently, but it remained difficult to disentangle how much of this increase reflected pandemic effects. These included base effects, bottlenecks – which were expected to fade eventually – and the indirect effects of imported energy. Because of the many special factors at work it was unclear to what extent these indicators were, at present, good indicators of underlying inflation. Wage pressures also remained relatively limited, which was an essential aspect for assessing underlying inflationary pressures.

Pipeline price pressures continued to build up. Owing to their lagged impact, this implied stronger upward pressure on non-energy industrial goods (NEIG) inflation in the future. At the same time, it was important to remember that goods represented only a relatively small fraction of the overall consumption basket underlying the HICP.

Turning to wage developments, growth in negotiated wages had remained low, at 1.3% in the third quarter of 2021. So far there was no evidence of substantial second-round effects. Allowing for productivity increases, this was not yet generating much domestic inflation pressure. Minimum wages in several euro area countries were expected to grow quite strongly, in part because of inflation indexation, which could have knock-on effects. The latest developments in indicators of actual wage growth continued to be strongly affected by measures taken in 2020 to cushion the effect of the pandemic, such as job retention schemes. These also affected the GDP deflator, which was usually seen as a measure for domestic price pressures. The contribution of unit labour costs to the GDP deflator had so far remained limited.

Measures of longer-term inflation expectations had increased significantly over the course of 2021 but had remained broadly stable in recent weeks – and were still below the 2% target. Surveys such as the ECB Survey of Professional Forecasters (SPF) or Consensus Economics supported the view that inflation would be high in 2021 and 2022 but fall afterwards and remain below the 2% target from 2023 onwards. Market-based measures of longer-term inflation compensation continued to signal inflation below 2%.

As regards monetary developments, Eurosystem asset purchases remained the largest contributor to money creation. But bank credit to the private sector had also strengthened in the third quarter of 2021 and in October. External monetary outflows were weighing negatively on money creation. Such outflows were consistent with Eurosystem purchases being larger than bond issuance in the euro area and the workings of portfolio rebalancing. Credit dynamics had remained relatively moderate since the September meeting of the Governing Council. This reflected contained demand for bank loans to firms, in the light of firms' high liquidity holdings, the recovery in revenues, and increased use of alternative external financing sources. Conversely, the footprint left by supply bottlenecks was growing, pushing up short-term lending to firms to finance working capital and inventories.

Turning to fiscal policies, the December 2021 Eurosystem staff projections foresaw a less pronounced fiscal tightening for 2022 than the September ECB staff projections. Some additional fiscal stimulus measures could still be expected, resulting in a looser stance. But after 2022, and once the general escape clause of the Stability and Growth Pact ceased to apply, some fiscal normalisation was to be expected. This would see fiscal policy becoming less supportive for growth in 2023-24 than during 2020-21.

Monetary policy considerations and policy options

Summing up, Mr Lane stressed that the euro area economy continued to recover and the labour market was improving, underpinned by ample policy support. Both the services and manufacturing sectors continued to expand. However, the pace of the expansion was moderating, and the pandemic situation had deteriorated. A sharp increase in cases of infection had resulted in the reimposition of tighter restrictions in some countries. These containment measures could, to some extent, delay the recovery in the most contact-intensive services. At the same time, manufacturing activity continued to be constrained by supply bottlenecks which were expected to persist throughout 2022, although gradually dissipating. Economic activity was being restrained by factors that were headwinds for the near-term outlook: the deterioration in the pandemic situation; ongoing shortages of labour, materials and equipment in some sectors; and the rise in energy costs. While the public health crisis was still ongoing, high levels of immunity and robust labour markets were mitigating the economic impact of the pandemic. In line with this assessment, activity was expected to pick up again strongly in the course of 2022.

GDP was projected to grow by 5.1% in 2021, 4.2% in 2022, 2.9% in 2023 and 1.6% in 2024. Compared with the September staff projections, growth had been marked up for 2021 on account of upward revisions to the first two quarters of the year, which outweighed the downward revisions to the final two quarters of the year. The projection for 2022 had been revised down owing to persistent supply-side disruptions and the resurgence of the pandemic. For 2023, growth had been revised up, reflecting the expected fading of supply bottlenecks, the continued global recovery and an unwinding of accumulated savings.

According to Eurostat’s flash estimate, HICP inflation had increased from 4.1% in October to 4.9% in November. Inflation had increased sharply, primarily on account of the surge in energy prices but also because the recovery in demand was outpacing constrained supply in some sectors. Inflation was expected to remain elevated over the next few months but to decline sharply in the course of 2022, as energy prices stabilised, consumption patterns returned to normal, and the bottlenecks in global supply petered out. Base effects – including the reversal of the temporary German VAT cut – would also fall out of the year-on-year inflation calculation. HICPX inflation had risen from 2.0% in October to 2.6% in November. The increase reflected higher services inflation, mirroring the strengthening of price dynamics for high-contact services. NEIG inflation had also increased as producer prices had risen amid ongoing global supply dislocations. Stronger pipeline price pressures were also evident at both the earlier and later stages of the pricing chain.

The December staff projections foresaw a significant upward revision to the path of inflation. Headline inflation was projected to average 2.6% in 2021, 3.2% in 2022, and 1.8% in both 2023 and 2024, with upward revisions of 0.4 percentage points for 2021, 1.5 percentage points for 2022 and 0.3 percentage points for 2023. The upward revisions were due to a significantly higher path of energy prices, as well as price pressures related to supply bottlenecks and to the reopening of the economy. Since these factors were expected to ease in the course of 2022, inflation was expected to fall back below the target in 2023 and 2024. At the same time, not only had the negative pandemic shock to the projected inflation path been eliminated, but also the projected gap vis-à-vis the medium-term inflation target had narrowed owing to the reabsorption of slack, stronger wage dynamics over the projection horizon and the increase in inflation expectations.

The risks to the economic outlook were broadly balanced. Economic activity could outperform expectations if consumers became more confident and saved less than expected. By contrast, the recent worsening of the pandemic, including the spread of new virus variants, could be a more persistent drag on growth. The future path of energy prices and the pace of the dissipation of supply bottlenecks were risks to the recovery and to the outlook for inflation. If such price pressures fed through into higher than anticipated wage rises, or if the economy returned more quickly to full capacity, inflation could turn out to be higher.

Financing conditions remained at favourable levels despite a pronounced deterioration in global risk sentiment and the associated fall in prices of risk assets. Compared with the last quarterly comprehensive assessment in September, risk-free and GDP-weighted sovereign yields had remained broadly stable. Bank and non-financial corporation (NFC) bond yields were above the levels that had prevailed in September, but the cost of equity was lower, and bank lending rates to both firms and households remained near historical lows.

Overall, progress on economic recovery and towards the Governing Council’s medium-term inflation target permitted a step-by-step reduction in the pace of asset purchases over the coming quarters. The pandemic emergency purchase programme (PEPP) had been launched with the dual objectives of offsetting the negative impact of the pandemic on the outlook for inflation and of staving off unwarranted market fragmentation caused by the pandemic that threatened the smooth transmission of monetary policy across the entire euro area.

The PEPP had delivered on this dual-purpose mission. First, inflation at the end of the projection horizon was expected to exceed the end-horizon rate that had been projected prior to the pandemic. Second, the fragmentation in monetary policy transmission that had occurred in the initial phase of the pandemic had been successfully countered. As a result, financing conditions for firms and households had been favourable throughout the euro area. Looking at the big picture, vaccination campaigns and the observed capacity of the economy to adapt to the pandemic supported the conclusion that terminating net purchases at the end of March 2022 met the criterion of the pandemic crisis phase being over.

At the same time, monetary accommodation was still needed for inflation to stabilise at the 2% inflation target over the medium term. In view of the current uncertainty, Mr Lane stressed that there was a need to maintain flexibility and optionality in the conduct of monetary policy.

Against this background, Mr Lane proposed the following:

1. to conduct net asset purchases under the PEPP at a lower pace than in the previous quarter and to communicate the expectation that the Eurosystem would discontinue net purchases under the PEPP at the end of March;

2. to communicate that the pandemic had shown that, under stressed conditions, flexibility in the design and conduct of asset purchases had helped to counter the impaired transmission of monetary policy and had made the efforts to achieve the Governing Council's goal more effective. In the future flexibility should remain an integral element of monetary policy whenever threats to monetary policy transmission and to the attainment of price stability became apparent. In the event of renewed market fragmentation related to the pandemic, PEPP reinvestments could be adjusted flexibly across time, asset classes and jurisdictions at any time. This could include purchasing bonds issued by the Hellenic Republic over and above rollovers of redemptions in order to avoid an interruption of purchases in that jurisdiction, which could impair the transmission of the stance to the Greek economy while it was still recovering from the fallout of the pandemic. In addition, Mr Lane stressed the need to state that net purchases under the PEPP could also be resumed, if necessary, to counter negative shocks related to the pandemic;

3. to extend the reinvestment horizon for the PEPP to until at least the end of 2024. In any case, the future roll-off of the PEPP portfolio would be managed to avoid interference with the appropriate monetary policy stance. The extension of the calendar guidance for PEPP reinvestments both contributed to the monetary policy stance and underpinned the role of PEPP reinvestment in countering market fragmentation risk;

4. in line with the step-by-step reduction in asset purchases and to ensure that the monetary policy stance remained consistent with inflation stabilising at the target over the medium term, the appropriate calibration for the asset purchase programme (APP) was to set the pace of monthly

net asset purchases under the APP at €40 billion in the second quarter; €30 billion in the third quarter; and, from October 2022 onwards, to maintain net asset purchases under the APP at a monthly pace of €20 billion for as long as necessary to reinforce the accommodative impact of the policy rates; and to continue to anticipate that net asset purchases would end shortly before key ECB interest rates started to be raised;

5. to confirm the level of the key ECB interest rates and the forward guidance on the future path of policy rates. This was crucial for maintaining the degree of accommodation that was necessary to stabilise inflation at the 2% inflation target over the medium term;

6. to signal that the Governing Council would continue to monitor bank funding conditions and ensure that the maturing of funds provided in the third series of targeted longer-term refinancing operations (TLTRO III) did not hamper the smooth transmission of monetary policy, and to signal that the Governing Council would also regularly assess the contribution of targeted lending operations to the monetary policy stance. Moreover, Mr Lane stated that the Governing Council should indicate that the special conditions applicable under TLTRO III were expected to end in June 2022, as announced. In addition, there was a need to assess the appropriate calibration of the two-tier system for reserve remuneration so that the negative interest rate policy did not limit the intermediation capacity of the banking system in an environment of ample excess liquidity;

7. to express readiness to adjust all the available instruments, as appropriate and in either direction, to ensure that inflation stabilised at 2% over the medium term.

Mr Lane stressed that the Governing Council should clarify the outlook for its policies so that financing conditions remained sufficiently supportive for inflation to be maintained on its path of convergence to the target. At the same time, necessary optionality would be retained so as to be able to respond adequately to any new inflation surprise leading to an upside unanchoring of expectations regarding inflation in the medium term.

The recalibration of the monetary policy instruments was a proportionate course of action in the pursuit of the price stability mandate. Inflation was still projected to be below the ECB’s target over the medium term. Therefore ensuring that the level of long-term interest rates provided sufficient support for economic activity was necessary in order to foster the convergence of inflation to the Governing Council’s target over the medium term. In the current environment of low interest rates, appropriately calibrated asset purchases were also a relatively more efficient measure than turning to alternative monetary policy tools to provide the necessary degree of monetary accommodation. Moreover, the potential side effects of the proposed recalibration did not outweigh the expected benefits in terms of price stability.

In line with the new monetary policy strategy, Mr Lane stated that the Governing Council should also assess the interrelation between monetary policy and financial stability twice a year. On the one hand, accommodative monetary policy supported growth and thereby corporate balance sheets in both the non-financial and financial sectors. On the other hand, the impact of accommodative monetary policy on property and financial markets warranted close monitoring, especially since some medium-term vulnerabilities had intensified. However, macroprudential policy was the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

2. Governing Council's discussion and monetary policy decisions

Economic, monetary and financial analyses

With regard to the economic analysis, members broadly 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 euro area economy continued to recover and the labour market was improving. The near-term outlook faced headwinds from the latest pandemic wave, the significant increase in energy prices and the shortages of materials, equipment and labour in some sectors. However, overall, society had become better at coping with the pandemic waves and resulting constraints, which was reducing the impact on the economy. While growth was moderating, activity was expected to pick up again strongly in the course of 2022. Inflation had risen sharply owing to the surge in energy prices, and also because demand was outpacing constrained supply in some sectors. Inflation was expected to remain elevated in the near term, but to ease in the course of 2022. The inflation projections had been revised up, but inflation was still projected to settle below the 2% target over the projection horizon.

As regards the external environment, members took note that 2021 had seen an early recovery in manufacturing and, more recently, a significant recovery in services too. The momentum in manufacturing was slowing, however, as supply bottlenecks in conjunction with strong increases in global demand had become more pervasive.

Turning to euro area developments, economic activity had been moderating over the final quarter of 2021 and this slower growth was likely to extend into the early part of 2022. Shortages of equipment, materials and labour in some sectors were hampering production of manufactured goods, causing delays in construction and slowing down the recovery in some parts of the services sector. These bottlenecks would prevail for some time but were likely to ease during 2022. The tighter containment measures reintroduced in some euro area countries to cope with the current pandemic wave could delay the recovery. The pandemic was weighing on consumer and business confidence, and the spread of new virus variants was creating additional uncertainty. Moreover, increased energy costs – and price increases more broadly – were headwinds for consumption. Nonetheless, the economic recovery was continuing and the labour market was improving, with more people in jobs and fewer in job retention schemes. This supported the prospect of rising household income and consumption as well as investment.

Members broadly agreed with the baseline view of economic growth in the December Eurosystem staff macroeconomic projections and the revisions compared with the September ECB staff projections. Expected growth rates for real GDP of 5.1% in 2021 and 4.2% in 2022 showed confidence in a solid recovery and suggested that the sensitivity of activity to the pandemic and the damage caused by the pandemic were seen as limited at this stage. Vaccination campaigns and the adaptation of households and businesses to life during the pandemic had probably been more effective than expected. As a result, the link between the strength of the pandemic and the economic outlook had been weakening over time. The downward revision to growth in the near term as a result of the evolution of the pandemic, and its subsequent rebalancing with higher growth later in 2022, were seen to be in line with what had been experienced in previous waves of the pandemic.

At the same time, it was cautioned that while economic performance had been better than expected, the economy was not yet “out of the woods”. Reference was made to the increased uncertainty implied by the emergence of the Omicron variant. Its emergence would be a setback for services, which had just been starting to recover. It was argued that the impact on inflation might be upward rather than downward in a context of more persistent supply-side constraints. However, the fall in oil prices that had followed the news about Omicron could be seen as a signal that the effect would be anti-inflationary.

Regarding fiscal policies, it was reiterated that targeted and growth-friendly fiscal measures should continue to complement monetary policy. This support would also help the economy adjust to the structural changes that were under way. An effective implementation of the Next Generation EU programme and the “Fit for 55” package would contribute to a stronger, greener and more even recovery across euro area countries.

Against this background, members assessed the risks to the economic outlook as broadly balanced. Economic activity could outperform the staff expectations if consumers became more confident and saved less than expected. By contrast, the recent worsening of the pandemic, including the spread of new variants of the coronavirus, could be a more persistent drag on growth. The future path of energy prices and the pace at which supply bottlenecks were resolved presented risks to the recovery and to the outlook for inflation in both directions. If price pressures fed through into higher than anticipated wage rises, or the economy returned more quickly to full capacity, inflation could turn out to be higher.

With regard to price developments, members largely concurred with the assessment presented by Mr Lane in his introduction. Inflation had increased further to 4.9% in November 2021 and – according to the Eurosystem staff projections – would remain well above 2% for most of 2022. Headline inflation was expected to remain elevated in the near term but to decline in the course of 2022. The upswing in headline inflation primarily reflected a sharp rise in energy prices, which in November had accounted for more than half of headline inflation. In addition, demand continued to outpace constrained supply in certain sectors. Base effects related to the end of the VAT cut in Germany were still contributing to higher inflation, but would only do so until the end of 2021. It was expected that in the course of 2022 energy prices would stabilise and price pressures stemming from global supply bottlenecks would subside. Over time, the gradual return of the economy to full capacity and further improvements in the labour market were expected to support faster growth in wages. Market and survey-based measures of longer-term inflation expectations had moved closer to 2% in recent months. These factors would tend to drive underlying inflation up further and were likely to contribute to stabilising headline inflation at the target over the medium term.

In their discussion of the baseline scenario for inflation in the December staff projections, members noted that the December projections had contained the largest cumulative upward revision to the inflation projections in the history of the exercise. The point was made that in the public perception repeated underestimations of inflation were likely to be more problematic than overestimations, as the general public was typically less concerned if actual inflation turned out lower than expected.

At the same time, it was observed that the Eurosystem staff inflation projection for 2022 was much higher than other recent forecasts, such as those from Consensus Economics. It was stressed that almost two-thirds of the upward revision to inflation for 2022 was due to developments in volatile energy prices. These prices reflected a number of economic and geopolitical factors affecting the balance of demand and supply, as well as types of shock that could not have been foreseen. However, it was pointed out that core inflation had increased strongly over recent months, and inflation had become more broad-based, with barely any of the items in the HICP still exhibiting the low rates of change in prices prevailing in the pre-pandemic period. This cautioned against portraying the current high level of inflation as being the result of just energy price developments and temporary factors.

Members were of the view that there was elevated uncertainty as to where inflation would settle in the medium term after the current hump. The baseline scenario of the December staff projections saw HICP inflation at 1.8% in both 2023 and 2024, and it was pointed out that rates below 2% were in line with the expectations of many other professional forecasters. At the same time, it was remarked that, in any case, this outlook did not imply a return to the low inflation regime of the pre-pandemic period but pointed to a regime more similar to that prevailing before the great financial crisis when inflation had averaged around 2%. This was to be seen as a welcome development.

However, it was also felt that such an outcome could not be taken for granted and high inflation could persist for longer than anticipated. It was reiterated that models calibrated on pre-pandemic data might not be well suited to capturing major structural changes or a potential switch from a lower to a higher inflation regime. Faced with a potential turning point in the inflation outlook, it was seen as paramount to pay close attention to timely signals emerging from the real economy, notably those from firms and wage-setters, rather than relying mostly on models and past patterns.

In this context, it was also reiterated that higher inflation in the medium term was unlikely to come about without dynamic wage growth. In this respect, the baseline scenario of the December staff projections was seen to be predicated on wage growth above the average of the past two decades. It was argued that high wage growth outcomes could only materialise in the presence of a structural change in the wage-setting process or strong second-round effects. However, the longer inflation remained substantially above the target, the more it could become entrenched in longer-term inflation expectations, which could then spill over into wage growth and actual inflation. It was noted that the latest available data for euro area negotiated wages suggested annual growth of around 1.5%, and did not point to second-round effects so far.

At the same time, it was recalled that developments in wage growth lagged those in other economic variables, and such effects should hence not be expected in the data at this stage. It was also argued that the staff projections of relatively high nominal wage growth needed to be put into perspective, as the numbers were still affected by the impact of job retention schemes. Moreover, if developments in productivity were taken into account, the projected growth in unit labour costs appeared much less striking, although measures of productivity were also uncertain and were affected by special factors related to the pandemic, including the impact on the number of hours worked.

Members discussed different upside and downside factors that could affect the baseline inflation outlook in the staff projections. Reference was made to the disinflationary impact of Omicron through lower global commodity prices. It was suggested that the fall in oil prices since the cut-off date for the projections would mechanically lower inflation in 2022. At the same time, the point was made that the balance between the disinflationary and inflationary consequences of Omicron was uncertain. In particular, it was argued that it would likely also affect supply adversely and, in line with previous experiences during the pandemic, could then also entail significant upside risks to inflation.

It was recalled that the baseline projections assumed that energy commodity prices would evolve according to current backward-bending futures prices. These implied a marked decline in energy prices over the projection horizon and contributions of energy prices to headline inflation in 2023 and 2024 well below historical average levels. It was also reiterated that increases in carbon prices towards levels needed to reach the objectives of the Paris Agreement would push inflation upwards in the coming years, both within and beyond the projection horizon. Finally, it was recalled that the inflation projections did not yet include developments in owner-occupied housing costs. Reference was made to estimates indicating that HICP inflation in the second quarter of 2021 would have been 0.2-0.3 percentage points higher if these costs had been included. At the same time, it was suggested that models and the pricing of inflation compensation derived from financial markets continued to point to a higher likelihood of inflation undershooting the medium-term target than of a lasting overshoot.

As regards inflation expectations, members took note of the assessment given by Ms Schnabel and Mr Lane that survey and market-based measures of longer-term inflation expectations had generally remained below but near to the ECB's inflation target. This was also the case taking into account estimates of risk premia, which varied over time and affected the interpretation of inflation expectations derived from the pricing of inflation compensation in financial markets. There were so far no signs that longer-term inflation expectations had moved away – or even become unanchored – from the target following the repeatedly higher than expected inflation figures in recent months, although they had increased significantly since the beginning of 2021. However, if inflation exceeded the target in both 2021 and 2022, this risked being perceived less and less as a temporary phenomenon and might drive up longer-term inflation expectations. If, by contrast, inflation declined sharply throughout 2022 from its current high rates, this would provide reassurance on the inflation outlook.

Members widely concurred with the assessment of financial and monetary conditions provided by Mr Lane in his introduction. Market interest rates had fallen since the Governing Council's October meeting but were little changed compared with the September meeting, when the previous quarterly assessment of the inflation outlook and financing conditions had been carried out. Financing conditions for the economy remained favourable. Bank lending to NFCs was being driven partly by short-term funding needs stemming from supply bottlenecks that increased expenses for inventory and working capital. However, NFCs' demand for loans remained moderate overall because of strong retained earnings and ample cash holdings, as well as high debt. By contrast, lending to households continued to be robust, driven by the demand for mortgages. Euro area banks had further strengthened their balance sheets thanks to higher capital ratios and fewer non-performing loans. Banks' profits had recovered to levels seen before the pandemic, despite continued pressure on net interest margins. Bank funding conditions remained favourable overall.

Monetary policy stance and policy considerations

With respect to the assessment of financing conditions it was noted that, overall, financial and financing conditions had remained favourable despite a pronounced deterioration in global risk sentiment and the associated fall in the prices of risky assets. Compared with the Governing Council's quarterly assessment of financing conditions in September, risk-free and GDP-weighted sovereign yields had remained broadly stable in nominal terms, and near or at historical lows in real terms. Bank and corporate bond yields were above the levels that had prevailed in September, but were counterbalanced by a lower cost of equity. Bank lending rates for firms and households remained around their historical lows. Reference was made to the euro having depreciated markedly, both against the US dollar and in nominal effective terms, as a factor loosening financial conditions. This was also seen as likely to exacerbate losses in the terms of trade and to contribute to upward pressures on the euro area inflation outlook.

Regarding the inflation outlook, members concurred that the recent and projected near-term increase in inflation was driven largely by temporary factors that were expected to ease in the course of 2022. Although the medium-term inflation outlook had been revised up in the staff projections, inflation was still projected to settle below the Governing Council's 2% target in the baseline scenario. It was stressed that the projected convergence of inflation expectations towards 2% was to be welcomed although the outlook was surrounded by exceptionally high uncertainty.

At the same time, it was cautioned that a "higher for longer" inflation scenario could not be ruled out. For 2023 and 2024, inflation in the baseline projection was already relatively close to 2% and, considering the upside risk to the projection, could easily turn out above 2%. It was seen as important to preserve the flexibility to act decisively to keep inflation expectations anchored in both directions, and thus also preserve the credibility of the Governing Council. The Governing Council should therefore communicate clearly that it was ready to act if price pressures proved to be more persistent and inflation failed to fall below the target as quickly as the baseline projections foresaw.

However, concerns were also expressed about any premature scaling back of monetary stimulus and asset purchases. It was argued that market participants seemed to question the credibility of the Governing Council's forward guidance, as they expected a first interest rate increase at a date that was difficult to reconcile with the conditions set by the Governing Council for such an increase.

Overall, members broadly agreed that progress on economic recovery and towards the Governing Council's 2% medium-term inflation target permitted a gradual normalisation of the monetary policy stance. There was general agreement that the downward impact of the pandemic on the projected path of inflation had dissipated or been offset, and that net purchases under the PEPP could accordingly be scaled down and discontinued at the end of March, in line with previous communication. At the same time, members widely agreed that substantial monetary policy support was still needed for inflation to stabilise at the Governing Council's inflation target over the medium term. It was argued that the Governing Council should look through the current supply disruptions and keep a steady hand, while carefully monitoring any developments pointing to an unanchoring of inflation expectations. A continued high degree of monetary policy support was also deemed necessary to prevent inflation falling below the target once the effects of the pandemic, which was still affecting large parts of the euro area economy, had subsided.

However, it was argued that a significant degree of policy stimulus was already in place through the Governing Council's forward guidance on interest rates, the large stock of acquired assets, together with the reinvestment policy, and the TLTROs. Therefore, given the measurable progress made in the convergence of medium-term inflation towards the target, there was no need for a further loosening of the stance through additional asset purchases.

At the same time, it was cautioned that the discontinuation of net purchases under the PEPP at the end of the first quarter of 2022 and the expiry of the favourable interest rate conditions in the TLTRO III operations would imply a monetary tightening in 2022. Moreover, a divergence from the monetary policy stance in other jurisdictions, which could be perceived as less accommodative than in the euro area, was seen as warranted by different economic conditions.

In the subsequent discussion, members widely agreed that the recalibration of the monetary policy instruments proposed by Mr Lane in his introduction was a proportionate course of action in the pursuit of the Governing Council's price stability mandate. Given the exceptionally high uncertainty surrounding the current economic environment, a gradual, data-driven and flexible approach was deemed proportionate to balance the higher near-term inflation outlook against increasing medium-term vulnerabilities, which required maintaining sufficient optionality to adjust policy as new information became available. At the same time, the argument was made that the benefits of additional asset purchases were diminishing and their costs and side effects were increasing. This was evidenced, for example, by a structural deterioration in liquidity conditions and the increasing impairment of market functioning as a result of the low free float of bonds in many jurisdictions. There were also growing risks to financial stability, especially in the housing market, as well as rising distributional effects as asset purchases disproportionally benefited those owning assets.

The proposed policy package was considered to be consistent with the economic outlook and was widely seen as appropriately calibrated to preserve the accommodative monetary policy stance needed to allow inflation to stabilise at the Governing Council's symmetric 2% inflation target over the medium term. Against the background of continued favourable financing conditions and the improved inflation outlook, there was broad agreement that net asset purchases under the PEPP should be conducted at a lower pace in the first quarter of 2022 than in the previous quarter. There was also agreement that net purchases under the PEPP should be discontinued at the end of March. The PEPP was assessed to have achieved its dual objectives of offsetting the negative impact of the pandemic on the outlook for inflation and staving off unwarranted market fragmentation caused by the pandemic that threatened the smooth transmission of monetary policy across the entire euro area.

The point was made that declaring an end to the emergency might be considered premature given the current deterioration in the pandemic situation. At the same time, it was widely felt that the "crisis phase" in economic terms could be considered to be coming to an end, in part since economic activity was expected to have returned to its pre-pandemic level by early 2022 and the pandemic shock to the inflation path was considered to have been offset. Moreover, it was recalled that net purchases under the PEPP could be resumed if the economic consequences of the pandemic endangered the attainment of the Governing Council's price stability objective in the future.

The extension of the guidance for reinvestments under the PEPP to until at least the end of 2024 was seen as assuring market participants that the Eurosystem would continue to be present in financial markets, thereby underpinning the ability of the PEPP reinvestments to counter market fragmentation risk. On the one hand, flexibility in operational parameters was seen as important to address potential disorderly market developments and therefore needed to remain in place over a longer period than previously announced. On the other hand, it was questioned whether lengthening the reinvestment horizon could be interpreted as adding more monetary stimulus, which seemed to contradict the direction of other elements of the policy package that were geared towards a scaling down of net asset purchases. In addition, a concern was voiced that continued asset purchases could lead to an unwelcome flattening of the yield curve if short-term interest rates needed to be raised before the end of the reinvestment horizon. However, the extension was also seen as important to ensure the effectiveness of PEPP reinvestments in protecting the monetary policy transmission mechanism.

Members broadly agreed that the experience with the PEPP during the pandemic had shown that, under stressed conditions, flexibility in the design and implementation of asset purchases helped to counter the impaired transmission of monetary policy and made it more effective. Maintaining this flexibility by adjusting the PEPP reinvestments across time, asset classes and jurisdictions in the event of renewed market fragmentation related to the pandemic was considered important to support the smooth transmission of monetary policy during a period in which net asset purchases were being reduced.

A number of considerations were put forward regarding a commitment to flexibility in the design and conduct of asset purchases more generally, i.e. beyond the crisis situation. On the one hand, it was seen as an important lesson of the PEPP that such flexibility should remain an element of monetary policy whenever threats to monetary policy transmission and to the attainment of price stability became apparent. The flexibility embedded in the PEPP was judged to have helped to provide the required monetary policy support and to reduce fragmentation in financial markets during the crisis. It was suggested that the Governing Council should therefore stress the importance of flexibility in its communication. On the other hand, it was argued that the PEPP’s flexibility was targeted at the specific pandemic shock and might not be proportionate if risks to the transmission of monetary policy and market fragmentation arose in other contexts. It was recalled that the PEPP had been designed to address a symmetric shock that could give rise to asymmetric consequences.

Members agreed that flexibility in relation to the PEPP reinvestments would include the ability to purchase bonds issued by the Hellenic Republic over and above rollovers of redemptions in order to avoid an interruption of purchases in that jurisdiction, which could impair the transmission of the monetary policy stance to the Greek economy while it was still recovering from the fallout of the pandemic. These purchases would provide assurance to market participants and help avoid market fragmentation.

The proposed pace of net purchases under the APP of €40 billion per month in the second quarter, €30 billion per month in third quarter and €20 billion per month from October 2022 onwards was widely seen as striking a reasonable balance between elevated inflation in the short term and high uncertainty about the medium-term outlook. The point was also made that the proposed pace of purchases was appropriate to ensure a sufficient level of monetary policy support following the discontinuation of net asset purchases under the PEPP while avoiding unwanted cliff effects.

Overall, members agreed that the legal framework of the APP was well established and would remain unchanged. While it was widely acknowledged that discontinuing net asset purchases under the PEPP would warrant a temporary step-up in net asset purchases under the APP, it was recalled that the two programmes had different objectives. The APP net purchases were intended to maintain a sufficiently accommodative stance to allow inflation to stabilise at the Governing Council’s 2% target over the medium term. It was argued that on this basis the change in the inflation outlook called for lower purchase volumes or an earlier phasing-out of purchases under the APP. The argument was also made that, in the present context of high uncertainty, the Governing Council should keep the APP open-ended but avoid any perception of a commitment to continuing net purchases under the APP beyond 2022.

Given the high uncertainty surrounding the economic outlook, a sufficient degree of optionality to respond adequately to any new inflation surprises was seen as important for stabilising inflation at the symmetric 2% target. As incoming data over time would allow the impact of the evolving pandemic to be better understood, the Governing Council should retain the ability to calibrate and recalibrate the monetary policy stance in a data-driven manner in either direction.

It was also emphasised that the Governing Council should reaffirm its forward guidance on interest rates, including the link to the end of the net asset purchases under the APP. The state-contingent nature of the

Governing Council's forward guidance was seen as well suited to addressing the current uncertain economic environment as it embedded both flexibility and optionality and ensured that short-term yields remained consistent with the inflation outlook. It was argued that, if risks to growth did not materialise and if the outlook for medium-term inflation moved above the Governing Council's symmetric 2% inflation target, the forward guidance would allow for a gradual normalisation of the monetary policy stance.

In relation to the targeted lending programme, members agreed that the Governing Council should confirm that it expected the special conditions applicable under TLTRO III to end in June 2022 as announced in 2020, and communicate that it would assess the appropriate calibration of the two-tier system for reserve remuneration so that the negative interest rate policy did not limit banks' intermediation capacity in an environment of growing excess liquidity.

In line with its new monetary policy strategy, the Governing Council for the first time considered the link between monetary policy and financial stability in a structured manner. It was argued that monetary policy was not well suited to dealing with financial stability risks as these tended to be concentrated in particular jurisdictions and were therefore better addressed with country-specific macroprudential measures. At the same time, it was noted that, as stressed in the monetary policy strategy review, existing limitations of macroprudential policy implied that there was a clear case for the ECB to take financial stability considerations into account in its monetary policy deliberations. It was pointed out that medium-term vulnerabilities had increased and required close monitoring. Concerns related in particular to credit, asset and housing markets as well as to higher debt levels in the corporate and public sectors as a legacy of the pandemic. It was also observed that the risk of a disorderly market reaction following a withdrawal of monetary policy support might lead to financial market fragmentation affecting monetary transmission across jurisdictions. However, this should not be used as an argument against modifying the monetary policy stance if that was required to achieve the ECB's primary objective of price stability in the euro area as a whole. From this perspective it was advised that the dual objectives of asset purchases, i.e. in relation to the monetary policy stance and to transmission, be kept distinct.

Overall, members concurred with the view that an accommodative monetary policy supported the balance sheets of companies and financial institutions, as well as countering risks of market fragmentation in the near term. To prevent the build-up of medium-term vulnerabilities, however, the impact of an accommodative monetary policy on property markets and financial markets should be closely monitored. Macroprudential policy was seen as the first line of defence in preserving financial stability and addressing medium-term vulnerabilities.

Monetary policy decisions and communication

In sum, a large majority of members agreed with the policy package proposed by Mr Lane, namely to conduct net asset purchases under the PEPP at a lower pace in the first quarter of 2022 than in the previous quarter; to adjust PEPP reinvestments flexibly across time, asset classes and jurisdictions if needed; to extend the PEPP reinvestment horizon until at least the end of 2024; to increase net asset purchases under the APP temporarily to ensure that the monetary policy stance remained consistent with inflation stabilising at 2% over the medium term; and to reconfirm the other elements of the current monetary policy configuration.

Some members retained reservations about some elements of the proposed package such that they could not support the overall package. These reservations pertained, in particular, to the recalibration of APP purchases and the extension of the minimum PEPP reinvestment period, as well as the statement about flexibility in future asset purchases beyond the confines of the specific circumstances of the present pandemic.

Regarding communication, it was emphasised that the Governing Council should stress its willingness to adjust all of its instruments as appropriate, in either direction, in order to stabilise inflation at 2% over the medium term. In addition, the Governing Council should reassure markets by stressing its determination to act flexibly and quickly to counter risks of fragmentation.

The Governing Council judged that the progress on economic recovery and towards its medium-term inflation target permitted a step-by-step reduction in the pace of its asset purchases over the coming quarters. But monetary accommodation was still needed for inflation to stabilise at the 2% inflation target over the medium term. In view of the existing uncertainty, the Governing Council needed to maintain flexibility and optionality in the conduct of monetary policy. With this in mind, 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 corresponding ECB press release.

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

Monetary policy statement

Monetary policy statement to the press conference of 16 December 2021 English

Press release

Monetary policy decisions

Meeting of the ECB’s Governing Council, 15-16 December 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 December 2021 under Article 10.2 of the ESCB Statute.

Other attendees

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

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

Accompanying persons

- Mr Arce
- Ms Buch
- Mr Demarco
- Ms Donnery
- Mr Garnier
- Mr Haber
- Mr Kaasik
- Mr Kuodis
- Mr Kyriacou
- Mr Lünnemann
- Mr Nicoletti Altimari
- Mr Novo
- Mr Ódor
- Mr Rutkaste
- Mr Sleijpen

- Mr Tavlas
- Mr Välimäki
- Mr Vanackere
- Ms Žumer Šujica

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, 3 March 2022.

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