



EUROPEAN CENTRAL BANK

EUROSYSTEM

23 August 2018

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

held in Frankfurt am Main

on Wednesday and Thursday, 25-26 July 2018

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Mario Draghi

President of the European Central Bank

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

Financial market developments

Mr Cœuré reviewed the latest financial market developments since the Governing Council's previous monetary policy meeting on 13-14 June 2018.

The slope of the US Treasury and German government bond yield curves, measured as the difference between the ten-year and two-year yields, had continued their flattening trend of recent months. In particular, between April and July 2018 estimates of the term premium in the United States had fallen deeper into negative territory despite factors which should have led, in principle, to a decompression of the premium, such as the gradual balance sheet wind-down by the Federal Reserve System and expectations of an increase in the supply of US Treasury securities based on a projected rise in the US fiscal deficit.

The most recent decline in term premia, both in the United States and in the euro area, might partly be attributed to the growing uncertainty over the global economic outlook owing, among other factors, to escalating trade disputes. This may have affected confidence among investors and contributed to an increase in demand for US Treasuries and German government bonds, widening the negative term premia that also reflected the stock effect of large-scale asset purchases.

Moreover, following the June Governing Council meeting, market participants' expectations of a first rate increase by the ECB had been pushed further into the future, as suggested by market pricing and the latest analyst surveys. This partly reflected the Governing Council's enhanced forward guidance on the future path of policy rates, which had also contributed to reducing interest rate uncertainty.

In foreign exchange markets, the euro had traded in a very narrow range against the US dollar. However, in nominal effective terms, the euro had appreciated, in particular against the currencies of a number of developing and emerging market economies. Part of the depreciation of these economies' currencies was likely related to the growing uncertainty over the impact of trade tensions.

Trade tensions were also seen by market participants to have had a negative impact on stock market valuations, most notably in China. Since its peak in late January 2018, the China Securities Index 300 had declined by nearly 20%, while other stock market indices in the region had also fallen but to a lesser extent. These equity market sell-offs no longer affected only sectors that would be most hit by tariffs. Rather, they had become more broad-based, possibly reflecting increasing concerns among investors over the impact of protectionist measures on the global growth outlook.

Credit spreads in emerging market economies had increased measurably, by around 80 basis points, since the start of 2018. However, they remained well below the levels observed in 2015 and early 2016.

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.

Regarding the external environment, the global economic expansion had continued, while trade had weakened further. At the same time, inflation dynamics had gained some momentum. Annual consumer price inflation in the OECD area had edged up to 2.6% in May, with inflation excluding food and energy also increasing marginally. Brent crude oil prices had decreased by 2.2% (in US dollar terms) since the June monetary policy meeting. Over the same period, non-oil commodity prices had decreased by 7.4%, food prices by 6.7% and metal prices by 9.7% (all in US dollar terms).

Looking at the euro area, the incoming data confirmed that the moderation in the first quarter of 2018 had reflected a pull-back from the very high growth levels of previous quarters, mostly on account of weaker export demand with some contribution from temporary and supply-side factors. The breakdown of first-quarter growth into its components showed that domestic demand and changes in inventories had contributed positively to the outturn, whereas the contribution of net exports had been negative.

High frequency indicators released since the June meeting had confirmed the ongoing broad-based expansion. The flash composite output Purchasing Managers' Index for July had decreased only slightly to 54.3, from 54.9 in June. Moreover, consumer confidence and confidence in the construction sector had remained at elevated levels, well above their historical averages. Favourable financing conditions, a robust labour market, and steady income and profit growth had continued to support private consumption and investment.

The June 2018 Eurosystem staff projections for euro area real GDP growth were broadly aligned with, or slightly below, available forecasts from other international institutions.

Turning to price developments, according to Eurostat's flash estimate, euro area annual HICP inflation had stood at 2.0% in June, up from 1.9% in May. The increase reflected higher inflation rates for the energy and food components, which had more than offset a decline in HICP inflation excluding energy and food. Meanwhile, measures of underlying inflation remained muted overall but had been increasing from earlier lows.

Annual growth in compensation per employee had increased to 2.0% in the first quarter of 2018, up from 1.8% in the fourth quarter of 2017. In the first quarter of 2018, the impetus for this upward trend had come from stronger negotiated wage growth, rather than wage drift, as had previously been the case. This shift to negotiated wage growth as the main driver bolstered confidence that the pick-up in wage growth would be sustained.

Both market and survey-based inflation expectations were largely unchanged since the June meeting. Compared with other forecasts, the June Eurosystem staff projections for euro area HICP inflation were at the upper end of the range for 2018 and in the middle of the range for 2019 and 2020.

Financial conditions had remained broadly stable, in spite of some exchange rate appreciation in nominal effective terms and lower equity markets. The Governing Council's June decisions had reduced interest rate uncertainty. In the weeks following the June meeting, EONIA forward rates had continued to decline, accompanied by a further flattening of the forward curve. Meanwhile, mounting global trade tensions weighed on euro area equity markets, while there were only modest changes in sovereign and corporate debt markets. The overall cost of financing for euro area firms had remained very favourable.

Turning to money and credit developments, the annual growth rate of the broad monetary aggregate M3 had risen to 4.4% in June from 4.0% in May. From a counterpart perspective, domestic sources of money creation had remained the main driver of M3 growth. The annual growth rate of loans to the private sector had continued its recovery, increasing to 3.5% in June, up from 3.3% in May. This acceleration had been mainly driven by loans to non-financial corporations (NFCs), which had stood at 4.1% in June.

At the euro area level, the composite cost of borrowing for NFCs had fallen to a new historical low in May, while the borrowing costs of loans for house purchase had remained stable at 1.8%. Moreover, according to the July 2018 euro area bank lending survey, credit standards had continued to ease for NFCs and households in the second quarter of 2018. The main factors contributing to the net easing had been competition and risk perceptions reflecting solid economic growth in the euro area.

Finally, with regard to fiscal policy, the euro area fiscal stance, measured as the change in the cyclically adjusted primary balance, was projected to stay mildly expansionary in 2018.

Monetary policy considerations and policy options

Summing up, Mr Praet noted that, since the June monetary policy decisions, financial conditions had remained broadly stable and borrowing conditions for households and firms had continued to be very favourable. The Governing Council's enhanced forward guidance on policy rates had struck a good balance between being sufficiently precise and maintaining adequate flexibility. Overall, the information received since the previous meeting had been broadly in line with the June assessment.

The most recent economic indicators and survey results had stabilised and confirmed the scenario of solid and broad-based growth momentum in line with the June Eurosystem staff projections.

Risks to the growth outlook could still be assessed as broadly balanced. Uncertainties related to global factors remained prominent. In addition, the risk of persistent heightened financial market volatility continued to warrant monitoring.

The strength of the euro area economy supported confidence that the convergence of inflation to levels below, but close to, 2% over the medium term would continue in the period ahead. This confidence was further bolstered by rising wages and increasing price pressures at the early stages of the pricing chain.

At the same time, underlying price pressures were building up only gradually, which argued in favour of patience, prudence and persistence with regard to the conduct of monetary policy in the period ahead.

On the basis of this assessment, Mr Praet proposed keeping monetary policy unchanged and reconfirming all elements of the Governing Council's forward guidance.

It was important for communication to emphasise that the incoming data confirmed that the euro area economy was proceeding along a solid and broad-based growth path and underlined that risks surrounding the euro area growth outlook could still be assessed as broadly balanced, but uncertainties related to global factors remained prominent.

It was furthermore important to highlight that the underlying strength of the euro area economy continued to provide confidence that the convergence of inflation to levels below, but close to, 2% over the medium term would proceed in the period ahead, as well as to stress that a significant monetary policy stimulus remained necessary for the sustained convergence of inflation.

Likewise important was for the Governing Council to reiterate that an ample degree of monetary accommodation would continue to be provided by the net asset purchases until the end of 2018, by the sizeable stock of acquired assets and the associated reinvestments, and by the enhanced forward guidance.

2. Governing Council's discussion and monetary policy decisions

Economic and monetary analyses

With regard to the economic analysis, members shared the assessment of the outlook and risks for economic activity in the euro area provided by Mr Praet in his introduction. The moderation in euro area real GDP growth in the first quarter of 2018 had reflected a pull-back from the very high levels of growth in 2017, relating mainly to weaker impetus from previously very strong external trade, as well as some temporary and supply-side factors. Moreover, the most recent economic indicators and survey results had stabilised and continued to point to ongoing solid and broad-based economic growth, in line with the June Eurosystem staff macroeconomic projections for the euro area. Overall, the risks to this growth outlook could still be assessed as broadly balanced, despite uncertainties related to global factors – notably the threat of protectionism – remaining prominent.

Regarding the external environment, members concurred with the view that the global economic expansion was expected to continue, although trade momentum had weakened. They furthermore agreed that uncertainties related to global factors remained prominent, in particular with regard to the threat of protectionism and the risk of an escalation of trade tensions. It was remarked that these tensions could generate a more general decline in confidence throughout the global economy, beyond any direct effects from the imposition of tariffs. Concerns were also expressed about the implications for emerging market economies and the recent depreciation of their currencies, with developments in these economies discussed prominently in the IMF's latest outlook for the global economy.

Turning to euro area activity, members concurred with the view that the easing in quarterly real GDP growth in the first quarter of 2018, to 0.4%, had by and large reflected a pull-back from the very high levels of growth recorded in 2017, with activity still exceeding the rate of growth of potential output. While the most recent data

entailed the prospect of real GDP growth in the second quarter of 2018 being somewhat lower than embedded in the June Eurosystem staff projections, the expectation was still that this would be largely temporary and that the outlook over the medium term continued to be consistent with solid and broad-based economic growth.

Looking at the main demand components, support for the medium-term growth outlook continued to come from strong consumption fundamentals, notably ongoing employment growth. Reference was also made to the probable boost provided by expansionary fiscal measures in some countries. Business investment was expected to continue to benefit from favourable financing conditions, rising corporate profitability and solid demand. By contrast, the momentum in export demand had eased after performing exceptionally well during 2017, explaining the pull-back observed in overall economic growth. In this context, the point was made that the weaker momentum in export growth and the associated losses in market shares might, in part, also reflect the past appreciation of the euro in conjunction with other determinants of export demand, such as global growth. Furthermore, a remark was made that supply factors might also be contributing to a “structural” levelling-off of economic growth, with a number of surveys pointing to labour market tightness becoming progressively more widespread across sectors and countries.

Overall, members considered that the risks surrounding the euro area growth outlook could still be assessed as broadly balanced, notwithstanding the uncertainties related to global factors, notably the threat of protectionism. The risk of persistent heightened financial market volatility also continued to warrant monitoring.

With regard to price developments, there was broad agreement with the assessment presented by Mr Praet in his introduction. Euro area annual HICP inflation had increased to 2.0% in June 2018, from 1.9% in May, reflecting mainly higher energy and food price inflation. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation were likely to hover around the current level for the remainder of the year. Moreover, while measures of underlying inflation remained generally muted, they had been increasing from earlier lows. According to the June Eurosystem staff projections, underlying inflation was expected to pick up towards the end of the year and to increase gradually thereafter. Patience was hence required, given the uncertainties in the baseline inflation outlook. With respect to domestic cost pressures, increasing support for the inflation outlook was seen to come from the ongoing strengthening in wage growth, although it remained to be seen to what extent wage inflation would translate into price inflation over time.

As regards developments in inflation expectations, comfort was drawn from the findings of the most recent ECB Survey of Professional Forecasters (SPF), which confirmed that probability distributions were moving towards higher headline inflation outcomes. At the same time, it was remarked that both survey-based and market-based measures indicated there was only a low probability of inflation exceeding 2% over the medium term.

Members broadly shared the view that uncertainties surrounding the inflation outlook had been receding. Developments since the previous monetary policy meeting had confirmed confidence in the continued convergence of inflation to levels below, but close to, 2% over the medium term, although expectations in the SPF for HICP inflation excluding energy and food in 2020 remained below those in the June Eurosystem staff projections. It was argued that uncertainties in the outlook for economic growth would not necessarily translate into corresponding risks to the inflation outlook. This held true, in particular, if such risks related to trade protectionism, in which case the impact on inflation was seen as being ambiguous.

Turning to the monetary analysis, members agreed with the assessment presented by Mr Praet in his introduction. The annual growth rate of broad money had risen in June, partly reversing the deceleration that had been observed between September 2017 and March 2018. While the somewhat weaker momentum in M3 dynamics over previous months had reflected the reduction in the monthly net asset purchases since the beginning of the year, this had been offset by an increase in the contribution of credit to the private sector and other counterparts. Overall, M3 growth continued to be supported by the impact of the ECB's monetary policy measures and by the low opportunity cost of holding the most liquid deposits.

It was noted that the recovery of credit to the private sector had continued in June, mainly driven by loans to NFCs. The origination of new loans for house purchase had also strengthened further, although, in net terms, housing loan growth had remained moderate owing to repayments of mortgages granted in the pre-crisis boom. The expansion of credit continued to be supported by very favourable borrowing costs for firms and households across the euro area, reflecting also the ongoing pass-through of the monetary policy measures put in place since June 2014. According to the July bank lending survey, loan developments had also benefited from some additional easing of credit standards across loan categories, in particular for households.

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. While uncertainties, notably related to the global trade environment, remained prominent, the information available since the previous monetary policy meeting was seen to indicate that the euro area economy was proceeding along a solid and broad-based growth path. The strength of the economy was assessed to confirm the Governing Council's confidence that the convergence of inflation to levels below, but close to, 2% over the medium term would continue in the period ahead and be maintained even after a gradual winding-down of net asset purchases. Nevertheless, significant monetary policy stimulus was considered to be still needed to support the further build-up of domestic price pressures and headline inflation over the medium term.

Members widely expressed satisfaction that the communication of the June monetary policy decisions had been well understood by financial markets. Since the June meeting, financial conditions had remained broadly stable and borrowing conditions for households and firms had continued to be very favourable. The Governing Council's enhanced forward guidance on the future path of policy rates had been effective in aligning market views about the future evolution of policy rates with the Governing Council's expectation that the key ECB interest rates would remain at their current levels "at least through the summer of 2019". This formulation was considered to have struck an appropriate balance between being sufficiently precise to provide effective forward guidance and maintaining a suitable degree of flexibility. In this regard, it was remarked that the Governing Council's expectation was probabilistic in nature.

There was broad agreement among members that an ample degree of monetary policy accommodation was still necessary to support the further build-up of domestic price pressures and headline inflation over the medium term. Overall, the uncertainties around the inflation outlook still called for caution and it was widely felt

that monetary policy had to remain patient, prudent and persistent. It was considered essential to retain sufficient flexibility and optionality for monetary policy in the period ahead, and the importance of data dependency in determining the Governing Council's monetary policy stance was stressed.

Against this background, members unanimously agreed to maintain the current monetary policy stance and to reconfirm all elements of the Governing Council's forward guidance. This involved reiterating that the Governing Council expected policy rates to remain at their present levels at least through the summer of 2019 and, in any case, for as long as necessary to ensure the continued sustained convergence of inflation to levels below, but close to, 2% over the medium term. It also meant reconfirming that the Governing Council would continue to make net purchases under its asset purchase programme (APP) at the present monthly pace of €30 billion until the end of September 2018 and that it anticipated that, after September 2018, subject to incoming data confirming its medium-term inflation outlook, the Governing Council would reduce the monthly pace of the net asset purchases to €15 billion until the end of December 2018 and then end net purchases. Finally, this included reconfirming the Governing Council's intention to reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of the net asset purchases and, in any case, for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

On communication, members widely concurred with all the elements proposed by Mr Praet in his introduction. It needed to be emphasised that the incoming data confirmed that the euro area economy was proceeding along a solid and broad-based growth path in line with the June Eurosystem staff projections. It was likewise seen as important to stress that risks surrounding the euro area growth outlook could still be assessed as broadly balanced, although it also had to be acknowledged that uncertainties related to global factors remained prominent. Moreover, it should be highlighted that the underlying strength of the euro area economy supported confidence that the convergence of inflation to levels below, but close to, 2% over the medium term would continue in the period ahead and would be maintained after a gradual winding-down of APP net asset purchases.

There was also broad agreement among the members to highlight that a significant monetary policy stimulus remained necessary for the sustained convergence of inflation to continue, and to emphasise that monetary policy had to remain patient, prudent and persistent. Accordingly, it was felt that the Governing Council needed to reiterate that an ample degree of monetary accommodation would continue to be provided by the anticipated net asset purchases until the end of the year, by the sizeable stock of acquired assets and the associated reinvestments, and by the Governing Council's enhanced forward guidance. Moreover, in the light of still prevailing uncertainties that could put the sustained convergence at risk, it was considered prudent to restate the Governing Council's readiness to adjust all of its instruments, as appropriate, to ensure that inflation continued to move towards the Governing Council's inflation aim in a sustained manner.

Monetary policy decisions and communication

Taking into account the foregoing discussion among the members, on a proposal from the President, the Governing Council decided that the interest rate on the main refinancing operations and the interest rates on

the marginal lending facility and the deposit facility would remain unchanged at 0.00%, 0.25% and -0.40% respectively.

The Governing Council expected the key ECB interest rates to remain at their present levels at least through the summer of 2019 and, in any case, for as long as necessary to ensure the continued sustained convergence of inflation to levels below, but close to, 2% over the medium term.

Regarding non-standard monetary policy measures, the Governing Council would continue to make net purchases under the APP at the current monthly pace of €30 billion until the end of September 2018. The Governing Council anticipated that, after September 2018, subject to incoming data confirming its medium-term inflation outlook, the monthly pace of the net asset purchases would be reduced to €15 billion until the end of December 2018 and that net purchases would then end. The Governing Council intended to reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of the net asset purchases and, in any case, for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

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/2018/html/ecb.is180726.en.html>

Press release

<http://www.ecb.europa.eu/press/pr/date/2018/html/ecb.mp180726.en.html>

Meeting of the ECB's Governing Council, 25-26 July 2018

Members

Mr Draghi, President

Mr de Guindos, Vice-President

Mr Cœuré

Mr Costa

Ms Georghadji

Mr Hansson*

Mr Hernández de Cos

Mr Knot

Mr Lane*

Ms Lautenschläger

Mr Makúch

Mr Mersch

Mr Nowotny

Mr Praet

Mr Rehn

Mr Reinesch

Mr Smets

Mr Stourmaras*

Mr Vasiliauskas

Mr Vella

Mr Villeroy de Galhau

Mr Visco*

Mr Weidmann

* Members not holding a voting right in July 2018 under Article 10.2 of the ESCB Statute.

Other attendees

Mr Teixeira, Secretary, Director General Secretariat

Mr Smets, Secretary for monetary policy, Director General Economics

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

Accompanying persons

Mr Antunes

Mr Arce

Mr Aucremanne

Mr Bradeško

Ms Buch

Mr Demarco

Ms Everett

Mr Gaiotti

Ms Goulard

Ms Koren

Mr Kuodis

Mr Mooslechner

Mr Ódor

Mr Pattipeilohy

Ms Razmusa

Mr Rutkaste

Mr Schoder

Mr Stavrou

Mr Tavlas

Mr Välimäki

Other ECB staff

Ms Graeff, Director General Communications

Mr Straub, Counsellor to the President

Mr Bindseil, Director General Market Operations

Mr Rostagno, Director General Monetary Policy, DG Economics

Release of the next monetary policy account foreseen on Thursday, 11 October 2018.