ECB: Summer is the time to pause to reflect

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- **July was a transition meeting for the ECB, with status quo on rates, stimulus program as well as policy guidance**
- **The ECB expects to see a rebound in activity in Q3, although risks are skewed to the downside.**
- **We expect changes to the tiering multiplier after the summer break**

As widely anticipated, the ECB maintained status quo today, holding its policy guidance, interest rates, as well as the deposit tiering system unchanged. Beyond the broader outcome, which was largely priced in, today's policy statement alongside ECB Chief Lagarde's post policy call shed important light on several issues and doubts amongst market participants. These were related to ECB's monetary policy strategy, particularly the extent of PEPP utilisation under the current evolving environment and the potential adjustments to the tiering multiplier, a timeline for the Strategic Review of monetary policy, the banking system and corporate sector outlook, ECB's take on the prospects of the EU Recovery Fund and its macro assessment in the wake of concerns over the second wave of COVID-19, rising de-globalisation trends, and geopolitical tensions.

ECB acknowledged the recent significant improvement in macro data as well as financial conditions, but reiterated its strong commitment to underlying stimulus programs, cautioning over the high uncertainty and still early stage of recovery. The central bank expects growth to rebound in Q3, although risks remain skewed to the downside.

With regards to monetary policy strategy, Mrs Lagarde clarified that, in principle, the entire envelope of PEPP would be fully utilized going forward unless there are significant upside surprises. Some ECB members had recently suggested that the entire PEPP envelope, boosted to Euro 1.35 trillion, might not be spent. The ECB has purchased over €360 bn in bonds under the PEPP until end June, although recent market stabilization and reduced 'fragmentation risk' have seen bond purchases slow. That said, the PEPPs flexibility with regards to capital key and its two pronged effectiveness in avoiding fragmentation risk while maintaining policy stance makes it ECB's most potent tool to help the Euro Area "get back to the trajectory of inflation pace pre-Covid-19".

Over the last few weeks there was some speculation over whether the ECB could signal a rise in the multiplier on tiered deposit rates with excess liquidity increasing significantly and expected to rise further going forward due to the asset purchase programs and the TLTROs. While ECB members did not discuss altering the tiered interest rate system in today's policy meeting, Mrs Largarde stated that the ECB is open to the possibility of changing it in future. The ECB could do so by either changing the multiple factor or the interest rate. On the flipside, Mrs. Lagarde emphasized that the tiering system is working well - alleviating side effects on banks and that the TLTRO has been a great success given its attractive cost and no-stigma effect. Meanwhile, the Strategic Review of monetary policy, which was postponed at the beginning of the pandemic, will start in September and could last probably until the second half of 2021, with climate change and financial stability playing an important role.

Beyond its direct monetary policy contours, Lagarde underscored ECB's concerns over the damaging 'cliff-edge' effect, as is likely to be anticipated by banks, of various fiscal schemes launched across the Euro Area to fight the pandemic, including the bank lending guarantee schemes, while referring to European Commissions' published best practices for engineering a smooth exit. Separately, Lagarde reiterated the ECB's support to the 'critical' EU Recovery Fund, while stressing that it has to be approved rapidly, while downplaying any risk of a breakdown in talks when EU leaders meet tomorrow to discuss the plan.

On concerns over risks of rising corporate defaults and the state of the banking sector, Mrs Lagarde struck a reassuring note, emphasizing the European banking system is much better prepared than in the past to face the pandemic shock, in terms of capital buffers, and in turn address corporate distress concerns.

All in all, today's wait and watch policy meeting suggests that the ECB will stay put in the short-run regarding monetary policy, in turn awaiting better clarity on the shape of economic recovery and financial market conditions, while continuing to use the PEPP with high flexibility. That said, a change in the tiering system for deposits after the summer break cannot be discounted.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in light grey and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE).

PRESS CONFERENCE

Christine Lagarde, President of the ECB,
Luis de Guindos, Vice-President of the ECB,
Frankfurt am Main, ~~4 June~~16 July 2020

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. We will now report on the outcome of today's meeting of the Governing Council, which was also attended by the Commission Executive Vice-President, Mr Dombrovskis.

Incoming information ~~confirms that the~~ since our last monetary policy meeting in early June signals a resumption of euro area ~~economy is experiencing an unprecedented contraction. There has been an abrupt drop in~~ economic activity ~~as a result of~~ , although the level of activity remains well below the levels prevailing before the coronavirus (COVID-19) pandemic and the outlook remains highly uncertain. Both high-frequency and survey indicators bottomed out in April and showed a significant, though uneven and partial, recovery in May and June, alongside the ongoing containment of the virus and the associated easing of the lockdown measures ~~to contain it. Severe~~ . At the same time, actual and expected job and income losses and the exceptionally elevated uncertainty about the evolution of the pandemic and the economic outlook ~~have led~~continue to ~~a significant fall in~~weigh on consumer spending and business investment. ~~While survey data and real-time indicators for economic activity have shown some signs of a bottoming-out alongside the gradual easing of the containment measures, the improvement has so far been tepid compared with the speed at which the indicators plummeted in the preceding two months. The June Eurosystem staff macroeconomic projections see growth declining at an unprecedented pace in the second quarter of this year, before rebounding again in the second half, crucially helped by the sizeable support from fiscal and monetary policy. Nonetheless, the projections entail a substantial downward revision to both the level of economic activity and the~~ Headline inflation ~~outlook over the whole projection horizon, though the baseline is surrounded by an exceptional degree of uncertainty. While headline inflation is suppressed~~is being dampened by lower energy prices~~,~~ and price pressures are expected to remain very subdued on account of the sharp decline in real GDP growth and the associated significant increase in economic slack.

~~In line with its mandate, the Governing Council is determined to ensure the~~Against this background, ample monetary stimulus remains necessary ~~degree of monetary accommodation and a smooth transmission of monetary policy across sectors and countries. Accordingly, we decided on a set of monetary policy measures~~ to support the ~~economy during its gradual reopening~~economic recovery and to safeguard medium-term price stability. Therefore, we decided to reconfirm our very accommodative monetary policy stance.

We will keep the key ECB interest rates unchanged. We expect them to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.

~~First, the Governing Council decided to increase the envelope for~~We will continue our purchases under the pandemic emergency purchase programme (PEPP) ~~by €600 billion to~~with a total envelope of €1,350 billion. ~~In response~~These purchases contribute to easing the overall monetary policy stance, thereby helping to offset the pandemic-related downward ~~revision to inflation over the projection horizon, the PEPP expansion will further ease the general monetary policy stance, supporting funding conditions in the real economy, especially for businesses and households~~shift in the projected path of inflation. The purchases will continue to be conducted in a flexible manner over time, across asset classes and among jurisdictions. This allows us to effectively stave off risks to the smooth transmission of monetary policy.

~~Second, we decided to extend the horizon for net purchases under the PEPP to at least the end of June 2021. In any case, we~~We will conduct net asset purchases under the PEPP until at least the end of June 2021 and, in any case, until the Governing Council judges that ~~-~~ the coronavirus crisis phase is over.

~~Third, the Governing Council decided to~~ We will reinvest the ~~maturing~~ principal payments from maturing securities purchased under the PEPP until at least the end of 2022. In any case, the future roll-off of the PEPP portfolio will be managed to avoid interference with the appropriate monetary policy stance.

~~Fourth, net~~Net purchases under our asset purchase programme (APP) will continue at a monthly pace of €20 billion, together with the purchases under the additional €120 billion temporary envelope until the end of the year. We continue to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of our policy rates, and to end shortly before we start raising the key ECB interest rates.

~~Fifth, we~~ We intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

~~Sixth, we decided to~~We will also continue to provide ample liquidity through our refinancing operations. In particular, the latest operation in the third series of targeted longer-term refinancing operations (TLTRO III) has registered a very high take-up of funds, supporting bank lending to firms and households.

The monetary policy measures that we have taken since early March are providing crucial support to underpin the recovery of the euro area economy and to safeguard medium-term price stability. In particular, they~~keep the key ECB interest rates unchanged. We expect them to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.~~

~~Together with the substantial monetary policy stimulus already in place, today's decisions will~~ support liquidity and funding conditions in the economy, help to sustain the flow of credit to households and firms, and contribute to maintaining favourable financing conditions for all sectors and jurisdictions~~, in order to underpin the recovery of the economy from the coronavirus fallout.~~. At the same time, in the current ~~rapidly evolving economic~~ environment of elevated uncertainty and significant economic slack, the Governing Council remains fully committed to doing everything necessary within its mandate to support all citizens of the euro area through this extremely challenging time. This applies first and foremost to our role in ensuring that our monetary policy is transmitted to all parts of the economy and to all jurisdictions in the pursuit of our price stability mandate. The Governing Council, therefore, continues to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~The latest economic indicators~~ Incoming data and survey results ~~confirm a sharp contraction of the euro area economy and rapidly deteriorating labour market conditions. The coronavirus pandemic and the necessary containment measures have severely affected both the manufacturing and services sectors, taking a toll on the productive capacity of the euro area economy and on domestic demand. In the~~ suggest that economic activity improved significantly in May and June from its trough in April, alongside the ongoing containment of the virus and the associated easing of the lockdown measures. At the same time, economic indicators remain well below the levels recorded before the pandemic, and the recovery is in its early stages and remains uneven across sectors and jurisdictions. After decreasing by 3.6%, quarter on quarter, in the first quarter of 2020, ~~when containment measures were only in place from mid-March in most countries,~~ euro area real GDP ~~decreased by 3.8%, quarter on quarter. Information from surveys, high-frequency indicators and incoming hard data all point~~is expected to ~~a~~have contracted even further ~~significant contraction of real GDP~~overall in the second quarter~~. Most recent indicators suggest some bottoming out of the downturn in May as parts of the economy gradually reopen. Accordingly, euro~~, broadly in line with the June 2020 Eurosystem staff macroeconomic projections. Signs of a recovery in consumption have emerged, while there has also been a significant rebound in industrial output. At the same time, subdued labour market conditions and precautionary household saving are weighing on consumer spending. Weak business prospects and high uncertainty are dampening investment, while the weakness in the global economy is hampering foreign demand for euro area goods and services.

Euro area activity is expected to rebound in the third quarter as the containment measures are eased further, supported by favourable financing conditions, an expansionary fiscal stance and a resumption in global activity, although uncertainty about the overall speed and scale of the rebound remains ~~highly uncertain.~~

~~This assessment is also broadly reflected in the June 2020 Eurosystem staff macroeconomic projections for the euro area. In the baseline scenario of the projections, annual real GDP is expected to fall by 8.7% in 2020 and to rebound by 5.2% in 2021 and by 3.3% in 2022. Compared with the March 2020 ECB staff macroeconomic projections, the outlook for real GDP growth has been revised substantially downwards by 9.5 percentage points in 2020 and revised upwards by 3.9 percentage points in 2021 and 1.9 percentage points in 2022.~~

~~Given the exceptional uncertainty currently surrounding the outlook, the projections also include two alternative scenarios, which we will publish on our website following this press conference~~high. In general, the extent of the contraction and the recovery will depend crucially on the duration and ~~the~~ effectiveness of the containment measures, the success of policies to mitigate the adverse impact on incomes and employment, and the extent to which supply capacity and domestic demand are permanently affected. Overall, the Governing Council ~~sees~~assesses the balance of risks ~~around the baseline projection~~ to the euro area growth outlook to remain on the downside.

According to Eurostat's flash estimate, euro area annual HICP inflation ~~decreased~~increased to 0.3% in June, from 0.1% in May, ~~down from 0.3% in April,~~ mainly ~~on account of lower~~reflecting less negative energy price inflation. On the basis of current and futures prices for oil and taking into account the temporary reduction in the German VAT rate, headline inflation is likely to decline ~~somewhat further over~~again in the coming months ~~and to remain subdued until the end of the year~~before picking up in early 2021. Over the medium term, weaker demand will put downward pressure on inflation, which will be only partially offset by upward pressures related to supply constraints. Market-based indicators of longer-term inflation expectations have ~~remained~~continued to increase from the historical lows reached in mid-March, but overall remain at ~~depressed~~subdued levels. While survey-based indicators of inflation expectations have declined ~~over~~since the ~~short and medium term~~start of the pandemic, longer-term expectations have been less affected~~.~~ than short and medium-term expectations.

~~This assessment is also reflected in the June 2020 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation in the baseline scenario at 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. Compared with the March 2020 ECB staff macroeconomic projections, the outlook for HICP inflation has been revised downwards by 0.8 percentage points in 2020, 0.6 percentage points in 2021 and 0.3 percentage points in 2022.~~

Turning to the **monetary analysis**, broad money (M3) growth increased to 8.~~3~~9% in ~~April~~May 2020, from ~~7.5~~8.2% in ~~March~~April. Strong money growth reflects bank credit creation, which ~~is~~continues to be driven to a large extent by the acute liquidity needs in the economy. Moreover, high economic uncertainty is triggering a shift towards money holdings for precautionary reasons. In this environment, the narrow monetary aggregate M1, encompassing the most liquid forms of money, continues to be the main contributor to broad money growth.

Developments in loans to the private sector continued to be shaped by the impact of the coronavirus on economic activity. The annual growth rate of loans to non-financial corporations rose further to 7.3% in May 2020, from 6.6% in April ~~2020, up from 5.5% in March~~, reflecting firms' need to finance their ongoing expenditures and working capital in the context of ~~rapidly declining~~ still anaemic revenues. At the same time, the annual growth rate of loans to households ~~decreased to~~remained unchanged at 3.0% in ~~April, from 3.4% in March~~May, after declining for two consecutive months, amid ~~consumption~~ongoing constraints ~~due to the containment measures, declining confidence and a deteriorating labour market.~~ on consumption.

~~Our~~The results of the euro area bank lending survey for the second quarter of 2020 provide further insights into these developments. With regard to firms, they show a continued strong upward impact of the pandemic on demand for loans, largely driven by emergency liquidity needs, while financing needs for fixed investment declined. Credit standards on loans to firms remained broadly unchanged. The tightening impact of the deterioration in the economic outlook and the associated decline in the creditworthiness of firms was broadly offset by the easing effects of policy measures, particularly the ECB's liquidity-support measures and government guarantees on loans. However, looking ahead, banks expect a net tightening of credit standards on loans to firms, in part related to the expected end of the state guarantee schemes. With regard to loans to households, credit standards tightened, reflecting in particular ~~the very favourable terms for~~ a deterioration in households' income and employment prospects in the context of the pandemic.

Overall, our ~~targeted longer-term refinancing operations (TLTRO III), should encourage banks to extend loans to all private sector entities. Together~~policy measures, together with the measures adopted by national governments and European institutions, ~~they~~will continue to support ~~ongoing~~ access to financing, including for those most affected by the ramifications of the ~~coronavirus~~ pandemic.

To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed that an ample degree of monetary accommodation is necessary for the robust convergence of inflation to levels that are below, but close to, 2% over the medium term.

Regarding **fiscal policies**, an ambitious and coordinated fiscal stance remains critical, in view of the sharp contraction in the euro area economy. Measures taken in response to the pandemic emergency should as much as possible be targeted and temporary in nature ~~in response to the pandemic emergency~~. The three safety nets endorsed by the European Council for workers, businesses and sovereigns, amounting to a package worth €540 billion, provide important funding support in this context. At the same time, the Governing Council urges further strong and timely efforts to prepare and support the recovery. We therefore strongly welcome the European Commission's Next Generation EU proposal ~~for a recovery plan~~, which is dedicated to supporting the regions and sectors ~~most severely~~hardest hit by the pandemic, to strengthening the Single Market and to building a lasting and prosperous recovery. It is important for the European leaders to quickly agree on an ambitious package.

In order to reach its full potential, the European Union's Recovery and Resilience Facility will need to be firmly rooted in sound **structural policies** conceived and implemented at the national level. Well-designed structural policies could contribute to a faster, stronger and more uniform recovery from the crisis, thereby supporting the effectiveness of monetary policy in the euro area. Targeted structural policies are particularly important to rejuvenate our economies, with a focus on accelerating investment in priority areas such as the green and digital transitions.

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