2. Monetary policy in the euro area

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2.1 Favourable financing conditions supported the recovery in the first half of the year

When the coronavirus spread across continental Europe in early 2020, it soon became clear that major measures would be needed to cushion the economic repercussions of the health crisis. In this context, monetary policy backed up the measures adopted by governments and prudential authorities by stabilising the financial markets, supporting bank lending and, more generally, by maintaining favourable financing conditions. To this end, the ECB Governing Council initially adapted its existing policy instruments. The operational modalities of the third series of targeted longer-term refinancing operations (TLTRO III) were thus loosened, while the amount of debt securities purchased under the Asset Purchase Programme (APP) was stepped up by € 120 billion in 2020. However, as it soon turned out that the severity of the crisis would require a much bigger policy reaction, a new temporary crisis asset purchase programme – the Pandemic Emergency Purchase Programme (PEPP) – was launched. The PEPP envelope was revised upwards several times, to reach € 1 850 billion, with asset purchases planned to continue at least until the end of March 2022, or in any case until the crisis phase of the pandemic is over.

Despite the sheer scope of the pandemic, the Eurosystem has managed to soften the repercussions for the euro area economy. The financial markets recovered quite quickly and bank lending remained intact. However, the euro area was still in a highly precarious situation at the beginning of 2021, with some sectors

of the economy having been shut down while vaccination campaigns still needed to be rolled out. Consequently, in the first half of 2021, monetary policy continued to focus on maintaining favourable financing conditions, through the instruments put in place in 2020, so as not to jeopardise the dynamic – although nascent and uncertain – economic revival.

The December 2020 Governing Council decision to use three additional TLTRO III operations implied that one such transaction took place in each quarter of 2021. These operations above all guaranteed that banks were able to continue to get funding at the highly attractive TLTRO III conditions. In 2021, the need for Eurosystem liquidity nevertheless turned out to be well below the previous year's level. While the banks still borrowed around € 1 700 billion through TLTRO III in 2020, some € 450 billion, net of repayments, were added in 2021. The amounts lent under the pandemic emergency LTROs (PELTRO), which provide banks with shorter-term liquidity, have remained quite limited, at around € 3 billion in 2021, as in the previous year (roughly € 25 billion).

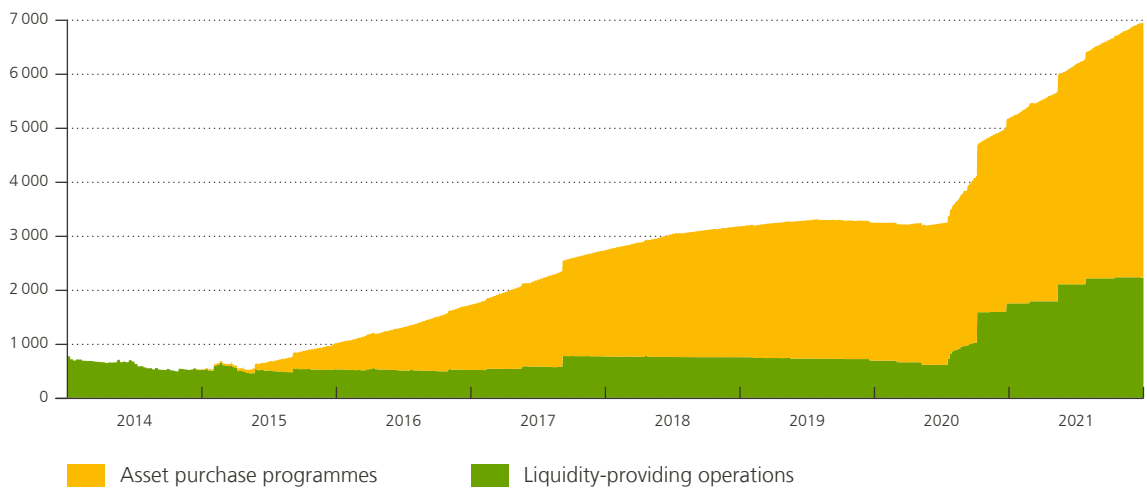
Bank lending rose considerably in 2020, on the back of strong demand for business loans over the first few months of the COVID-19 crisis. In 2021, this growth abated sharply. While firms saw their revenue start rising again as a result of the economy reopening, they were also able to resort to the liquidity buffers built up the year before. Loans to households in the euro area followed a net upward trend over the last year, bolstered by demand for mortgage loans. This, in turn, needs to be seen against a backdrop of rising house prices and with interest rates still extremely low. Thanks to the continued accommodative monetary policy, bank lending rates to firms and households remained at historically low levels in 2021. Against that background, the Governing Council decided in December to schedule no further new TLTRO operations after 2021. It is nevertheless continuing to closely monitor the banks' funding conditions so as to make sure that discontinuing these operations does not hinder the smooth transmission of monetary policy.

Once the additional envelope of € 120 billion had been spent in 2020, purchases made under the Eurosystem's APP dropped back to a pace of € 20 billion a month in 2021. As far as asset purchases under the PEPP were concerned, the Governing Council had decided in December 2020 that they would be carried out to maintain favourable financing conditions and tackle the downward impact of the pandemic on the projected path

Chart 2.1

The Eurosystem balance sheet total has continued to rise

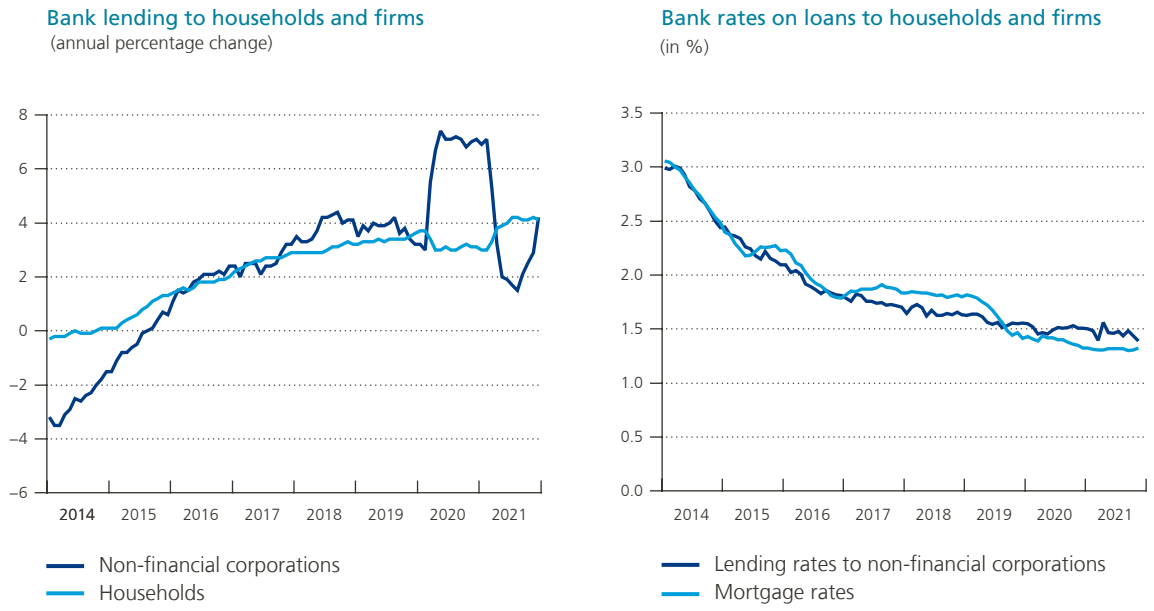
(€ billion)



Source: ECB.

Chart 2.2

Accommodative monetary policy has supported bank lending in the euro area



Source: ECB.

of inflation. Guaranteeing advantageous financing conditions implies that neither the overall level of interest rates, nor market fragmentation tensions should rise too much. As government bond yields and the risk-free interest rate serve as a reference for borrowing conditions applied to households and firms, they are closely monitored by the Governing Council.

At the beginning of the COVID-19 crisis, government bond rates had risen more in some countries – that had higher initial debt levels and had been hit harder by the crisis – than in others. The PEPP has managed to stem these fragmentation tensions, that were no longer evident in 2021: government bond rates in the different euro area countries moved in very similar ways last year. The EU itself also became a big bond issuer, with similar rates to Belgian and French government bonds.

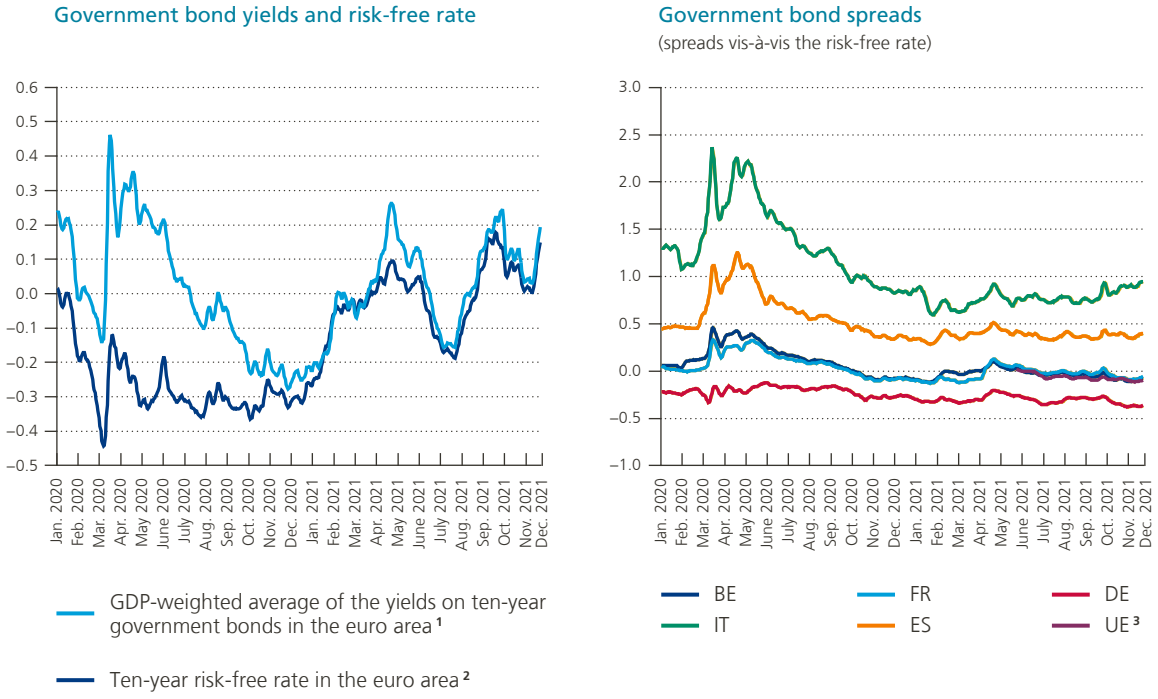
The acute tensions observed on the financial markets were no longer evident in 2021

In a bid to stimulate the economic recovery, it was also important for the general level of borrowing costs not to increase excessively. In this context, the Governing Council decided in March to significantly step up the pace of asset purchases under the PEPP. At the start of the year, the nominal risk-free interest rate had in fact started gradually rising and government bond yields in the various euro area countries followed this movement. That can be largely explained by spillover effects associated with the situation observed at the time in the United States, where Treasury rates had started to rise earlier, fuelled by favourable prospects for the economic recovery. The roll-out of vaccination campaigns and the recovery plan that President Biden approved in March generated a wave of optimism across the economy. To tackle rising interest rates, the Governing Council decided in March to considerably step up the pace of asset purchases made under the PEPP in the second quarter of 2021 compared with the first few months of the year. In this way, it intended to prevent any increase in government bond yields and the risk-free interest rate from being passed onto households' and firms' financing conditions, which was deemed undesirable given the still extremely fragile economic situation in the euro area. Even though the recovery had gained further momentum in June,

Chart 2.3

The PEPP has played a key role in preserving easy financing conditions in the euro area

(in %, five-day moving averages)



Source: Refinitiv (an LSEG company).

1 Based on data from eleven euro area countries, namely Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Portugal, Finland, Ireland and Greece.

2 Ten-year Eonia swap rates.

3 Yields on EU bonds issued under the NGEU.

the Governing Council felt that the faster pace of purchases under the PEPP should also be kept up in the third quarter so as not to jeopardise the nascent recovery and the upward pressure on inflation.

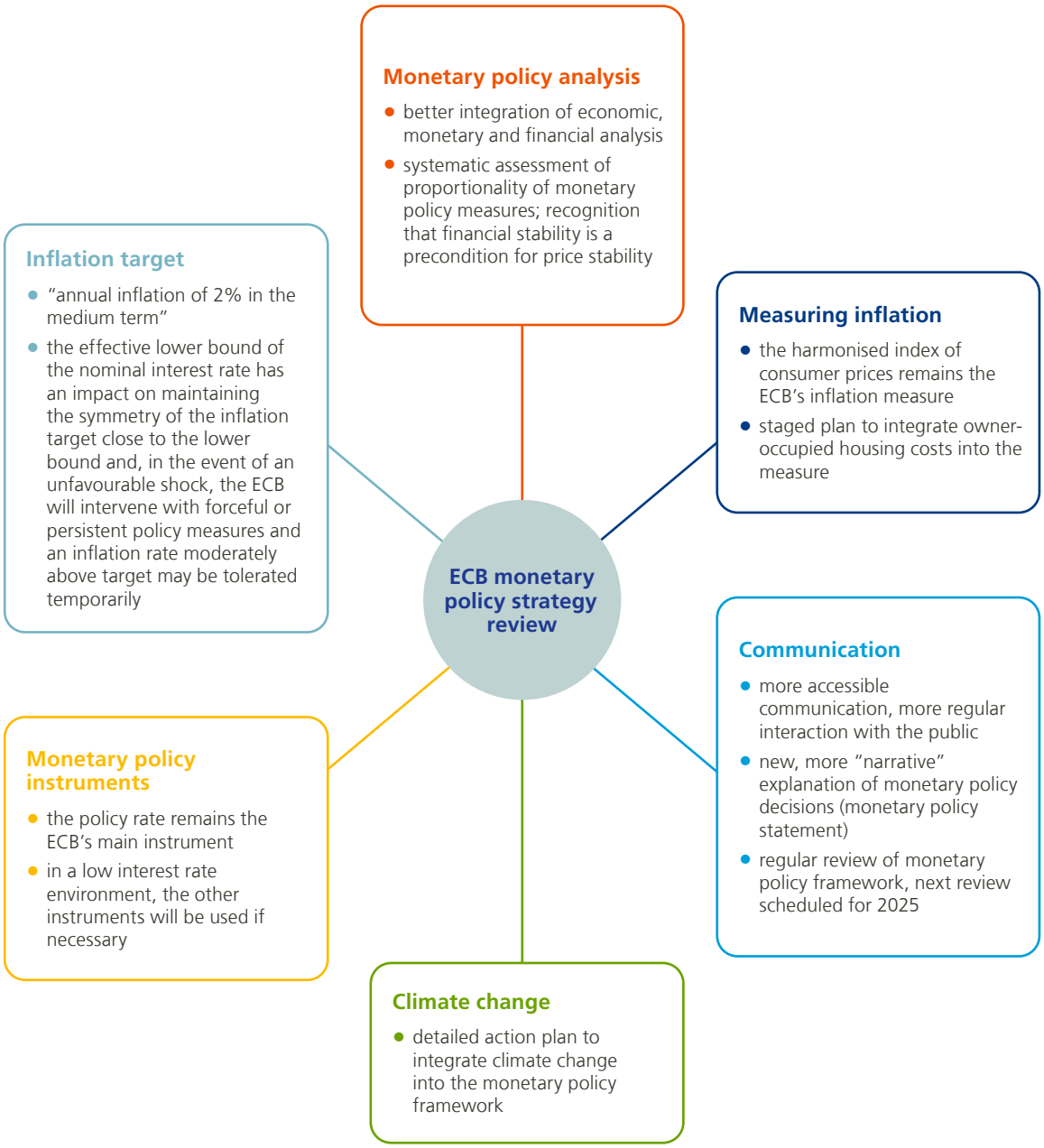
Thanks to the increased rate of asset purchases via the PEPP, the Governing Council managed to halt any further rise in government bond rates in the euro area. After this initial rise at the beginning of the year, their GDP-weighted average has remained stable, at around 0 %. It was not until early summer that these rates started to drop, after the Governing Council announced, on 8 July, the results of its monetary policy strategy review.

2.2 The Governing Council completed the review of its monetary policy strategy in July

The ECB Governing Council started the review of its monetary policy strategy back in January 2020. Although the whole process had been due to be finalised by the end of 2020, it was postponed until the summer of 2021 because of the COVID-19 crisis. As the previous strategy assessment was as far back as 2003, a very wide-ranging review was deliberately chosen this time. However, the ECB's mandate *per se*, and the price stability objective in particular, were not being called into question, as that would have required an amendment of the Treaty on the Functioning of the EU. Instead, the assessment sought to examine how to best fulfill the ECB's mandate within the limits of the EU Treaty, but in a very different environment. The context in which the ECB and other central banks carry out their activities has in fact radically changed over the last few decades. The fall in the equilibrium interest rate, combined with a long period of sluggish growth and low inflation in the aftermath of the global financial crisis, has led to wider use of non-standard monetary policy instruments. The COVID-19 crisis has further reinforced this trend. Moreover, a series of structural developments – such as globalisation, digitalisation, climate change and the transformation of the financial landscape – also throw up major challenges for monetary policy.

Chart 2.4

The ECB's monetary policy strategy review was wide-ranging and covered various aspects of the policy framework



Source: ECB.

The new strategy was announced on 8 July and the changes cover six different aspects. First of all, it was felt that aiming for an inflation rate of "2 % in the medium term" rather than inflation "below, but close to, 2 % in the medium term" was the best way to safeguard price stability. This new definition is symmetric, with deviations, both positive and negative, from the target being regarded as equally undesirable. Through this simplified inflation target, the Governing Council wants to provide a clear nominal anchor for inflation expectations. In order to preserve the symmetry of the inflation objective, the ECB acknowledges that it is crucial to consider the consequences of the effective lower bound. More precisely, when interest rates are close to their lower bound, monetary policy measures that are especially forceful or persistent are necessary to avoid deeply rooted negative deviations from the objective. This can also imply a transitory period with inflation slightly above target.

With the new symmetric inflation target, the Governing Council wants to provide a clear anchor for inflation expectations

Secondly, monetary policy remains focused on the medium term. This makes it possible to take into account not only delays in monetary policy transmission, but also uncertainties or other considerations. On this last point, for example, the medium-term orientation provides the necessary flexibility to assess the nature of the shock – is inflation changing because of demand factors or supply factors ? – and enables any temporary rise in inflation to be discounted. Such a policy horizon also guarantees the necessary margin to assess the proportionality of monetary policy decisions in a systematic and well-thought-out way, balancing the benefits of the policy against any possible side effects. Such side effects may for example take the form of risks for financial stability, which, in the new strategy, is explicitly recognised as a condition for price stability. The new analytical framework, that underlies monetary policy decisions and involves a more integrated study of economic, monetary and financial developments, must be considered in this context too.

Thirdly, while the harmonised index of consumer prices (HIPC) will continue to be the ECB's inflation measure, a decision has been taken to include owner-occupied housing costs in it. The fact that these costs are not included in the inflation figures used by the ECB was considered to be an aberration by the general public, as revealed in the various "listening" consultations held as part of the strategy review. Therefore, over the next few years, an inflation measure that takes these costs on board will be sought. Until such an index is available, estimates will be used to start taking owner-occupied housing costs into account in the ECB's analyses[1].

A fourth aspect concerns the ECB's various monetary policy instruments. Although it was decided that the policy rate would remain the ECB's main instrument, the European Central Bank acknowledges that, in a low interest rate environment, other instruments will also have to be implemented in order to reach the inflation target. Asset purchases, longer-term refinancing operations and indications given in the Governing Council's communication on monetary policy (the so-called forward guidance) will therefore continue to be an integral part of the ECB's range of monetary policy instruments.

The way in which the ECB can take into account the effects of climate change was also on the agenda for the strategy review. Climate change actually has an impact on the economy and the financial system and, for this reason, involves risks in terms of price stability and financial stability. Climate transition risks can also influence the valuation of assets on the Eurosystem balance sheet. In this context, a detailed multiannual action plan has been drawn up with a view to integrating climate change into the ECB's monetary policy framework. There are initiatives that seek to improve the understanding of the consequences and risks of climate change and eventually integrate them into analyses and models underpinning the ECB's macroeconomic projections and policy. Specific measures will also be adopted for monetary policy operations, for example as regards risk assessment, the collateral accepted for such operations or corporate bond purchases under the ECB asset purchase programmes.

The central banks have changed the way in which they communicate on monetary policy matters. What's more, communication itself has become a

1 See also *La BCE va davantage tenir compte du coût du logement propre (ECB to take greater account of the cost of owner-occupied housing)*, NBB blog, 15 November 2021: https://www.nbb.be/fr/blog/la-bce-va-davantage-tenir-compte-du-cout-du-logement-propre.

monetary policy instrument, with forward guidance being a prominent example. Clear communication on monetary policy decisions actually makes them more effective: the better markets and the general public understand these decisions, the easier the policy transmission to the economy. This is why monetary policy communication will be adapted and made more accessible. That means, for example, that the monetary policy statement from now on takes a more "narrative" tone: monetary policy decisions are motivated by information drawn from economic, monetary and financial analysis. In addition, interaction with the public will be organised more systematically. The experience of the "listening" events, held in 2020 and 2021 by the ECB and the different national central banks of the euro area[1], will serve as a starting point here. Lastly, the ECB has undertaken to review its monetary policy strategy more regularly, with the next review already scheduled for 2025.

1 In Belgium, this listening event was held on 22 January 2021. To back up this event with viewpoints of Belgian citizens, an online portal "The NBB Listens" was also set up; its main conclusions are summarised in the article by Wauters J. (2021) entitled "Summary Report on the NBB Listens Portal", NBB, *Economic Review*, December.

2.3 The new monetary policy strategy guided policy decisions in the second half of the year

The revamped strategy has an impact on the way in which the different policy instruments are used. While some effects will mainly emerge in the longer term – including owner-occupied housing costs in the inflation measure and the implementation of the climate action plan being just two examples –, other aspects of the revised strategy have a more immediate impact. For instance, the ECB's forward guidance, which throws some light on future movements of policy rates, was adjusted during the Governing Council's 22 July meeting in order to align it on the new strategy. Two changes made to the monetary policy strategy in particular have required an adjustment of forward guidance: the new symmetrical inflation target and the statement that "especially forceful or persistent monetary policy measures" are required to safeguard this symmetry when the economy is close to the lower bound. With a low interest rate and medium-term inflation expectations below target, that implies keeping the accommodative monetary policy stance over a longer period.

More specifically, the conditions that need to be met – simultaneously – before the Governing Council starts raising policy rates have been tightened up. The first condition stipulates that inflation should reach its 2 % target well before the end of the ECB's projection horizon, which is two to three years. This condition provides reassurance that convergence of inflation towards the target is sufficiently advanced when interest rates are raised. By stating that inflation must reach 2 % well before the end of the projection horizon, the Governing Council is also seeking to prevent monetary policy decisions from being taken on the basis of projections that would need to be adjusted later on, as is more often the case for longer-term forecasts. The second condition is for the inflation target to be attained durably for the rest of the projection horizon. In other words, inflation cannot fall back below the 2 % mark in this timescale. That should prevent monetary policy from reacting to a brief surge in inflation. The third condition is that underlying inflation should also have increased sufficiently to be compatible with a stabilisation of inflation at 2 % in the medium term. This condition is based on published inflation rates and offers extra protection against monetary policy tightening in the event of shocks likely to trigger a temporary surge in inflation but destined to dissipate rapidly. Underlying inflation is a wide-ranging concept referring to the persistent component of inflation which rectifies short-term volatility and thus brings more clarity to the real direction in which inflation seems to be moving in the medium term. Lastly, the revised forward guidance explicitly acknowledges that inflation can remain moderately above target during a transitory period, which is in line with the new strategy.

The announcement of the revised strategy and forward guidance has not been without consequences for the financial markets. The prospect of seeing the Governing Council showing more patience in future before raising its policy rate has prompted the markets to expect a later interest rate rise. Moreover, the revised strategy and forward guidance have also influenced inflation expectations. Both market expectations – which are derived from prices of swap contracts covering inflation risks in the euro area – and expectations drawn from surveys of professional forecasters were revised upwards in the summer.

Expectations that the Governing Council would stick to a highly accommodative monetary policy over a longer period has also exerted some pressure on long-term risk-free interest rates and on government bond yields. This has resulted in an easing of borrowing

conditions in the euro area, which prompted the Governing Council to decide in September to moderately slow down the pace of purchases under the PEPP in the last quarter of the year in comparison to the two previous quarters.

While the *nominal* interest rate, – such as sovereign bond yields – is directly observable, the *real* interest rate – that is, after deducting expected inflation – reflects the real cost of borrowing for economic agents. Prices of swap contracts covering inflation risk in the euro area give some measure of expected inflation, which enables the real interest rate level to be estimated. The combination of a falling nominal rate and rising inflation expectations therefore led to a drop in the real interest rate in the euro area over the summer, bringing down the real cost of financing in its wake.

From the end of August onwards, the rise in inflation expectations intensified even further, against the background of higher-than-expected inflation in the euro area. At the end of October, the ten-year inflation expectations inferred from inflation swaps for the euro area were again above 2 %, something that had not been seen for seven years. Initially, this trend was accompanied by a rise in the ten-year nominal interest rate, as the markets had once again revised upwards their anticipations of a possible tightening of monetary policy in the context of the higher-than-expected surge in inflation. However, when the nominal rate stopped rising from October on, the real interest rate also continued to fall back. At the end of the year, the ten-year real interest rate posted an all-time low of –2 %.

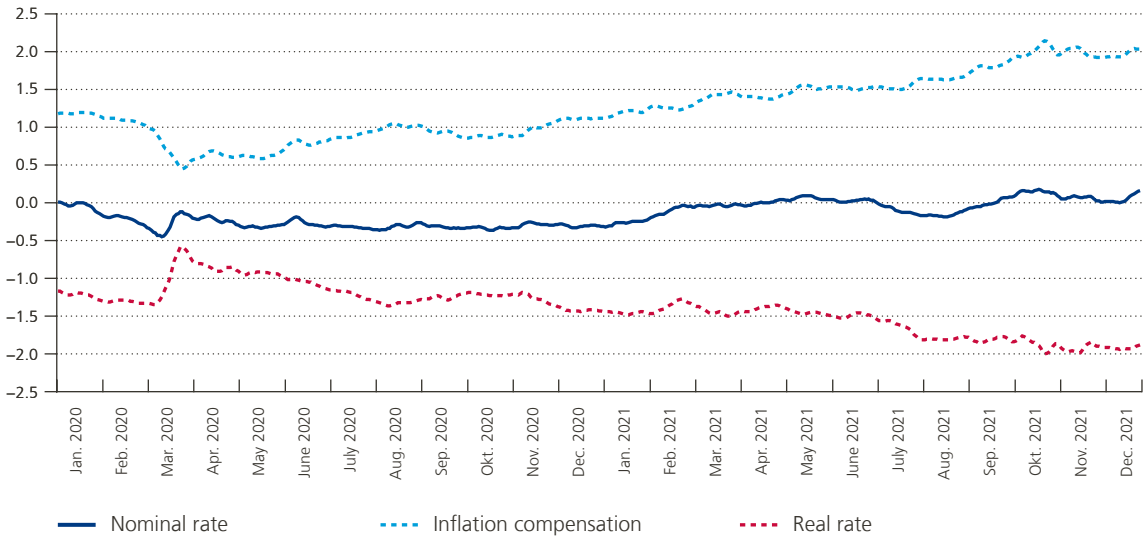
Inflation swaps contain risk premiums, which makes it harder to interpret them as an indication of inflation expectations, especially for longer maturities. Inflation expectations drawn from surveys of professional forecasters do not have this complication. They certainly have risen but have always remained below the target for longer horizons, unlike the compensation for inflation risk demanded on the market.

This pick-up in inflation and inflation expectations must be considered against the background of the strong recovery of the global and euro area economy. This upturn has been accompanied by a sharp rise in energy prices. On the one hand, this trend constitutes a base effect, given that prices had fallen back sharply over the previous year. On the other

Chart 2.5

The real interest rate in the euro area continued to fall in 2021

(breakdown of the ten-year risk-free nominal interest rate[1] in the euro area, percentages, 5-day moving averages)

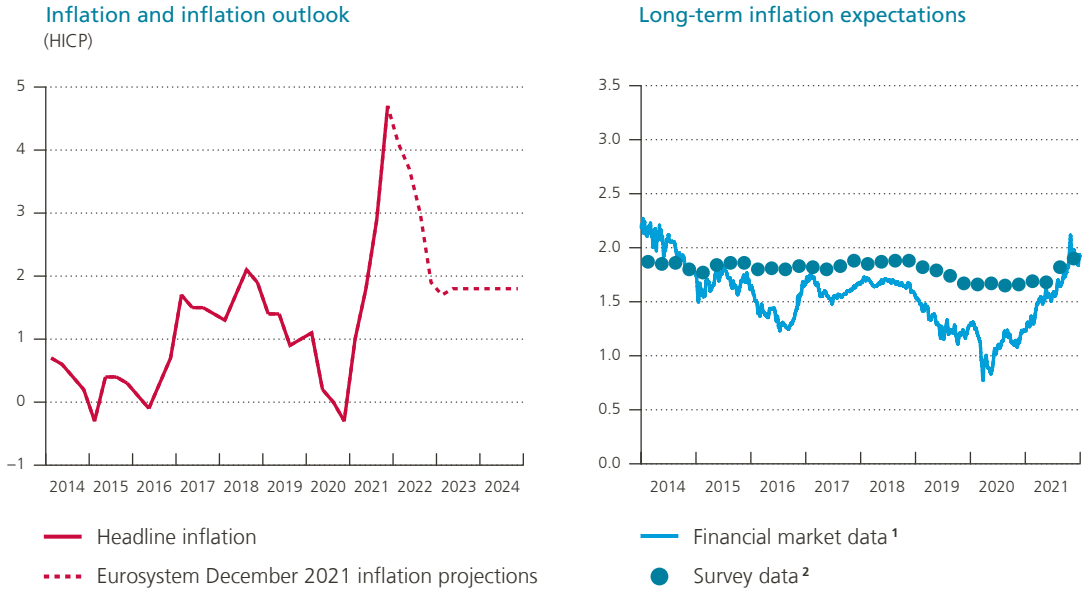


Source: Refinitiv (an LSEG company).
1 Ten-year Eonia swap rate.

Chart 2.6

Inflation and inflation expectations rose sharply in 2021

(in %)



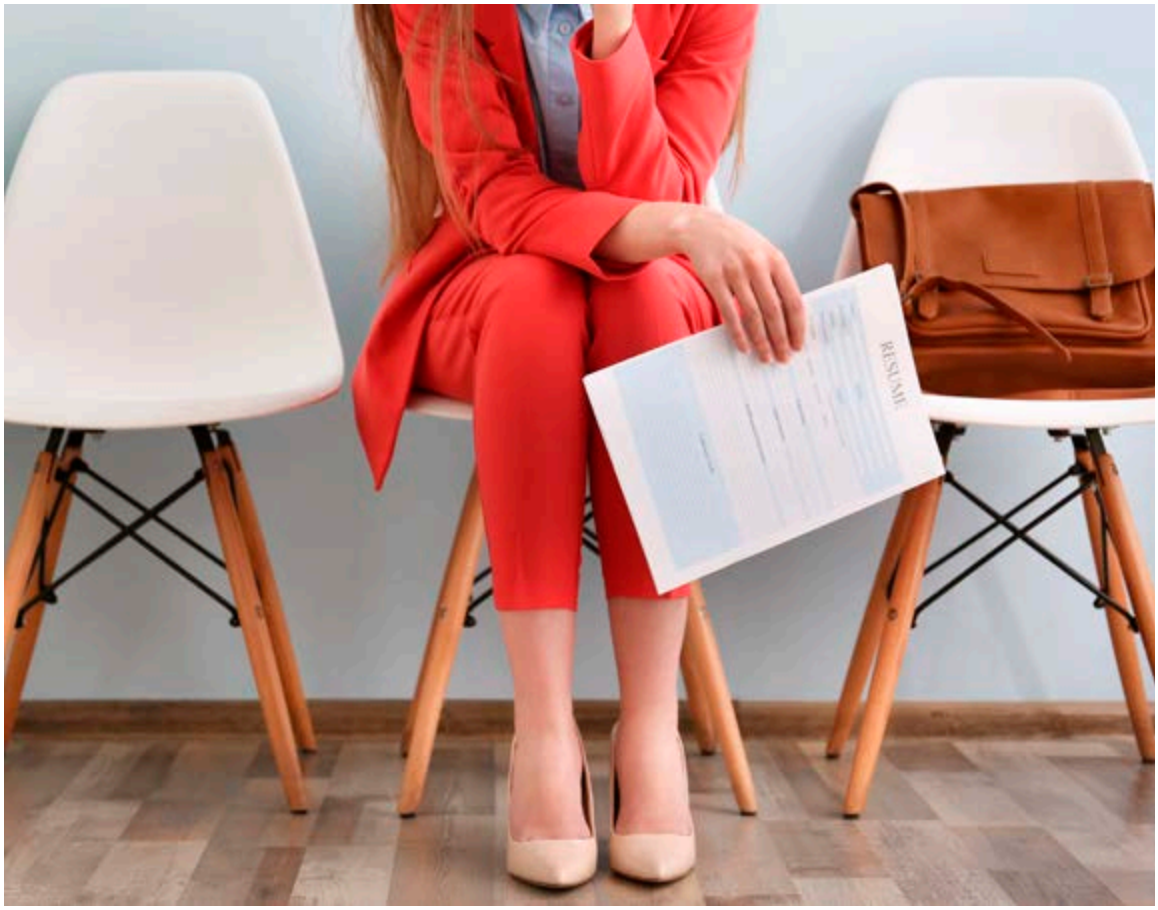
Sources: ECB, Refinitiv (an LSEG company).

1 Five-year-on-five-year inflation expectations, based on prices recorded by swap contracts, which hedge euro area inflation risk over a period of five years, starting five years after the contract is concluded.

2 Five-year inflation expectations based on the ECB's quarterly survey of professional forecasters (average of the aggregate probability distribution for this projection horizon).

hand, the rise in energy prices was much stronger than expected, owing to supply-related problems (chapter 1 deals with this aspect in more detail). Furthermore, base effects not only played a role in the case of energy inflation. Certain government decisions, such as the VAT reduction in Germany, also pushed prices downwards in 2020, to then exert a positive (base) effect on inflation in 2021, after the measure expired at the end of 2020. Supply chain disruptions constituted a second major factor explaining the rise in inflation. What is more, prices in services sectors, that had been particularly hard-hit by the crisis and were only able to open again after a long period of closure, also rose sharply. This combination of factors brought particularly strong upward pressure to bear on inflation in the euro area, which took off from the summer onwards, rising from 2.2 % in July to a peak of around 5 % in December.

According to the Eurosystem's December projections, inflation is nevertheless expected to slow down again in 2022, precisely because the factors fuelling it stem mainly from the reopening and recovery of the economy, so that their effects should gradually fade out. Beyond 2021, the base effects will also disappear from inflation rates and will cease to exert any upward force. However, so-called second-round effects could induce more persistent upward pressure on prices, if their increase starts to feed through to wages. Although there are indications of a slight increase in wage growth in the short to medium term, wage pressure is not likely to be strong enough, according to the Eurosystem projections, to push up inflation on a lasting basis. The fact that a fraction of the population has left the labour market in the last two years effectively explains in part why unemployment in the euro area is almost back to its pre-coronavirus level. In a continued economic recovery scenario, a strong return to employment is expected, thus helping to curb the upward pressure on wages. Consequently, the Eurosystem expects, in its December projections, that inflation will drop again, falling back to 1.8 %



in 2023 and 2024, after having reached 3.2 % in 2022. These inflation projections were significantly revised upwards from the September projections. This just goes to show the huge uncertainty clouding the forecasts, being highly dependent on future movements in energy prices and wages.

In view of the upward revision of inflation forecasts and the ongoing economic recovery, the Governing Council decided in December that a gradual exit from the crisis measures was possible. Nevertheless, in view of the considerable uncertainty surrounding the projections, it wanted to keep sufficient monetary support and a certain degree of flexibility in the conduct of monetary policy.

Against this background, the Governing Council decided, in December, to slow the pace of net asset purchases under the PEPP over the first three months of 2022 in comparison to the previous quarter, before suspending them altogether at the end of March 2022. In addition, the Governing Council postponed for a year, i.e. until at least the end of 2024, the horizon for full reinvestment of the principal payments from maturing securities purchased under the PEPP. To deal with any new pandemic-related risks of fragmentation, some latitude will also be given to the way in which this principal may be reinvested. During the pandemic, it has emerged that the flexibility allowed with the asset purchases has contributed to preserve the transmission of monetary policy in crisis situations. If necessary, the Governing Council will retain this flexibility by spreading out the reinvestments under the PEPP over time, between the different asset classes and between the euro area countries. As far as the latter are concerned, Greek government bonds, which are not eligible for the APP because they do not meet the quality requirements, will be able to be bought up over and above rollovers of redemptions. Finally, net purchases made under the PEPP themselves could be relaunched if the pandemic were again to trigger negative shocks.

Lastly, in order to be able to gradually reduce asset purchases while ensuring that inflation continues to

converge towards the target, the pace of purchases made under the APP has also been changed. While they had been carried out at a rhythm of € 20 billion per month, they will rise to, respectively, € 40 and 30 billion per month in the second and third quarters of 2022. The ending of net purchases under the PEPP will therefore not cause any sudden nosedive in purchases of securities by the Eurosystem. As of October 2022, the total monthly amount of asset purchases will be brought down to its pre-crisis level of € 20 billion. Purchases under the APP are expected to end shortly before the first rise in policy rates.

2.4 Monetary policy is facing major challenges

The combination of fiscal, monetary and prudential policies has made it possible to react forcefully to the COVID-19 crisis, and the synergies between these different areas of action have led to a collective policy response going well beyond the cumulative individual results of these three policies. While monetary policy has largely produced its effects via fiscal policy, there has nevertheless not been any explicit coordination between the two. Nor should this exceptional situation imply that monetary policy is dictated by the degree of sustainability of public finances. Monetary policy has remained faithful to its mandate, which is to ensure price stability by steering total demand in the economy according to supply. It is therefore important to reconstitute buffers to be able to deal with unforeseen economic difficulties, all the more as inflation is accelerating. Inflationary pressures also show that a policy based solely on supporting demand has its limits. The supply side of the economy needs to be reinforced; Belgium's priorities in this regard are set out in chapter 7 of this Report.

The current low interest rates are not set in stone

As regards monetary policy more specifically, the revised strategy and forward guidance suggest that the Governing Council will be more patient before going ahead with the first rise in interest rates – and likewise, before ending asset purchases under the APP. The conditions governing any policy tightening have effectively been reinforced. At the same time, the strategy mentions explicitly that financial stability is important for price stability. Moreover, the assessment of proportionality of the Governing Council's decisions and their potential side effects are expected to figure prominently in future.

Different scenarios may of course play out in the future. In the base scenario, inflation converges sustainably towards the 2 % target and the monetary support can be gradually relaxed. If inflation remains high and the inflation forecasts are no longer compatible with the ECB's objective, the monetary policy stance will have to be tightened more quickly. Any such sudden and unexpected rise in interest rates may uncover hidden vulnerabilities, for example for financial stability or sustainability of public finances. A soft landing will thus depend heavily on the various economic stakeholders' resilience and their ability to adapt.

Inflation may also drop and remain below target for an extended period of time. In this case, the accommodative policy should in principle be maintained indefinitely. In the face of such a situation, it is increasingly likely that the assessment of proportionality, which weighs up the costs and benefits of the policy, becomes binding.

This scenario effectively raises questions about the advantages or effectiveness of the policy followed to stimulate inflation: the sensitivity of economic activity to interest rates may, for instance, weaken when rates are very low for a long time. At the same time, the costs of the policy followed may rise themselves. A prolonged period of low interest rates can disrupt the sound functioning of the financial sector, affect savers or help keep otherwise unviable companies in business. Apart from these undesirable side effects, the persistence of the low interest rate policy also has its risks that are mainly evident in the financial sector and on the fiscal policy front. Existing vulnerabilities are thus likely to get worse.

While low interest rates have opened up wide budgetary margins for the national public authorities in the euro area, not all countries have used them to build up reserves. The current low interest rates are nevertheless not set in stone. If inflation expectations eventually rise, interest rates will follow. The risk premium paid by governments on their debt may also go up: the Eurosystem stands ready to alleviate governments' liquidity problems, but it is powerless if the debt is basically unsustainable. The central bank therefore must have the assurance that governments are able to cope with a heavier debt burden, without which it risks not being able to fulfill its price stability mandate. Chapter 7 of this Report describes the challenges facing the sustainability of the Belgian public debt in a European context.

The persistently low interest rates may also encourage excessive risk-taking, building up bubbles in certain market segments, such as stocks or real estate. These developments fall largely under prudential policy, which has targeted instruments to tackle specific financial vulnerabilities. It must, however, be borne in mind that there are limits to what this policy can accomplish, something which justifies close monitoring by the Governing Council.

In this context, the Governing Council will systematically weigh up the costs and benefits of its policy. If the cost of a policy choice starts to outweigh its benefits, the Governing Council will adjust it, drawing for example on the flexibility that the medium-term orientation of its policy offers.