CENTRAL BANKS

QE extension but unexpectedly at a lower pace

Sonsoles Castillo / Miguel Jiménez

- The ECB extended the asset purchase programme until December 2017, but from April monthly purchases will be cut to EUR 60 bn. Such decision combined with the announced technical changes adds upward pressure on bond yields and leads to steeper curves.
- New economic projections were broadly similar to the previous ones, but the new projections for 2019 foresee inflation at 1.7%, below the ECB objective.
- The ECB remains in a middle ground between hints of tapering and wording that tries to avoid that impression. There is uncertainty on the ECB strategy beyond 2017.

At yesterday's meeting the ECB extended its QE up to December 2017 but with a lower quantity after March 2016 (EUR 60 bn per month) than expected and that the current purchases (EUR 80 bn). At the same time, the ECB introduced technical changes to be able to continue purchasing bonds, but instead of increasing the issuance/issuer limits it can buy (as expected) it extended the maturities of bonds to be purchased (lowering the minimum from 2 to 1 year) and announced that it will buy, if necessary, bonds at below the deposit rate, currently at -0.40%.

What can be read from these changes? First, the most obvious impact is some higher pressure on euro yields as the size of asset purchases will be reduced. Second, with the updated parameters the ECB purchases are more biased to shorter maturities, thus favoring the steepening of the yield curve. Third, the option of increasing the issue and issuer limits seems to be out of the table, as Mr. Draghi, surprisingly, said that "there was an increasing awareness of the legal and institutional constraints that would make such a change difficult". Fourth, the option to buy below the depo rate is not a necessity (as the yield curve has shifted upwards), "the relevant committees will look when this could become a necessity. So it's more to give sort of an option for continuing the smooth implementation of the programme".

The new economic projections (see table below) were broadly similar to the previous ones, but the new projections for 2019 foresee inflation at 1.7%, below the ECB objective, which is a dovish sign that the ECB has more to do (as Mr Draghi confirmed when asked about it).

Mr Draghi tried to defend repeatedly during the Q&A that the new provisions do not imply tapering of QE measures, even if the new, lower amount of purchases surprised markets. The GC statement explicitly says that these lower measures could be reversed (extending them in time or quantity if required), Mr Draghi said that tapering was not discussed during the meeting and stressed that in essence the ECB's QE is open ended. Still, the initial market reaction was a sign that the new measures could be the starting point towards tapering, and the recognition that the deflation risk is now lower than what it was in March 2016 (when QE was raised from 60 to 80 bn) implies that the new amount responds to better conditions.

All in all, the new ECB remains in a middle ground between hints of tapering and wording that tries to avoid that impression. Despite the step surprise, Draghi´s narrative on continued support (at least until December 2017) has avoided a negative market (over)reaction (the lesson from the Fed taper tantrum has been learnt. The ECB is likely to remain dovish for the time being but, going forward, the guidance is more uncertain. If macroeconomic conditions continue improving and the political outlook in Europe becomes less uncertain, further QE reductions are likely to be announced during the second half of 2017.

	2016	2017	2018	2019
GDP	1.7% (1.7%)	1.7% (1.6%)	1.6% (1.6%)	1.6%
Inflation	0.2% (0.2%)	1.3% (1.2%)	1.5% (1.6%)	1.7%

Note: In parenthesis the previous ECB projections (September 2016)

PLEASE NOTE: TRACKING CHANGES IN FOLLOWING STATEMENTS

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

Mario Draghi, President of the ECB,~~-~~
Vítor Constâncio, Vice-President of the ECB~~,-~~
Frankfurt am Main, ~~20 October2016~~<u>8 December 2016</u>

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<u>, which was also attended by the Commission Vice-President, Mr Dombrovskis</u>.

Based on our regular economic and monetary analyses, we ~~decided to keep the key ECB interest rates unchanged. We continue to expect them to remain at present or lower levels for an extended period~~<u>today conducted a comprehensive assessment</u> of ~~time,~~<u>the economic</u> and ~~well past~~<u>inflation outlook and our monetary policy stance. As a result,</u> the ~~horizon of our net asset purchases. Regarding~~<u>Governing Council took the following decisions in the pursuit of its price stability objective:</u>

<u>As regards</u> non-standard monetary policy measures, we ~~confirm that the~~ <u>will continue to make purchases under the asset purchase programme (APP) at the current</u> monthly ~~asset purchases~~<u>pace</u> of €80 billion ~~are intended to run~~ until the end of March<u> 2017. From April 2017, our net asset purchases are intended to continue at a monthly pace of €60 billion until the end of December</u> 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim.<u> If, in the meantime, the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment of the path of inflation, the Governing Council intends to increase the programme in terms of size and/or duration. The net purchases will be made alongside reinvestments of the principal payments from maturing securities purchased under the APP.</u>

~~The information that has become available since our meeting in early September confirms a continued moderate but steady recovery of the euro area economy and a gradual rise in inflation, in line with our previous expectations. The euro area economy has continued to show resilience to the adverse effects of global economic and political uncertainty, aided by our comprehensive monetary policy measures, which ensure very favourable financing conditions for firms and households. Overall, however, the baseline scenario remains subject to downside risks.~~

~~Looking ahead, we remain committed to preserving~~<u>To ensure the continued smooth implementation of the Eurosystem's asset purchases, the Governing Council decided to adjust the</u>

parameters of the APP as of January 2017 as follows. First, the maturity range of the public sector purchase programme will be broadened by decreasing the minimum remaining maturity for eligible securities from two years to one year. Second, purchases of securities under the APP with a yield to maturity below the interest rate on the ECB's deposit facility will be permitted to the extent necessary.

The key ECB interest rates were kept unchanged and we continue to expect them to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases.

Today's extension of the asset purchase programme has been calibrated to preserve the very substantial degree of monetary accommodation ~~which is~~ necessary to secure a sustained convergence of inflation rates towards levels below, but close to, 2% over the medium term. ~~To that end, we will continue to act, if warranted,~~Together with the sizeable volume of past purchases and forthcoming reinvestments, it ensures that financial conditions in the euro area will remain very favourable, which continues to be crucial to achieve our objective. In particular, the extension of our purchases over a longer horizon allows for a more sustained market presence and, therefore, a more lasting transmission of our stimulus measures. This calibration reflects the moderate but firming recovery of the euro area economy and still subdued underlying inflationary pressures. The Governing Council will closely monitor the evolution of the outlook for price stability and, if warranted to achieve its objective, will act by using all the instruments available within ~~our~~its mandate. ~~In December the Governing Council's assessment will benefit from the new staff macroeconomic projections extending through to 2019 and from the work of the Eurosystem committees on the options to ensure the smooth implementation of our purchase programme until March 2017, or beyond, if necessary.~~

Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP in the euro area increased by 0.3%, quarter on quarter, in the ~~second quarter of 2016, after 0.5% in the first quarter. The latest data and survey results point to continued growth in the~~ third quarter of 2016, ~~at around the same pace as in the second quarter.~~following similar growth in the second quarter. Incoming data, notably survey results, point to a continuation of the growth trend in the fourth quarter of 2016. Looking further ahead, we expect the economic expansion to proceed at a moderate but ~~steady pace. Domestic demand should be supported by the~~firming pace. The pass-through of our monetary policy measures to the real economy~~. Favourable financing conditions and improvements~~ is supporting domestic demand and has facilitated deleveraging. Improvements in corporate profitability and very favourable financing conditions continue to promote a recovery in investment. Moreover, ~~still relatively low oil prices and~~ sustained employment gains, which are also benefiting from past structural reforms, provide ~~additional~~ support for households' real disposable income and private consumption. ~~In addition, the fiscal stance in the euro area will be broadly neutral in 2017.~~At the same time, there are indications of a somewhat stronger global recovery. However, ~~the~~ economic ~~recovery~~growth in the euro area is expected to be dampened by ~~still subdued foreign demand, the necessary balance sheet adjustments in a number of sectors and~~ a sluggish pace of implementation of structural reforms~~. The risks to~~ and remaining balance sheet adjustments in a number of sectors.

This assessment is broadly reflected in the December 2016 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 1.7% in 2016 and 2017, and by 1.6% in 2018 and 2019. Compared with the September 2016 ECB staff macroeconomic projections, the outlook for real GDP growth is broadly unchanged. The risks surrounding the euro area growth outlook remain tilted to the downside~~ and relate mainly to the external environment~~.

According to ~~Eurostat~~Eurostat's flash estimate, euro area annual HICP inflation in ~~September~~November 2016 was 0.~~4~~6%, up further from 0.~~2~~5% in ~~August.~~October and 0.4% in September. This reflected ~~mainly~~to a ~~continued~~large extent an increase in annual energy inflation, while there are no signs yet of a convincing upward trend in underlying inflation. Looking ahead, on the basis of current oil futures prices, headline inflation rates are likely to pick up ~~over~~significantly further at the ~~next couple~~turn of ~~months, in large part~~the year, mainly owing to base effects in the annual rate of change of energy prices. Supported by our monetary policy measures ~~and~~, the expected economic recovery and the corresponding gradual absorption of slack, inflation rates should increase further in ~~2017~~2018 and ~~2018~~2019.

This pattern is also reflected in the December 2016 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 0.2% in 2016, 1.3% in 2017, 1.5% in 2018 and 1.7% in 2019. By comparison with the September 2016 ECB staff macroeconomic projections, the outlook for headline HICP inflation is broadly unchanged.

Turning to the monetary analysis, broad money (M3) ~~continued to increase at a robust pace in August~~growth moderated in October 2016, with its annual rate of growth ~~standing at 5.1~~decreasing to 4.4%, after ~~4.9~~5.1% in ~~July~~September. As in previous months, annual growth in M3 was mainly supported by its most liquid components, with the narrow monetary aggregate M1 expanding at an annual rate of ~~8~~7.9% in ~~August~~October, after 8.4% in ~~July~~September.

Loan dynamics followed the path of gradual recovery observed since the beginning of 2014. The annual rate of change of loans to non-financial corporations ~~stood at~~ increased to 2.1~~.9~~% in ~~August~~October 2016~~.~~, from 2.0% in the previous month. The annual growth rate of loans to households ~~also~~ remained ~~stable,~~ at 1.8~~%, in August.~~%. Although developments in bank credit continue to reflect the lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets, the monetary policy measures put in place since June 2014 are significantly supporting borrowing conditions for firms and households and thereby credit flows across the euro area.

~~The euro area bank lending survey for the third quarter of 2016 indicates some further improvements in both supply and demand conditions for loans to the non-financial private sector. Furthermore, banks continued to report that the ECB's asset purchase programme and the negative deposit facility rate had contributed to more favourable terms and conditions on loans.~~

To sum up, a cross-check of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed the need to take today's monetary policy decisions so as to preserve the very substantial amount of monetary support that is necessary in order to secure a return of inflation rates towards levels that are below, but close to, 2% without undue delay.
Monetary policy is focused on maintaining price stability over the medium term and its accommodative stance supports economic activity. As emphasised repeatedly by the Governing Council, ~~and as again strongly echoed in both European and international policy discussions,~~ in order to reap the full benefits from our monetary policy measures, other policy areas must contribute much more decisively, both at the national and at the European level. The implementation of structural ~~reformsneeds~~reforms in particular needs to be substantially stepped up to reduce structural unemployment and boost potential output growth in the euro area. Structural reforms are necessary in all euro area countries. The focus should be on actions to raise productivity and improve the business environment, including the provision of an adequate public infrastructure, which are vital to increase investment and boost job creation. The enhancement of current investment initiatives, ~~including the extension of the Juncker plan,~~ progress on the capital markets union and reforms that will improve the resolution of non-performing loans will also contribute positively to this objective. In an environment of

accommodative monetary policy, the swift and effective implementation of structural reforms will ~~not only lead to higher sustainable economic growth in the euro area but will~~ also make the euro area more resilient to global shocks. Fiscal policies should also support the economic recovery, while remaining in compliance with the fiscal rules of the European Union. Full and consistent implementation of the Stability and Growth Pact over time and across countries remains crucial to ensure confidence in the fiscal framework. At the same time, it is essential that all countries ~~should strive for~~intensify efforts towards achieving a more growth-friendly composition of fiscal policies.

We are now at your disposal for questions.

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