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ECB Watch: The ECB delivers a "down size" of the APP

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- **The ECB has opted for an alternative way to taper QE, downsizing monthly purchases to 30 bn euros**
- **The Asset Purchase Programme remains open-ended, extended until September 2018 or beyond**
- **The size of the ECB's balance sheet and forward guidance will replace net purchases as the main tool for monetary policy**

As widely expected, the ECB has unveiled the APP recalibration. As regards non-standard measures, the central bank decided: i) to extend the asset purchase program (APP) until at least Sept 2018 but at a monthly pace of EUR30 billion (until December 2017 the program will run at the currently monthly pace of EUR60 billion), ii) to reinvest the principal payments on the securities purchased under the APP as they mature for an extended period of time after the end of the net asset purchases, and as long as necessary and, finally, iii) to extend the FRFA (fixed rate tender procedures with full allotment) at least until the end of 2019.

Mr. Draghi said that today´s decision was not unanimous, but he highlighted that there was a broad consensus on some issues and a large majority on others. The tone remained dovish; the easing bias was retained as the central bank reiterated its willingness to act further if needed. "The Governing Council (GC) stands ready to increase the APP in terms of size and/or duration."

On standard measures, key interest rates were left unchanged, as expected, and the ECB reiterated its pledge to keep them unchanged "until well past the horizon of the net asset purchases". For the economic outlook, the tone has genuinely improved while risks remain broadly balanced.

During the press conference, the focus was on the following issues:

- **The recalibration of the APP.** This recalibration **reflects growing confidence** in the gradual convergence of inflation towards the target. Mr. Draghi wanted to underline that the euro area still needs an "ample" degree of stimulus ("very substantial" was used in previous statements) as "domestic price pressures are still muted overall and the economic outlook and the path of inflation remain conditional on continued support." Mr Draghi also took the opportunity to highlight that the program is **open-ended** and is not going to stop suddenly. "It's never been our view that it should stop suddenly," which leaves the door open to running the program until the last quarter of 2018. Last, but not least, the decision of recalibration was **not unanimous**, as some members of the GC had preferred to announce a close end-date for QE. The ECB also wanted to separate itself from Fed style on the recalibration plan (this option would have implied a linear scaling back of the asset purchases). All in all, the recalibration was broadly in line with market's expectations after the ECB´s communication over the last few weeks, particularly regarding its horizon.
- **The reinforcement of the ECB´s forward guidance (apart from maintaining the "sequence") by:**
    - **Reinvesting the principal payments of the securities purchased under the APP.** Mr Draghi stressed that this is quite an important measure with the aim to maintain the degree of monetary accommodation and favorable conditions for liquidity for a long time. He wanted to emphasize that even when purchases will end, the amount of bonds under APP would stay huge. The ECB also announced that it will publish on a monthly basis (starting next month) the amount of expected monthly redemptions.
    - **Extending the FRFA.** The ECB decided to continue "conducting the main refinancing operations and three-month longer-term refinancing operations as fixed-rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2019.

- The size of the ECB’s balance sheet and forward guidance will replace net purchases as the main tool for monetary policy

As expected, the ECB has adopted a flexible strategy and an open-ended program i.e. contingent upon the evolution of economic conditions, in order to guide market expectations. They opted for a longer extension of the program as a way of anchoring interest rate expectations (and, by extension, the euro, which has disappeared from the ECB’s radar) and trying to cope with the volume of sovereign bonds available under the current APP rules (as the scarcity of bonds will eventually be an issue for the ECB). In any case, today the ECB has taken another stealth step on the normalization process.

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

in black, wording common to both the current and previous statements, in grey 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, ~~7 September~~26 October 2017

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 Vice-President, Mr Dombrovskis.

Based on our regular economic and monetary analyses, ~~we decided to keep~~today we conducted a thorough assessment of the outlook for inflation, the risks surrounding this outlook and our monetary policy stance. As a result, the Governing Council took the following decisions in pursuit of its price stability objective.

First, the **key ECB interest rates** were kept unchanged~~. We~~ and we continue to expect them to remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases.~~ Regarding~~

Second, as regards **non-standard monetary policy measures**, we ~~confirm that our net asset purchases,~~will continue to make purchases under the asset purchase programme (APP) at the current monthly pace of €60 billion~~, are intended to run~~ until the end of December 2017. From January 2018 our net asset purchases are intended to continue at a monthly pace of €30 billion until the end of September 2018, 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. ~~The net purchases are made alongside reinvestments of the principal payments from maturing securities purchased under the asset purchase programme.~~
~~The incoming information, including our new staff projections, confirms a broadly unchanged medium-term outlook for euro area economic growth and inflation. The economic expansion, which accelerated more than expected in the first half of 2017, continues to be solid and broad-based across countries and sectors. At the same time, the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability.~~

~~While the ongoing economic expansion provides confidence that inflation will gradually head to levels in line with our inflation aim, it has yet to translate sufficiently into stronger inflation dynamics. Measures of underlying inflation have ticked up slightly in recent months but, overall, remain at subdued levels. Therefore, a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term.~~ If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase ~~our asset purchase programme in terms of size and/or duration. This autumn we will decide on the calibration of our policy instruments beyond the end of the year, taking into account the expected path of inflation and the financial conditions needed for a sustained return of inflation rates towards levels that are below, but close to, 2%.~~the APP in terms of size and/or duration.

Third, the Eurosystem will reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and in any case for as long as necessary. This will contribute both to favourable liquidity conditions and to an appropriate monetary policy stance.

And fourth, we also decided to continue to conduct the main refinancing operations and three-month longer-term refinancing operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2019.

Today's monetary policy decisions were taken to preserve the very favourable financing conditions that are still needed for a sustained return of inflation rates towards levels that are below, but close to, 2%. The recalibration of our asset purchases reflects growing confidence in the gradual convergence of inflation rates towards our inflation aim, on account of the increasingly robust and broad-based economic expansion, an uptick in measures of underlying inflation and the continued effective pass-through of our policy measures to the financing conditions of the real economy. At the same time, domestic price pressures are still muted overall and the economic outlook and the path of inflation remain conditional on continued support from monetary policy. Therefore, an ample degree of monetary stimulus remains necessary for underlying inflation pressures to continue to build up and support headline inflation developments over the medium term. This continued monetary support is provided by the additional net asset purchases, by the sizeable stock of acquired assets and the forthcoming reinvestments, and by our forward guidance on interest rates.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Euro area real~~ The economic expansion in the euro area continues to be solid and broad-based. Real GDP increased by 0.~~6~~7%, quarter on quarter, in the second quarter of 2017, after 0.~~5~~6% in the first quarter. ~~Survey~~The latest data and survey results point to ~~continued broad-based~~unabated growth momentum in the ~~period ahead~~second half of this year. Our monetary policy measures ~~are supporting domestic demand and~~ have facilitated the deleveraging process~~.~~ and continue to support domestic demand. Private consumption is underpinned by rising employment~~ gains~~, which ~~are~~is also benefiting from past labour market reforms, and by increasing household wealth. The ~~recovery~~upswing in business investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. ~~Moreover~~Construction investment has also strengthened. In addition, the broad-based global recovery ~~will support~~ is supporting euro area exports.

~~This assessment is broadly reflected in the September 2017 ECB staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 2.2% in 2017, by 1.8% in 2018 and by 1.7% in 2019. Compared with the June 2017 Eurosystem staff macroeconomic projections, the outlook for real GDP growth has been revised up for 2017, reflecting the recent stronger growth momentum, and is broadly unchanged thereafter.~~

Risks surrounding the euro area growth outlook remain broadly balanced. On the one hand, the ~~current positive~~ strong cyclical momentum~~ increases the chances of a stronger than expected economic upswing.~~, as evidenced in recent developments in sentiment indicators, could lead to further positive growth surprises. On the other hand, downside risks continue to ~~exist,~~relate primarily ~~relating~~ to global factors and developments in foreign exchange markets.

Euro area annual HICP inflation ~~was~~remained unchanged at 1.5% in ~~August~~September. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation are likely to temporarily decline towards the turn of the year, mainly reflecting base effects in energy prices. At the same time, measures of underlying inflation have ticked up moderately ~~in recent months~~since early 2017, but have yet to show more convincing signs of a sustained upward trend. ~~Domestic~~Wage growth has increased somewhat, but domestic cost pressures~~, notably from labour markets, are~~ still remain subdued overall. Underlying inflation in the euro area is expected to continue to rise gradually over the medium term, supported by our monetary policy measures, the continuing economic expansion, the corresponding gradual absorption of economic slack and rising ~~wages~~wage growth.

~~This assessment is also broadly reflected in the September 2017 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.5% in 2017, 1.2% in 2018 and 1.5% in 2019. Compared with the June 2017 Eurosystem staff macroeconomic projections, the outlook for headline HICP inflation has been revised down slightly, mainly reflecting the recent appreciation of the euro exchange rate.~~

Turning to the **monetary analysis**, broad money (M3~~), despite some monthly volatility,~~) continues to expand at a robust pace, with an annual rate of growth of ~~4.~~5.1% in ~~July~~September 2017, after 5.0% in ~~June~~August. 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 9.~~1~~7% in ~~July~~September 2017, ~~down~~up from 9.~~7~~5% in ~~June~~August.

The recovery in the growth of loans to the private sector observed since the beginning of 2014 is proceeding. The annual growth rate of loans to non-financial corporations increased to 2.~~4~~5% in ~~July~~September 2017, ~~up from~~after 2.~~0~~4% in ~~June~~August, while the annual growth rate of loans to households remained stable at 2.~~6%.~~ 7%. The euro area bank lending survey for the third quarter of 2017 indicates that net loan demand has continued to increase for all loan categories. Credit standards have further eased for loans to households, while they remained broadly unchanged for loans to enterprises. Banks' overall terms and conditions on new loans have continued to ease for all categories of loans.

The pass-through of the monetary policy measures put in place since June 2014 continues to significantly support borrowing conditions for firms and households, access to financing – notably for small and medium-sized enterprises – and credit flows across the euro area.

To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed the need ~~for a continued very substantial~~to recalibrate the policy instruments to ensure the degree of monetary accommodation necessary to secure a sustained return of inflation rates towards levels that are below, but close to, 2%.

In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively to strengthening the longer-term growth potential and reducing vulnerabilities. The implementation of **structural reforms** in all euro area countries needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost euro area productivity and growth potential~~ and productivity~~. Regarding **fiscal policies**, all countries would benefit from intensifying efforts towards achieving a more growth-friendly composition of public finances. A full, transparent and consistent implementation of the Stability and Growth Pact and of the macroeconomic ~~imbalances~~imbalance procedure over time and across countries remains essential to ~~bolster~~increase the resilience of the euro area economy. Strengthening Economic and Monetary Union remains a priority. The Governing Council welcomes the ongoing discussions on further enhancing the institutional architecture of our Economic and Monetary Union.

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