ECB Watch: Another step towards monetary policy normalization, as expected

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- **The ECB removed the easing bias on the Asset Purchase Programme**
- **Macro projections remained mostly unchanged**
- **Protectionism (re)emerges as a downside risk**

At today's monetary policy meeting there were **no changes in the ECB's monetary policy stance**, as the central bank left key interest rates unchanged and reiterated that asset purchase programme (APP) will continue to run at a monthly pace of EUR30bn until September 18 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. However, **the ECB removed the easing bias on the APP** as the central bank dropped the reference to increase the APP in terms of size and/or duration if necessary. This removal was the next logical step in the process of normalization of monetary policy, and the ECB delivered on it as we expected.

The updated **Staff macroeconomic forecasts showed minor changes for the short-run figures**, but somewhat better incoming data and the strength of domestic factors made the **ECB more confident on the ongoing cyclical recovery, while the variance around the convergence path of inflation narrowed**.

The forecast of GDP growth has been revised slightly upward for 2018 (by 0.1pp to 2.4%) and left unchanged for 2019 (1.9%) and 2020 (1.7%). **Risks** surrounding this outlook **remain broadly balanced**, as the upward bias from the stronger domestic cyclical recovery is offset by global downward risks, such as rising protectionism, a higher exchange rate and tighter financial conditions. **Mr. Draghi warned in particular about the risks of US trade measures.** Though their immediate effect should not be large, unilateral decisions are dangerous and their final impact depends on many factors, such as retaliation from trade partners, the response of exchange rates and confidence. In this context, Mr Draghi also wanted to put on the table the risk of financial de-regulation.

Inflation forecasts were broadly unchanged. The slight downward revision of inflation in 2019 (by -0.1pp to 1.4%) is due to a stronger euro than expected in December over the forecast horizon (almost 6% higher) that more than offsets higher oil prices (around 4% higher on average). However, **the ECB continues to expect headline inflation to increase to 1.7% in 2020, and maintains unchanged its forecast of a gradual upward trend in core inflation** (1.1% in 2018, 1.5% in 2019 and 1.8% in 2020). The Governing Council did not discuss about risks on inflation, but Mr. Draghi stressed this outlook remains conditional on the ample degree of monetary stimulus, while the uncertainty surrounding the path of potential growth – and therefore the amount of slack in the economy – requires the ECB to be persistent and patient.

The main novelty of the meeting was the **removal of the "explicit reference" to the possibility of increasing the size of its bond buying programme** (a reference introduced in 2016 when the economic outlook was very different from the current one). Such decision was taken by unanimity and was attributed to the most recent growth upgrade that confirmed the ECB's existing confidence in the outlook. Moreover, Mr Draghi stated that **it was really backward looking decision while other references to forward guidance remain unchanged.** In particular, the **ECB kept its expectation to maintain rates at present levels for an extended period of time and well past the end of its net asset purchases,** its intention to continue **asset purchases until September "or beyond" if needed and to reinvest maturing securities.** Additionally, Mr Draghi also emphasized that the **central bank monetary policy remains "reactive and not proactive."**

All in all, the message from the ECB has come in line with our expectation of gradual changes in the forward guidance (removing the downward bias on the APP) while maintaining a cautious tone. Regarding the normalization process, our baseline scenario remains unchanged, i.e. ending QE during 4Q18 and hiking rates in 2019 (first depo rate by March and first refi rate by June). In the meantime, **the ECB will continue to adjust its forward guidance, with the next step in June.**

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)

PRESS CONFERENCE

Mario Draghi, President of the ECB,

Vítor Constâncio, Vice-President of the ECB,

Frankfurt am Main, ~~25 January~~8 March 2018

Ladies and gentlemen, ~~first of all let me wish you a Happy New Year. The~~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 the **key ECB interest rates** unchanged. 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 **non-standard monetary policy measures**, we confirm that our net asset purchases, at the ~~new~~current monthly pace of €30 billion, are intended to run 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. ~~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 the asset purchase programme (APP) in terms of size and/or duration.~~ The Eurosystem will continue to reinvest the principal payments from maturing securities purchased under the ~~APP~~asset purchase programme 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.

Incoming information, including our new staff projections, confirms ~~a robust pace of economic expansion~~the strong and broad-based growth momentum in the euro area economy, which ~~accelerated more~~ is projected to expand in the near term at a somewhat faster pace than previously expected ~~in the second half of 2017. The strong cyclical momentum, the ongoing reduction of economic slack and increasing capacity utilisation strengthen further~~. This outlook for growth confirms our confidence that inflation will converge towards our inflation aim of below, but close to, 2~~%.~~% over the medium term. At the same time, ~~domestic price pressures~~measures of underlying inflation remain ~~muted overall~~subdued and have yet to show convincing signs of a sustained upward trend. ~~Against~~In this ~~background, the recent volatility~~context, the Governing Council will continue to monitor developments in the exchange rate ~~represents a source of uncertainty which requires monitoring~~and financial conditions with regard to ~~its~~their possible implications for the ~~medium-term~~inflation outlook ~~for price stability~~. Overall, 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 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**. Real GDP increased by 0.~~7~~6%, quarter on quarter, in the fourth quarter of 2017, after increasing by 0.7% in the third quarter ~~of 2017, following similar growth in the second quarter~~. The latest economic data and survey results indicate continued strong and broad-based growth momentum ~~at the turn of the year.~~. Our monetary policy measures, which have facilitated the deleveraging process, continue to underpin domestic demand. Private consumption is supported by rising employment, which is also benefiting from past labour market reforms, and by growing household wealth. Business investment continues to strengthen on the back of very favourable financing conditions, rising corporate profitability and solid demand. Housing investment has improved further over recent quarters. In addition, the broad-based global expansion is providing impetus to euro area exports.

This assessment is broadly reflected in the March 2018 ECB staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 2.4% in 2018, 1.9% in 2019 and 1.7% in 2020. Compared with the December 2017 Eurosystem staff macroeconomic projections, the outlook for real GDP growth has been revised up for 2018 and remains unchanged for 2019 and 2020.

The risks surrounding the euro area growth outlook are assessed as broadly balanced. On the one hand, the prevailing ~~strong~~positive cyclical momentum could lead to ~~further positive~~ stronger growth ~~surprises~~ in the near term. On the other hand, downside risks continue to relate primarily to global factors, including rising protectionism and developments in foreign exchange and other financial markets.

~~Euro~~According to Eurostat's flash estimate, euro area annual HICP inflation ~~was~~decreased to 1.~~4~~2% in ~~December 2017, down~~February 2018, from 1.~~5~~3% in ~~November~~January. This reflected mainly ~~developments~~negative base effects in ~~energy prices~~unprocessed food price inflation. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation are likely to hover around ~~current levels in~~1.5% for the ~~coming months. For their part, measures~~remainder of the year. Measures of underlying inflation remain subdued ~~– in part owing to special factors – and have yet to show convincing signs of a sustained upward trend. Yet, looking~~overall. Looking forward, they are expected to rise gradually over the medium term, supported by our monetary policy measures, the continuing economic expansion, the corresponding absorption of economic slack and rising wage growth.

This assessment is also broadly reflected in the March 2018 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.4% in 2018, 1.4% in 2019 and 1.7% in 2020. Compared with the December 2017 Eurosystem staff macroeconomic projections, the outlook for headline HICP inflation has been revised down slightly for 2019 and remains unchanged for 2018 and 2020.

Turning to the **monetary analysis**, broad money (M3) continues to expand at a robust pace, with an annual rate of growth of 4.~~9% in November 2017, after 5.0% in October~~6% in January 2018, unchanged from the previous month, reflecting the impact of the ECB's monetary policy measures and the low opportunity cost of holding the most liquid deposits. Accordingly, the narrow monetary aggregate M1 ~~continued to be~~remained the main contributor to broad money growth, ~~expanding~~continuing to expand at ~~an~~a solid annual rate ~~of 9.1% in November, after 9.4% in October~~.

The recovery in the growth of loans to the private sector observed since the beginning of 2014 is ~~proceeding~~progressing. The annual growth rate of loans to non-financial corporations ~~increased~~strengthened to 3.4% in January 2018, after 3.1% in ~~November~~December 2017, ~~after 2.9% in October,~~ while the annual growth rate of loans to households ~~stood~~remained unchanged at 2.~~8% in November, compared with 2.7% in October. The euro area bank lending survey for the fourth quarter of 2017 indicates that loan growth continues to be supported by increasing demand and a further easing in overall lending conditions.~~

9%. 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 an ample degree of monetary accommodation to secure a sustained return of inflation rates towards levels that are below, but close to, 2~~%.~~% over the medium term.

In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively to ~~strengthening~~raising the longer-term growth potential and reducing vulnerabilities. The implementation of **structural reforms** in euro area countries needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost euro area productivity and growth potential. Against the background of overall limited implementation of the 2017 country-specific recommendations, as communicated by the European Commission yesterday, greater reform effort is necessary in the euro area countries. Regarding **fiscal policies**, the increasingly solid and broad-based expansion ~~strengthens the case~~calls for rebuilding fiscal buffers. This is particularly important in countries where government debt remains high. 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 imbalance procedure over time and across countries remains essential to increase the resilience of the euro area economy. ~~Strengthening~~Deepening Economic and Monetary Union remains a priority. The Governing Council ~~welcomes the ongoing discussions on completing~~urges specific and decisive steps to complete the banking union and the capital markets union~~, and on further deepening Economic and Monetary Union~~.

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