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December ECB meeting: Improved growth outlook, but little progress on inflation

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- At its regular monetary policy meeting on Thursday 14 December, as widely expected, the ECB Governing Council (GC) kept key policy interest rates unchanged and its asset purchase programme of EUR30bn (per month) intact until September 2018 or beyond if necessary, and in any case until the GC ensures a sustained adjustment in the path of inflation consistent with its medium-term target of 2.0%. The GC sounded ready to increase the size and/or the duration of the APP, should the outlook become less favorable or financial conditions are not in line with further progress towards a sustained adjustment in the path of inflation. Moreover, the Eurosystem will reinvest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of net asset purchases, and for as long as necessary, contributing to favorable liquidity conditions and to an appropriate monetary policy stance.

- Focus centered on the updated Staff macroeconomic forecasts on inflation and growth, with significant upward revisions in real economic activity but only marginal upgrade in headline inflation (Table 1). In particular, real GDP growth forecast for 2017 and 2018 was raised to 2.4% (from 2.2% in September) and to 2.3% (from 1.8% in September), reflecting the strong cyclical momentum. The projection for 2019 was also lifted by 0.2pp to 14.9%, while the ECB expects that growth will moderate to 1.7% in 2020 with risks to the economic outlook broadly balanced. On the inflation front, headline inflation was revised slightly higher by 0.2pp to 1.4% for 2018 reflecting mainly stronger oil and food prices, while 2017 and 2019 HICP inflation forecasts were both kept unchanged at 1.5%. Nevertheless, the ECB lowered its core inflation forecast for 2017 and 2018 0.1pp to 1.0% and by 0.2pp to 1.1%, respectively. Meanwhile, the new 2020 core inflation forecast at 1.8% is closer to the ECB's target, in line with the Central Bank's confidence that underlying inflationary pressures will rise amid continued robust economic momentum and an expected increase in wage growth to 2.7% in 2020.

- At the press conference that followed the conclusion of the meeting, ECB President Mario Draghi described euro area growth as strong highlighting that the economic slack has reduced significantly. Nevertheless, domestic inflationary pressures remain subdued, while a rather very gradual increase in HICP inflation is expected over the forecast horizon. As the output gap closes, the ECB expects wage and price dynamics to increase, something not yet evident in the wage and price data so far. Hence, Mr. Mario Draghi repeated that very accommodative monetary conditions are still warranted to ensure a sustained adjustment in consumer price inflation towards the ECB target.

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- The reaction to the ECB's monetary policy decision was contained in the rate markets despite the larger than expected upward revisions to the staff GDP forecasts. Initially the 2-yr German yield moved wider and hit a session high of -0.689% after the positive remarks in the press conference; however it retreated lower soon after, reaching a multi-day low of -0.745%, post the acknowledgement of recent disappointments in inflation. Similarly, the 10-yr German yield rose to a week high of 0.338%, before falling to a low of 0.29% in European trade on Friday and, therefore, testing the critical level of 0.30% for one more time this month. The 2/10-yr German yield spread ended Thursday's session flatter at 102 bps whilst the 5/30-yr spread tightened by 3 bps to 146 bps by the end of the day. Periphery spreads versus Germany and swap spreads faced similar pressures and ended the day at tighter levels. European equity markets fell on the day with the EURO STOXX 50 index closing at 3556 points. In FX markets, the US dollar index firmed by 0.21% following the ECB meeting and EUR/USD fell to a session low of 1.1770 on Thursday afternoon. The pair recovered some if its losses during early European trading, on Friday, hovering around 1.1795, while the EUR/USD 1 month implied volatility collapsed to new multi-year lows, continuing this year's trend and also reflecting the approaching holiday season.

- Looking ahead, we share the view that it is very likely for the ECB to end its APP by Q4 18, tapering gradually purchases to zero by year-end due to technical restrictions, the growing size of QE reinvestments and waning deflationary risks. Provided that there is a gradual increase in underlying inflation pressures, with core inflation staying slightly above 1.0% in 2018 and moving towards 1.5% in 2019, the ECB might move ahead with its first deposit rate hike at the beginning of 2019, supported by a growing urge among GC members to proceed with the normalization of its monetary policy so as to prevent falling behind the curve.

Table 1

ECB Staff macroeconomic forecasts on inflation and growth, December 2017

ECB projections	2017	2018	2019	2020
HICP inflation	**1.5**	**1.4**	**1.5**	**1.7**
September projection	1.5	1.2	1.5	
Core inflation	**1.0**	**1.1**	**1.5**	**1.8**
September projection	1.1	1.3	1.5	
GDP growth	**2.4**	**2.3**	**1.9**	**1.7**
September projection	2.2	1.8	1.7	
Unemployment rate	**9.1**	**8.4**	**7.8**	**7.3**
September projection	9.1	8.6	8.1	
Wage growth	**1.7**	**2.1**	**1.9**	**2.7**
September projection	1.5	2.0	2.3	

Source: ECB, Eurobank Research

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