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GLOBAL ECONOMIC &
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FOCUS NOTES

ECB December 8th policy decisions and market reaction

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- Aiming to support euro area economic growth and secure a sustained convergence of inflation towards levels consistent with the medium-term target of "below but close to 2%", the ECB Governing Council decided at the December 8th monetary policy meeting:

(i) An extension of the asset purchase programme (APP) for 9 months until at least December 2017.

(ii) A reduction in the monthly pace of asset purchases to €60bn from €80bn, effective as of April 2017. This came as a hawkish surprise because the ECB had committed to keeping the pace of €80bn monthly asset purchases until the Governing Council sees "a sustained adjustment in the path of inflation consistent with its inflation aim".

(iii) Adjustment on certain parameters of the APP, effective as of January 2nd 2017 aiming to address the bond scarcity issue though it has been less of an issue for the ECB lately after the recent increase in long-term bond yields. The said amendments include: (a) broader pool of eligible securities for the APP. The minimum remaining maturity for qualifying securities was decreased from two years to one year, allowing purchases of bonds with residual maturity from 1 to 30 years; (b) to the extent that is necessary, purchases of eligible securities with a yield to maturity below the interest rate on the ECB's deposit facility (-0.40% currently). With respect to the latter, there are no details available yet. According to an ECB press release "the implementation details will be worked out by the relevant committees".

(iv) Introduction of cash collateral in the PSPP securities lending facilities without having to reinvest it in a cash-neutral manner, an option offered by the ECB and by the national central bank of Belgium, Germany, Ireland, Spain and the Netherlands.

(v) Key interest rates remained unchanged (main refinancing rate at 0.00%, marginal lending facility rate +0.25%, deposit facility rate -0.40%)

- The extension of the APP until at least December 2017 suggests that the ECB is far from meeting the macroeconomic targets that were set when it initiated QE in March 2015 in terms of real economic growth and inflationary pressures and, thus, a continuously accommodative stance is still warranted. On the flipside, the reduction in the pace of its monthly asset purchases came in response to an improvement in macro fundamentals compared to March 2016, when the ECB decided to increase its purchases to €80bn a month due to a sharp tightening in financial conditions and a decline in inflation expectations. Deflationary risks have recently faded away, while the economic recovery has proven to be resilient. Adding to this, the ECB's move to reduce its monthly purchases mirrors the magnitude of the political limits that it faces, given that the hawkish members of the Governing Council have grown largely uncomfortable with a large scale of asset purchases amid the upcoming elections in Germany and Netherlands.

- Responding to a relevant question during the Q&A session, ECB President Mario Draghi stressed that slowing the monthly pace of asset purchases is not tantamount to tapering. He clarified that "tapering is a process whereby purchases would gradually go to zero" over a given time span stressing that no member of the Governing Council was in favor of tapering. Reflecting the above comments, the official ECB policy statement read clearly that "if, in the meantime —i.e., by the end of December 2017— the outlook becomes less favorable, 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". Indeed, the euro area macro outlook remains vulnerable to downside risks. Political uncertainty prevails in the euro area ahead of a string of looming ballots in the region, i.e., general elections in the Netherlands on March 15 2017, French presidential election in April & May 2017 and German presidential election in autumn 2017. Furthermore, some of the tailwinds that supported domestic consumption over the past few years, such as low inflation, have started to disappear amid higher oil prices. Furthermore, core inflation remains below 1% with the ECB President confirming that there is no convincing upward trend. Supporting the above, recent data suggest there is little sign of mounting wage pressures across the euro area even though the unemployment rate fell in October below 10% for the first time in the last seven years. That said, should downside risks materialize, the ECB has prepared a safety net to increase again the duration of the programme or/and the pace of monthly asset purchases and/or proceed with further amendments to the parameters of the APP. However, barring such risks in the months ahead, the December 8^{th} ECB policy outcome could be interpreted as a pre-announcement of a gradual tapering with the Central Bank either tapering or making another stepwise QE adjustment in late Q3 / early Q4 2017, after the German presidential election.

- The Eurosystem staff released its updated macroeconomic projections through 2019, with the outlook for real GDP growth in the euro area economy remaining broadly unchanged compared with the September 2016 ECB staff projections. Meanwhile, the risks surrounding the euro area growth outlook remain tilted to the downside. In more detail, annual real GDP growth is projected at 1.7% in 2016 and 2017, and at 1.6% in 2018 and 2019. As far as inflation is concerned, the ECB expects HICP inflation to increase gradually from 0.2% in 2016, to 1.3% in 2017, 1.5% in 2018 and 1.7% in 2019. The forecasts for 2017 and 2018 were slightly changed by 0.1% and -0.1%, respectively (Table 1). Given that the consensus estimate for 2017 GDP growth is 1.3%, the ECB seems optimistic on the economic outlook of the euro area economy. The increased level of political uncertainty should weigh on investment spending and, consequently, on overall growth in the coming year, so the ECB could potentially be forced to downwards revise its GDP growth projection for 2017 in the coming months.

Table 1- ECB Staff macroeconomic Forecasts, December 2016

	ECB Staff projections			
	2016	**2017**	**2018**	**2019**
Change in real GDP	**1.7**	**1.7**	**1.6**	**1.6**
Sept. projection	1.7	1.6	1.6	-
HICP inflation	**0.2**	**1.3**	**1.5**	**1.7**
Sept. projection	0.2	1.2	1.6	-

Source: ECB

- In reaction to the ECB's decision for certain changes to the APP parameters, the front-end of the German government bonds rallied on market perception that these adjustments imply redistribution of asset purchases towards shorter maturities. In a knee-jerk reaction to the ECB announcement, the 2-yr Bund yield hit a multi-week peak of -0.632% before embarking on a downward trend recording a fresh record low of -0.770% the following session (Friday, December 9th). On the flipside, longer-term German sovereign paper came under selling pressure in response to the ECB's decision for a reduced pace of monthly asset purchases. Indicatively, the 30-year German bond yield recorded a multi-month peak of 1.201% earlier today (Friday, December 9th) compared to levels slightly below 1.0% ahead of the ECB policy meeting. As a result, the 2/30-yr Bund yield curve undertook a bullish steepening with the corresponding spread surging to 187.5bps at the time of writing (14:00GMT, Friday, December 9th), the widest since mid-2014. Meanwhile, yield premiums of 10-yr EMU periphery sovereign bonds moderately underperformed their German peers with the corresponding spread undertaking some widening. European equity markets gained further with the FTSEurofirst 300 index testing levels slightly above 1,400 on Friday, December 9th for the first time since early January. In FX markets, the reduction in the size of monthly purchases in combination with a programme extension caused volatility in EUR/USD. Following a short-lived jump to a three-week peak of 1.0872 in a knee-jerk reaction to the ECB policy announcement, EUR/USD moved lower marking a session low of 1.0548 on Friday, December 9th, approaching a year-to-date low of 1.0503 recorded a few sessions ago. Technically, strong support stands at recent lows in the way to 1.0450 (late March 2015 trough) with investors keeping their focus on the December 13-14 FOMC policy meeting as well as upcoming developments on the Italian political scene and Italian banks' recapitalization plans.

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