CENTRAL BANKS

ECB further hints at a possible QE: “early next year”

Financial Scenarios Unit
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- The Governing Council is set to reassess current measures early next year.
- The Council does not need “unanimity” to implement a pure QE.
- The ECB revised its inflation and growth projections “significantly” downwards.

As expected, at today’s monetary policy meeting the ECB left the key policy rate unchanged at 0.05%. The central bank did not take additional steps on non-standard measures but said that it will reassess current stimuli early next year. Mr. Draghi reiterated the unanimity within the Governing Council (GC) to use unconventional monetary policy instruments within its mandate to tackle a prolonged period of low inflation. However, for the first time, he explicitly said that the central bank could embark on a “pure” quantitative easing (QE) (i.e. purchases of government bonds) without the unanimity of the GC. On the inflation outlook, the GC will be “particularly vigilant” on the impact of oil prices on the medium-term inflation outlook (there was an explicit reference to the need to closely monitor such risk). Meanwhile, downside risks to the economic outlook persist.

During the Q&A, the focus was on future monetary policy steps, which seem more likely by the first quarter of 2015. Mr. Draghi strengthened the ECB’s pledge to increase the balance sheet towards its early 2012 levels, shifting the ECB´s balance sheet goal from an “expectation” to an “intention”. He highlighted that the change in wording was not unanimous, but counted on a “vast majority” within the GC (taking back some of last month´s words). This shows, once again, the absence of unanimity within the GC. Regarding potential future measures, Mr. Draghi said that the GC had a very “rich discussion” that included various options of QEs: not only the purchase of government bonds but also of other assets, “except gold.” Regarding the possibility of buying foreign assets, he stated that they do not intend to do so as “it would amount to FX intervention.” Moreover, he stressed that the committees in charge of technical preparations for further measures have stepped up their work.

As expected, the ECB has revised downwards its quarterly growth and inflation projections as a result of the persistent weakness in the growth outlook and lower oil prices. The statement describes various supports for modest growth in 2015, but Draghi’s wording sounded clearly dovish. The staff growth projections are now 1% and 1.5% for 2015 and 2016 (down from 1.6% and 1.9%), and below ours (1.3% and 2.4%). Inflation is now expected to be on average 0.7% and 1.3% over the same period, down from 1.1% and 1.4% following the new oil price scenario which projects Brent oil prices at USD85.60 next year and USD88.50 in 2016. This inflation outlook is broadly in line with our own projections - the only difference being a higher oil price scenario in our case that results in higher headline inflation (but similar core inflation) for 2016. Still, Mr. Draghi emphasised that some of the recent fall in inflation came from services. He also mentioned that the cut-off date for establishing oil price assumptions did not incorporate the subsequent fall in Brent prices, and hence they will re-evaluate the impact from the oil scenario early next year, implying that he sees further downward risks to inflation. This could add to the battery of arguments to justify QE early next year.

Starting next month, the frequency of the ECB's monetary policy meetings will change to a six-weekly cycle from the current monthly schedule. The first meeting will be held on 22 January. Moreover, the current voting rules in the ECB's Governing Council will be replaced by a new rotation system of voting rights.

During this year, the ECB has already implemented a wide range of measures to fight both the worsening of inflation expectations and the persistent weakness in economic activity: it cut interest rates to record lows (zero-lower bound), injected new liquidity through TLTROs and bought private assets through ABSPP and CBPP. Up to now, the ECB has delayed the possibility of embarking on a pure QE, but further hints at its realisation. Will the ECB finally implement it? We think that it will. The ECB's rhetoric, the economic outlook and the difficulty in expanding the balance sheet to the targeted levels of early 2012 will continue to support our expectations of a QE in the first quarter of 2015.

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, Frankfurt am Main, ~~6 November~~ 4 December 2014

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to ~~our~~the first press conference in our new premises. 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, and in line with our forward guidance, we decided to keep the **key ECB interest rates** unchanged. ~~Following up on the decisions of 2 October 2014~~As regards our **non-standard monetary policy measures**, we ~~last month~~ have started purchasing covered bonds ~~under our new programme. We will also soon start to purchase~~ and asset-backed securities. ~~The~~ These purchase programmes will last for at least two years. ~~Together with the series of~~ Next week, we will conduct the second targeted longer-term refinancing operation~~s~~, to be ~~conducted~~ followed by six further operations until June 2016~~, these asset purchases~~. Taken together, our measures will have a sizeable impact on our balance sheet, which is ~~expected~~intended to move towards the dimensions it had at the beginning of 2012.

~~Our~~ In the coming months, our measures will ~~enhance the functioning of the monetary policy transmission mechanism, support financing conditions in the euro area, facilitate credit provision to the real economy and generate positive spillovers to other markets. They will thereby~~ further ease the monetary policy stance more broadly, support our forward guidance on the key ECB interest rates and reinforce the fact that there are significant and increasing differences in the monetary policy cycle between major advanced economies. However, the latest euro area macroeconomic projections indicate lower inflation, accompanied by weaker real GDP growth and subdued monetary dynamics.

~~With the measures that have been put in place, monetary policy has responded to the outlook for low inflation, a weakening growth momentum and continued subdued monetary and credit dynamics. Our accommodative monetary policy stance will underpin the firm anchoring of medium to long-term inflation expectations, in line with our aim of achieving inflation rates below, but close to, 2%. As they work their way through to the economy, our monetary policy measures will together contribute to a return of inflation rates to levels closer to our aim.~~

~~However, looking ahead, and taking into account new information and analysis, the Governing Council will closely monitor and continuously assess the appropriateness of its monetary policy stance.~~In this context, early next year the Governing Council will reassess the monetary stimulus achieved, the expansion of the balance sheet and the outlook for price developments. We will also evaluate the broader impact of recent oil price developments on medium-term inflation trends in the euro area. Should it become necessary to further address risks of too prolonged a period of low inflation, the Governing Council ~~is~~remains unanimous in its commitment to using additional unconventional instruments within its mandate. ~~The~~ This would imply altering early next year the size, pace and composition of our measures. In response to the request of the Governing Council ~~has tasked~~, ECB staff and the relevant Eurosystem committees ~~with ensuring the~~ have stepped up the technical preparations for further measures, which could, if needed, be implemented in a timely ~~preparation of further measures to be implemented, if needed~~manner. All of our monetary policy measures are geared towards underpinning the firm anchoring of medium to long-term inflation expectations, in line with our aim of achieving inflation rates below, but close to, 2%, and contribute to a return of inflation rates towards that level.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Euro area real GDP increased~~Real GDP in the euro area rose by 0.~~1~~2%, quarter on quarter, in the ~~second~~ third quarter of this year~~, revised up as compared with the~~. This was in line with earlier ~~estimate. Since the summer months, incoming data and survey evidence have overall indicated~~ indications of a weakening in the euro area's growth momentum~~. This information has now been incorporated into the most recent forecasts by private and public institutions, which indicate~~, leading to a downward revision of the outlook for euro area real GDP growth ~~over the projection horizon up to 2016, with the outlook~~

~~for a modest economic recovery remaining in place. This picture is broadly in line with the Governing Council's current assessment.~~in the most recent forecasts. The latest data and survey evidence up to November confirm this picture of a weaker growth profile in the period ahead. At the same time, the outlook for a modest economic recovery remains in place. On the one hand, domestic demand should be supported by our monetary policy measures, the ongoing improvements in financial conditions, the progress made in fiscal consolidation and structural reforms, and significantly lower energy prices supporting real disposable income. Furthermore, demand for exports should benefit from the global recovery. On the other hand, the recovery is likely to continue to be dampened by high unemployment, sizeable unutilised capacity, and the necessary balance sheet adjustments in the public and private sectors.

~~The risks surrounding the economic outlook for the euro area continue to be on the downside. In particular, the weakening in the euro area's growth~~ These elements are reflected in the December 2014 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 0.8% in 2014, 1.0% in 2015 and 1.5% in 2016. Compared with the September 2014 ECB staff macroeconomic projections, the projections for real GDP growth have been revised substantially downwards. Downward revisions were made to the projections for both domestic demand and net exports.

The risks surrounding the economic outlook for the euro area are on the downside. In particular, the weak euro area growth momentum, alongside ~~heightened~~ high geopolitical risks, ~~could~~ has the potential to dampen confidence and~~, in particular,~~ especially private investment. In addition, insufficient progress in structural reforms in euro area countries constitutes a key downward risk to the economic outlook.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.~~4% in October 2014, after 0.~~3% in ~~September.~~November 2014, after 0.4% in October. Compared with the previous month, this mainly reflects a stronger fall in energy price inflation and a somewhat ~~less negative contribution from energy~~ lower annual increase in services prices ~~and slightly stronger annual increases in food prices. A fall in industrial goods prices was partly compensated for by an increase in services price inflation. On the basis of current information and prevailing futures prices for energy, annual HICP inflation is expected to remain at around current low levels over the coming months, before increasing gradually during 2015 and 2016. This is also the picture portrayed by the most recent forecasts, which now incorporate the recent sharp fall in oil prices~~. Taking into account the current environment of very low rates of inflation, it will be important to assess the broader impact of recent oil price developments on medium-term inflation trends and to avoid spillovers to inflation expectations and wage formation.

Against the background of recent oil price developments, it is crucial to recall that forecasts and projections are based on technical assumptions, especially for oil prices and exchange rates. On the basis of information available in mid-November, at the time the December 2014 Eurosystem staff macroeconomic projections for the euro area were finalised, annual HICP inflation was foreseen to reach 0.5% in 2014, 0.7% in 2015 and 1.3% in 2016. In comparison with the September 2014 ECB staff macroeconomic projections, they have been revised significantly downwards. These revisions reflect mainly lower oil prices in euro terms and the impact of the downwardly revised outlook for growth, but they do not yet incorporate the fall in oil prices over the past few weeks following the cut-off date for the projections. Over the coming months, annual HICP inflation rates could experience renewed downward movements, given the recent further decline in oil prices.

The Governing Council will continue to closely monitor the risks to the outlook for price developments over the medium term. In this context, we will focus in particular on the possible repercussions of dampened growth dynamics, geopolitical developments, exchange rate and energy price developments, and the pass-through of our monetary policy measures. We will be particularly vigilant as regards the broader impact of recent oil price developments on medium-term inflation trends in the euro area.

Turning to the **monetary analysis**, data for ~~September 2014 continue to point to~~ October 2014 support the assessment of subdued underlying growth in broad money (M3), with the annual growth rate ~~increasing moderately, however, to~~ standing at 2.5% in October, unchanged from September~~, after 2.1% in August~~. Annual growth in M3 continues to be supported by its most liquid components, with the narrow monetary aggregate M1 growing at an annual rate of 6.2% in ~~September~~October.

The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) ~~remained negative at -1.8% in September, after -2.0% in August and -2.2% in July.~~was -1.6% in October, after -1.8% in September, showing a gradual recovery from a trough of -3.2% in February. On average over recent months, net redemptions have moderated from the historically high levels recorded a year ago. Lending to non-financial corporations continues to reflect the lagged relationship with the business cycle, credit risk, credit supply factors and the ongoing adjustment of financial and non-financial sector balance sheets. The annual growth rate of loans to households (adjusted for loan sales and securitisation) was 0.6% in ~~September~~October, after 0.5% in ~~August. In line with some stabilisation in credit flows, the October bank lending survey for the euro area reported a net easing of credit standards on loans to~~

~~enterprises and households. At the same time, it has to be kept in mind that the level of credit standards is still tight from a historical perspective. Following the completion of the ECB's comprehensive assessment, a further strengthening of banks' balance sheets can be expected to contribute to reducing credit supply constraints and facilitating more lending~~September. The monetary policy measures in place and the completion of the ECB's comprehensive assessment should support a further stabilisation of credit flows.

To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis confirms the ~~recent decisions taken by the Governing Council~~need to closely monitor the risks to the outlook for price developments over the medium term and to be prepared to provide further monetary policy accommodation~~ and to support lending to the real economy~~, if needed.

Monetary policy is focused on maintaining price stability over the medium term and its accommodative stance contributes to supporting economic activity. However, in order to strengthen investment activity, boost job creation and raise productivity growth, other policy areas need to contribute decisively. In particular, the ~~legislation and~~determined implementation of **product and labour market reforms** as well as actions to improve the business environment for firms need to gain momentum in several countries. ~~The effective implementation of~~ It is crucial that structural reforms be implemented credibly and effectively as this will raise expectations of higher incomes and encourage firms to increase investment today and bring forward the economic recovery.~~ As regards **fiscal policies**,~~ **Fiscal policies** should support the economic recovery, while ensuring debt sustainability in compliance with the Stability and Growth Pact, which remains the anchor for confidence. All countries ~~with remaining fiscal imbalances should not unravel the progress already made and~~ should ~~proceed in line with the rules of the Stability and Growth Pact. Throughout the procedural steps under the agreed framework, the Pact should remain the anchor for confidence in sustainable public finances. The existing flexibility within the rules should allow governments to address the budgetary costs of major structural reforms, to support demand and to achieve~~use the available scope for a more growth-friendly composition of fiscal policies. ~~A full and consistent implementation of the euro area's existing fiscal and macroeconomic surveillance framework is key to bringing down high public debt ratios, to raising potential growth and to increasing the resilience of the euro area economy to shocks~~The Investment Plan for Europe which the European Commission announced on 26 November 2014 will also support the recovery.

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