BBVA | Research

ECB Watch: The ECB will go ahead with QE decisions in October

Sonsoles Castillo / Agustín García / Miguel Jiménez / María Martínez

7 September 2017

- **Effects from euro appreciation and QE strategy dominate today's meeting**
- **After very preliminary discussion on alternative scenarios to calibrate QE, decisions will most likely be taken in October**
- **The volatility of the exchange rate is seen as a source of uncertainty, but the new projections are optimistic: stronger growth and only a slight downward revision of inflation**

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 it intended to run the monthly asset purchases of €60 billion until the end of December 2017, or beyond if necessary. Nonetheless, the ECB made clear that it will very probably decide most of the details of the future of QE in October. For the economic outlook, risks remain broadly balanced. Importantly, on the euro, a paragraph was included in the statement to show that there is a broad consensus within the Governing Council (GC) about "recent volatility" as it "represents a source of uncertainty which requires monitoring".

During the Q&A, the attention was focused on the monetary policy normalization and the exchange rate. On monetary policy tools, Mr Draghi revealed that there was a discussion among the (Governing Council) GC on the calibration of the APP, although it was very preliminary. In particular, he stated that they discussed pros and cons of several scenarios as well as the transmission channels, covering length and size of the different plans. However, a cautious tone was retained as Mr Draghi remarked that taper decision is "complex" and they want to see the work ECB´s committees before deciding. The ECB president showed reluctant to commit the taper announcement date but he stated that probably the bulk of these decisions will be taken in October. Anyway, Draghi made it very clear that the GC did not discuss about the sequence, reiterating that interest rates are expected to remain "at their present level" well past the horizon of net asset purchases. On the euro, Mr Draghi repeated the reference to the statement, while conceding that expectations of more favourable economic growth are a driver of the recent appreciation of the euro. All in all, he showed less concern than we had expected.

The updated Staff macroeconomic projections shed light on the ECB's view about the drivers behind the recent appreciation of the euro and its pass-through effect to economic growth and inflation. The stronger momentum of the economy over the first half of the year, supported by the strengthening domestic demand might be partly behind the upward performance of the euro and of the moderate rise in core inflation since the second quarter of the year.

The euro value incorporated in the new projections is around 8% more appreciated versus the USD than in June Staff's forecasts, although its effect on inflation could be partly offset by the oil prices assumed now (around 2%-3% higher in the forecast horizon). The assumption on the global outlook remains broadly unchanged. All in all, a somewhat stronger domestic demand than projected three months ago along with the improvement in global demand and the effect of the stronger euro lead to a slight upward revision of the ECB growth forecast by 0.3pp to 2.2% this year, with no changes over the rest of the forecast horizon (1.8% in 2018 and 1.7% in 2019). Headline inflation forecasts remain unchanged in 2017 (1.5%), but have been revised down slightly by 0.1pp for the next two years to 1.2% in 2018 and 1.5% in 2019, as the effect of the euro appreciation was partly offset by stronger growth and higher oil prices. This revision of inflation is somewhat smaller than expected, as growth is revised upwards also more than expected. In addition, the ECB points to a more limited effect of the exchange rate as it is not driven only by exogenous factors but also by domestic strength. The Staff forecasts also incorporate a limited pass-through to core components, as underlying inflation figures have been revised only slightly down by 0.1pp (to 1.3% in 2018 and 1.5% in 2019).

Overall, the ECB remains confident on the inflation outlook, but an accommodative monetary policy is still needed, and they will continue to monitor the response of domestic cost pressures to improving labor market and its consistence with a sustainable upward trend of the core inflation. Finally, the risks surrounding the growth outlook remain broadly balanced, but the recent volatility in exchange rate is a source of uncertainty which requires monitoring its implications for price stability.

All in all, October still looks to be the month when details will be revealed regarding the taper of the APP. It is difficult to foresee, in the coming weeks, a variation in the inflation outlook or in the global outlook that would change their minds. We expect a reduction of the APP starting in January 2018. While Draghi gave no clear hints on the choice of any particular taper scenario, they will look a formula that gives them maximum flexibility, given the complexity of the process.

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

in grey, wording common to both the current and previous statements, in 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, ~~20 July~~7 September 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 the key ECB interest rates unchanged. We 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 current monthly pace of €60 billion, are intended to run until the end of December 2017, 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.

~~Our monetary policy measures have continued to secure the very supportive financing conditions that are necessary to make continuous progress towards a sustained convergence of inflation rates to levels below, but close to, 2% over the medium term.~~ The incoming information, including our new staff projections, confirms a ~~continued strengthening of the~~ broadly unchanged medium-term outlook for euro area economic growth and inflation. The economic expansion ~~in the euro area~~, which ~~has been broadening~~accelerated more than expected in the first half of 2017, continues to be solid and broad-based across countries and sectors ~~and regions. The risks to~~. 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 ~~growth~~medium-term outlook ~~are broadly balanced.~~ 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. ~~Headline inflation is dampened by the weakness in energy prices. Moreover, measures~~Measures of underlying inflation have ticked up slightly in recent months but, overall, remain ~~overall~~ 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%.

Let me now explain our assessment in greater detail, starting with the economic analysis. Euro area real GDP increased by 0.6%, quarter on quarter, in the ~~first~~second quarter of 2017, after 0.5% in the ~~last~~first quarter ~~of 2016. Incoming~~. Survey data~~, notably survey results, continue to~~ point to ~~solid,~~continued broad-based growth in the period ahead. ~~The pass-through of our~~Our monetary policy measures ~~is~~are supporting domestic demand and ~~has~~have facilitated the deleveraging process. Private consumption is underpinned by employment gains, which are also benefiting from past labour market reforms, and by increasing household wealth. The recovery in investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. ~~Private consumption is supported by employment gains, which are also benefiting from past labour market reforms, and by increasing household wealth. Moreover, the global recovery should increasingly lend support to trade and euro area exports. However, economic growth prospects continue to be dampened by a slow pace of implementation of structural reforms, particularly in product markets, and by remaining balance sheet adjustment needs in a number of sectors, notwithstanding ongoing improvements~~Moreover, the broad-based global recovery will support euro area exports.

~~The risks~~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 ~~are~~remain broadly balanced. On the one hand, the current positive cyclical momentum increases the chances of a stronger than expected economic upswing. On the other hand, downside risks continue to exist, primarily relating to global factors ~~continue to exist~~and developments in foreign exchange markets.

Euro area annual HICP inflation was 1.~~3~~5% in ~~June, down slightly from 1.4% in May, mainly due to lower energy price inflation.~~August. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation ~~is~~are likely to ~~remain around current levels in~~ temporarily decline towards the ~~coming months.~~turn of the year, mainly reflecting base effects in energy prices. At the same time, measures of underlying inflation ~~remain low and~~ have ticked up moderately in recent months, but have yet to show convincing signs of a ~~pick-up, as domestic~~sustained upward trend. Domestic cost pressures, ~~including wage growth~~notably from labour markets, are still subdued. Underlying inflation in the euro area is expected to rise ~~only~~ gradually over the medium term, supported by our monetary policy measures, the continuing economic expansion~~ and~~, the corresponding gradual absorption of economic slack and rising wages.

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~~.0~~% in ~~May~~July 2017, after ~~4.9~~5.0% in ~~April~~June. 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.~~3~~1% in ~~May~~July 2017, ~~unchanged~~down from ~~April.~~ 9.7% in June.

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 ~~remained stable at~~increased to 2.4% in ~~May~~July 2017, up from 2.0% in June, while the annual growth rate of loans to households ~~increased to~~remained stable at 2.6~~%, from 2.4% in April. The euro area bank lending survey for the second quarter of 2017 indicates that credit standards for loans to enterprises and loans to households for house purchase have further eased and that loan growth continues to be supported by increasing demand.~~%. 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 degree of monetary accommodation 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 needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost euro area growth potential and productivity~~ growth~~. 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 procedure over time and across countries remains essential to bolster 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.

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.