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ECB Watch: The ECB strikes a dovish tone

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- **The ECB left its forward guidance communication unchanged**
- **Renewed concerns over exchange rate volatility**
- **"Very few chances" of a rate hike this year**

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 the asset purchase programme (APP) will run as from January 2018 at a monthly pace of EUR30bn until September 18, or beyond, if necessary. The dovish stance remains in place as the central bank maintained its pledge to keep interest rates unchanged until well past the horizon of the net asset purchases and maintaining the possibility to increase the APP in terms of size and/or duration if necessary. On the growth outlook, the economic expansion continues at robust pace and the risks surrounding the euro area remain broadly balanced

The recent appreciation of the euro exchange rate has triggered a response from ECB's Governing Council. As in September 2017, when the euro reached 1.20 vs USD, a paragraph was included in the statement to show this concern: "the recent exchange rate volatility represents a source of uncertainty which requires monitoring". Mr Draghi reiterated that the exchange rate is not a policy target but it is very important for growth and price stability. He also stressed that the volatility of the exchange rate might have negative implications for financial stability. Moreover, he said that if these developments lead to an unwanted tightening of their monetary policy stance they will have to rethink their monetary policy strategy.

During the Q&A, part of the attention was focused on the view that policy guidance could soon need to be revised, as the minutes of December minutes showed. Trying to temper expectations about future steps on the normalization strategy, Mr Draghi stated the discussion within the Governing Council (GC) has not "really started" because "there hasn't been much of a change in the outlook, except a strengthening of the economy." In this respect, we expect changes in the forward guidance would be possible by March (coinciding with the staff's forecasts revision) but it also could be by April, once the ECB has confirmed that inflation has already bottomed out. On the question if the APP will finish abruptly or not, Mr Drahi seemed ambiguous as signalled that they "need to distinguish between sudden stop, extension of program and gradual tapering", and refused to single out a preferred option. Moreover, he took the opportunity to remind the audience that the GC is committed to the sequence of monetary policy normalization, and hence interest rates will remain at the present levels "well past" the horizon of the net asset purchases, emphasizing that "well past" is a fundamental part of its forward guidance. In this regard, he also stated that based on current data, he see "very few chances" of a rate hike from the bank this year.

All in all, the ECB left monetary policy unchanged, as expected, without giving details on the QE recalibration and the future of the exit strategy. Certainly, the ECB is not in a hurry to accelerate the normalization of monetary policy, but during 1H18 the central bank will have to adjust its forward guidance to prepare the markets for the next steps, first the end of QE and later on rate hikes

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)

Mario Draghi, President of the ECB,

Vítor Constâncio, Vice-President of the ECB,

Frankfurt am Main, ~~14 December 2017~~25 January 2018

INTRODUCTORY STATEMENT

Ladies and gentlemen, ~~the~~first of all let me wish you a Happy New Year. 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 ~~President of the Eurogroup, Mr Dijsselbloem, and 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 ~~from January 2018 we intend to continue to make~~our net asset purchases~~ under~~, at the ~~asset purchase programme (APP), at a~~new 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 ~~APP~~asset purchase programme (APP) in terms of size and/or duration. The Eurosystem will reinvest the principal payments from maturing securities purchased under the APP 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.

~~Our monetary policy decisions have preserved the very favourable financing conditions that are still needed for a sustained return of inflation rates towards levels that are below, but close to, 2%. The incoming~~Incoming information~~, including our new staff projections, indicates a strong~~ confirms a robust pace of economic expansion~~ and a significant improvement~~, which accelerated more than expected in the ~~growth outlook.~~second half of 2017. The strong cyclical momentum~~ and~~, the ~~significant~~ongoing reduction of economic slack ~~give grounds for greater~~and increasing capacity utilisation strengthen further our confidence that inflation will converge towards our inflation aim~~.~~ of below, but close to, 2%. At the same time, domestic price pressures remain muted overall and have yet to show convincing signs of a sustained upward trend. ~~An ample degree of monetary stimulus therefore~~Against this background, the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term 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 ~~additional~~ net asset purchases~~ that we decided on at our October monetary policy meeting~~, 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**. ~~The economic expansion in the euro area continued in the third quarter of 2017, when real~~Real GDP increased by 0.~~6%~~7%, quarter on quarter, ~~after 0.7%~~ in the third quarter of 2017, following similar growth in the second quarter. The latest economic data and survey results ~~point to solid~~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 ~~support~~underpin domestic demand. Private consumption is ~~underpinned~~supported by ~~ongoing~~rising employment~~ gains~~, which ~~are~~is also benefiting from past labour market reforms, and by ~~rising~~growing household wealth. Business investment continues to strengthen on the back of very favourable financing conditions, rising corporate profitability and ~~strengthening~~solid demand. Housing investment has ~~also risen~~improved further over recent quarters. In addition, ~~euro area exports are being supported by~~ the broad-based global expansion is providing impetus to euro area exports.

~~This assessment is broadly reflected in the December 2017 Eurosystem staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 2.4% in 2017, 2.3% in 2018, 1.9% in 2019 and 1.7% in 2020. Compared with the September 2017 ECB staff macroeconomic projections, the outlook for real GDP growth has been revised up substantially.~~

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

~~According to Eurostat's flash estimate, euro~~Euro area annual HICP inflation was 1.4% in December 2017, down from 1.5% in November~~, up from 1.4% in October. At the same time, measures of underlying inflation have moderated somewhat recently.~~. This reflected mainly developments in ~~part owing to special factors~~energy prices. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation are likely to ~~moderate in the coming months, mainly reflecting base effects in energy prices, before increasing again. Underlying inflation is~~hover around current levels in the coming months. For their part, 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 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 December 2017 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.5% in 2017, 1.4% in 2018, 1.5% in 2019 and 1.7% in 2020. Compared with the September 2017 ECB staff macroeconomic projections, the outlook for headline HICP inflation has been revised up, mainly reflecting higher oil and food prices.~~

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~~ 2017, from 5.2% in September~~, 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 the main contributor to broad money growth, expanding at an annual rate of 9.1% in November, after 9.4% in October~~, after 9.8% in September~~.

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 increased to ~~2.9~~3.1% in ~~October~~November 2017, after 2.~~4~~9% in ~~September~~October, while the annual growth rate of loans to households ~~remained stable~~stood 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.

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%.

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** in ~~all~~ euro area countries needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost euro area productivity and growth potential. Regarding **fiscal policies**, the increasingly solid and broad-based expansion strengthens the case 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 Economic and Monetary Union remains a priority. The Governing Council welcomes the ongoing discussions on completing the banking union and the capital markets union, and on further ~~enhancing the institutional architecture of our~~deepening Economic and Monetary Union.

We are now at your disposal for questions.

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