Eurozone

ECB: “A sustained presence on the markets”

- **The ECB decided to extend its Asset Purchase Programme (APP) by 9 months (up to December 2017, at least) and to reduce the volume of monthly purchases from EUR 80 bn to EUR 60 bn starting in April 2017.**
- **Given the scarcity of eligible securities, the ECB had to choose between the pace of monthly purchases and the duration of the programme. It opted to extend QE for a longer period but at a slower monthly pace.**
- **The ECB modified two parameters of its public securities purchase programme (PSPP) that concern the short end of the yield curve: the minimum maturity of eligible securities was reduced from 2 years to 1 year, and the deposit facility rate floor (which is currently -0.40%) was removed.**
- **Although December’s decision will increase the total volume of purchases, it could trigger a slight upturn in long-term rates given the reduced monthly flows. Any upturn should remain limited, however, since Mario Draghi has made it clear that the ECB intends to maintain “a sustained presence” on the markets.**

Given the need to extend quantitative easing (QE) beyond March 2017, the ECB’s Governing Council had to choose between extending the securities purchase programme by 6 months at the current pace, or to extend the programme for a longer period of time but with a smaller volume of monthly purchases. The ECB finally opted for the second option, extending its Asset Purchase Programme (APP) by 9 months (through December 2017 at least) while reducing the pace of monthly purchases from EUR 80 bn to EUR 60 bn as of April 2017 (returning to the pace effective between March 2015 and March 2016). The ECB nonetheless kept open the option of increasing the duration and/or pace of QE through December 2017 if the outlook were to become less favourable and/or financial conditions deteriorate, but did not envision the opposite possibility. In the end, the ECB decided to extend QE by *at least* 9 months at a *minimum* pace of EUR 60 bn a month.

This decision must be interpreted in the light of the scarcity of assets restricting the total size of the APP. ECB purchases of public securities are distributed according to the contribution of each member state to the ECB’s capital. Under this (self-imposed) rule, Germany benefits most from ECB purchases. Yet there is not enough German public debt securities to allow a substantial extension of QE (more than 6 months) at the current pace of EUR 80 bn a month. To consider this option, the ECB would have had to accept deviations from the capital key for its purchases and/or increase the issuer limit currently at 33%. The first option was politically unacceptable and the second, hard to apply without disrupting the smooth functioning of the bond market given the co-existence of CAC and non-CAC bonds.

To put it straight, the ECB had to scale back the pace of monthly purchases to continue intervening directly in the bond markets for a longer period of time. To ensure the smooth implementation of QE, it also modified two parameters of its public securities purchase programme that concern the short end of the yield curve: the minimum maturity of eligible securities was reduced from 2 years to 1 year, and the deposit facility rate floor (currently at -0.40%) was removed.

Although December’s decision increases the total volume of securities purchased (EUR 540 bn vs. EUR 480 bn if QE were extended only 6 months at the current pace of EUR 80 bn a month), it could trigger a slight upturn in long-term rates due to the reduction in monthly flows. Actually, much will depend on the composition of future purchases all along the yield curve. By removing the deposit facility rate floor and by including securities with maturities of between 1 and 2 years, the ECB has paved the way for a reduction in the average maturity of purchases. If this were the case, then QE would become less effective, since the purpose of the policy was precisely to target long maturities, which are more pertinent for the financing of the economy. It remains to be seen whether it will apply to all member countries in the same manner: a steepening of the yield curve would be less a problem (even welcome) in Germany than in Italy and Spain.

Naturally, the communication will also play a key role in the evolution of long-term government bond yields. From this perspective, Mario Draghi adopted a very accommodative tone during the press conference: he was particularly careful to distinguish between scaling back the pace of monthly purchases and a tapering. Defining tapering as the gradual reduction of purchases to zero, Mario Draghi pointed out that the ECB, to the contrary, intended to maintain a sustained presence on the markets. He added that the Governing Council had not discussed the idea of tapering.

The press conference’s very dovish tone was echoed by the possibility that the ECB could revise increase its QE programme in size and/or duration through December 2017 if needed. This tone was also reflected in the economic projections unveiled this month. GDP growth forecasts for the next three years remained in line with September’s forecasts (1.7% in 2017, 1.6% in 2018 and 1.6% in 2019), and the risks are still on the downside. But the biggest questions concern the inflation outlook. The central bank expects consumer price inflation to reach 1.3% next year, 1.5% in 2018 and only 1.7% in 2019. When asked during the press conference if 1.7% could be considered as consistent with the ECB’ mandate M. Draghi answered that is was “not really” the case, suggesting that if more is needed, more will be done.