International Comment:
ECB POLICY DECISION (3 December)

(FED), (ID) (FED)

Key Points:

- The ECB cut the deposit rate by 10bps to -0.3%, President Draghi gave no indication of whether this now represents the effective floor.
- The Asset Purchase Programme (APP) was extended by 6 months to March 2017, and the monthly purchase rate was maintained at €60bn. The overall increase in the programme size of €360bn disappointed markets.
- As bonds mature, the principal will be reinvested, for as long as necessary. And purchases will be extended to regional and local government bonds, increasing the eligible universe of assets. Markets view the reinvestment of principal and the extension to sub-national government bonds as relatively modest announcements.
- Support for the package of measures was not unanimous but a *'very large majority'* of the Governing Council were in favour.
- The December Eurosystem staff macroeconomic projections for GDP growth were broadly unchanged relative to September, while the inflation projections were marked down a little. HICP inflation is expected to be 1.6% in 2017.
- The market reaction was negative. In particular European equities fell by around 3% on the day and the euro appreciated by 2% against the dollar. 1-year, 1-year OIS rates have increased by 14bps and Bunds also increased by 14bps.
- Gilt yields are up 7-12bps across the curve today. Sterling short rates implied by LIBOR futures are also up, by 7-10 bps.

What has the ECB announced today?

The ECB announced a package of five measures:

- **A cut in the deposit rate:** the rate was cut by 10bps to -0.3%. The interest rates on the main refinancing operations and the marginal lending facility were left unchanged at 0.05% and 0.3% respectively. Despite being asked directly President Draghi gave no signal at all about whether the deposit rate was now at its effective floor or whether further cuts might be considered. He simply described the cut of 10bps as *'adequate'*.

- **An extension in the duration of the Asset Purchase Programme (APP):** purchases will be extended to March 2017, with the monthly purchase rate maintained at €60bn. That is a €360bn increase in the size of the APP. Our central case had been increase of €650bn (broadly similar to what markets had expected). While we expected a 6-month increase in duration our central case had been that the ECB would increase the monthly purchase rate by €20bn. The Governing Council maintained its previous language that in any case the programme would continue until it saw a sustained adjustment in inflation, suggesting that in principle a further extension beyond March 2017 is possible if data disappoint.
- **Reinvestment of principal payments**: as bonds mature the ECB will reinvest the principal. While this measure will have a significant impact on the future size of the ECB's balance sheet, it will take time to build. Brokers' estimates suggest that just €10bn of bonds will mature in 2017 and €60bn in 2018.
- **Extension to regional and local government bonds:** the ECB extended the asset classes that can be purchased to include sub-national government bonds. President Draghi wouldn't be drawn on by how much this would increase the eligible universe of assets. Given the limited increase in the size of the APP the reason for the extension at this time is a little unclear. Our latest analysis suggests that the ECB could easily complete the APP, including the extension announced today, without extending to other asset classes. This announcement could signal that the ECB is more worried about scarcity than we had previously thought, or simply that it is being proactive to ensure that further extensions, if required, can be easily accommodated. The regional debt market is most developed in Germany (the country where scarcity would potentially bind first) and Spain.
- **Three-month refinancing operations to be extended**: the ECB announced that three-month full allotment liquidity operations would be extended for as long as necessary and at least until the end of 2017.

The decision on the package of measures was not unanimous but the President said that it was supported by a *'very large majority'.* We will revisit the macroeconomic impact of these measures as part of the forthcoming *Feb IR* forecast round.

How did the ECB explain the decision and staff projections?

In describing the outlook President Draghi emphasised the weakness in the global economy noting that the recovery was being dampened by *'subdued growth prospects in emerging markets and moderate global trade.'* He also noted that the geopolitical situation was particularly uncertain. The President emphaisised that the Governing Council viewed its asset purchases to date as effective and re-iterated that the APP was flexible and could be adjusted to meet the ECB's price stability mandate (and that the parameters will be reviewed in the Spring).

The Eurosytem December 2015 macroeconomic projections were also published today (Table 1). These projections are not owned by the Governing Council and are instead produced by staff.[2] The projections therefore do not account for the measures announced today, except to the extent that they were anticipated and so already reflected in asset prices. Expectations of policy action today reversed the moves in asset prices that occurred after the cut-off date for the September projections, and so the

[2] The March and September projections are produced by ECB staff while the June and December projections are produced by national central bank staff and ECB staff.

September and December projections are conditioned on broadly similar levels of asset prices. The exception is oil prices which are around 5% lower.

Euro-area GDP is expected to be 1.5% in 2015, 1.7% in 2016 and 1.9% in 2017. The GDP projections are broadly unchanged from the September projections (Table 1).[3] This reflects two offsetting factors: first somewhat stronger domestic demand, in part reflecting fiscal measures taken in response to the refugee crisis; and second, weaker foreign demand.

HICP inflation is expected to be 0.1% in 2015, 1.0% in 2016 and 1.6% in 2017. The inflation projection for 2016 is 0.2pp lower than in September, while the projection for 2017 is unchanged.[4] The weaker projections for inflation are attributed to weaker external pressures and in particular lower oil prices.

Table 1: Eurosystem staff macroeconomic projections

	2015	2016	2017
GDP (percent)			
Jun-15	1.5	1.9	2.0
Sep-15	1.4	1.7	1.8
Dec-15	1.5	1.7	1.9
HICP (percent)			
Jun-15	0.3	1.5	1.8
Sep-15	0.1	1.1	1.7
Dec-15	0.1	1.0	1.6

Market reaction

Markets have reacted negatively to the ECB's policy announcements, reflecting the fact the announced measures failed to meet expectations. European equities are down around 3.3% on the day, 10-year Bund yields are up 14bps and the euro has appreciated 2.3% versus the dollar. Front-end yields are sharply higher after President Draghi declined to provide details of whether further cuts in the deposit rate were possible; 1-year, 1-year OIS rates have increased by 14bps to -0.22%. Risky assets have generally underperformed, with European credit and peripheral sovereign spreads wider on the day. 10-year Italian spreads to bunds have widened by around 8bps since the announcement. Longer-term inflation expectations have fallen by around 4bps.

Both the cut in rates and the expansion of the PSPP disappointed relative to market expectations. In particular, contacts attributed the sharp rise in bond yields to the decision not to increase the pace of purchases. Neither the extension of the fixed-rate full allotment regime nor the confirmation that principal repayments on PSPP holdings would be reinvested were considered to be significant. The inclusion of regional debt had largely been expected.

Gilt yields are up 7-12bps across the curve today. Yields were up shortly after the ECB announcement, and have continued to increase over the day, with the 10-year up from 1.77 (pre-announcement) to 1.87% (4pm). Sterling short rates implied by LIBOR futures are also up, by 7-10 bps (this has had little impact on the point at which the 1-month forward OIS curve reaches 0.75%, which remains in early 2017).

[3] While the 2017 figure is 0.1pp higher in Table 1, based on unrounded data the revision to 2017 is 0.0pp.
[4] Based on unrounded figures the revisions since September are -0.2pp in 2016 and 0.0pp in 2017. The rounded figures in Table 1 suggest -0.1pp in both 2016 and 2017.