LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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FIVE BULLETS
ON THE ECB'S EXTENSION OF THE ASSET PURCHASE PROGRAMME (APP)

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The European Central Bank's press conference on 3 December 2015 included an announced extension of the asset purchase programme (APP), which I found:

- **a mixed bag**. Certainly, what was delivered today by the ECB Governing Council cannot be regarded as the Asset Purchase Programme 2 (APP 2), but rather a "recalibration," as President Draghi put it (i.e. APP 1½). It was short of market expectations at least on two counts: modest reduction in the deposit rate and no (apparent) sizable increase in the purchase programme. Still, the element of novelty, which was highlighted by President Draghi twice, is the decision to reinvest the principal of bonds maturing, and this will extend even beyond the expected end of the programme in March 2017. All in all, it is a mixed bag, probably short of the noises coming from Frankfurt over the past few days but still not a negligible decision.
- **short of market expectations**. Let's go to the details. The ECB decided today to cut the rate of the deposit facility by 10bps to -0.30%, while maintaining the refinancing rate and the marginal lending facility unchanged at historically low levels of 0.05% and 0.30% respectively. The cut in the depo rate was largely anticipated after President Draghi mentioned at the October press conference that such an option had been discussed already at that time, but the size of the cut was short of expectations in financial markets. In the press conference, President Draghi announced a time extension of the asset purchase programme to March 2017 "or beyond", again probably short of expectations. The pool of eligible assets was extended to include bonds of regions and local governments. This increases the flexibility of ECB's purchases, especially in those countries facing some shortage of government bonds (Germany). More importantly, the ECB Governing Council decided to reinvest the principal payments of bonds already in portfolio as they mature. This would effectively increase monthly buying by a variable amount and will allow the ECB to smooth changes in its balance sheet. This is a very important decision whose importance has probably not been fully discounted by the knee-jerk reactions in financial markets in the immediate aftermath of the decision. Finally, the yield floor for assets purchased by the Eurosystem was not removed and other fancy ideas not mentioned at all.

- **missing the deposit rate cut**. The most effective monetary policy measure to boost inflation in the short term is probably a deposit rate cut and it would have been better to introduce some innovation in that regards. The suggested two-tiered system, by which a lower rate would act as a penalty rate for deposits above a certain threshold, would have amplified the effects of the APP while reducing the risks of a pass-through to lending rates. This did not happen. It is also somewhat shocking that while Draghi acknowledged that lowering the deposit rate is highly effective, quoting studies by the ECB staff and quantifying the impact of the APP programme on the economy, the missing action is exactly on the perceived most powerful tool: the deposit rate.
- **backed by marginal revisions in forecasts**. In the press conference, President Draghi presented updated staff macroeconomic projections. They were largely unchanged on GDP growth, with a small reduction in the inflation forecasts. GDP growth is projected at 1.5%, 1.7% and 1.9% in 2015, 2016 and 2017 respectively (versus 1.4%, 1.7% and 1.8% back in September). Inflation projections were 0.1%, 1.0% and 1.6% in 2015, 2016 and 2017 respectively (versus 0.1%, 1.1% and 1.7% back in September). These small reductions in the outlook for inflation are also probably to blame for the somewhat disappointing decision. On top of that, there was some disagreement within the board and the decision was not unanimous, as acknowledged by Draghi, although there was a "very large majority in favour". And this may explain the somewhat tame policy response.
- **likely to require further action**. Will there be a fresh revision of forecasts at the next round? Draghi indicated that monetary conditions "have clearly improved," and he said the ECB is "confident but not complacent". Obviously, monetary policy works with long lags, and it may well be that the big chuck of the effect of measures delivered in the past has yet to come. By contrast, the downside risk of projections stemming from the uncertainty regarding the outlook for emerging markets and China, and from the escalation in the geopolitical risk is not properly included in inflation forecasts. There is a clear risk the ECB will have to revise inflation projections again in the spring and thus take further action.

In conclusion, the decision was certainly short of expectations. Still, a close look at the decision to reinvest the principle of bonds coming due may reserve some surprises. At the minimum, it means that there is no risk of an unwanted reduction in the total size of the ECB balance sheet. But it could also mean a sizeable expansion if amounts coming due over the next few months are truly sizeable. At any rate, my feeling is that the ECB is not yet done with monetary accommodation. More is to come in the spring.