



BOXES

Box 1

THE GOVERNING COUNCIL'S EXPANDED ASSET PURCHASE PROGRAMME

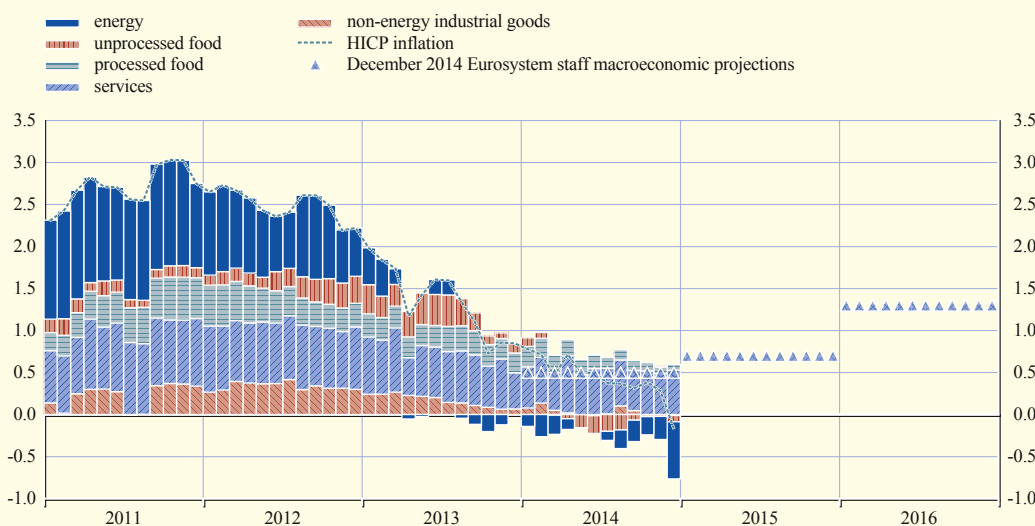
At its meeting on 22 January 2015 the Governing Council of the ECB decided to launch an expanded asset purchase programme (APP), encompassing the existing purchase programmes for asset-backed securities and covered bonds, as well as purchases of euro-denominated investment-grade securities issued by euro area governments, agencies and European institutions in the secondary market. Under this expanded programme, the combined monthly purchases of public and private sector securities will amount to €60 billion. The intention is for these purchases to be carried out until the end of September 2016, and they will, in any case, be conducted until the Governing Council sees a sustained adjustment in the path of inflation which is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. This box explains the rationale for the Governing Council's decision to expand its existing asset purchase programme and indicates the main transmission channels and key modalities of the APP.

Rationale for expanding the ECB's asset purchase programme

With regard to the outlook for price developments, the December 2014 Eurosystem staff projections pointed to a relatively low path for inflation until 2016 in an environment of gradual recovery. More recently, the fall in oil prices further weakened the short-term inflation outlook. In this environment, the likelihood had increased that inflation would remain too low for a prolonged period, implying risks to medium-term price stability. While the sharp fall in oil prices over recent months remains the dominant factor driving current inflation developments, measures of HICP excluding energy and food prices have also been falling since 2013 and remained relatively low in 2014 (see Chart A). Moreover, from the summer of 2014 the weaker inflation dynamics started to influence market-based measures of inflation expectations across

Chart A Annual HICP inflation and Eurosystem staff macroeconomic projections

(annual percentage changes and percentage point contributions)



Sources: Eurostat and Eurosystem staff macroeconomic projections.

a range of maturities, including at horizons at which they should normally show resilience to realised inflation observations. In January 2015 market-based inflation expectations suggested that inflation would only return to more normal levels at very extended horizons. Overall, the risk had intensified that the sequence of negative surprises to headline inflation figures would be propagated to price formation in the future.

Regarding the assessment of the monetary stimulus achieved via the monetary policy initiatives adopted between June and September 2014, the Governing Council considered two dimensions: the pass-through potential of each unit of euro liquidity introduced and the quantity of liquidity likely to be generated.

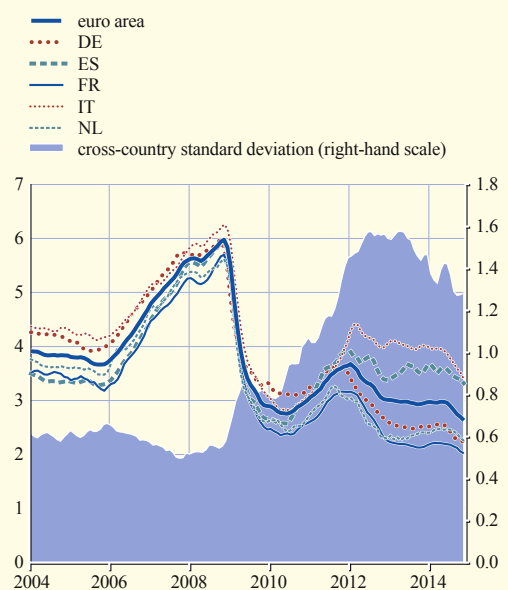
The strength of the pass-through from a given amount of liquidity injected into private sector borrowing costs has been satisfactory. This can be seen, for instance, in the downward trend of bank lending rates to non-financial corporations that started in the third quarter of 2014, coinciding with the first targeted longer-term refinancing operation (TLTRO) and the announcement of the asset-backed securities purchase programme (ABSPP) and covered bond purchase programme (CBPP-3; see Chart B). In addition, on average, over recent months net redemptions of loans to non-financial corporations have moderated from the historically high levels recorded a year ago, and net lending flows turned slightly positive in November 2014. In addition, the January 2015 Bank Lending Survey indicated a further net easing of credit standards across all loan categories in the fourth quarter of 2014.

However, the monetary policy measures did not result in a sufficient quantity of liquidity being generated. In this regard, recent measures have fallen short of the expectations regarding the expansion of the Eurosystem's balance sheet that had been entertained when the measures were calibrated with a view to fostering a more rapid return of inflation to levels below, but close to, 2%. This has weakened the overall transmission of the measures to the broader financing conditions in the economy, thereby significantly reducing the upside support that the summer 2014 measures were expected to provide to inflation in the medium term.

A forceful monetary policy response therefore became warranted. Given the weakened medium-term outlook on price stability and the quantitative shortfall of existing monetary policy measures, the Governing Council judged the prevailing degree of monetary accommodation as insufficient to adequately address the heightened risks of too prolonged a period of low inflation and to ensure that the ECB fulfils its objective of price stability.

Chart B Composite indicator of the nominal cost of bank borrowing for non-financial corporations

(percentages per annum; three-month moving averages)



Source: ECB.

Notes: The composite indicator of the cost of borrowing is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes. The cross-country standard deviation is calculated over a fixed sample of 12 euro area countries. The latest observation refers to November 2014 preliminary data.

Transmission and key modalities of the ECB's expanded asset purchase programme

With key interest rates at their lower bound, the Governing Council considered outright purchases of securities with a high potential for influencing the financing conditions faced by euro area households and firms to be warranted in view of the ECB's price stability mandate. At the lower bound for policy interest rates, the adoption of further quantitative measures that can expand the size and change the composition of the Eurosystem's balance sheet constitutes the only effective tool to provide further monetary policy accommodation. In this regard, balance sheet measures in the form of outright asset purchases allow full control to be taken of the degree of monetary stimulus. At the same time, further outright purchases should be composed of assets that both feature a high transmission potential to the real economy and are available in sufficient volumes. Purchases of investment grade bonds of euro area sovereigns are an effective instrument in this respect for at least two reasons. First, the sovereign yield curve constitutes the bedrock benchmark indicator for pricing a vast array of credit instruments and forms of external finance for the private economy, for example bank loans, corporate loans and equity. Conducting such purchases in proportions across sovereign issuers that indirectly reflect the economic weight of the various Member States in the euro area economy broadens the scope of interventions and thus amplifies their monetary impact. Second, the market for such securities is sufficiently deep and liquid to minimise the potential distortive effects of central bank action on the formation of market prices.

The APP will work through the same channels that have been shown to be associated with quantitative policies in other jurisdictions, although the relative importance of these channels may differ. The ECB's interventions underscore the Governing Council's determination to use all available tools within its mandate to address the risks of too prolonged a period of low inflation. In this way, the announcement of a significant expansion in the size and composition of the Eurosystem's balance sheet through the APP will strengthen confidence and support inflation expectations, having a direct impact on real interest rates and thus counteracting an unwarranted tightening of financial conditions. Furthermore, the ECB's interventions will reduce yields on government bonds, which will set in motion a more conventional chain of propagation channels that will support the economic recovery and help bring inflation back to levels below, but close to, 2%. These avenues work through price effects – as mentioned above, the pricing of a large variety of assets and loan contracts in the economy are a function of sovereign yields – and through quantity effects, as the additional liquidity introduced through the purchases is used by private investors to re-allocate their portfolios into a multitude of other assets that are not addressed by the central bank interventions, thereby leading to an easing of conditions across broad sources of private-sector financing.

The Governing Council decided on the purchase modalities for the APP. Purchases will be conducted at a monthly pace of €60 billion and are intended to be carried out until the end of September 2016 and, in any case, until the Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. The monthly purchases will comprise purchases of asset-backed securities and covered bonds under the ABSPP and CBPP-3, as well as additional purchases of securities issued by euro area governments, agencies and EU institutions. With regard to these additional asset purchases, the Governing Council retains control over all the design features of the programme, including the purchase allocation, asset eligibility, and the pace and size of the purchases, thereby safeguarding the singleness of the Eurosystem's monetary policy.

While the ECB will coordinate the purchases, the Eurosystem will make use of decentralised implementation to mobilise its resources.

With regard to the sharing of hypothetical losses, the Governing Council decided that 20% of the additional asset purchases will be subject to loss sharing. The Governing Council decided that purchases of securities of European institutions (which will constitute 12% of the additional asset purchases and will be purchased by NCBs) will be subject to loss sharing. The rest of the NCBs' additional asset purchases will not be subject to loss sharing. The ECB will hold 8% of the additional asset purchases. This implies that 20% of the additional asset purchases will be subject to a regime of risk sharing. The arrangement underlines the choice of the monetary policy instrument that is most appropriate to achieve price stability, while taking into account the unique institutional structure of the euro area, where a common currency and single monetary policy coexists with 19 national fiscal policies. In particular, the chosen regime ensures the effectiveness of sovereign bond purchases by mitigating concerns relating to moral hazard, thereby preserving incentives for prudent fiscal policies and the necessary structural reforms.

With regard to asset eligibility, the Governing Council announced the following criteria. The Governing Council decided to buy securities that fulfil the collateral eligibility criteria for marketable assets in order to participate in Eurosystem monetary policy operations. Securities that do not achieve the specified criteria will be eligible, as long as the Eurosystem's minimum credit quality threshold is not applied for the purpose of their collateral eligibility. Moreover, in the case of euro area Member States under financial assistance programmes, eligibility will be suspended during reviews and will resume only in the event of a positive outcome.

The sizeable increase in the Eurosystem's balance sheet will further ease the monetary policy stance, and the APP will decisively underpin the firm anchoring of medium to long-term inflation expectations. Moreover, these decisions by the Governing Council will support its forward guidance on the key ECB interest rates and reinforce the fact that there are significant and increasing differences in the monetary policy cycles of major advanced economies. Taken together, these factors should strengthen demand, increase capacity utilisation, and support money and credit growth, thereby contributing to a sustained return of inflation towards a level below, but close to, 2% over the medium term.