

## 2 The recalibration of the ECB's asset purchase programme

**At its meeting on 26 October 2017 the Governing Council of the ECB decided to recalibrate the expanded asset purchase programme (APP).** It confirmed that purchases under the APP will be made at the current monthly pace of €60 billion until the end of December 2017 and that from January 2018 the net asset purchases are intended to continue at a monthly pace of €30 billion until 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. In line with recent communications, the Governing Council reiterated its readiness to increase the APP in terms of the size of purchases and/or the duration of the programme if the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation. The Governing Council also confirmed that the Eurosystem would 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, with a view to contributing to favourable liquidity conditions and to maintaining an appropriate monetary policy stance. This box explains the rationale for the Governing Council's decision to recalibrate the APP and explains the main transmission channels of the programme.

### Rationale for recalibrating the APP

**In January 2015 the Governing Council decided to launch the APP to address risks of too prolonged a period of low inflation.** From March 2015 to March 2016 the Eurosystem purchased public and private sector securities at a pace of €60 billion per month. To accelerate the return of inflation rates to levels consistent with the ECB's definition of price stability, monthly purchases were increased to €80 billion from April 2016 to March 2017. In December 2016 the Governing Council announced a recalibration of the APP, extending the net purchases until December 2017 at a reduced monthly pace of €60 billion. Following the decision made on 26 October 2017 the monthly pace will be further reduced to €30 billion from January 2018 and net purchases will be carried out until September 2018.

**The recalibration of the APP reflects growing confidence in the gradual convergence of inflation rates towards the ECB's inflation aim,** on account of the increasingly robust and broad-based economic expansion, an uptick in measures of underlying inflation and the continued effective pass-through of the Governing Council's policy measures to the financing conditions of the real economy. Economic indicators point to unabated growth momentum in the second half of 2017. The broad-based global recovery should support euro area exports in the period ahead. Private consumption is underpinned by rising employment, owing in part to past labour market reforms, and by increasing household wealth. The cyclical upswing in investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. While there is further evidence that measures

of underlying inflation have ticked up, they have yet to show more convincing signs of a sustained upward trend. Overall, a substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term consistent with the ECB's definition of price stability.

**The size and duration of asset purchases are calibrated to deliver a constellation of yields and thus, indirectly, financing conditions that are consistent with achieving the ECB's inflation aim.** Taking into account the endogenous adjustment of the whole spectrum of market conditions, including bank lending rates, corporate bonds and mortgages, as well as the euro exchange rate, the calibration of the APP is aimed at providing the necessary amount of stimulus to the economy to support inflation developments in line with the ECB's definition of price stability.

### The transmission channels of the APP

**The level and shape of the yield curve can be influenced by acting on two components of long-term interest rates,** namely the expectations component and the term premium. The expectations component reflects market expectations regarding the future path of short-term interest rates, which are more directly affected by monetary policy rates. The term premium reflects the excess yield that an investor receives as compensation for exposure to duration risk, i.e. the portfolio losses that could potentially arise on bonds with a long residual maturity if interest rates increase unexpectedly.

**By purchasing long-dated bonds, the Eurosystem absorbs part of the duration risk that otherwise would have to be borne by private investors.** By announcing that, under the APP, it will withdraw a certain stock of long-term bonds over a certain horizon – and thus a share of the duration risk that otherwise would have to be borne by the market – the ECB can influence the term premium and the yield curve in general. By compressing the term premium, the APP puts pressure on longer-term interest rates in order to make long-term borrowing more affordable, thereby promoting investment and the consumption of durables. With fewer long-dated bonds available overall for them to hold, private investors have more balance sheet capacity to hedge against the amount of duration risk that remains in the market and more risk-bearing capacity to reallocate funds to other investments, including the acquisition and financing of productive capital. This process of portfolio rebalancing is the key mechanism for propagating easing, stemming from duration extraction through quantitative interventions, across the entire economy.

**Overall, the Governing Council's decision reflects the assessment that a sustained adjustment in the path of inflation has yet to fully materialise.** This assessment is based on checking the latest inflation developments against four criteria: first, that headline inflation is on a path to levels below, but close to, 2% over a meaningful medium-term horizon; second, that there is sufficient confidence that the convergence will be durable and inflation will stabilise around those levels; third,

that inflation developments will be self-sustaining, meaning that the trajectory will be maintained despite diminished support from monetary policy. And finally, the metric used is euro area inflation, rather than the inflation rates of any individual country. The ongoing economic expansion gives grounds for confidence that inflation will gradually converge to the ECB's objective, but patience is needed. The recalibration of the APP reflects the fact that, notwithstanding the reduction in the monthly pace of purchases, a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term.