

## ECB decision time: For Europe's central bank, crucial decisions need to be taken

The fourth wave of the pandemic and the new Omicron variant have complicated the European Central Bank's already not so easy life in the run-up to what is supposed to be a big bang meeting today



ECB President, Christine Lagarde, is facing many challenges

A lot has been said, analysed and speculated about the ECB's crucial meeting on 16 November. Most leading indicators are pointing to a loss of economic momentum in the fourth quarter, and the current fourth wave of the pandemic and the new Omicron variant will add further downward pressure to the eurozone economy, particularly to private consumption. At the same time, headline inflation has continued to accelerate and even "team transitory" has had to admit that inflationary pressure will last longer than previously anticipated. Against this backdrop, the ECB will have to decide on how to proceed with its emergency measures in particular and how much monetary stimulus the eurozone economy still needs in general.

### Fresh round of staff projections

An important element for the discussions will be the next round of ECB staff macro projections. However, we don't expect any significant changes here. Back in September, the ECB had forecast GDP growth to come in at 5.0%, 4.6% and 2.1% in 2021, 2022 and 2023, respectively. Inflation was expected at 2.2%, 1.7% and 1.5%. Traditionally, the ECB's inflation forecasts have been highly

affected by the so-called technical assumptions on oil prices and the exchange rate, and these have hardly changed. Luckily for the ECB, the surge in oil prices after the September meeting recently came to an end, suggesting little additional pressure on the ECB's headline inflation projections.

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### *The 2024 inflation forecast needs to be watched closely*

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The weakening of the exchange rate has been too insignificant to drastically change the inflation projections. As the ECB's inflation models seem to underestimate the current pass-through from higher producer prices to consumer prices and will also hardly capture any post-pandemic wage bargaining, we don't expect any significant change to the inflation projections. Instead, what needs to be watched closely is the inflation forecast for 2024.

Even if the inflation discussions between 'team transitory' and 'team permanent' become more heated, we don't see them being concluded any time soon. In fact, these talks could easily continue at least until the summer of next year. Consequently, with no fundamental changes to the inflation outlook, save for some stretching of the term 'transitory', the ECB's discussion will not focus on any tightening but simply on how to proceed with the Pandemic Emergency Purchase Programme (PEPP), the ongoing Asset Purchase Programme (APP) and Targeted Long-Term Refinancing Operations (TLTROs) for banks.

## **What's next for the Pandemic Emergency Purchase Programme?**

Regarding the PEPP, President Christine Lagarde put the entire ECB in a corner when she – probably unintentionally – said at the last press conference that the programme would end as expected in March 2022. While the current fourth wave of the pandemic may be a good reason for the ECB to extend PEPP by one quarter, this option is unlikely given comments by Lagarde and others. The central bank could officially confirm the end next week but might want to play it safe and simply postpone a decision until the early February meeting.

The problem with ending the PEPP is the 'cliff edge' effect, as it currently runs at some €60b per month. An abrupt halt would bring total monthly net asset purchases by the ECB down from €80b to €20b (the size of the APP). Of course, the ECB could decide to simply stop PEPP and to just use reinvestments as a means to smooth the transition but we think that this would not be taken well by market participants. Instead, we think that the Bank will have to present a more powerful transition tool, which offers the same flexibility as the current emergency purchase programme.

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### *Extending PEPP could be the easiest way out but could damage Lagarde's credibility*

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To maintain this flexibility, the ECB could simply extend PEPP, adjust the terms of the 'old' QE programme (APP) or introduce a new third programme. Extending PEPP could be the easiest way

out but could damage Lagarde's credibility in communicating with financial markets. Adjusting the terms of the APP to give the same flexibility is possible but could lead to new lawsuits in Germany as sticking to the capital key was one of the requirements for the German Constitutional Court to give the green light to it. This leaves the start of a new programme as an attractive option. In our view, the ECB could start a Post-Pandemic Transition Purchase Programme (PPTPP), with an envelope of €300b in order to provide a smooth transition after March 2022, while offering the same flexibility as the PEPP.

## Words and action

ECB Executive Board member Isabel Schnabel was the first ECB official to say recently that "risks to inflation are skewed to the upside", while also making the point that there could be "certain structural factors" pushing up energy price inflation in the coming years; the most notable being the green transition. If this wording is echoed in next week's official ECB communication, it would mark a significant U-turn towards a much more hawkish ECB. However, we still think that the Bank might not yet be willing to fully go down this road.

Therefore, we expect the ECB to continue to sound cautious about the economic outlook, acknowledging the risk of higher inflation while sticking to the view that inflation is transitory and will eventually return to 2%. In order to gradually start the exit from ultra-loose monetary policy without giving up flexibility amid a fourth wave of the pandemic, we expect the ECB to confirm the end of PEPP in March 2022 and to introduce a third asset purchase programme to smooth the transition. TLTROs will not be extended at their current favourable conditions but instead, the tiering multiplier will be increased from 6 to 10.

## Cautious recalibration

Given that the Fed has retired the word 'transitory', it would be wise for the ECB to prepare for outcomes other than inflation eventually falling back to below 2%. Therefore, a gradual recalibration of all emergency measures to prepare for the possibility of more permanent inflation is a very logical step and good risk management at the current juncture.

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