ECB slowly joins the tapering bandwagon

With inflation being notoriously higher than the European Central Bank's own forecasts, the risk of being behind the curve has increased, triggering the beginning of tapering soon

European Central Bank, Frankfurt, Germany

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It took a while but the ECB finally shifted its official communication on inflation from the broad denial of the summer months towards a much more balanced assessment and a good in-depth analysis of the factors currently driving inflation. Even though the ECB admitted that its previous forecast on when inflation would come down again, had been too optimistic, the overall view that the current inflation spur is temporary remains in place. ‘Temporary’ or ‘transitory’ has just become a bit longer. However, the risk remains that as much as the ECB frequently overestimated inflation dynamics during the last decade, it could now structurally underestimate inflation.

In our view, the ECB will not quickly change the new more balanced assessment of inflation. Even if energy prices were to stay high or move even higher, the definition of ‘transitory’ could be stretched out even further. This means that it would require a sharp acceleration in underlying inflation or services inflation, to start another rethink at the ECB. In this regard, wage developments will be key. However, similar to the Federal Reserve’s approach, we expect the ECB to tolerate at least one bout of second-round effects on wages, labelling them as welcome compensation for the 2020 drop in real disposable incomes.

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As long as the ECB sees higher inflation as being transitory, there won't be any drastic change in monetary policy. Indeed, there is very little the ECB can actively do to stop the current inflation surge. No one can seriously believe that ECB action will move containers faster from Asia to Europe or increase global oil and microchip production. To some extent, an inflationary supply shock is actually deflationary. However, the current economic backdrop of a still improving economy and too high actual inflation, increasingly argues in favour of withdrawing some monetary policy stimulus.

The ECB's previous assessment that the costs of being behind the curve are smaller than the costs of premature tightening, might need a rethink. The ECB does not really want to end up in a situation in which it has to admit that it was wrong on inflation being transitory and then having to react swiftly and with full force, potentially causing a recession. Consequently, we expect the ECB to make a clear distinction between reducing and stopping the current emergency measures on the one hand, and actively hiking interest rates on the other. It will be like taking the foot off the accelerator gradually but not hitting the brakes.

What we expect the ECB to decide in the coming months

In our view, the following will happen at the December meeting and in the months after:

- The Pandemic Emergency Purchase Programme will be gradually reduced starting in January 2022 and brought to an end in March;
- A new asset purchase programme (call it the Pandemic Transition Purchase Programme) will be introduced to deal with the 'cliff edge' effect and to maintain the flexibility of PEPP (mainly to continue purchasing Greek bonds). This programme will have an envelope of around €300b and will last at least until 3Q 2022. Alternatively, the ECB might decide to make the 'old' asset purchase programme (APP) more flexible and tackle the cliff edge problem only with this;
- The 'old' asset purchase programme will continue to run at €20b per month and at least until 2Q 2023;
- The favourable conditions of the Targeted Longer-Term Refinancing Operations (TLTRO) will not be extended beyond the end of this year. If TLTROs are stopped entirely, the current tiering system could become more favourable for banks;
- Against all of the above, a first rate hike will not be on the cards before the second half of 2023.

All of this means that the ECB is slowly joining the central bank bandwagon of tapering, even if it is in no rush to actually tighten monetary policy.

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