

Something for everyone from a cautious ECB

The European Central Bank seems to be having trouble deciding whether it's hawkish or doveish as it announces a cautious taper; it's bringing down net asset purchases to €20bn a month by October 2022. So, doveish actual decisions but on inflation, we see definite signs of hawkishness



ECB President, Christine Lagarde, at Thursday's news conference in Frankfurt

This is what's happening

First things first, here's what Christine Lagarde and the ECB just announced:

- The Pandemic Emergency Purchase Programme (PEPP) will be reduced in the first quarter of next year and will definitely end by March 2022.
- The reinvestments from PEPP will continue until at least the end of 2024 and PEPP could be restarted at any time if deemed necessary by the ECB
- The 'old' Asset Purchase Programme (APP) will be increased from €20bn to €40bn in Q2 2022, reduced to €30bn in Q3 2022, and brought back to the current €20bn in Q4 2022
- All policy rates remain on hold
- There was no decision on the future of TLTROs and the tiering of banks' reserves.

There is something for everyone. The short-lived boost to APP is clearly a victory for the hawks, while the open-ending to APP purchases should be regarded as a victory for the doves. Stalling the decision on TLTROs and the tiering of deposits shows that the ECB still has a lot to discuss, with it apparently having opted to 'extend and pretend'.

With today's decision, the ECB has entered into a very cautious tapering process. The details of the taper are less clear-cut than we had expected. The ECB did not announce a (third) transitional asset purchase programme. It decided instead to ensure the same level of PEPP flexibility in the asset purchases, including allowing it to purchase Greek bonds, and with the reinvestment of PEPP purchases.

ECB staff projections

The reasons why Europe's central bank didn't go any further and remained very dovish can be found in the latest round of macro projections. The ECB expects a soft patch for the eurozone due to the fourth wave of the pandemic and the effects of the Omicron variant. Still, the ECB's staff projections predict GDP growth to come in at 5.1% in 2021, 4.2% in 2022, 2.9% in 2023, and 1.6% in 2024. Risks to this economic outlook are, according to the ECB, balanced.

As for inflation, the ECB once again had to revise upwards its projections and now expects inflation to come in at **2.6%** in 2021, **3.2%** in 2022, **1.8%** in 2023, and 2024 - a sharp increase across the entire forecast horizon.

At the same time, the ECB's core inflation forecasts come in at **1.4%** in 2021, **1.9%** in 2022, **1.7%** in 2023, and **1.8%** in 2024.

Interestingly, the sentence that "*if price pressures feed through into higher than anticipated wage rises or the economy returns more quickly to full capacity, inflation could turn out to be higher*" could also be read as a "*the risks to the inflation outlook are tilted to the upside*" - in former times a very hawkish statement.

Our assessment

As long as the surge in inflation is mainly driven by one-off factors, often related to the pandemic, and so long as the ECB believes in this story, there is very little it can do to immediately curb inflation. No single ECB action would bring containers from Asia to Europe any faster, speed up the production of microchips, or lower energy prices. However, even if the ECB cannot directly stop inflation, it has definitely run out of arguments for continuing with all emergency measures and ultra-loose monetary policy as if nothing had happened. Today's cautious taper is only a logical consequence.

It's very hard to tell where the ECB will be going from here

While today's decisions are in our view tilted to the side of dovishness, the sharp upward revision in the ECB's inflation projections, as well as the risk assessment, added an element of hawkishness. So it's very hard to tell where the ECB will be going from here.

Taking today's words and decisions for granted, the open-end of the APP purchases and the fact that the ECB has always said it would first stop asset purchases before starting rate hikes could be seen as a sign we won't see an interest rate rise before the summer of 2023. That assumes that the ECB would want to leave a longer time between the end of QE and the start of a rate hike. However, we would be cautious in currently extrapolating today's decisions and comments into the distant future. The sharp increase in the ECB's own inflation forecasts between the September meeting and that of today illustrates how fast things can change.

Underestimating the inflation surge

We think the ECB's own economic models have clearly underestimated the current inflation surge, both in terms of size and duration. The main reason for this poor forecasting performance is the fact that no standard economic model, based on historic experiences and relations, was able to predict supply chain frictions and the mismatch of supply and demand in and after a pandemic. Somewhat more economic intuition, however, could have helped. While sticking to the models makes sense for the ECB as it gives some kind of control, it is surprising to see that the bank seems to have no doubts at all that wage settlements and wage growth will still follow traditional patterns and could not show a post-pandemic behaviour as well.

It's obvious the ECB wants to push out any rate hike speculation for as long as possible

Against all of the above, we stick to our view that the first rate hike will come earlier rather than later and it could be as early as the first half of 2023 as inflation, after a temporary slowdown once all post-pandemic effects have petered out, will structurally be higher than the ECB currently expects.

All in all, despite all this juggling between dovishness and hawkishness, the ECB today also marked its very own tapering. As so often in Europe, it is more complicated than elsewhere in the world, but the fact is that net asset purchases will – one way or the other – be reduced from currently around €80bn per month to €20bn within less than one year. It is obvious that the ECB wants to push out any rate hike speculation for as long as possible.

However, don't forget that it was only three months ago that ECB president Christine Lagarde said that "the lady is not tapering". It is a cautious taper for now but we think that rate hike speculation will emerge much earlier than she or the wider European Central Bank might like.

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