

The ECB's roadmap to normalisation

At today's hearing at the European Parliament, European Central Bank President Christine Lagarde tried to put the hawkish genie back into the bottle after an aggressive repricing in markets following Thursday's ECB meeting. There is now a lot of speculation as to what the Bank will do and when. Here's what we think



European Central Bank building and the Frankfurt skyline

The aftershocks of Thursday's ECB meeting are still haunting financial markets. A widening of government bond yield spreads, markets aggressively pricing in two rate hikes this year and tons of articles and views on what the ECB should or could do in the coming months. Let's be clear, if the ECB had known what it wanted to do next, it would have said so last week. It's already been decided that asset purchases will not end and there will be no rate hikes; we're just waiting for this to be announced at the March meeting. Instead, last week's ECB has simply marked a turning point. A turning point, opening the door to a faster reduction of asset purchases and the door to a rate hike this year. However, don't expect the ECB to rush to the exit. Here are some options for the ECB and a more detailed take on how we expect the ECB hawkish backward roll to unfold.

Lagarde tried to put the hawkish genie back into the bottle at EP

Just to sum up the most important elements from last week's ECB meeting again: the ECB no longer sees a swift return of inflation to target; the phrase 'risks to the outlook for inflation are tilted to the upside' was officially used again for the first time in almost 10 years, and ECB President Lagarde refused to confirm her previous statement that raising interest rates in 2022 was 'very unlikely'.

At today's hearing at the European Parliament, Lagarde mainly repeated the main messages of Thursday's ECB meeting but subtly pushed back on overly aggressive rate hike expectations. She stressed that any policy adjustment "will be very gradual" and that there were no signals that "inflation will be persistently and significantly above our target over the medium term, which would require measurable tightening." Also, she said that the ECB was determined to use all tools necessary to ensure an equal transmission of its policy to all member states. While these comments leave some open questions, like how to combine the end of asset purchases with still narrow bond yield spreads, it is clear that Lagarde's mission today was to put the hawkish genie back into the bottle. Normalisation does not mean tightening.

Three stages on the ECB's road to normality

To understand what the ECB will do and when, we need to distinguish between three different stages on the road to policy normalisation: tapering, the end of negative interest rates, and finally moving towards a more neutral monetary policy stance. Each of these stages will have different discussions on inflation.

- **Tapering.** The Pandemic Emergency Purchase Programme (PEPP) will stop in March. This decision was already taken at the December meeting. Inflation forecasts had returned more or less to their pre-pandemic levels, fulfilling the goal of PEPP. The higher the ECB's inflation forecasts are for 2022 and 2023, the lower the support to continue with the Asset Purchase Programme (APP). Remember that in December, the ECB announced it would use the APP to soften any market impact from the end of PEPP by increasing asset purchases under the APP to €40bn in 2Q, and then lowering them to €30bn in 3Q and €20bn in October. No end to the APP had been announced. There are several options to bring QE to a faster end: keep the APP at the current €20bn, do not allow for a temporary increase, accept a potential cliff-edge effect and stop the APP by September 2022. A smoother option could be to allow the APP to increase to €40bn in 2Q but to bring it to an end by September 2022.
- **The end of negative rates.** Once net asset purchases are brought to an end, the next crisis tool will be discussed and likely returned to the toolkit. Returning the deposit rate back to zero could bring relief to the banking sector and could be an adequate signal that the era of unconventional measures is over. Here, the same inflation considerations as in the tapering discussion will apply.
- **Hiking interest rates beyond zero.** The timing of rate hikes once the deposit rate has been brought back to zero is a completely different issue and will be highly dependent on the ECB's longer-term inflation view, in particular, its view on whether or not structural factors, such as the fight against climate change, demographic factors and deglobalisation will push up inflation. If they do, the ECB has only two options: either accept somewhat higher inflation - as rate hikes will have a limited impact on inflation driven by global drivers as rate cuts had on deflation driven by global drivers - or start a series of rate hikes at the risk of

choking off the recovery and disincentivising investment needed for the green transition.

Next to the inflation outlook discussion, the ECB is also likely to have a discussion on yield spreads. Does the ECB want to actively keep spreads narrow to allow for a smooth and homogenous transmission of its monetary policy across eurozone countries? Or will it accept wider yields and their potential implications on debt sustainability? And will reinvesting maturing bonds be sufficient to keep spreads at bay? To be clear, at the current levels, there is still lots of room for yields to go up before they undermine debt sustainability. Plus, governments have used the period of negative bond yields to roll over debt and to lengthen duration.

What has the ECB got to decide?

The only thing that the ECB really will have to decide at the March meeting is whether it wants to accelerate the asset purchase reductions or not. If it does, it will have to announce changes to planned APP purchases. Otherwise, APP purchases could still end immediately after October.

As long as the ECB sticks to the principle of sequencing, i.e. no rates hikes before net asset purchases have ended, a rate hike will not be on the agenda at the March meeting, nor at the June meeting.

What will the ECB decide?

In the absence of a severe economic accident in the next weeks, we expect the ECB's inflation projections to be revised upwards once again, preparing the grounds for a faster taper. We expect the ECB to stick to the initial increase of the APP to €40bn per month to smooth the end of the PEPP but to subsequently end the APP over the course of the third quarter. This opens the door to a rate hike in the fourth quarter. Remarkably, as illustrated by the Dutch central bank governor Klaas Knot's comments yesterday, even the hawks are refusing to call for an earlier rate hike. If, however, at the end of the third quarter, headline inflation starts to come down and/or rate hikes in the US turn out to be too aggressive, a rate hike could still come in 1Q 2023. Shortly thereafter, the ECB could hike the deposit rate for a second time and technically also increase the refi rate. With a deposit rate of zero and a refi rate of 0.25%, the ECB will take a wait-and-see approach for the remainder of 2023.

One often hears that the risk to such a scenario is an unwarranted widening of bond yield spreads. A European technocrat's answer would be that in such a scenario the famous Outright Monetary Transactions (OMT) programme could be triggered. Yes, the tool to make whatever-it-takes operational. However, OMT requires a eurozone country to first apply for a fiscal support programme at the European Stability Mechanism, putting the country more or less under European surveillance. Politically always delicate. We expect the ECB to try to keep spreads at bay by the reinvestment of maturing assets. Alternatively, the ECB could consider giving up the principle of sequencing, running a small asset purchase floor of around €20bn per month (the Monetary Transmission Mechanism Harmonising Asset Purchase Programme), while bringing the deposit rate back to zero. However, while this option could work for the phase of returning the deposit rate back to zero, it would be counterproductive once the ECB decides to lift the refi rate further.

All in all, expect further attempts by ECB members in the coming weeks to steer and influence the policy debate in either direction. This will come with volatility in financial markets. In any case, we think that market speculation about the ECB's tapering and rate lift-off is currently as exaggerated

as it was underappreciated just one week ago. Over the last 20 years, the ECB has hardly been in a rush to drastically change its stance.

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