

ECB: From autopilot to driving by sight

The end of net quantitative easing by year-end marks the end of the ECB's autopilot. Now the central bank is fully back to being data-dependent



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Not a surprise but still a great achievement and to some even historic. The ECB just announced, or better, confirmed the end of its net asset purchasing programme (QE). What looks like pure boredom is, in fact, the result of masterly communication, setting itself on autopilot and preparing financial markets. Some might argue that the end of net QE actually comes too late, few others currently contemplate that it might come too early. In any case, the ECB has managed to shelve the first unconventional crisis tool without distorting markets or the economy. Contradicting fears of market turbulence or surging bond yields, the ECB managed to end QE, and no one seems to care.

From net QE to forward guidance

With the most prominent crisis-fighting measure of the ECB now almost back in the toolbox, the big question is, what will be next? More action, shelving of the next crisis-fighting measure negative deposit rates or nothing at all? At least for now, the ECB will use forward guidance on rates, as well as on the reinvestment, as its main instruments to steer markets. While the forward guidance on rates with the well-known “at least through the summer of 2019” has remained unchanged,

the forward guidance on reinvestments has been slightly adjusted, with the ECB today adding that the reinvestments will continue after a first ECB rate hike. A potentially troubling point for some smaller eurozone countries was the suggestion that the reinvestments might evolve towards the new capital key.

It is clear that the ECB has purposely refrained from delivering more details on this forward guidance. This was nicely reflected in some bits and pieces during the press conference. According to ECB President Mario Draghi, the ECB did not discuss when interest rates will rise, neither did it discuss a specific timeframe for bond reinvestments nor exact options for new rounds of fresh longer-term liquidity operations for banks. Also, Draghi repeated earlier remarks that QE was now a permanent part of the ECB's toolbox.

Still rather optimistic take on eurozone economy

While many market participants have recently revised down their growth forecasts for the eurozone, the ECB remains relatively optimistic. According to the latest staff projections, GDP growth in the eurozone is expected to come in at 1.9% in 2018, 1.7% in 2019, 1.7% in 2020 and 1.5% in 2021. The downward revisions for 2018 and 2019 are only small compared with the September forecasts. Interestingly, however, the ECB Governing Council added a somewhat more cautious note to these forecasts, stating that the "balance of risks is moving to the downside". During the press conference, Draghi summarised the sense from the ECB discussion as "continuing confidence with increasing caution".

As regards inflation, the ECB's assessment was very brief. A substantial acceleration of inflation is still more wishful thinking than reality. This was also reflected in the latest staff projections, expecting headline inflation to come in at 1.8% in 2018, 1.6% in 2019, 1.7% in 2020 and 1.8% in 2021, slight downward revisions for 2019 and 2020. The core inflation forecasts, which in our view are much more important for next ECB steps, were also revised downwards for 2018, 2019 and 2020 but the expected acceleration over the forecast horizon remains intact. A clear prerequisite to keep any rate hike fantasies alive.

From autopilot back to driving by sight

Where to go from here? Despite the moderately upbeat take on the economy, it is clear that the ECB wants to remain extremely cautious. The autopilot set in place in June has now been replaced by the previous data-dependent monetary policy by sight. And at least until Spring next year, the ECB's current forward guidance should be more than sufficient and will only require changes in case of a protracted slowdown in the economy. In case of a major economic accident, the ECB's first line of defence would probably be to extend forward guidance on rates. Judging from today, everything is possible and based on the ECB's macro assessments and projections, some rate action towards the end of 2019, as well as new longer-term liquidity operations, look plausible.

All in all, the ECB has stopped the auto pilot and has returned to monetary policy by sight. For now, the ECB is keepings as many cards to its chest as possible to keep a maximum degree of

flexibility.

One issue will be whether the ECB dares to normalise the negative deposit rate with a technical increase of the refi rate in a bid to shelve the second unconventional measure, or whether this would risk market speculation about a series of rate hikes. Another issue will be how to provide transitional liquidity without affecting forward guidance on rates. Given how complicated it is to actually check the lending benchmarks, a shorter, e.g. 18-month – liquidity operation with flexible interest rate next year looks more likely than another TLTRO. If the ECB base case scenario turns out to be wrong, there will be a completely different discussion, involving postponement of rate hikes and revamping QE.

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