The ECB has finally woken up to inflation reality

ECB president Christine Lagarde just said it: the ECB discussed only three things today: inflation, inflation and inflation. The ECB still sees the period of higher inflation as transitory but has become much more balanced with its inflation analysis, paving the way for further asset purchase reductions in December

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

It took a while, but the European Central Bank has finally shifted its official communication on inflation from the broad denial of the summer months towards a much more balanced assessment. The official communication after today's ECB meeting, in the introductory statement and the Q&A session, underlined this more balanced assessment, explicitly presenting a good analysis of the (mainly temporary) 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 only become a bit longer. However, in our view, the ECB is clearly crawling back from its fully convinced view of inflation being transitory. This was among other things reflected in the finer details, for example, the scrapping of a sentence such as *"Measures of longer-term inflation expectations have continued to increase, but these remain some distance from our two per cent target"* but also in the assessment that wages will rise.

Lagarde (accidentally?) announces end of PEPP next year

Looking ahead, there is still, in our view, very little the ECB can actively do to stop the current inflation surge. No one can seriously believe that any ECB action would move containers faster from Asia to Europe or would 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.

> *There is still very little the ECB can actively do to stop the current inflation surge*

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. 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 a car driver on the left lane taking the foot gradually off the accelerator but not hitting the brakes.

ECB president Lagarde preempted parts of the ECB's December debate by announcing that she expected the Pandemic Emergency Purchase Programme (PEPP) to end as planned in March next year. Whether this was an intended or rather an accidental comment is unclear. However, taking Lagarde's announcement for granted, the ECB will face several key questions at the December meeting, backed by an update of its inflation projections: how to deal with any cliff-edge effect from the end of PEPP, how to deal with other emergency measures, how much asset purchases does the eurozone economy need to bring inflation sustainably back to target and is it the monthly net purchases or rather the total size of the ECB's balance sheet which matters most for inflation.

Here is what we expect the ECB to announce in the coming months

- The PEPP will be gradually reduced starting January 2022 and brought to an end in March;
- A new asset 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 300bn euro, not monthly purchases and will last at least until Q3 2022. Alternatively, the ECB might decide to make the 'old' asset purchase programme (APP) more flexible and tackle the cliff edge problem only with the APP;
- The 'old' asset purchase programme (APP) will continue to run at 20bn euro per month and at least until Q2 2023;

- The favourable conditions of the TLTROs will not be extended beyond the end of this year. 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.

The gradual shift towards tapering

All of this means the ECB is in no rush to tighten monetary policy as it still sticks to the view that the current episode of too high inflation is only temporary. However, the view that the costs of being behind the curve are much lower than the costs of the premature normalisation of monetary policy seems to stand on less solid feet than a few months ago. If today's ECB meeting was characterised by three words, 'inflation, inflation, inflation', then the December meeting could in our view be characterised by three other words: 'tapering, tapering and tapering'.

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