ECB: More bang and the return of the compass

The ECB has increased its PEPP programme by 600bn euro but the weak inflation outlook leaves the door open for additional stimulus in the future

The European central bank just added to the Eurozone policy fireworks of recent days, increasing the size of its pandemic emergency purchase programme (PEPP) by 600bn euros to a total of 1350bn euro.

The purchases will last at least until the end of June 2021, and in any case, until the Governing Council judges that the corona crisis is over.

Also, the ECB will reinvest the proceeds from the PEPP purchases until at least 2022. The APP purchases and reinvestments, as well as low-interest rates and forward guidance, remain unchanged.

Macro-economic assessment: The ECB doesn't have a crystal ball

The macro-economic assessment illustrates that the ECB is in no better position than all other forecasters trying to get a grip on the depth of the economic crisis and the pace of the recovery. In its base-case scenario, the ECB sees a bottoming out of the downswing in the month of May, followed by rebound leading into the second half of the year.

We fully agree.

In its base-case scenario, the ECB staff projections predict the eurozone economy to contract by 8.7% this year and then to rebound by 5.2% in 2021 and 3.3% in 2022.

Needless to say that this is a significant downward revision for 2020 compared with the March projections. The world looked very different back then. Interestingly, the ECB added the typical risk assessment to the growth outlook, which had disappeared in the April communication. The balance of risk is tilted to the downside. In two alternative scenarios, the economy would contract by 5.9% or 12.6% this year.

With regards to inflation, the ECB staff projections predict headline inflation to come in at 0.3% in 2020, 0.8% in 2021 and 1.3% in 2022. This muted inflation forecast was the main driver behind today's decision to increase the size of PEPP. Remember that not too long ago, Executive Board member Isabel Schnabel called the inflation outlook the single most important factor. Call this the return of the one-needle compass.

The German Court and the return of the compass

Before today's meeting, there was speculation about how the ECB would react to the German Constitutional Court's ruling on QE. During the press conference, Christine Lagarde more or less showed the Court the ECB's cold shoulder, emphasizing that the ECB falls under the jurisdiction of the European Court of Justice, which had judged that QE has been in line with the ECB's policy mandate. In her view, the German Court's ruling was directed at the German government and German parliament. She hoped that a good solution was found, which would not compromise the ECB or the primacy of European law.

> *Today's decision should dent any future speculation about whether or not the ECB is willing to play its role of lender of last resort for the Eurozone*

For the time being, the ECB today has added to the recent tailwinds for the eurozone economy. After the announcement of the European Recovery Plan and last night's powerful German fiscal stimulus package, today's decision should dent any future speculation about whether or not the ECB is willing to play its role of lender of last resort for the Eurozone.

Despite this cold shoulder, it was remarkable that Lagarde referred to the ECB's single mandate, inflation projections and bringing back inflation more often than during previous press conferences. A safe way to avoid any future legal challenges. Even though asked by a journalist that inflation was not mentioned at the start of PEPP Lagarde answered that PEPP was also aimed at easing financing conditions in the whole eurozone, ensuring a smooth transmission of monetary policy.

In our view the emphasis on inflation means that the good old one-needled compass from Jean-Claude Trichet is back. In turn, this also means that with inflation forecast clearly below 2% in 2022, more monetary stimulus further down the road should not be excluded.

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