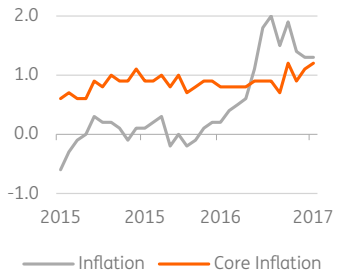
ECONOMICS | Eurozone

25 August 2017

Taper tiptoeing

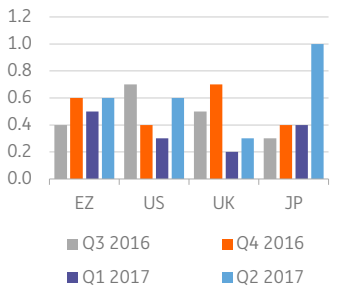
The ECB after Jackson Hole

Inflation remains below target...



Source: Eurostat

...but economic growth is strong



Source: Eurostat, Macrobond

After all the excitement about possible Draghi fireworks in Jackson Hole, the just delivered speech was an anti-climax, a non-starter. With no hints at tapering or the current stance of monetary policy, markets will now look out for the 7 September meeting. The demand for an ECB game plan on tapering will only get stronger and Draghi will have to address it. The cautious taper tiptoeing will continue.

When the ECB currently looks at the Eurozone, it sees a modest party with people enjoying themselves. The party is far from over but it could probably do with fewer QE drinks served by one of the hosts: Mario Draghi. In fact, serving less would come in handy as the drinks in Mario's fridge are running low. But how to tell the party guests? And how to do it without getting called out as a party pooper?

In more economic terms, Mario Draghi's latest speeches have illustrated that the ECB is paving the road towards the beginning of the QE exit but it still does not know how and when to put it into practice. Tonight's Jackson Hole speech only confirmed that even if the ECB had a plan, they are not willing to share it (yet). Draghi came to Jackson Hole to deliver a non-monetary-policy speech and that is what he just did. Don't take this as a dovish signal. Only as a signal that 7 September will be the big day.

Still, the ECB will have to prepare and present a game plan for tapering. This is why we think that in the run-up to the next ECB meeting on 7 September, when the ECB is likely to task the committees to look into tapering, the members of the Governing Council will have two important home assignments to solve before meeting in Frankfurt: besides the scarcity of assets, what are the economic arguments behind tapering and how should it be implemented?

In our view, the main arguments in favour of tapering are the successful defeat of the deflation risk, the strong economic recovery and bond scarcity. Tapering should be a cautious and very gradual withdrawal of some monetary stimulus, preferably without causing any tightening of financial conditions. The best option to do this could be a tapering announcement to reduce the monthly purchases from €60bn currently to €30bn starting January 2018 for at least six months combined with an extension of the list of eligible assets for QE purchases. This could exactly be what the minutes of the last ECB meeting described as "the Governing Council needed to gain more policy space and flexibility to adjust policy and the degree of monetary policy accommodation, if and when needed, in either direction".

We expect the ECB to at least present a game plan at the September meeting, probably enriched by a clear message that the relevant committees have been tasked to investigate options for tapering. A dovish tapering which avoids the so-called unwarranted tightening of financial conditions is what the ECB is aiming at. Taper tiptoeing will continue

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The Eurozone economy has recovered markedly since 2015...

The Eurozone economy has strengthened substantially since the start of the QE programme in early 2015. GDP growth is currently 2.2% YoY, which is above trend and the recovery is broad-based as all Eurozone countries are recording YoY GDP growth. Not only is the recovery broad-based by country, it is also carried by stronger domestic demand and net exports. The outlook for the months ahead remains positive, although growth could slow down somewhat. Forecasts have been raised for 2017 and we expect GDP growth to come in at 2% for the year.

...but inflation is unlikely to reach the ECB target anytime soon

While the economy is in a stronger phase at the moment, inflation has failed to pick up. To paraphrase Robert Solow: we see the recovery everywhere but in the inflation statistics. Headline inflation is currently stagnant at 1.3% and is not expected to move back above 1.5% for the rest of the year. While core inflation has picked up somewhat over the past months, it is also unlikely to recover significantly in the months ahead. Wage growth, an important driver of domestic price growth and Mario Draghi's proclaimed lynchpin under self-sustained inflation improvements, has even decreased further in 1Q and is expected to increase just modestly as the labour market is still experiencing significant slack.

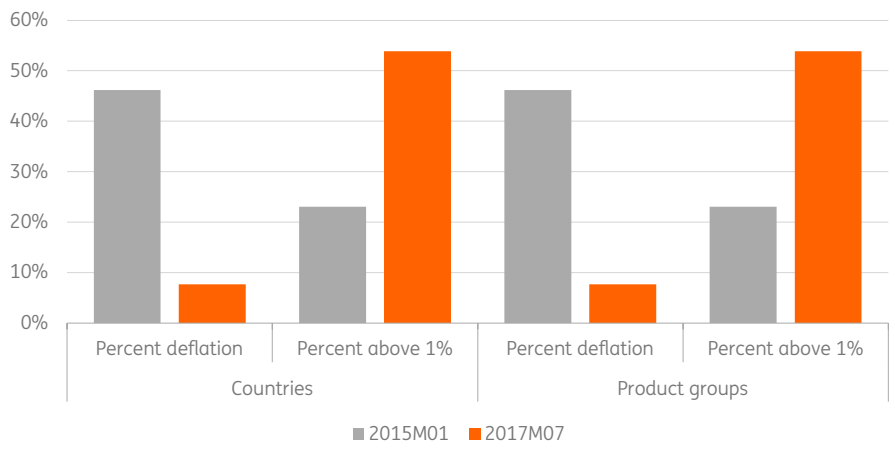
Some might call it goldilocks, others might call it *inflationless* growth but for the ECB – as well as for many other central banks – the new conundrum of strong growth without inflation poses a clear challenge.

Tapering despite lack of inflation?

Although inflation is weak, there are reasons to taper...

With headline inflation below the 2%-mark and, even more important and the ECB's inflation projections for the next two years also far off, one might ask the question why tapering should be an issue at all. A well performing economy with fewer transmission mechanisms that fail to work, subsided deflation risks and the technical issue of running out of eligible bonds to buy seem to be the key arguments for ending the asset purchase programme.

Fig 1 Deflation risks have substantially decreased since early 2015



Source: Eurostat, ING Economics Department

...as the deflation risk has subsided...

The number one reason to start tapering is that deflation has been defeated. Back in 2015, the ECB started QE to fend off deflation risks and it is safe to say that those have largely disappeared. The negative inflation was mainly caused by lower oil prices and although the impact was widespread among countries, negative inflation did not spread much beyond energy prices. The much feared negative price-wage spiral has also not materialised.

...and the recovery has surprised many positively (though not the ECB)

The ECB's flirt with tapering is also driven by other factors beside the disappeared threat of deflation. The recovery is one of them. Growth has surprised on the upside for several quarters in a row. However, the ECB should not have been surprised. Back in 2015, the ECB expected Eurozone GDP growth to come in at 1.9% in 2016 and 2.1% in 2017. In June this year, the ECB staff projections had 1.7% and 1.9% for 2016 and 2017 respectively. Still, the Governing Council has been much less optimistic than its staff forecasts for a long while.

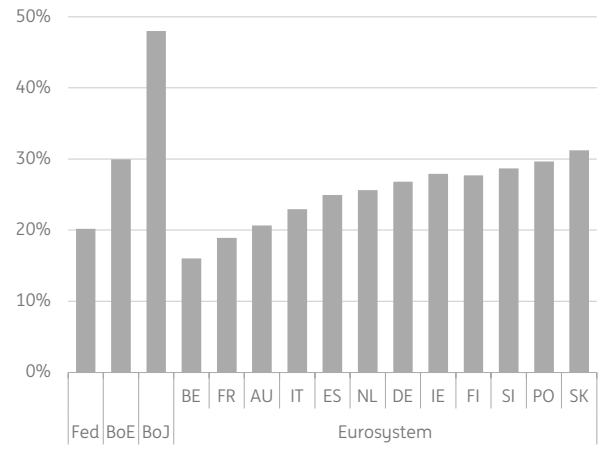
This leads the ECB to consider adjusting its policy...

Now that the ECB can finally bank on the Eurozone recovery and wishful thinking has become reality, somewhat less monetary stimulus could easily be justified. In this context, Mario Draghi's comments at the Sintra speech were remarkable, namely *"as the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged"*.

...even if it's only to keep the current stance unchanged

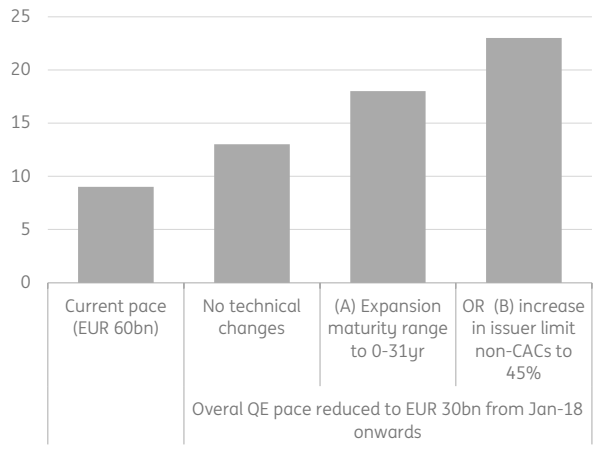
While this can mostly be seen in the context of managing expectations regarding the future monetary stance, it does make theoretical sense. Improved growth will increase money demand, which increases the equilibrium interest rate. By keeping interest rates low, that results in a more accommodative stance than before. To give a simplified illustration of this, the Taylor rule suggests that the current environment warrants a change in the policy stance as inflation comes closer to target and the output gap decreases.

Fig 2 Sovereign debt holdings (% of targeted market) are getting close to the 33% limit



Source: ECB, NCBs, estimates ING Rates Strategy

Fig 3 Number of months before German issuer limit is hit differs significantly depending on different changes to programme



Source: ECB, NCBs, estimates ING Rates Strategy

Scarcity of bonds is also an important reason to taper

The final argument in favour of tapering despite low inflation is a technical one: scarcity. The amount of assets that are eligible for the ECB to purchase under current guidelines are running out. The ECB has to purchase bonds from the different Eurozone economies according to size of the economy (capital key) and can only hold up to 33% of each bond issue (issuer limit). Those limits are close to being hit at the moment, as Figure 6 shows. For Slovenia, Portugal and Slovakia, the total amount of bonds held by the ECB is closing in on 33%. As the ECB has indicated that the capital key will be interpreted with some flexibility, it is most important to focus on the larger economies and here Germany shows to be most problematic with about 27% of sovereign bonds held by the ECB. The scarcity of German bonds will therefore to a large degree dictate the amount of purchases that the ECB can still do, unless it changes the rules under which it operates.

With a reduction to €30bn a month the ECB would be able to buy German bonds until August 2018. This would mean that an extension at half the current pace for half a year is possible, but does not leave much leeway for further extension in case this would be necessary. When extending the eligible maturities further or increasing the issuer limit, the ECB would be able to continue at half the pace until January or June 2019, respectively.

The communication challenge

Uncertainty about the path ahead has increased recently

Financial market reactions since the Sintra speech in June suggest that Mario Draghi and the ECB have lost some of their golden touch when it comes to guiding expectations. This has been partly driven by the fact that the ECB itself does not seem to be fully convinced what to do next and also by regularly changing its main messages. Just think of the continuous shift from a one-needled compass, inflation expectations, wages as the lynchpin and the new speed limit measure. The lack of a clear game plan has in our view led to returning uncertainty and a lack of clarity.

Looking ahead, the above means that the ECB will try to come up with a somewhat clearer game plan for tapering, addressing the why, when and how. Tonight's speech in Jackson Hole did not present any reference to such a game plan.

With three meetings left, a communication shift is likely

The ECB has only three official meetings left to communicate and moderate the beginning of the end (of QE). In our view, the ECB will continue shifting the communication away from a pure inflation focus towards the defeated risk of deflation and stronger growth. At the same time, the ECB will have a close eye on the reaction of financial reactions as it will try whatever it can to avoid an unwarranted tightening of financial conditions in the wake of tapering.

We expect the ECB to prepare for the exit in September

In our view, the two speeches confirm that the ECB is cautiously preparing the exit from QE. The next communication steps should follow at the September meeting. Over the last three years, the ECB has had basically two major ways in preparing markets for upcoming policy changes: 'task the relevant committees' and 'review and re-examine the current monetary policy stance'. The first one was applied at the start of QE and at the end of last year when the key phrase the "Governing Council has tasked ECB staff and the relevant Eurosystem committees" to do something indicated upcoming action. This action never came in the subsequent meeting, but rather three months later. The phrase that the Governing Council would "review and re-examine the current monetary policy stance at the next meeting" was used in late 2015 and early 2016 when the ECB beefed up QE twice. This option was always followed by immediate action at the subsequent meeting.

Which means that Jackson Hole was not key for Draghi

All of this means that the Draghi didn't need to use the Jackson Hole platform [UPDATE ON FRIDAY] to pre-announce any upcoming policy changes. He can either opt for the well-known "committees" option at the September meeting to prepare for a December tapering or try to limit further euro appreciation by keeping his cards to his chest in September, and also prepare for the "re-examine" option in October. While the latter could be the more dovish option, we think that Draghi and the ECB will want to go down the well-known road at the September meeting, announcing that the Governing Council has tasked the relevant committees to investigate options for a reduction of QE in 2018.

Any change of mind possible?

It is even possible that nothing will happen at all...

Which would mean that eligible assets would increase

Playing the devil's advocate, is there any scenario possible in which the ECB forgets about tapering? There is. Think of a further strengthening of the euro exchange rate in the next months, to for example 1.25 EUR/USD. Also, an unexpected slowing of the Eurozone economy, probably driven by international events and disappointing wage negotiations in Germany in the autumn could motivate the ECB to postpone any tapering decision. Also, the 2018 Italian elections could easily give the ECB a headache. Any gains by Eurosceptic parties in the run-up to the elections, combined with less ECB QE could cause a re-evaluation of Italian bonds.

In this regard, the phrase in the last ECB minutes calling for more flexibility in both directions was noteworthy. It could have been a hint that increasing the list of possibly eligible assets for QE would be the price that the ECB hawks will have to pay for tapering.

What could tapering look like?

A gradual reduction or lowering to a constant level seem likely

There are quite a few variables that the ECB can tweak at the upcoming meetings, which make for several possible outcomes ranging from very dovish to very hawkish. Two commonly named routes are either a gradual reduction of the programme or an adjustment to a constant lower level of purchases.

The gradual reduction would mimic the Fed's tapering

A gradual reduction would follow the Fed's unwinding of QE. After the initial announcement of tapering in December 2013, the Fed reduced its programme of US$85bn per month by US$10bn every month until the programme stopped in October 2014. This gradual reduction tends to give a smaller shock to financial markets than a one-off reduction, but would not give the ECB much room for manoeuvering in case it needed to increase stimulus again.

But the one-off would grant more flexibility each way

A one-off constant reduction would give a larger shock in the monthly purchases at the start, but has the advantage that it would look more open-ended and would give markets the impression that the ECB is still, partly, flirting with the idea of a further extension or even stepping QE up again. This option would definitely be in line with Draghi's earlier comments that QE would not end abruptly as it would make a second taper more likely. To offset any potential hawkish shock, the ECB could keep 'lower for longer' somewhat more open-ended by extending QE until 'at least June 2018 and in any case until the ECB sees a sustainable adjustment of inflation'. A fully open-ended QE has become much more difficult with the recent verdict of the German Constitutional Court. Tweaking the QE modalities, eg, by increasing issuer limits or extending maturities, could add credibility to this dovish tapering.

The ECB could also start tapering later than January

Finally, the ECB could still be flexible in the start date of reductions to QE. It could for example continue until March at the current pace before it starts tapering to set a dovish tone. This would mean that it has less flexibility in reduction adjustment given the scarcity issues, but with limits stretched, this could be an option.

But a one-off reduction to €30bn seems most likely to us

In our view, it seems most likely that the ECB would reduce the monthly purchases to €30bn in January, with an open end to the programme but at least until June 2018 and probably increasing the issuer limit and broadening maturities to grant itself maximum flexibility to scale back up once conditions warrant such a move. In the eyes of the ECB, the latter could avoid an unwarranted tightening of financial conditions in the wake of tapering.

Fig 4 A range of options are available to the ECB as it tiptoes towards the exit

	Monthly purchases	Open-ended or fixed steps	Start of reduction	Change in guidelines\
Very dovish	60 billion	Fully open-ended	NA	Issuer limit to 45%
Dovish	50 billion	10 billion reduction per month	March	Issuer limit to 45%
ING base case	30 billion	Until June or beyond	January	Issuer limit to 45%
Hawkish	40 billion	20 billion reduction every 2 months	January	None

Source: ING Economics Department

Conclusion

With summer ending, a policy change is imminent for the ECB

Mario Draghi has extended the summer lull a little further as his Jackson Hole speech brought anything but fireworks. The fall (or autumn for European English-speakers), for which Draghi has promised a decision on the next steps for QE, is about to start and he is running out of possibilities to announce the future path for his asset purchasing programme. A significant change to the programme is to be expected, but the ECB will be very cautious not to tighten financial conditions any further.

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