

September 9, 2021 03:19 PM GMT

ECB Reaction | Europe

Decisions in December

Today, in a mildly hawkish decision, the ECB revised up its projections, and agreed to run PEPP purchases at a "moderately lower pace". The key decision on QE after PEPP is now set for December, where we expect agreement on a more flexible APP to allow a smooth handover as PEPP ends.

Projections | Upward revisions: As expected, the ECB upgraded its growth and inflation projections, in the light of the improved outlook since the last projection meeting in June. In particular, the ECB hiked 2021 growth from 4.6% to 5%, while keeping future years broadly unchanged, and upgraded its unemployment forecast to 7.9% this year from 8.2% in June. The ECB also hiked its inflation projections, but still had 2022-23 inflation below target, with 2023 inflation only raised 10 bps to 1.5%, and so still well below the new 2% target, which would warrant ongoing accommodation.

PEPP purchases – a moderately lower pace but perhaps just as favourable? On its joint assessment of financing conditions and the inflation outlook, the ECB decided to moderately lower the PEPP purchase pace. We see this decision as potentially awkward. The ECB has just agreed in the strategy review both a higher inflation target and that more forceful action is appropriate when rates are close to the lower bound. Yet, its first action after the review is to tighten policy, even while it continues to forecast that it will undershoot its inflation target. But we see two mitigating factors: first, the reduction in pace sounds modest, perhaps from EUR 80 bn to EUR 70 bn per month, and second, 4Q issuance will be weaker, due to seasonality and the drawdown in cash reserves accumulated during the pandemic, so if stimulus is measured relative to issuance, there may be no policy tightening in fact. Still, this does look like a victory for the hawks, in the sense that it now looks unlikely that PEPP will be used in full, which would require purchases to average EUR 70 bn per month to end-March.

December decision: a more flexible APP, we think: However, the key debate – a bigger fish than the PEPP purchase pace to December – is the decision on QE after PEPP's likely expiry in March 2022, which President Lagarde clearly indicated today would be resolved at the December meeting. Our view is that the weak medium-term inflation outlook implies that monetary policy should continue to be accommodative, which points to further QE, and we expect a smooth handover to an expanded APP. Moreover, in order to provide the headroom for further QE, if required, we [expect](#) the ECB to raise the 33% issuer limit and abolish or raise the 10% limit on supra holdings. However, we also see the outcome as uncertain and data-dependent, given a divided Council, and expect an active debate through the autumn.

MORGAN STANLEY & CO. INTERNATIONAL PLC

Jacob Nell

ECONOMIST

Jacob.Nell@morganstanley.com

+44 20 7425-8724

Mario Pietrunti

ECONOMIST

Mario.Pietrunti@morganstanley.com

+44 20 7677-2823

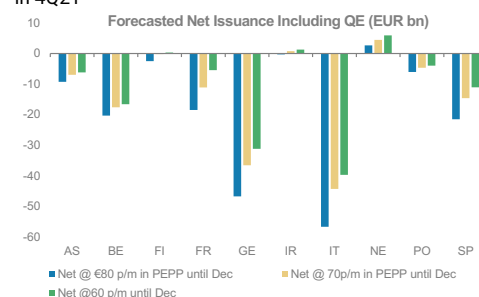
Markus Guetschow

ECONOMIST

Markus.Guetschow@morganstanley.com

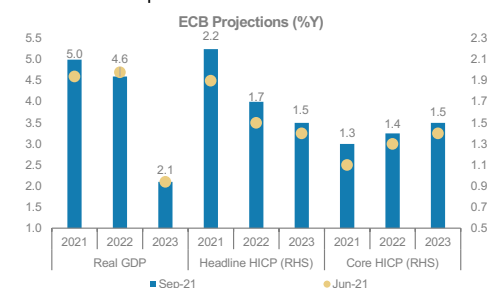
+44 20 7677-8468

Exhibit 1: Maintaining favourable financing conditions at a moderately lower pace: even at a PEPP pace of EUR 70 or 60 bn per month, negative net issuance set to continue in 4Q21



Source: Morgan Stanley Research estimates

Exhibit 2: An upward revision across the board



Source: ECB, Morgan Stanley Research

For important disclosures, refer to the Disclosure Section, located at the end of this report.