Nordea

28 October 2021

ECB Watch: Unconvincing

Jan von Gerich

The ECB was surprisingly relaxed about the recent increase in short market rates. We continue to find rate moves from the ECB very unlikely already next year, but expect gradual moves away from exceptional monetary policy measures.

- The tone in the ECB's message was quite positive and the central bank did not make serious attempts to change the market pricing of higher short rates already next year.
- Inflation worries may be increasing also within the Governing Council, even if Lagarde maintained that inflation will be below the target in the medium term.
- We find rate hikes next year very unlikely, but given the ECB's vague signals regarding market pricing, such pricing may yet escalate in the short term.
- Big decisions will be ahead in December, and we see an end to the PEPP and a fixed envelope of purchases for the APP.

The ECB did not make changes to its monetary policy setup at the October meeting, while Lagarde supported expectations that the Pandemic Emergency Purchase Programme (PEPP) will be concluded by March 2022, in terms of net purchases, and the decision will be taken in December. The ECB continues *to judge that favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme than in the second and third quarters of this year.*

That neither the press release of the monetary policy statement addressed the current market pricing was not a huge surprise, **but the vagueness of Lagarde in trying to moderate the market pricing in the short end of the curve was somewhat surprising.**

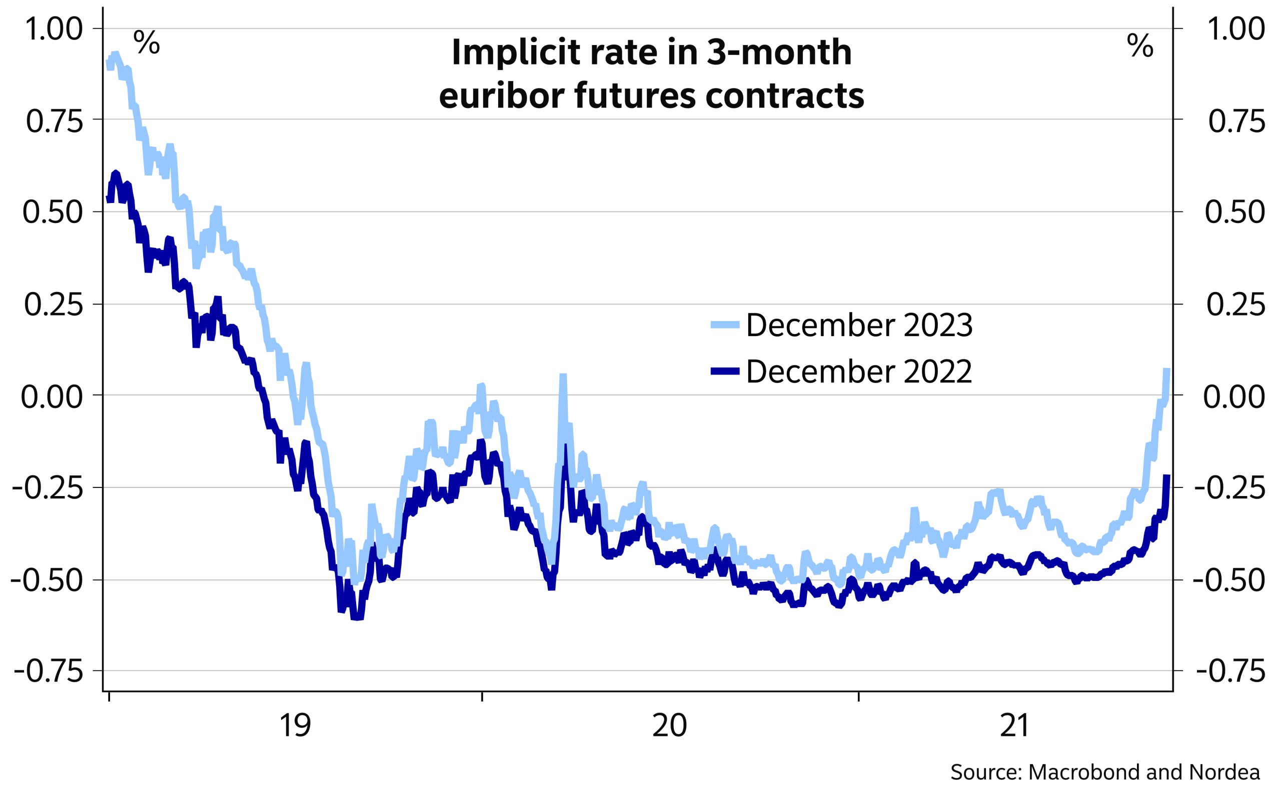
Lagarde clumsily read from paper that market bets on interest rates were not in line with the ECB's guidance. She later said that it was ***not for me to say*** **if markets are ahead of themselves in pricing rate moves already for 2022**. If her intention was to bring market pricing more in line with the ECB's guidance, she failed miserably.

Another possibility is that **the Governing Council is itself becoming more concerned about the inflation outlook**, and thus has no bigger problems with the current market pricing, even if Lagarde confirmed that the ECB still thinks that inflation will fall back next year and undershoot the 2% target in the medium term. After all, **the general tone of the press conference was rather positive**, Lagarde confirmed that the main topic of the meeting had been inflation and while market rates had increased, **overall financing conditions**

remained favourable. Further, the recent rapid increase in market-implied inflation expectations is likely already adding to the concerns of the more hawkish Governing Council members.

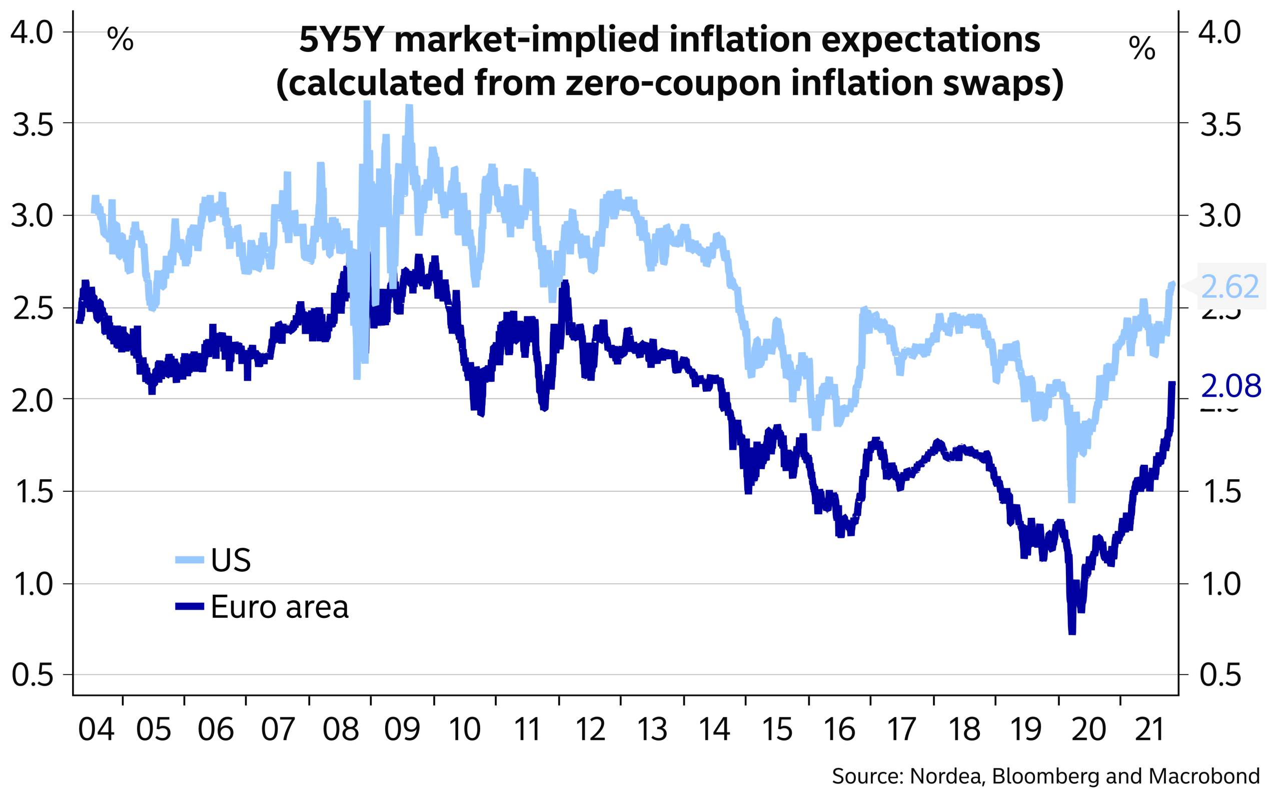
While we expect the ECB to gradually move away from its exceptionally easy monetary policy measures, **we continue find it unlikely that the ECB would move their benchmark rates already next year**, as underlying inflation pressures remain muted. We thus see the pricing in the short end of the curve overdone. Currently, the short end of the EUR curve is pricing in around 15bp higher overnight rates on a 1-year horizon. However, given the weakness of the ECB to go against such pricing, **the pricing of hikes could still increase in the short term. We do see more upside in longer yields especially looking into next year, as the recovery proceeds, ECB's bond purchases decrease, real rates continue to look very low and US yields climb higher, and expect the curve to steepen at the same time.**

Short end pricing continuing to surge higher



Pricing

Market implied inflation expectations risen rapidly in the Euro area



Inflation

Big changes ahead in December

The December meeting will tell us much more about the ECB's intentions and increased uncertainties regarding the outlook, both in terms of the new staff forecasts, which will include forecasts for 2024 for the first time, and in terms of the actual monetary policy decisions taken.

We think that instead of bigger open-ended asset purchases, **the ECB will decide on a purchase envelope of a fixed size** to complement the current open-ended EUR 20bn monthly pace of purchases under the Asset Purchase Programme (APP). We recall that prior to the introduction of the PEPP, the ECB boosted the APP with an envelope of EUR 120bn in March 2020. This time the size of the envelope could be around EUR 200bn until the end of 2022, to be used flexibly as needed. The open-ended part of the APP could also be removed altogether in favour of a full envelope-based approach.

The envelope approach could work as a compromise between the hawks and the doves and would also be more flexible compared to a fixed flow of monthly purchases. If the ECB felt that financing conditions tightened too rapidly, it could accelerate the purchases temporarily. If instead easy financing conditions could be maintained with smaller purchases, the central bank could buy less, leading to smaller overall purchases and pleasing the more hawkish members of the Governing Council. The size of the envelope could then be reviewed and recalibrated as needed, as has been done with the PEPP, and would also allow for a shorter tapering period, if quicker changes became necessary.

New tools may be on the table as well, as there have been reports that the ECB is studying a new bond purchase programme that could complement the APP and not necessarily follow the capital key in dividing the purchases between the bonds of Euro-area countries. We would not rule out the chance of such a programme, especially if it was a backstop that would not immediately be taken into use, but would note that dividing the purchases according to the capital key has been a very important guiding principle for the ECB. Deviations from the capital key were relatively small even amidst the Covid-19 crisis, although the PEPP would have supposedly allowed for bigger deviations. As a result, **our ECB baseline does not include the introduction of such a programme.**

Ample liquidity provision will also continue in 2022, and we find it likely that another round of Targeted Longer-Term Refinancing Operations (TLTRO) will be announced, but with somewhat less generous terms compared to the current version of the TLTROs.

Jan von Gerich
Chief Analyst
jan.vongerich@nordea.com
+358 9 5300 5191