Flash

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# ECB to extend bond buying, but tapering nears

Bond purchases are an unconventional tool to fight deflation, but…

...as conditions have changed, the tool is no longer needed and

…the ECB should gradually return to its standard tools.

However, the timing to do so isn't right

Therefore we expect an extension of APP (amount of €80B) for next 3 months

Some technical parameters of the programme will be changed though.

In September, Draghi announced that the December ECB meeting would be important for the next weeks and months. The ECB tasked various committees to examine all aspects of the current unconventional policy (asset purchases), including their contribution to the ECB's inflation mandate and technical problems popped up since its start in March 2015. Mario Draghi stressed, however, that it's the general council, and not the committees, that takes decisions.

**Since September, a lot of new developments took place like the presidential victory of Donald Trump and the re-orientation towards an easier US fiscal policy, the OPEC agreement & higher oil prices and distortions in the repo-market due to the scarcity of good collateral, a side-effect of the asset purchase programme.** Lots of often contradictory ECB comments and so-called stories based on sources "with knowledge of the issues" have caused unusual uncertainty about the outcome of Thursday's ECB meeting. Early last week, Mario Draghi repeated that all options were open. **Three main issues will need to be decided**. First, **will the ECB continue its APP** (asset purchase programme) after March 2017 for a fixed period of time and will (when) it start tapering its purchases? Second, **which technical changes to the modalities of the current programmes are needed and will be taken.** Third, **how will it address the distortions in the repo-market** (scarcity good collateral), a subject we don't touch in this preview.

## Will the ECB continue its programme?

Let's first look today's context and draw on an interview Mario Draghi gave to the El Païs newspaper on November 30th. The recovery is modest, but robust. GDP has returned to its pre-crisis level and Europe has created 4 million jobs in the past four years pushing the unemployment rate from 13% to 10% (9.8% according to the most recent figures). There are still big differences between countries, but fewer than before. There were multiple political uncertainties this year like the slowdown in China, the stagnation of world trade, Brexit and the US elections. So far, their impact on the economy and markets has been more muted than people feared.

**Mario Draghi said its unconventional policy measures (negative rates and asset purchases) have been successful.** The transmission channel works again and the redenomination risk (risk of euro area collapse and birth of nation currencies) disappeared.

**Inflation, the prime objective of ECB policy, is a mixed bag.** Headline inflation has risen to 0.6% Y/Y in November from a -0.2% Y/Y low in February, largely the result from higher oil prices. This rise will continue for the next few months. ECB Weidmann suggested headline inflation could reach 1.5% Y/Y in spring, while ECB vice chair Constancio dropped 1.3% Y/Y as a possibility. Mr. Draghi suggested that the ECB objective could be reached by 2019. The ECB staff projections may show that.

**However, following the Trump election and the increase in yields, especially in the periphery, the tone changed** and Mr. Constancio said that the ECB would not be satisfied by the mere fact inflation touched its objective. It needed some sustainability. Constancio also downplayed the impact of stronger US growth on euro area growth due to uncertainties about the protectionist impact. **Core inflation stabilized at 0.8% Y/Y in past months** without signs of accelerating dynamics. Mario Draghi is concerned too: *"We do not see a consistent strengthening of underlying price dynamics. Despite the recovery in growth and employment, the persisting output gap is still keeping inflation dynamics weak".*

**Deflation fear was one of the reasons for the start of the unconventional ECB measures, but it is no longer at play, has largely gone away.** Anecdotal evidence shows that firms and consumers expect higher prices. Import price deflation eased and Chinese PPI became positive, suggesting that the deflationary impact of Chinese exports is over. More importantly, inflation expectations are on the rise, also in EMU. The euro weakened versus the dollar, but less on a trade weighted basis. The 5-yr/5-yr forward inflation expectations rose to 1.66% from a low of 1.25%. So, the ECB may b disappointed by the stability of the core inflation, but it will be happy with these more general indications that deflation is no issue anymore.

**Concluding, the general growth and inflation environment has improved substantially. Unconventional policy was implemented to face deflation risk, so the ECB should legitimately question if and for how long it will keep the unconventional policy measures in place now as deflation risk faded. Can they return to "normal" policy tools? Research showed that these measures work better in crisis situations where the policy transmission to the economy is distorted.**

We think that the timing for a gradual retrenchment from APP is not right yet. The still low headline and core inflation rates pose communication issues. The announcement of an near term end of APP may also lead to another bond sell-off and eventually a further re-widening of peripheral yield spreads, which would be risky given the recent market volatility. The Fed will raise rates next week, which might cause turmoil as it did early 2016. We can now add uncertainty after the Italian referendum. Finally, there is no hurry for the ECB as the business cycle is still in its infancy contrary to the US. **Therefore, we think that the ECB will announce an extension of the APP, but only for three months with an likely unchanged monthly amount of €80B a month.** It gives the ECB room to verify whether the economic recovery continues and whether core inflation moves up. The General Council will have new ECB staff projections in March (and June) allowing it to choose the best timing to start tapering the APP programme and turn gradually back to normal monetary policy tools. The extension by three months (at full €80B) will also prepare markets on the inevitable end of the bond buying. **We envisage that the APP will be finished by March 2018.**

In his El Pais interview, Mario Draghi hinted what could happen with the APP. *"We can deliver the appropriate stance by different combinations of instruments, for instance the amount of monthly purchases or the length of time over which they take place. I won't prejudge the debate on the various options."*

## Technical modifications to the PSPP

**Even if the ECB chooses to start tapering at some point in the "near future", it might at a certain point hit the technical boundaries of the programme.** The increase in yields in past months created some more room (especially for the core countries), pushing these hurdles further out in time. So, the ECB could even postpone a decision e.g. to March to see how the recovery and inflation evolve. There are three constraints build into the APP programme. **Sovereign Bonds are eligible if they have a maturity between 2 and 30 year and a yield above the depo-rate (-0.40%).** Of these bonds, the ECB may buy maximum 25% or 33% (in case of bonds without CAC clause) per eligible issue. On top of, it may buy maximum 33% of the issuer (eligible bonds). The third constraint is the capital key limit (% of the total ECB capital determines the amount the ECB buys every month). For Portugal, which has relatively few bonds outstanding (many loans as part of the bail out) the issuer constraint is key. For Germany it is the issue limit, as many of its bonds trade below -0.40%. For Italy and most other countries, the third constraint (capital key) is the most important binding factor.

Various decisions are possible to address the (future) scarcity problem. We think **the ECB will raise the issue limit for non-CAC bonds to 50%,** which would solve the "German problem" if rates would decline again. Changing the **capital ratio allocation** would be positive for the countries with relatively high debt levels, but it would be a bad signal as it favours the fiscal most profligate countries. Other possibilities are skipping **the depo-rate constraint, which** would also help solve the "German" problem. **However, it increases the scarcity problem in the repo-market, with German and other high-rated bonds becoming even more expensive and with more failures to deliver.** Allowing

purchasing bonds with a maturity of more than 30-years wouldn't solve the scarcity problem as the amount of such bonds is small. Some also put forward the **substitution option** in which Germany "gives" part of his (capital ratio) allocation to other countries, which allows to buy German bonds for longer. It would be Market-wise positive for peripheral (Italian) bonds at the expense of the German ones.

However, we don't think that this will occur. Some also suggest also that the ECB could buy more Italian bonds now that the referendum ended with a "No". The ECB may in a minor way temporarily buy more Italian bonds in the APP framework, but it is a monetary policy tool to fight deflation, not to help a country against a speculative attack. Italy may eventually ask for a conditional full or precautionary ESM programme which may trigger the until now unused OMT, That would allow the ECB to buy unlimited amounts of bonds of a country with a maturity up to 3 years.

**Piet Lammens, KBC Brussels**
**Mathias Van der Jeugt, KBC Brussels**

# Contacts

| Brussels Research (KBC) | | Global Sales Force | |
|---|---|---|---|
| Piet Lammens | +32 2 417 59 41 | **Brussels** | |
| Peter Wuyts | +32 2 417 32 35 | Corporate Desk | +32 2 417 45 82 |
| Mathias van der Jeugt | +32 2 417 51 94 | Institutional Desk | +32 2 417 46 25 |
| **Dublin Research** | | France | +32 2 417 32 65 |
| Austin Hughes | +353 1 664 6889 | London | +44 207 256 4848 |
| Shawn Britton | +353 1 664 6892 | Singapore | +65 533 34 10 |
| **Prague Research (CSOB)** | | | |
| Jan Cermak | +420 2 6135 3578 | **Prague** | +420 2 6135 3535 |
| Jan Bures | +420 2 6135 3574 | | |
| Petr Baca | +420 2 6135 3570 | | |
| **Bratislava Research (CSOB)** | | | |
| Marek Gabris | +421 2 5966 8809 | **Bratislava** | +421 2 5966 8820 |
| **Budapest Research** | | | |
| David Nemeth | +36 1 328 9989 | **Budapest** | +36 1 328 99 85 |

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