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Flash

Thursday, 20 October 2016

Draghi delays ECB decisions to December

No major clues from October policy meeting

December should provide some clarification, but maybe not all the answers

No major change to eco outlook, but slightly dovish tint to inflation assessment

Some subtle hints that asset purchase extension not entirely a done deal

Estimated impact of ECB QE large, emphasising importance of next policy step

Markets could become choppy if uncertainty about ECB intentions increases

ECB president, **Mario Draghi, did his very best to be very dull at the press conference** that followed today's policy meeting of the ECB governing council. In response to repeated questioning, **he said that the ECB hadn't discussed the key market-sensitive topics of whether the current Asset Purchase Programme would be extended** past its potential end date of March 2017 **or whether any potential extension would be on a reduced (or tapered) scale** from the current €80 billion monthly pace of purchase.

Countdown to Christmas begins

There was a strong hint from the ECB today that clear guidance in relation to these issues **would be provided** at the next ECB policy meeting which is scheduled for **December 8th**. The opening press statement emphasises the additional information the ECB will have at its disposal at that point in the shape of new economic projections –- that will provide a first glimpse at official thinking at the outlook for 2019—and work being prepared by various committees within the ECB on the technical functioning of the asset purchase programmes. The market view implicit in the muted response today is that Mr Draghi will again take on the role of Santa Clause in December and signal the continuation of the ECB's largesse for an extended period at that point.

Our best guess is that the ECB will provide notably greater clarity in early December but there is some risk that significant issues will remain unresolved at that point and, as was the case in September, markets could be left relying on their faith in Mr Draghi to deliver measures appropriate both to a still uneven and underwhelming Euro area recovery and to markets that have probably become overly reliant on the continuing support of the ECB.

No ECB Discussions Of Key Issues Hard To Credit

Mr Draghi repeatedly emphasised that today's ECB meeting had focussed its attention exclusively on the current economic situation and on interim reports from its various committees and had not given any consideration at all to the broader context of when and how current policy settings might be altered.

It is impossible to imagine that extensive discussions on these important and likely market-moving issues haven't taken place within the ECB. The fact that these topics have been kept off the agenda of today's formal Governing council policy meeting (thereby allowing Mr Draghi to respond as he did) likely reflects two considerations of relevance to the outlook for financial markets through the next five or six weeks.

First, **there is still considerable uncertainty about the forward momentum of activity and, particularly, inflation in the Euro area** with the result that there is an associated uncertainty about the appropriate degree of policy support that should be provided.

Second, even if there is some element of consensus in terms of a possible 'central scenario' for GDP growth and inflation, **it seems likely that different members of the governing council take notably different views in weighing the relative importance of the benefits and costs of continuing the Asset Purchase Programme** at its current pace—and, in some instances, there may be doubts as to whether action of this nature on any scale is appropriate—beyond March of next year.

With markets unsure about the current economic reality and possibly about the reaction function of the ECB, there is some risk of increased volatility and outsized market movements in the run-up to the early December policy meeting in response to either surprising economic news or any indication of the particular policy stance preferred by prominent ECB officials.

Some Subtle Changes In ECB Comments Suggest Difficulties

While Mr Draghi did his very best to say little or nothing of significance today—and largely succeeded in this task (to judge from the muted response of financial markets), there were **a number of comments that hint at the difficulties currently facing the ECB** and the dilemma it has in arriving at a coherent and consensus driven policy response.

As Mr Draghi noted the ECB's assessment of the economic outlook has changed little since its September meeting. Growth is still seen continuing at a '*moderate but steady'* pace but risks '*remain tilted to the downside'*. Similarly, in line with '*previous expectations*', '*a gradual rise in inflation'* is envisaged.

Significantly, the October press statement adds that '… *there are no signs yet of a convincing upward trend in underlying inflation*.**'** This assessment is particularly important to the ECB's policy stance given the restated commitment today ' *…that the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim*.'

It can be argued that, at the margin, this assessment of economic conditions entailing **both a continuing recognition of downside risks to activity and the new acknowledgement of a lack of upward momentum in underlying inflation is dovish in terms of ECB policy prospects but there is something of a counterweight** in the press statement in the form of a slightly changed wording in relation to policy intentions.

For some time now, the ECB has held out the possibility of further policy easing by indicating as it did in September that *'If warranted, we will act by using all the instruments available within our mandate'* . Today's press statement contains a subtle but potentially significant difference in noting that '**we will continue to act***, if warranted, by using all the instruments available within our mandate.' (Emphasis ours).*

This slight alteration could be interpreted as effectively removing any consideration of lower policy rates from the policy debate. More importantly, it appears to suggest that **any extension of the Asset Purchase Scheme should be regarded as a further policy easing.** In a similar vein, today's press statement talks about how the technical work being done by committees within the ECB will ensure '*the smooth implementation of our purchase programme until March 2017, or beyond, if necessary'*.

Markets have all but taken the extension of the scheme as a formality but this subtly changed phrasing in today's press statement hints that, within the ECB, the hurdle for such an outcome may be somewhat higher than is generally discounted.

We think that today's opening press statement was carefully crafted with a primary intention of not unsettling markets but also allowing for the introduction of some small element of two-way risk which might be suggested by the emphasis one places on either the comments in relation to activity and inflation on one hand or the automaticity of whether the ECB would continue to act on the other.

Said Mr Draghi a little more than intended?

In his replies to questions at today's press conference, **Mr Draghi also endeavoured to strike a tone that was balanced as well as guarded** but two of **his responses hint at differences of opinion** around the Governing council table as well as significant difficulties in communicating nuanced messages to nervous markets.

While emphasising that policy changes had not been discussed today, **the ECB president added that '***current monetary policy cannot stay in place forever'* **, a phrase that saw the Euro briefly rise a little over half a cent against the US dollar.** At one level, this remark can simply be seen as underlining the exceptional nature of current policy setting.

However, this comment may also speak to an element of frustration on the part of some of the more hawkish ECB officials at the extent to which Central Bank support is taken as a given—a reality highlighted by the immediate market reaction. **The absence of any follow-up comment in the same vein by Mr Draghi meant the spike in the Euro was short lived, but this little incident hints at how open to suggestion markets might be in coming weeks.**

Mr Draghi was also asked repeatedly about the possibility of tapering and eventually offered the view that an abrupt end of the asset purchase programme was unlikely. When pressed as to whether this was the consensus view within the ECB, he again emphasised the lack of discussion on this topic, but ventured that 'my perception is that a sudden stop is not in anybody's mind for many reasons'.

These remarks of Mr Draghi in relation to tapering throw up the possibility that a decision could be announced at the ECB's December policy meeting to reduce the scale of monthly asset purchases from end-March but, in light of the ambiguities across many of today's comments, it should be emphasised that a range of other interpretations is also possible.

Large estimated eco impact of APP emphasises the ECB's dilemma

Some further indications as to why **the question of whether or when to taper or end the current Asset Purchase Programme matters so much** were provided by Mr Draghi when he elaborated on the estimated impact of the unconventional measures adopted by the ECB since 2014. He indicated that the cumulative impact of these easing measures over the period between 2016 and 2018 had been to raise Euro area GDP by 1.3% and inflation by 1.4%. These estimates are somewhat higher than had been suggested by a number of other studies.

As the most recent ECB projections envisage a cumulative increase in GDP of 5% and cumulative inflation of 3% over this period**, it would seem that forward momentum in the Euro area and,** even more so, **in inflation, is heavily dependent on the contribution of ECB policymaking. This highlights the critical importance of calibrating the next policy move very carefully.**

At one level, the conventional wisdom that the stock rather than the flow of Asset purchases is more important to the impact of such programmes might suggest that a recovering Euro area economy needs to be weaned off the dependence on such policies as soon as possible. A counter argument would emphasise the risks of a relapse into recessionary tendencies and further disinflation if they are stopped or reduced too quickly.

Yet **another important dimension is the impact on financial stability of any marked or unexpected policy shift**. Mr Draghi spoke positively today of the ending of fragmentation and the elimination of spreads related to redenomination risk within the Euro area. However, if the run-down of the asset purchase scheme were to effectively remove the current buyer of last (first?) resort, **some market segments, even some Sovereigns, might face a return of such difficulties**.

Similar risks are hinted at in a recent ECB research paper (The response of asset prices to monetary policy shocks: stronger than thought, No. 1967, 30 Sep 2016,Lucia Alessi, Mark Kerssenfische) which notes; *Our results imply stronger financial stability consequences of monetary policy decisions compared to the literature. Overall, our findings call for increased vigilance on the repercussions that a monetary policy tightening in whichever form - including a quicker than expected unwinding of unconventional measures—could have on financial markets.*

Choppy countdown to Christmas?

These varied and sometimes contradictory element s of today's ECB press conference and related ECB commentary underscore the importance of the decisions now facing the ECB. Equally, we feel they point towards **an array of considerations that make the outcome of the ECB's deliberations less of a foregone conclusion that many in the markets now envisage.**

In the run-up to the December meeting, markets could become more volatile as they reflect on the non-negligible prospect that the ECB may begin to gradually scale back its support to markets by tapering the Asset Purchase Programme at some point during 2017. If investors also begin to debate the risks around such a course of action, **some replay of the 'taper tantrum'** seen during 2013 when the Federal Reserve first mooted scaling back its asset purchases **cannot be ruled out.**

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