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ECB does as little as possible but sets up December as key policy meeting

Pace of bond-buying reduced slightly but Lagarde emphasises it's not a policy change

Many reasons to postpone policy decisions that will be pressing in December

Limited changes also an indication of increasing differences of opinion on ECB governing council

New ECB projections suggest spurt in growth and inflation to be short-lived…

So, ECB remains far from point where start to normalising policy might be contemplated…

…but could higher inflation and ECB hawks make markets more nervous?

Although the European Central Bank (ECB) yesterday announced a small and widely expected reduction in the pace of its bond-buying for the final quarter of this year, **there were no major changes or pointers towards future changes in the ECB's policy stance** following its Governing council meeting. The subsequent press conference gave a strong sense that the ECB wants to avoid any talk or action that might materially alter current market expectations or affect market stability. **However, there are a number of small hints at more difficult decisions and potentially volatile market conditions to come.**

Lots of reasons to do very little

The fact that a knee-jerk reaction saw the Euro slip on currency markets and Euro area bond yields eased somewhat in the immediate aftermath of ECB president Christine Lagarde's press conference suggests that some in the market anticipated a more 'hawkish' outcome to the ECB's policy deliberations.

We think that the substance of **yesterday's press conference continues to point towards an uneasy compromise between notably differing opinions on the Governing** council that made it extremely difficult and probably dangerous to have moved any further than the ECB has.

Arguably, the most important aspect of the outcome of today's ECB meeting was that the decision '*…that favourable financing conditions can be maintained with a moderately lower pace of net asset purchases under the pandemic emergency purchase programme (PEPP) than in the previous two quarters*.' **was unanimous.** In view of the substantive divisions that emerged from the July policy meeting, the ECB badly needed to put forward a picture of at least temporary unity.

Arguing in the same direction is the fact that **anything other than the marginal 'recalibration' of the ECB'S bond buying announced would have seemed premature if not entirely unwarranted because of the range of uncertainties that cloud the prospects for the Euro area economy** and, hence, the policy outlook at present.

Opinions vary widely as to the likelihood that current inflation pressures will prove persistent and are similarly divided as to the degree of dislocation now threatened by the Delta variant of the pandemic. So, there were strong practical arguments for saying and doing as little as possible.

However, difficult decisions can't be postponed indefinitely. As ECB chief economist, Philip Lane previously hinted, yesterday's meeting only buys a little time. **Mme Lagarde indicated that altogether more challenging policy decisions lie ahead, noting** that '*We have not discussed what comes next and that is something for which we will prepare in the months to come and I think that* ***there will be more interesting matters that will be debated in December***..'.

This promises some possibly testing times as the various strands of thinking within the ECB set out what are likely to be sharply contrasting views as to the future of its Asset Purchase Programmes and the less pressing outlook for Its key policy interest rates against a backdrop of continued upward pressure on Euro area inflation in coming months.

Reduction in pace of bond-buying seen as a 'recalibration' rather than any tapering

In an effort to avoid any market over-reaction, ECB president Christine Lagarde went to great pains to characterise yesterday's decision to scale back the pace of bond-buying under the PEPP programme as a *'recalibration'* rather than a tapering. Her paraphrasing of the former British Prime Minister, Margaret Thatcher by saying today that *'the Lady's not for tapering'* might seem an unfortunate choice given Mrs Thatcher' penchant for autocratic decision-making and that the 'Iron lady' first used the original phrase to reject her colleagues appeals for a more supportive policy stance in the face of very weak economic conditions.

In circumstances where **financial conditions remain broadly favourable and risks are judged to increasingly lie to the upside for inflation,** some small reduction in the pace of bond-buying might seem warranted . Moreover, mechanically, in order to accommodate the continuation of the PEPP programme to its scheduled End-March deadline, s**ome slight reduction in the pace of bond-buying** from the roughly €80bn per month current rate **was required.**

The likelihood is that this was also a limited concession to the hawks on the ECB Governing council. To the extent, that inflation risks have increased and financial conditions remained very accommodative, tweaking the pace of bond-buying also emphasises that the ECB's forward guidance is 'state-contingent' rather than absolute.

New projections remain 'dovish' and somewhat at odds with Governing council views?

To the extent there was a dovish tinge to yesterday's ECB pronouncements, it might be argued that this lies in the new ECB projections-which are the responsibility of the ECB staff rather than the governing council. Although the projection for GDP growth for 2021 was revised up to 5% from the June estimate of 4.6%, much of this reflects upward revisions to growth outcomes for the first half of the year. The GDP estimate for 2022 was revised down fractionally from 4.7% previously to 4.6% and that for 2023 left unchanged at 2.1%.

So, the improvement in activity of late is not seen building progressively in coming years in the new projections. In contrast, the tone of the Governing council statement seems much more upbeat. It speaks of the rebound in activity being *'increasingly advanced'*, '*Output expected to exceed its pre-pandemic level by the end of the year'*- somewhat earlier than previously envisaged and also notes that '*the economy has largely reopened, allowing consumers to spend more and companies to increase production'.*

The **new inflation projections also acknowledge recent elevated readings by scaling up the 2021 estimate for headline inflation** from 1.9% to 2.2% **but add progressively smaller increments to following years** with the 2022 figure moving from 1.5% to 1.7% and that for 2023 from 1.4% to 1.5%. **The alterations to core inflation are even smaller**- with 2021 moving from 1.1% to 1.3%, 2022 to 1.4% from 1.3% and 2023 from 1.4% to 1.5%.

It should be noted that the latest ECB projections assume a higher level of oil prices through the forecast period than previously, a lower Euro exchange rate and market interest rates as well as predicting a modestly lower unemployment rate in all three years of the projections than was the case in the June projections, Against this backdrop, **it might have been expected that inflation pressures would build somewhat more than the ECB now anticipates.** This might suggest that ECB staff take the view that the structural factors that have depressed Euro area inflation will significantly re-assert themselves in coming years. **Importantly,** in light of the recent ECB policy review, **the new ECB projections suggest that mechanically,** for the next few years at least, **the conditions required for the ECB to justify a start to policy normalisation will remain absent.**

Our sense is that some on the ECB governing council may take a very different view and that arguments around the likely path for inflation and the appropriate path for ECB policy will become an important issue for markets as end-year approaches

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