Flash

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ECB to play for time

No new decisions as ECB awaits December meeting to clarify future intentions

Climate is gradually shifting away from overdependence on Monetary policy towards fiscal policy

ECB Monetary policy easing may be near to an end. Will markets worry about the exit path?

The September ECB policy meeting actually turned out to be a non-event instead of a previously signalled key meeting. Admittedly, Brexit didn't cause the turmoil that everybody expected – at least yet -and financial conditions are even more favourable than before Brexit. Mr. Draghi during his September press conference was unusually guarded in relation to future ECB actions. He said there had been no discussion as to whether the ECB' asset purchase programme might be extended. He didn't give any clear hint either in which direction the technical underpinnings of the asset purchase programme would have to be changed to allow the ECB to continue its €80B per month purchases.

The ECB and Mario Draghi merely said that the relevant committees within the ECB would be tasked with evaluating options to ensure "a smooth implementation" of the asset programme. The results of these committees are awaited for the December meeting when also the new ECB staff projections will be available. Importantly, the staff projections will now also include the first ECB estimates for inflation and economic activity for the year of 2019.

While expectations are fairly low in terms of major announcements or policy adjustment s this week, we think observers could again be disappointed by the outcome of Thursday's meeting. **It is unlikely the ECB will give more details concerning the operational changes in the PSPP (asset purchase programme.) and still more unlikely that the ECB will communicate eventual changes to the amount of assets the ECB will buy after March 2017.** Mr Draghi is likely to be non-committal. However, at this juncture, he won't want to provoke expectations of a sudden stop in ECB support for a still lackluster Euro area economy that is still producing minimal inflation. For this reason, it is likely the ECB will keep the door open for an unaltered (amount) purchase programme after March 2017.

In his October 9 speech, vice governor Constancio said the following: "As the ECB Governing Council has committed itself to pursuing the present set of policies, particularly the QE component, until we attain "a sustained path towards our inflation objective" and "at least until March 2017", we will have to decide <u>closer to that date</u> the final timeline of the programme and its conditions" This may point to the December 8, 2016 meeting, but could eventually be the January 19 or March 9, 2017 meetings. We think that the technical adaptations to the programme are likely to be decided in December, but the fate of the QE programme after 2017 and more particular the amount of monthly purchases may be decided only in early 2017 when the March projections are available. .

Taper talk: No smoke without fire.

Bloomberg ran an article, based on non-identified sources, early October suggesting that an informal consensus was building amongst policymakers that asset purchases would have to be tapered, but these sources didn't rule out the

possibility that that QE would be continued after March 2017 at the pace of €80B per month. The article was officially denied by the ECB spokesman who said that this wasn't discussed at the ECB meeting. However, It seems more plausible that this 'sources' story was a deliberate leak to check the market reaction and to start preparing bond investors for a potential change in the programme, if needed. As we noted in our comment on the outcome of the September policy meeting, markets looked too complacent regarding the continuation of the asset purchases at an unchanged pace.

A second, important recent message came from in two parts from the ECB. In a break with the pattern of recent years when two year ahead projections were only published in March, we will get a first glimpse of ECB thinking in relation to 2019 in December, when staff projections will extending to that year. It could be argued that the inclusion of these earlier estimates for 2019 is merely a technical change to the projections. However, closer to the December date, some may argue that its purpose is to provide a basis for a looming change in the stance of ECB policy.

A second related development of late was the message from **Mr. Draghi** himself. **He said that the inflation target could be reached by the end of 2018 or early 2019, of course conditional on ongoing accommodative policies**. That could prove optimistic, but the mood in markets on this score may stay optimistic in the near term on the grounds that actual inflation which has risen to 0.4% Y/Y in September will accelerate further in the next month on the back of higher energy prices (and base effects).

Coming into 2017, headline inflation may be above 1%. Admittedly, the ECB minutes of the September meeting noted that "underlying price pressure continue to lack "a convincing upward trend", an observation regularly repeated by ECB chief economist Peter Praet. However, it may not preclude, we think, a lowering of the asset purchases from March onwards. **Even if the programme is extended, which is very likely, we feel markets may begin to reposition as they explore the implications of a lowering of the amount of assets purchased by €20B to €60B per month**.

QE has negative side-effects

Since September, many -but not all central bankers have expressed more concern about the effects of unconventional policy tools on the financial sector (with issues surrounding DB and the Italian banking sector headline news) to and a number of other sectors, while the uneven distribution of the wealth effect of their measures has gotten notably more press coverage. There is also some empirical/theoretical? evidence that the positive effect of QE on inflation diminishes or disappears when excess reserves reach a certain amount. Finally, the central bank interventions have artificially pushed down term and credit premiums and decreased liquidity, which might end in sharp movements and risk leave central banks paralyzed and unable to change policies if needed.

Fiscal policy to do the heavy lifting

Another reason why markets may come to move away from the possibility of further rate cuts and begin to consider the start of "tapering" possibly after March 2017 **is the increasing insistence of the ECB that the fiscal policymaker should step up the challenge and introduces structural reforms and make fiscal policy more growth friendly**. We saw such shift towards more activist policy in the UK and expect the US to follow after the elections, especially should Hillary Clinton becomes president and the Democrats take the Congress. Such an outcome may also restart investment that remained very subdued given the uncertainties surrounding the presidential elections. **The rebalancing between monetary and fiscal policy will also (gradually) take place in the Eurozone, helped too by key elections in Germany and France.**

Economy is doing ok

There are signs that the global economy is on the mend. Also the Eurozone economy looks to be on somewhat firmer ground of late. Production rebounded strongly in August and so did the EU economic sentiment for September. The German ZEW sentiment surprised on the upside, accompanied by strong order intake and trade figures in August. On a more dissonant note, EMU PMI eased slightly in September, but the Q3 average was in line with Q2. There is a possibly excessive relief in markets that Brexit effects have been very limited in the data but this may owe something to a delay in the calling of Article 50 by the UK which has meant something approaching 'business as usual' has continued –at least for now.

Inflation: Is the worst behind us?

Regarding inflation, the Headline HICP climbed to 0.4% Y/Y, but the core measure disappointed, stabilizing at a still too low 0.8% Y/Y and showing no signs of accelerating. However, some early inflation indicators dispelled any lingering fears of deflation and may encourage views of an eventual pick-up in prices. .

Consumer price expectations jumped higher and firms selling prices was marginally higher in September and positive for the fourth consecutive month. The 5-yr/5-yr EUR inflation swap at 1.37% is off the lows (1.2) with stronger gains for the US and UK measures.

Conclusion

There are still a lot of uncertainties in the euro area, UK and elsewhere, which may affect monetary policy, if they lead to destabilising outcomes-as has been the tendency in recent years.. However, we think that markets are beginning to consider whether monetary policy has now reached a turning point. Change will be very gradual though and become only visible after some time. Fiscal policy will become the focus of efforts to push inflation higher. The inflation expectations show tentative signs of such a development as does the steepening of the yield curves. In this context, **we think markets could move away from any expectation of another rate cut and begin to focus instead on the possible implications of the ECB announcing a reduction in the amount of its asset purchases**. This should steepen the curve further in the euro area.

Piet Lammens, KBC Brussels
Austin Hughes, KBC Dublin

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
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Mathias van der Jeugt	+32 2 417 51 94	France	+32 2 417 32 65
Dublin Research		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
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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