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OPINION

Markets Insight

Doves have strong case against premature ECB tightening

Central bank is pulling back but needs to convince markets its asset purchase programme will not end too soon

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The European Central Bank has signalled a scaling back of its Covid-19 emergency programme of asset purchases, saying it intends to trim its monthly bond purchases for the rest of this year. But that should be largely irrelevant to market participants by now. What matters is what the ECB does in 2022 and beyond.

As the economic outlook improves and inflation rises to levels not seen in a decade, hawkish noises on monetary policy have resumed. Several governing council members have spoken out against what they see as excessively dovish changes to the ECB's forward guidance, warning of too long of a commitment to asset purchases.

The timing of the comments in the run-up to Thursday's policy announcement looks particularly challenging for the ECB. It is still in the process of translating a new framework on monetary policy into its communication and policy stance.

What is at stake is not the emergency programme — nearly everyone expects it to end in 2022 anyway. Instead, the debate will probably intensify over the future of its longer-running, regular Asset Purchase Programme, or quantitative easing.

The hawks will try to oppose a large expansion of the APP running into 2023 or beyond. Their strategy would be to decouple asset purchases from the lift-off in policy rates.

For the ECB, this would be hawkish. Its current forward guidance states net asset purchases will "end shortly before it starts raising the key ECB interest rates". If the ECB decouples this relationship, the risk is that it allows for an earlier end of the APP — no longer "shortly before" it starts raising policy rates.

Moreover, some hawks have explicitly ruled out a transfer of flexibility of the pandemic programme in areas such as the eligibility of assets that can be purchased. But this would only postpone some inevitable decisions. The most obvious example is Greece, which could be excluded from asset purchases in April 2022 without adjustments to the eligibility rules of the APP.

More broadly, an open-ended QE programme could face significant technical and legal constraints, including the self-imposed issuer limits. ECB holdings cannot buy more than a third of any member country's eligible debt.

We estimate that the share of ECB holdings of German debt under the APP currently stands at just under 30 per cent. It could exceed the 33 per cent threshold by 2023, assuming a constant pace of ECB buying and a slowdown in German sovereign debt issuance.

The doves will have a strong case to push against premature monetary tightening. The staff projection for core inflation was revised only modestly higher on Thursday to 1.5 per cent in 2023. Such a projection is hardly consistent with the ECB's new "symmetric" 2 per cent target where negative and positive deviations of inflation from that level are seen as "equally undesirable".

Downside risks remain but, more fundamentally, pre-serving favourable financial conditions will be a matter of consistency and credibility. The ECB just committed to an "especially forceful or persistent" monetary stance as long as policy rates remain close to their lower limit.

The newly adopted forward guidance on policy rates reflects this policy adjustment, with stricter conditions set for core inflation before the ECB even thinks about thinking about hiking rates. Now unconventional policy tools will have to be adjusted accordingly, which include the APP but also its scheme for financing banks at deeply negative levels below the ECB's deposit rate, known as Targeted Longer-Term Refinancing Operations.

We have long expected the monthly pace of APP purchases to be doubled to €40bn from the second-quarter of 2022, and the flexibility of the programme to be enhanced, but it could take a completely different form. For instance, the ECB could decide on an annual QE amount to be spent in a flexible way, based on financial conditions but also on the projected increase in government bond supply. Indeed, for the ECB's strategy to be successful, it will require continued co-ordination with fiscal policy.

Either way, the ECB's overall asset purchases will probably halve in 2022, to around €500bn-€600bn in our projections, down from €1,100bn in 2020 and 2021.

While evidence suggests that the stock of QE matters more than the flow and the supply of government bonds will also slow significantly next year, the euro area bond market has operated under the assumption of continued ECB intervention. Bond yields thus remain at risk of moving to a damaging level if the APP were to be halted prematurely.

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