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ECONOMICS: EUROPEAN PERSPECTIVES

WILL THE ECB STICK OR TWIST?

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The case for a reduction in the monthly pace of ECB bond purchases is starting to grow. But with bond markets looking fragile, this would be a dangerous step, in our view. At some point, though, the ECB will need to address the cliff risk associated with the current structure of its asset purchase program and this may involve switching to a more flexible approach.

There seems little doubt that the European Central Bank (ECB) will extend its asset purchase program at its next council meeting on December 8. Whether or not it chooses to maintain the monthly purchase pace at €80 billion is, however, a much closer call.

Before assessing the factors likely to influence the ECB's decision, it's worth recalling the ECB's forward guidance.

First, the ECB has said that "*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.*"

Second, it has promised to preserve "*the very substantial degree of monetary accommodation which is necessary to secure a sustained convergence of inflation towards levels below, but close to, 2% over the medium term.*"

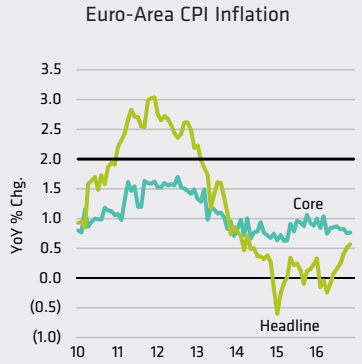
Although the euro-area economy continues to recover and headline inflation is now rising, there's absolutely no evidence that this is feeding through into higher underlying inflation. Core inflation is still anchored below 1.0% (*Display 1*) and likely to average just 0.8% this year, slightly below last year's 0.9% and well below the 1.1% expected when the ECB raised the volume of its monthly purchases in March.

Based on this and the ECB's forward guidance, there are strong arguments for extending the current purchase pace. But there are also arguments for dialing it back.

When the ECB increased the volume of its bond purchases to €80 billion in March, it did so largely because it feared that downside risks might be crystallizing. Since then, the euro-area economy has continued to grow at a steady, if unspectacular, pace and downside risks have dissipated. The rationale for a higher purchase pace is therefore weaker than it was in March.

The recent rise in headline inflation points in a similar direction. Although largely due to energy prices, the very fact that inflation is back in positive territory and rising will lessen the ECB's concerns about inflation being too low for too long and resultant risk that deflationary expectations might become entrenched. Further comfort will be drawn from market-based measures of

Display 1
Core Inflation Still Moving Sideways



As of November 30, 2016
Source: Haver Analytics

Display 2
Sharp Rise in Inflation Expectations

As of December 1, 2016
Five-year/five-year forward inflation-linked swap
Source: Bloomberg

inflation expectations, which have risen strongly in recent weeks (*Display 1, previous page*).

There may also be strategic reasons for scaling back the volume of monthly purchases. If, as we suspect, the ECB is beginning to think it may take longer than expected to drive inflation back to target, one possibility would be to lower the volume of monthly purchases but conduct them over a longer period. There were echoes of such a shift in a recent interview with ECB president Mario Draghi: "W*e 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.*"

So it's possible to make a strong case for extending the asset purchase program but reducing the monthly volume to €60 billion. This would certainly have the advantage of making it easier for the Governing Council's hawks and doves to reach consensus.

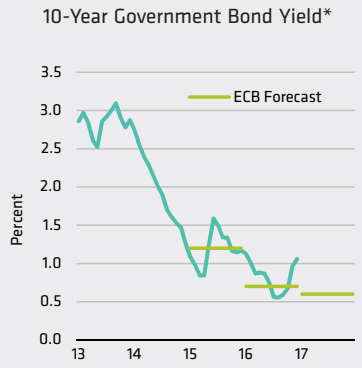
But is this the right time for such a move? Spurred on by rising US yields and worries about tapering in Europe and Japan, the weighted-average 10-year bond yield in the euro area has risen by 50 basis points since September and is now significantly higher than assumed in the ECB's latest forecasts. This is likely to be seen as an unwarranted tightening of monetary conditions (*Display 3*).

Moreover, no matter how hard the ECB tries, the market is likely to interpret any reduction in the monthly volume of bond purchases as a tapering, or winding down, of the program. Particularly in the current environment, there's a clear risk that this could send bond yields soaring—not least in Italy, should Sunday's constitutional referendum result in a no vote.

We therefore think the most likely scenario is an unchanged monthly purchase pace. A reduction to €60 billion, even with an extended time horizon, seems less likely to us, particularly given asymmetric risks for bond yields.

Nonetheless, at some point, the ECB will need to address the cliff risk associated with its current program and forward guidance. A Bank of Japan style yield cap is probably a step too far. But a flexible approach, allowing the ECB to vary its monthly purchases according to underlying economic and financial conditions, is not without merit. ■

Display 3
Unwarranted Tightening of Monetary Conditions



As of December 1, 2016
*Weighted average of euro-area countries. ECB forecast is September 2016 staff forecast.
Source: Bloomberg and ECB