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ECONOMICS: EUROPEAN PERSPECTIVES

ECB GETS ITS MESSAGING RIGHT

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The ECB surprised markets this week by reducing the monthly pace of its asset purchase program. But a longer-than-expected extension and carefully nuanced press conference should help reassure investors that the ECB will be a "sustained presence" in the market for some time to come. Once the dust has settled, we expect investors to draw considerable comfort from this.

The European Central Bank (ECB) delivered a carefully crafted message at its December press conference. Contrary to expectations, it announced a reduction in the pace of its monthly asset purchases from €80 billion to €60 billion as of April next year.

But in order to counter speculation that this might represent a "tapering" (or winding down) of its purchases, the ECB extended the program by a further nine months, to at least the end of December 2017, and stated its intention to increase the pace of purchases again if the outlook for inflation starts to darken.

Deflation Risks Recede

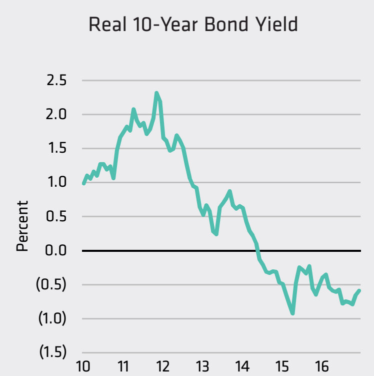
So the improvement in the economic backdrop and reduction in deflation risk since the monthly purchase pace was raised to €80 billion in March outweighed any concerns the Governing Council might have about rising bond yields. The ECB was surprisingly relaxed about the latter, probably because the recent increase in nominal yields has been accompanied by rising inflation expectations—thus limiting the increase in real yields and tightening of financial conditions (*Display 1*).

Nonetheless, ECB president Mario Draghi made it clear that one of the reasons for extending the program by nine months was to reassure investors that the ECB would be a "sustained presence" in markets for some time to come. He also poured cold water on any suggestion of tapering, stating that not a single member of the Governing Council was in favor of this.

But this was not simply an exercise in expectation's management. During the press conference, Draghi was asked whether or not he thought the ECB's inflation forecast of 1.7% for 2019 was satisfactory. His answer was a weary "not really", adding that this was why the ECB needed to continue providing extraordinary monetary accommodation.

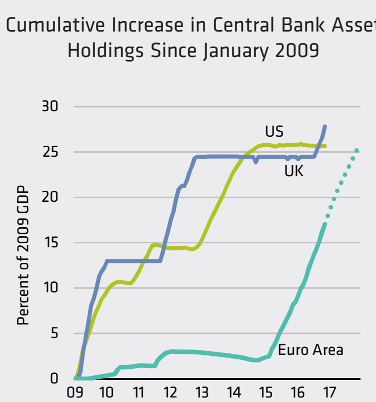
Moreover, any disappointment at the reduction in the monthly purchase pace should be weighed against the formal commitment to buy an extra €540 billion of bonds between April and December of 2017. This is a longer commitment than we expected and will bring the overall increase in the ECB's asset holdings in line with the US Federal Reserve and Bank of England (*Display 2*).

Display 1
Modest Rise in Real Yields



As of December 8, 2016
Weighted-average 10-year bond yield deflated by 5-year/5-year forward inflation-linked swap
Source: Bloomberg

Display 2
ECB Starting to Catch Up



As of November 30, 2016
Dotted line assumes ECB purchases bonds in line with latest guidance.
Source: Haver Analytics and AB

Nor should we automatically assume that the ECB's next move will be a further reduction in the monthly purchase pace. That's certainly possible if the economy continues to strengthen, and particularly if core inflation starts to rise. But in light of the subdued outlook for core inflation, that's by no means a given. Moreover, the ECB has made it clear that it's willing to reverse its decision to lower the purchase pace if downside risks start to rise again and/or financial conditions start to tighten. The Governing Council has therefore introduced an element of asymmetric flexibility into its asset purchase program.

Discordant Note?

The only discordant note during the press conference came when Draghi was asked whether or not the ECB could reduce the monthly pace of bond purchases before December 2017 if economic data turn out better than expected. His answer was to say that we are "fairly far away from any such high-class problem" (which is not quite the same as saying no).

Moreover, Draghi later confirmed that the program was "state-contingent rather than open-ended". This is an important clarification because it means the ECB could, in theory, renege on the time commitments included in its forward guidance if it sees evidence of a "sustained adjustment in the path of inflation consistent with its aim". A high-class problem, indeed, and not one we expect the ECB to encounter during 2017 given subdued prospects for core inflation. But something to be aware of, nonetheless.

Job Well Done

Overall, we think the ECB delivered a very balanced message at this week's press conference. Yes, the monthly purchase pace is set to slow, but only back to where it was before the ECB thought downside risks might be crystallizing and deflation risks starting to grow.

Meanwhile, the nine-month extension has reduced the risk of the program being brought to a premature end. Moreover, Draghi repeatedly stressed during the press conference that the ECB was committed to retaining a "sustained presence" in the market for some time to come. Once the dust has settled, we expect investors to draw considerable comfort from this. ■