PICTET
1805

Flash Note

Euro area: monetary policy

ECB preview: slower, longer, stronger

Pictet Wealth Management - Asset Allocation & Macro Research | 18 October 2017

In light of recent signals, we expect the ECB to announce a 9-month extension of asset purchases, until at least September 2018, at a monthly pace of EUR30bn. The ECB's emphasis on "patience and persistence" means that an even longer QE extension is possible, e.g. at EUR20-25bn for 12 months.

Stronger forward guidance is a given, but the ECB's credibility will depend both on the duration of the QE programme and on the extent to which bond scarcity is being addressed. We continue to expect corporate bonds purchases to represent a larger share of the programme in the future.

ECB communication continuity should be reflected in a commitment to keep policy rates low until "well past" the end of QE, to reinvest bond proceeds for longer, and to retain the option of increasing QE if needed. We keep our forecast of a first refi rate hike in Q3 2019 but reckon that a one-off deposit rate hike is now unlikely in 2018.

Recent ECB communication has been remarkably consistent in signalling a 'slower for longer' QE extension into 2018 – the main risk scenario we described our QExit note. In light of these signals, we expect the ECB to announce at its 26 October meeting that **asset purchases will be extended for 9 months, until at least September 2018, at a reduced pace of EUR30bn**.

The Governing Council will of course discuss a range of alternative options. The ECB's emphasis on "patience and persistence" means that an even longer QE extension, at EUR20-25bn for 12 months, looks more likely than a 6-month extension at EUR40bn (as per our initial baseline). Meanwhile the focus could shift to *gross* purchases, including reinvestment. Either way, we expect ECB communication to be articulated around the following guiding principle: **the larger the reduction in monthly purchases, the longer the extension, and the stronger and the more credible the forward guidance,** as the first rate hike will be delayed and QE can be extended further if needed.

We expect the ECB to favour continuity, keeping its commitment to leave policy rates at present levels **"well past"** the horizon of net asset purchases. A one-off deposit rate hike looks unlikely in 2018, not least because the ECB cannot risk further EUR appreciation. We keep our forecast unchanged of a first refi rate hike in Q3 2019, followed by a gradual tightening cycle of 25bp rises every six months. We also expect the ECB to retain the option of increasing QE in size and/or duration, while its **reinvestment policy could become more explicitly 'Delphic' in nature**.

Crucially, for stronger guidance to be credible, the ECB needs to make sure that QE recalibration addresses the issue of bond scarcity. **We continue to forecast corporate bond purchases (CSPP) to represent a bigger share of total purchases** and/or to continue until after sovereign bonds purchases are terminated. Some technical details could be postponed to the 14 December meeting, including on reinvestment and the composition of asset purchases.

Looking for additional sweeteners and surprises, the ECB could hint at the possibility of new refinancing operations in the future, or an easing of the terms on existing targeted longer-term refinancing operations (TLTROs), which will mature between June 2020 and March 2021. However, those options are more likely to be kept as extra ammunition for 2018 in case of an unwarranted tightening of financial conditions.

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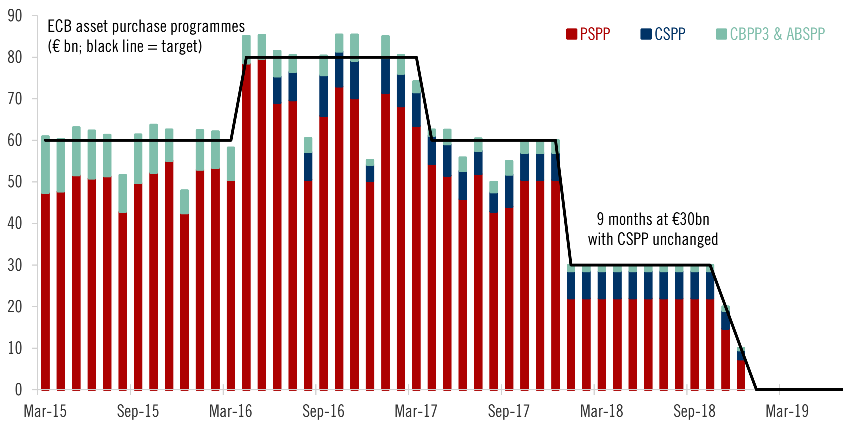
A balancing act on QE stock and flows

Last month, we signalled that the ECB was leaning toward a 'slower for longer' QE extension relative to our and consensus expectations. The macro outlook has not changed, but consistent signals from Governing Council members have to be taken on board.

As a result, **we now expect the ECB to extend asset purchases for 9 months, until at least September 2018, at a reduced pace of EUR30bn**. There are in fact several ways for the ECB to achieve a broadly similar result. The ECB's emphasis on the duration of the QE programme suggests that an even longer extension, at EUR20-25bn for 12 months, is a clear possibility.

From a broader macro perspective, it may not matter that much *how* the ECB ends asset purchases, since the programme is constrained by the self-imposed rules of 33% issuer limits and capital keys breakdown, which are very unlikely to be dropped. **What matters is the credibility of the threat to do more, which will hinge on forward guidance**, as we discuss below. We expect the main elements of ECB's forward guidance to be either maintained or strengthened, including the commitment to keep policy rates **"well past"** the horizon of net asset purchases and the **option to increase QE in the future**, if needed, in terms of size and/or duration.

Chart 1: our baseline for a 'slower for longer' QE extension, at EUR30bn for 9 months



Source: Pictet WM – AA&MR, ECB

We expect the ECB's decisions and communication to be articulated around the following guiding principles:

- **QE rescaling, not tapering**: the ECB is more likely to keep the option to extend QE further than to call an end-date to its programme (reference: Benoît Coeuré on the December 2016 decision).
- **Accompanying the recovery**: recalibration of the monetary stance as deflation risks have disappeared but the adjustment in core inflation remains incomplete (reference: Mario Draghi in Sintra in June 2017).
- **Shift the focus to the duration of asset purchases, away from monthly flows**: consistent with the ECB's 'Confidence, Patience, Persistence, Prudence' mantra and the emphasis on QE stock effects, while reinvestment policy continues to support the flow effects (reference: accounts of the ECB's July 2017 meeting).

- **Shift the focus to the broader package of measures and favour continuity in terms of policy tools and communication**: forward guidance, negative rates and TLTROs as the natural policy tools favouring the rates and credit transmission channels (reference: recent speeches by Benoît Coeuré and Peter Praet).
- **The larger the reduction in monthly purchases, the longer the extension, the stronger the forward guidance,** as the first rate hike is delayed and the threat to extend QE becomes more credible.

QE flexibility is key for the credibility of forward guidance

With those principles in mind, the October meeting should be all about fresh ECB guidance on the post-QE monetary stance, to be articulated around a renewed commitment to keep policy rates low for longer, to expand QE further if needed, and to reinvest maturing bonds. But, for that threat to be credible, the ECB needs to make sure that the issue of bond scarcity in Germany – the largest constraint in terms of programme implementation – is being properly addressed, regardless of the extension modalities.

The larger the reduction in monthly purchases the better, in terms of scarcity, but other technical details will matter, too, and a similar result could be achieved in many different ways. In particular, we reiterate our call for **a larger role for corporate bond purchases** relative to sovereign bonds in the future (see "ECB QExit: mapping the scenarios" for technical details).

In *Table 1* below, we describe the main QE recalibration options and their implications for bond scarcity (the date when issuer limits will be hit in Germany as a proxy for maximum QE duration) as well as the earliest date for a rate hike assuming a three-month taper followed by a six-month period after the end of net asset purchases, with our baseline highlighted in grey.

Table 1: main ECB QE options their implication for policy rates and bond scarcity

Policy option		Composition	Earliest date for a rate hike (three months taper, then six months "well past" the end of QE)	Maximum QE duration (estimated date when German limits will be hit)
Baseline	€30bn for 9 months	composition unchanged	Jun-19	Feb-19
		rescaling on sovereign bonds (*)	Jun-19	May-19
Even slower for longer	€20n for 12 months	composition unchanged	Sep-19	Oct-19
		rescaling on sovereign bonds (*)	Sep-19	Aug-20
Shorter extension	€40bn for 6 months	composition unchanged	Mar-19	Sep-18
		rescaling on sovereign bonds (*)	Mar-19	Nov-18
Target gross purchases (including reinvestment)	€30bn for 9 months (~€20bn in net terms)	composition unchanged	Jun-19	Oct-19
		rescaling on sovereign bonds (*)	Jun-19	Aug-20
Total envelope	€250bn over 12 months	composition unchanged	Sep-19	Sep-19
Gradual taper to zero	€5bn per month until Dec-18	composition unchanged	Jun-19	Depending on when QE is extended

(*) rescaling at the full expense of sovereign bonds, CBPP3 and ABSPP, with CSPP and Supras unchanged

Source: Pictet WM – AA&MR, ECB

Among the last three options described in the table, we would favour the **'shift to gross purchases'** as reinvestments are projected to rise to about EUR10bn per month in 2018, with significant volatility from one month to the other. A QE monthly target in terms of gross purchases would help smooth out the profile of sovereign debt redemptions that the ECB needs to reinvest. This option would result in an announcement of larger monthly purchases and be consistent with the accounts of the September meeting, when the Governing Council noted that the reinvestment of proceeds from French bonds was "spread over several months", resulting in temporary deviations from capital keys.

Looking for other sweeteners and potential surprises

Although we expect the ECB to favour communication continuity, other innovative options cannot be ruled out.

The ECB could move toward 'Delphic', calendar-based guidance eventually, as opposed to the 'Odyssean' element of state contingency implying that QE would continue until the ECB sees "a sustained adjustment in the path of inflation". One might argue that this is close to the ECB's approach to policy rates, assuming "well past" means at least six months after the end of QE, but this wording could still change in the future as forward guidance adjusts to economic reality.

Our impression is that **the ECB is still comfortable leaving some degree of constructive ambiguity as regards policy rates, although this may no longer apply to the deposit facility rate (DFR)**. We have long argued that a one-off, technical adjustment in the -0.40% DFR would make sense in 2018 while keeping a clear commitment to leave the ECB's main refinancing rate unchanged at 0% for longer. However, none of the conditions we had identified as necessary have materialised (see "ECB: escape the (NIRP) room"): the hawks have not pushed for a deposit rate hike in return for a longer QE, and the ECB has not changed its assessment of side-effects of negative rates on the banking sector. Meanwhile, EUR appreciation has made it nearly impossible for the ECB to hint at a change in exit sequencing without triggering a further tightening in financial conditions.

It may be politically more acceptable for the ECB to make its reinvestment policy more explicitly 'Delphic' in nature. Since the decision was made in December 2015, the ECB has been committed to reinvesting the principal payments on the securities purchased under the APP as they mature, "for as long as necessary", along with some vague reference to reinvestment amounts over 2018-19. One option could be to commit to reinvestment for a given period of time, for instance until at least the end of 2020. An alternative would be for the ECB to continue reinvestment until "well after" the normalisation of policy rates has started. We think that committing to a target in terms of total balance sheet size is less likely.

Looking for additional sweeteners and surprises, the ECB could hint at the possibility of new refinancing operations in the future, or **an easing of the terms on existing targeted longer-term refinancing operations (TLTROs)**, which will mature between June 2020 and March 2021. However, those options are more likely to be kept as extra ammunition for 2018 in case of an unwarranted tightening of financial conditions.