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ECB: WAIT AND SEE AS POLICY IS EFFECTIVE

Berenberg Macro Flash

Contrary to widespread expectations that the ECB may announce an extension of its €80bn asset purchase programme beyond the end of March 2017, the ECB did not do so today. As before, ECB president Draghi merely stressed that the programme is "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." The decision to stay put makes sense, in my view. First of all, with almost seven months to go until the currently scheduled end of the programme, the ECB need not be in any hurry. It can wait and see how much the Brexit vote will affect the Eurozone economy and how political risks such as the US elections on 8 November or the Italian referendum in late November or early December play out. Second, judging by the evidence available so far, the economic outlook has not changed by enough to warrant an additional monetary stimulus now.

The ECB left its staff projections for growth and inflation almost unchanged. While raising the GDP projection for 2016 marginally from 1.6% to 1.7%, it reduced its 2017 and 2018 calls from 1.7% to 1.6%, that is to the same rate of growth which the Eurozone had achieved in 2015. That is a remarkably stable outlook. For inflation, the ECB lowered the 2017 projection from 1.3% to 1.2% but left its more important 2018 projection at 1.6%. As monetary policy works with a long and variable lag until it affects inflation, the unchanged outlook for rising inflation in 2018 reinforces the major message: no need to add to the extraordinary stimulus at this stage.

Macroeconomic projections

	GDP			Inflation		
	2016	**2017**	**2018**	**2016**	**2017**	**2018**
ECB Sep 2016	1.7	1.6	1.6	0.2	1.2	1.6
ECB Jun 2016	1.6	1.7	1.7	0.2	1.3	1.6
Berenberg	1.5	1.4	1.6	0.2	1.4	1.6
Consensus	1.5	1.2	1.5	0.3	1.3	1.6

Source: ECB staff projections, Bloomberg consensus, Berenberg forecasts

On a more technical level, Draghi announced that the ECB council has tasked the "relevant committees" to evaluate all options to ensure the smooth implementation of its asset purchase programme in the current low interest environment. In other words, the ECB will look very closely whether it can expand the universe of eligible bonds to make sure it has enough paper for its monthly purchases of €80bn until the end of March 2017 or beyond. In a way, this can be seen as a technical preparation for prolonging the asset purchase programme at the December ECB meeting.

While not announcing any new easing today, the ECB carefully left the door to further easing open, emphasising that risks to growth are tilted to the downside.

In my view, the ECB will probably extend its asset purchase programme beyond March 2017 in the end, either with the full €80 billion per month or a reduced amount. If growth and inflation develop in line with ECB projections, a gradual tapering may start in April 2017 already. However, if the ECB has to downgrade its inflation and or growth forecasts even slightly at its December meeting, the ECB would likely extend its €80bn asset purchases by six months before starting to taper them in late 2017.

In a somewhat combative performance, Draghi took on those who accuse the ECB of doing more damage than good with its aggressive monetary stance. According to Draghi, the transmission of monetary policy has never worked better than it does today, pointing to the gradual increase in credit growth and an improvement in the ECB's bank lending survey. He explained that it takes a stronger economy and firmer credit demand to support higher interest rates, concluding that "interest rates have to be low today to be high tomorrow". Although Draghi may have exaggerated how well the transmission mechanism is working, I at least agree with that final assessment: a monetary policy that keeps the economy more or less on track lays the foundation for stronger credit demand and hence for less depressed real interest rates in the future.

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