

## ECB Preview (26<sup>th</sup> October) – A dovish taper

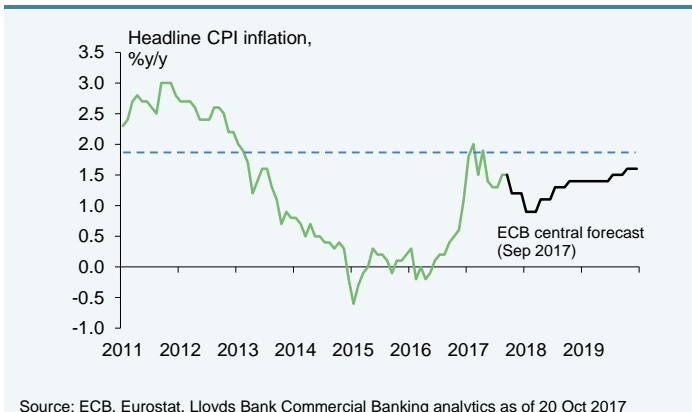
- After the September ECB meeting, President Draghi said that the “bulk of decisions” for the asset purchase programme starting in 2018 will be made at the next meeting on 26<sup>th</sup> October.
- We forecast an announcement of a reduction in monthly purchases to €30bn from the current pace of €60bn, but an extension of the programme to at least September 2018. The risk is a larger reduction in monthly purchases, with a more prolonged exit.
- The ECB is likely to maintain its flexibility, keeping open the option to increase monthly purchases, should it be needed.
- It may also place greater emphasis on the ‘stock’ of asset purchases, rather than the monthly net ‘flow’, especially as it will continue to reinvest maturing assets.
- We expect its forward guidance that interest rates are not expected to be increased until “well past” the horizon of asset purchases will be maintained. This suggests that the deposit rate, currently at -0.4%, will not be raised until 2019 at the earliest.
- Our central expectation for policy seems to be broadly in line with market expectations. As such, we anticipate the euro will remain within recent ranges, but the emphasis on a later exit suggests possible downside risks.

## A HALVING OF NET ASSET PURCHASES, BUT A SLOW EXIT

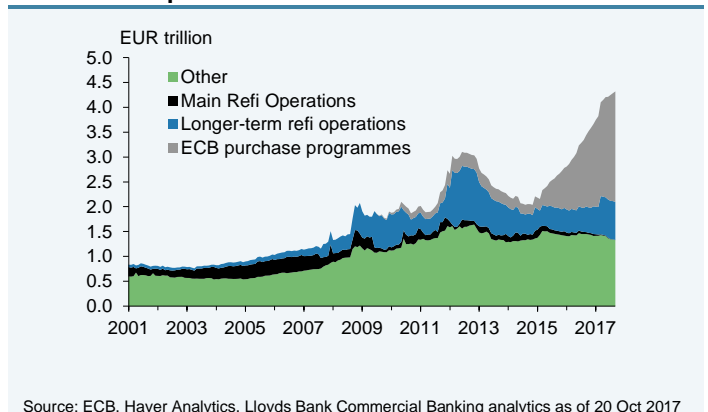
ECB President Mario Draghi announced after the September policy meeting that the “bulk of decisions” for the asset purchase programme in 2018 will be made at the next meeting on 26<sup>th</sup> October. It has been buying assets, mostly government bonds, at an average monthly pace of €60bn since April, which will continue until the end of the year. The broad-based and resilient Eurozone economic upswing, coupled with diminished deflation risks, mean that policymakers will reduce the degree of stimulus next year. At the same time, inflation has yet to return to the target of “close to, but below, 2%” on a sustained basis, so any withdrawal of stimulus is likely to be gradual.

We expect the ECB will announce a reduction in net monthly purchases to €30bn, but to extend the programme until at least September 2018. This would imply additional net purchases of €270bn, taking the total to around €2.55tn or 22% of nominal GDP. Without changes to the ECB’s asset purchase rules, such as the capital key or the issue/issuer limits, reports suggest that there may be about €300bn of bonds left to buy. The risk to our central view is a larger reduction in monthly purchases, alongside a more prolonged exit. In a recent speech, ECB Chief Economist Peter Praet said that, during a less volatile market environment (such as now), there is a preference for a longer purchase horizon even if it means a sharper reduction in the monthly pace. A reduction to €25bn a month until December 2018, for example, would result in a similar amount of additional net asset purchases to our base case. The ECB will probably not pre-announce the composition of its asset purchases, but there may be a relative movement away from government bonds, given potential scarcity concerns. Over the past six months, about 75% of purchases have been in government bonds, about 10% each for corporate bonds and supranational assets and 5% in covered bonds.

**Chart 1: Deflation fears have disappeared, but inflation remains subdued**



**Chart 2: The ECB’s balance sheet will remain elevated for a considerable period**



## MAINTAINING FLEXIBILITY ON PURCHASES AND FORWARD GUIDANCE ON INTEREST RATES

The halving of the pace of monthly asset purchases, coupled with an extended duration for the programme, would represent a compromise between the 'doves' and 'hawks' on the Governing Council. Another aspect of policy that ECB officials, especially the 'doves', want to preserve is flexibility and to not commit yet to a 'final' end date for asset purchases. This is because underlying inflation remains well below target, even though outright deflation risks have largely disappeared. Annual 'core' CPI inflation, which excludes food and energy, was only 1.1% in September. Headline inflation was higher at 1.5%, but is likely to fall towards, or even below, 1% in the coming months due to temporary energy price base effects (see chart 1). Hence, markets will be looking for a restatement of the commitment that "we stand ready to increase our asset purchase programme in terms of size and/or duration".

The ECB may also decide to place greater emphasis on the 'stock' of its asset purchase programme, rather than the net monthly flow of purchases. The policy of reinvesting maturing assets will continue and is estimated to be around €10bn a month next year, in addition to our forecast of net monthly purchases of €30bn. 'Gross' monthly asset purchases would then be around €40bn. The size of the ECB's balance sheet will continue to rise, helping to maintain accommodative monetary policy (see chart 2). In the US, the Federal Reserve has only recently started limiting its reinvestment of maturing assets, which will result in a gradual decline in its balance sheet three years after the end of its quantitative easing programme.

Finally, we expect the ECB to maintain its forward guidance on interest rates, which states that they are expected to remain at present levels "well past the horizon of our net asset purchases". In other words, the ECB does not expect to raise interest rates until well after the end of its asset purchase programme, which we expect by the end of 2018. This suggests that interest rates will not be raised until early 2019 at the earliest. Our central view is for the deposit rate to rise by 10bps to -0.3% in Q2 2019, with a further increase in -0.2% by the end of that year. The refi rate, currently 0%, is not expected to rise until 2020.

## MARKET REACTION AND MEDIUM-TERM OUTLOOK

The ECB appears to have been relatively comfortable with the euro's ascent since the spring, arguing that it has been largely 'endogenous', reflecting the stronger economic outlook. Nevertheless, it did warn at last month's meeting that recent exchange rate volatility "requires monitoring", while some members expressed concern about the risk of the euro 'overshooting'. We expect the ECB's policy announcements next week, in particular, a prolonged exit and the maintenance of its forward guidance on short-term interest rates will limit the risk of the euro overshooting and will keep it in a 1.15-1.23 range against the US dollar and a 0.8750-0.92 range against the euro for now. In the medium term, our central forecast, published in the October *International Financial Outlook*, is for EUR/USD to rise gradually over the coming year to 1.22 and EUR/GBP to rise to 0.93 (or GBP/EUR to fall to 1.07) at end-2018. We look for the yield curve to bear-steepen, with 2-year bund yields at -0.4% and 10-year bund yields at 0.9% at end-2018.

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## CONTACT DETAILS

Hann-Ju Ho  
T: 02071581745  
E: hann-ju.ho@lloydsbanking.com

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