ECB: ENHANCED POLICY OPTIONALITY

Since its launch, the ECB's asset purchase programme has had, through various transmission channels, a significant impact on financial markets, activity and inflation. In recent months, doubts about the positive effects of additional purchases and concerns about possible negative consequences have increased. Against this background, the ECB has cut the link between the timing of the end of net asset purchases and the rate lift-off. This is a welcome decision that increases the governing council's optionality. The new staff macroeconomic projections remind us of the pervasive uncertainty we are facing. In such an environment, monetary policy can be nothing else than data-dependent.

In the press conference following last week's governing council meeting of the ECB, the words 'some time' were mentioned 14 times. It shows the importance of the decision to drop the phrase introduced in September 2019 that stated that the governing council expected net asset purchases "*to end shortly before it starts raising the key ECB interest rates*". Upon its introduction in 2019, the strict link between QE and the policy rate lift-off reinforced expectations that net asset purchases would continue for a long time, considering that hiking official interest rates was a distant prospect. In recent months, the situation has changed however. First, looking at the different transmission channels, the economic impact of additional asset purchases has become questionable. QE seeks to avoid that inflation expectations would stabilize well below the central bank's target. However, at the current juncture, the risk of de-anchoring has switched to inflation expectations moving permanently above the inflation objective. Commercial banks' excess reserves at the central bank are abundant, giving banks ample opportunity to increase their loan volume, so extra reserve creation via net asset purchases is no longer necessary. It is also doubtful that these purchases would still have a considerable additional impact on bond and equity prices. QE can also cause a depreciation of the exchange rate, but given the inflation outlook and the huge increase in commodity prices that are invoiced in US dollar, such a movement would be unwelcome from an inflation perspective. Finally, when starting net asset purchases, the central bank sends a signal that the policy rate will remain unchanged for a long time. This is no longer what the market expects[1] nor does it correspond to the message that the ECB wants to give.

Whereas doubts have grown about the positive effects of additional purchases[2] , concern about possible negative consequences has increased. "*The focus on ending net asset purchases … reflects, at least in part, the fact that their side effects tend to increase over time*[3]." According to ECB board member Isabel Schnabel, these side effects concern the large impact on house prices, the shrinkage of the bond free float in certain countries, the possibility that ongoing asset purchases would raise concerns about fiscal dominance and the impact on the euro exchange rate[4]. Interestingly, the account of the February meeting of the governing council reveals that a number of the members "*were of the view that the forward guidance conditions were already broadly satisfied and expressed a preference for adjusting the forward guidance on the phasing-out of the APP at the present meeting.*" Against this background, dropping "to end shortly before" and replacing it with "some time after" was a welcome decision.

EURO AREA REAL GDP GROWTH (QOQ IN %) - ECB PROJECTIONS

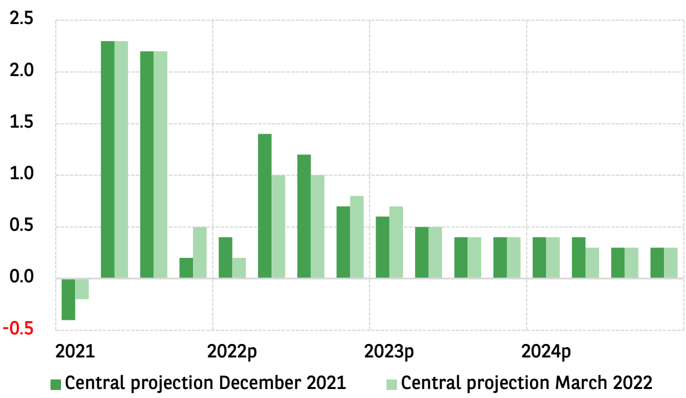

CHART 1

P: PROJECTIONS
SOURCE: ECB STAFF MACROECONOMIC PROJECTIONS MARCH 2022, EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS DECEMBER 2021, BNP PARIBAS

1. In the autumn of last year, markets were already pricing a lift-off of the deposit rate by the end of 2022. For an overview of the reasons, see *Deposit rate lift-off, markets and the ECB, Ecoweek*, BNP Paribas, 8 November 2021.
2. It is important in this respect to distinguish between the stock effect of QE (the cumulative purchases) and the flow effect (the net purchases over a given time period). Research shows that the former has had a considerable impact on long-term interest rates (lower bond yields, in particular due to a compression of term premia). However, when the monthly purchases are small compared with the cumulative purchases thus far, the incremental impact on bond yields will decline significantly.
3. Source: *Finding the right sequence*, Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at a virtual policy panel on "Unwinding QE" at the first annual Bank of England Agenda for Research (BEAR) conference, Frankfurt am Main, 24 February 2022.
4. *"Over the past years, these measures have contributed to large capital outflows from the euro area, thereby putting downward pressure on the euro exchange rate. The exit from these measures can thus support the currency and, for a net importer of energy, provide tangible and immediate support to euro area households and firms by improving the terms of trade.*" Source: see footnote 3.

Dropping "to end shortly before" and replacing it with "some time after" was a welcome decision. The decision to hike rates will fully depend on the data. This shows how limited the visibility is.

In doing so, the ECB has cut the link between the timing of the end of net asset purchases and the rate lift-off, thereby following last year's example of the Federal Reserve[5]. This increases the governing council's optionality. Current policy rates can be maintained as long as necessary without having to worry about the side effects of QE considering that the link between the two has been cut. Moreover, net purchases are expected to end in the third quarter, based on the updated guidance. *"If the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases, the Governing Council will conclude net purchases under the APP in the third quarter[6]."* This change in guidance caught markets by surprise, causing a jump in bond yields and a short-lived appreciation of the euro against the US dollar.

The focus has now shifted completely to the interpretation of 'some time after'. Christine Lagarde has been very clear in what it means, namely that the decision to hike rates will fully depend on the data. The use of these words "*opens sufficiently wide an interval of time so that we can review the data, determine the robustness of the data, make sure that some uncertainty has cleared a bit so that we can make a decision.*[7]" Clearly the robustness of the data –the strength of demand growth, the dynamics of wages and underlying inflation, etc.- will to a large degree be influenced by the war in Ukraine and its economic consequences. Compared to the December projection, the ECB has revised the projection for quarterly growth downwards for the first three quarters of the year but slightly upwards for the following two (chart 1). A more instructive way is to compare the profile of the level of real GDP (chart 2). In the March projection, GDP in the fourth quarter of last year was estimated to be 0.6% higher than the December estimate, but in the third quarter of this year it is projected to be 0.4% lower, implying a hit to growth of about 1 percentage point. The revised inflation path (chart 3) -with inflation moving higher and staying well above the December projection until the middle of next year- plays a key role in this respect. It is based on an assumption for the price of a barrel of Brent crude oil of USD 92.6 in 2022 (USD 71.1 on average in 2021), USD 82.3 in 2023 and USD 77.2 in 2024. However, since the projections have been finalised, energy prices have increased significantly[8]. Given the huge uncertainty, monetary policy can be nothing else than data-dependent.

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ECB PROJECTIONS: DIFFERENCE IN REAL GDP LEVEL

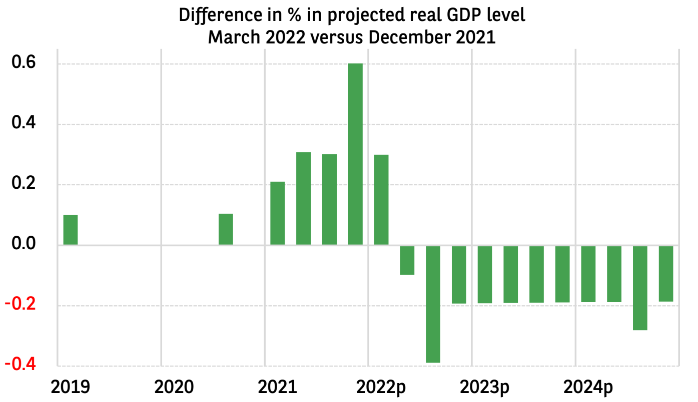

CHART 2

P: PROJECTIONS
SOURCE: ECB STAFF MACROECONOMIC PROJECTIONS MARCH 2022, EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS DECEMBER 2021, BNP PARIBAS

ECB HICP INFLATION PROJECTIONS

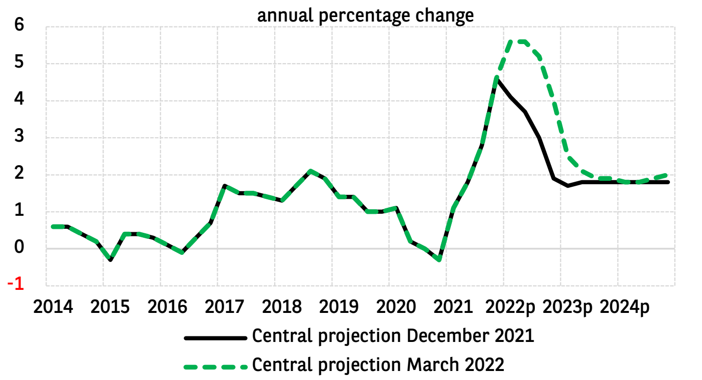

CHART 3

P: PROJECTIONS
SOURCE: ECB STAFF MACROECONOMIC PROJECTIONS MARCH 2022, EUROSYSTEM STAFF MACROECONOMIC PROJECTIONS DECEMBER 2021, BNP PARIBAS

5. In his speech at the annual Jackson Hole symposium of the Federal Reserve Bank of Kansas City, Jerome Powell had been very clear that tapering would not signal a change in the outlook for the federal funds rate: "*The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test.*"Source: *FED adapts forward guidance, will ECB do the same?* Ecoweek, BNP Paribas, 6 September 2021.
6. ECB, Monetary policy statement, 10 March 2022.
7. ECB, Press conference of Christine Lagarde, President of the ECB, Luis de Guindos, Vice-President of the ECB, Frankfurt am Main, 10 March 2022
8. Under an adverse (severe) scenario, with even higher energy prices and other repercussions, the ECB staff projects growth of 2.5% (2.3%) this year and inflation at 5.9% (7.1%).