MARKET COMMENTARY

A tug of war between inflation and omicron

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- **At the December 16 policy meeting we expect the ECB to further reduce its weekly PEPP purchases (to about € 12 bn/ week from € 16 bn/week since the September adjustment) and to reiterate that there will most likely be no rate hike in 2022.**
- **The worsening of the pandemic situation amid a period of prolonged high inflation creates exceptionally high uncertainty on the further course of monetary policy. The ECB needs to be prepared for various contingencies.**
- **In our base case we expect the PEPP total envelope of € 1.85 tr to remain unchanged and APP to continue to run at €20bn per month through 2022. The means not exhausted until March will be used to smooth the exit from monetary policy emergency flexibly until the end of next year. We continue to see the first rate hike in 2024 but acknowledge that the risks of a hike already in 2023 have increased as of late.**

At the December policy meeting the Governing Council will have to decide about the end of the PEPP at a time when the pandemic has gathered new momentum while inflation rose to a record high of 4.9% yoy in November. the ECB's expected annual inflation for 2022 (of currently 1.7%) will need to be revised to maybe slightly above 2% in the new macroeconomic projections. Moreover, with the extension of the forecast horizon to 2024 the ECB's pre-pandemic inflation path will likely be exceeded. The PEPP was designed to bring the economy back to this path. So, mission accomplished, back to normal?

It is still somewhat trickier. On the one hand, the arrival of the omicron variant adds to uncertainty at a time when a new pandemic wave is building up in any way. Will vaccines remain effective? And how lethal will this mutation be? The final judgement and hence the likely effect on growth and inflation still stands out but there are clearly downside risks. On the other hand, upside risks to inflation prevail over the medium term. ECB officials continued to emphasize in their communication that they keep assessing the present inflation spike as transitory for the well-known trinity of base effects, higher energy prices and bottlenecks but also expressed increased awareness for upside risks to inflation. In their communication Governing Council members made clear that they would not react to a supply-shock but that de-anchoring inflation expectations and destabilizing wage and price-setting could turn it into an "*ugly inflation*" (Panetta) to which the ECB would need to react. While there is no indication of them at present, the ECB will watch especially wage negotiations very carefully. Furthermore, Mrs Schnabel – rather known as a centrist than a hawk – for instance referred not only to the closing of the output gap (which the EC foresees for 2022) but also to structural changes in the global economy when speaking about upside risks to inflation, e.g. due to shortage of skilled labour and the green transition.

In this field of tension, we deem it most likely that the ECB adopts a risk-management approach to monetary policy that Mrs Schnabel advocated also publicly. But to be prepared for all contingencies the ECB needs to lay the ground for policy changes while avoiding market gyrations. The job is complicated by the fact that the ECB committed itself to stop asset purchases just shortly before raising rates. Therefore, barring exceptional circumstances, weaning markets from supportive purchases in a homeopathic way is the first step. This is not an easy task given that in 2021 the ECB will have bought (under PEPP and APP) about € 1 tr of assets. **Weekly PEPP purchases** will have to be adjusted further. **We look for a reduction from the current average since the September meeting of € 16 bn to about € 12 bn**. Beyond that the key question is: how much pandemic support is still needed given that the disinflationary effect of the pandemic will have been largely eliminated and the output gap will probably be closed in 2022. The recovery is now largely self-sustaining and there is much less stress and fragmentation than at the start of the pandemic. President Lagarde was quite clear that she expects the PEPP to be terminated in March. If our above assumption on the adjustment of the weekly PEPP purchases towards € 12 bn is right, there would still be about € 200 bn left in the envelope. How to proceed?

Just before the arrival of omicron there seemed to be diverging views among GC members. President Lagarde (26.11.) saw "*no reason to doubt that we will stop net asset purchases under the PEPP in the spring*", consistent with the view that (possible augmented) APP purchases would now have to do the trick. In contrast, Panetta (24.11.) urged in a speech that until the economy had returned to its pre-crisis trend "*we should keep using all of our instruments for as long as warranted, with the necessary flexibility"* giving leeway for the PEPP to continue. He also mentioned that after the end of PEPP asset purchases would not to be calibrated to avoid a policy cliff. Vice-President de Guindos (30.11.) recently stated that PEPP purchases "*could be resumed if necessary*". **What the ECB does will in the end critically depend on the GC's view on the pandemic development** (see also table below). Three scenarios stand out:

- In our base case omicron does not change the pandemic outlook fundamentally to the worse. The output gap will still be closed in 2022. The ECB will use the remaining € 200 bn from the PEPP envelope to offset the recent pandemic-related headwinds to activity and to smooth the exit from the monetary policy emergency state. It will do so by spreading this amount over circa 39 weeks with downward steps through time.
- In a scenario of a surprisingly strong economy no additional money will be needed. The € 200 bn buffer will be kept in order to fight a potential resurgence of pandemic-related issues which is enough to ensure ongoing favorable financing conditions. Alternatively, a persistent supply shock or the prospect of structurally higher inflation due to the green transition might even induce the ECB to start unwinding its APP purchases already in 2022 (inflation scenario).
- In a strong recession scenario the ECB would again face a deviation from the pre-pandemic inflation path and a re-widening of the output gap. Taking 2021 as a benchmark, a back on the envelope calculation suggests that the ECB may counter a 1 pp fall in the output gap with an increase of the PEPP volume by € 200 bn. If pushed back into crisis mode, the PEPP envelope would again be increased and used discretionarily in order to fight the nasty financial market consequences of the pandemic.

ECB QE Outlook for 2022

PEPP volume ↑ / flexibility →	steady purchases	quarterly adjustment of purchases	discretionary purchases
PEPP envelope beefed up	**unlikely**	€ 20 bn APP/ month + not exhausted PEPP (~ € 200 bn) + PEPP beef-up **(severe downturn)**	PEPP enevelope increased to above € 2 tr **(strong recession)**
Not exhausted PEPP purchases used	€ 20 bn APP/ month + not exhausted PEPP equally distributed from Apr. to Dec. **(steady QE in 2022)**	€ 20 bn APP/ month Remaining PEPP to smooth transition, purchases decreasing quarterly **(base case)**	€ 20 bn APP/ month not exhausted PEPP (~ € 200 bn) (**downturn)**
Net PEPP purchases stop	€ 20 bn APP/ month + not exhausted PEPP (~ € 200 bn) not used **(strong economy)**	€ 20 bn APP/month reduced to pave the way for a 2023 rate hike **(infation scenario)**	**unlikely**

All in all, 2022 will most likely be a year of transition towards a less extreme monetary accommodation. President Lagarde and all other Governing Council members made clear that a rate hike in 2022 is very unlikely. We expect the ECB to hammer this message also at the December meeting. The ECB's new strategy has lifted the bar for hiking rates as inflation needs to reach its target well ahead of the end of the projection horizon (which will be extended to 2024 now) and be durably for the rest so that also core inflation is consistent with the inflation target in the medium term. Thereby the risk of premature hiking (in 2022) looks remote. Against this backdrop our **base case remains a first rate hike in 2024** and we expect the ECB to largely **exhaust the remaining PEPP means over the course of the year** to counter the worsening of the pandemic situation and to ensure a smooth exit from the state of emergency. That said, the inflation risks are clearly skewed to the upside so that a rate hike already in 2023 has gained probability.