PREVIEW: ECB Policy Announcement due Thursday 28th October 2021

- **ECB policy announcement due Thursday 28th October; rate decision at 12:45BST/07:45EDT, press conference from 13:30BST/08:30EDT**
- **A decision on the future of PEPP is not expected to take place at the upcoming meeting**
- **Focus will be placed on how the emphasis that the ECB puts on its transitory inflation outlook**
- **President Lagarde will likely push back on current market pricing for rate lift-off**

OVERVIEW: The ECB is set to stand pat on rates whilst leaving the size of the PEPP envelope unchanged at EUR 1.85 tln. With the pace of PEPP purchases for Q4 already determined at the September meeting and a decision on a replacement program/bulking up of APP not expected until December, the upcoming meeting should bring little in the way of fireworks. The discussion on post-PEPP policy might begin at the meeting, but market participants are unlikely to be presented with much in the way of details or the balance of views on the matter. The press conference will not be accompanied by new macro staff projections, however, market participants will be eyeing how the ECB classifies current risks to its transitory inflation view. The account of the September confab noted "that upside inflation risks were increasingly discussed" and it is fair to say that those risks will only have been intensified since the last meeting. Finally, comms from President Lagarde during the press conference will likely be focused on pushing back on current market pricing which looks for a 10bps hike in December 2023.

PRIOR MEETING: As expected, the ECB stood pat on rates, and held the size of its PEPP envelope at EUR 1.85trl. The key adjustment to the policy statement was that purchases under PEPP were to be conducted at a “moderately lower” pace compared to Q2 and Q3. At the follow-up press conference, President Lagarde noted that the Euro area economic rebound was in an increasingly advanced stage, and output was set to exceed pre-pandemic levels by the end of the year. Subsequently, the accompanying economic projections saw the central bank’s 2021 growth forecast upgraded to 5.0% from 4.6%, with the base-effect spill over resulting in a minor tweak lower to the 2022 growth view, to 4.6% from 4.7%, while 2023 growth view was left unchanged at 2.1%. The ECB still characterises inflationary pressures as transitory, however, its 2021 inflation projection was lifted to 2.2% from 1.9%, the 2022 CPI forecast was raised to 1.7% from 1.5%; note, 2023 was revised up a touch to 1.5% from 1.4%, and thus it still sees inflation below target at the end of its forecast horizon. Lagarde went on to state that the decision to slow purchases, and the wording in the statement, was unanimously agreed. For those looking for clues on “life after PEPP”, the President remarked that this discussion will take place at the December meeting.

RECENT DATA: Y/Y CPI printed at 3.4% in September vs. 3.0% in August with the core metric rising to 1.9% from 1.6%. Looking ahead, Pantheon Macroeconomics expects core inflation to drop sharply in January as VAT base effects fade before rising strongly towards the middle of the year. From a growth perspective, flash Q3 GDP is not due until the day after the meeting. Timelier flash PMI readings for October saw the EZ-wide Composite metric fall to 54.3 from 56.2 with commentary from IHS Markit relatively downbeat, noting that "After strong second and third quarter expansions, GDP growth is looking much weaker by comparison in the fourth quarter.” In the labour market, the unemployment rate in August saw a further decline to 7.5% from 7.6%, however, economists caution that the pace of the recovery in the jobs market could be tempered as regional furlough schemes draw to an end. On wages, ING notes that the relatively low unemployment rate combined with higher vacancy rates puts moderate upward pressure on wages and as such, ING believes that wages have the potential to return to growth rates seen in 2019 or slightly higher.

RECENT COMMUNICATIONS: Since the prior meeting, ECB President Lagarde (28th Sept) downplayed the longevity of price pressures in the Eurozone by noting that the challenge for the Bank is to ensure that it does not "overreact" to transitory supply shocks which have no bearing on the medium-term outlook. Furthermore, in a more recent speech, Lagarde remarked that there is no evidence of significant second-round effects via wages. This view on inflation has also been reaffirmed by Chief Economist Lane and Executive Board member Schnabel with the latter stating that there is no indication that elevated inflation rates are becoming entrenched. Elsewhere, Chief Economist Lane has pushed back on recent adjustments to market pricing, which is now fully factoring in a 10bps hike to the Deposit Rate by the Bank towards the end of next year. Lane stated that it is hard to reconcile such pricing with the ECB's forward guidance. Elsewhere, commentary has focused on the conditions that should be applied to any bond-buying program that will replace PEPP when it concludes in March 2022. At the hawkish end of the spectrum, the likes of Estonia's Muller cautioned that legal constraints means that it is unlikely that the Bank could just transfer PEPP's flexibility into APP. More dovish members of the Governing Council such as Italy's Visco and Greece's Stournaras believe that the flexibility of PEPP should be carried over beyond March with the latter also attempting to make the case that Greek bonds should be included within any program going forward after having previously being excluded pre-PEPP due to their rating.

RATES: From a rates perspective, consensus looks for the Bank to stand pat on the deposit, main refi and marginal lending rates of -0.5%, 0.0% and 0.25% respectively. Since the prior meeting there has been an acceleration in the market pricing for a 10bps hike to the deposit rate. As it stands markets now price a 10bps hike to the deposit rate in 2023. The shift in market pricing since the prior meeting has largely been a by-product of the ECB getting caught up in a tide of other major global central banks (e.g. BoE) becoming more hawkish on the timeline for rate lift-off. In contrast to market pricing, a poll conducted by Reuters revealed that economists do not expect the ECB to move on rates until 2024. This is on the basis of current forward guidance which, as noted by Danske Bank means that before hiking rates, the ECB has to 1) acknowledge that inflation is not transitory, 2) remove 'at present or lower' from its guidance and 3) end APP before hiking rates. With this in mind, it is widely-accepted that market pricing is way too aggressive, particularly when it comes to point "3" as this would mean that the ECB would have to end bond purchases before the end of next year to comply with its guidance. As such, Chief Economist Lane recently remarked that it is challenging to reconcile current pricing with ECB forward guidance. Pictet suggests that the Bank could enhance forward guidance by dropping the word "shortly" from its commitment to end the APP "shortly before" it starts raising rates.

BALANCE SHEET: With the pace of Q4 PEPP purchases already determined to take place at a "moderately lower" pace than Q2 and Q3, the role of the ECB's balance sheet will take less of a focus than it has done in recent meetings. Accordingly, expectations are for the PEPP envelope to be held at EUR 1.85trl and run until the end of March 2022, whilst the APP is to be maintained at a clip of EUR 20bln per month on an open-ended basis. As March 2022 draws closer, the debate around life after PEPP is beginning to heat up, however, the decision on PEPP is set to be more of a topic for the December meeting which will be accompanied by the latest round of macro projections. That said, there will likely be some initial debate at the upcoming meeting about the flexibility of any future PEPP replacement as hawks and doves attempt to draw their battle lines ahead of the December showdown. Note, a recent sources piece suggested that the ECB could unveil a new bond-buying program with increased flexibility to complement the traditional APP. ING suggests though, that Lagarde is unlikely to provide much colour on the discussions at the upcoming press conference as this could act to widen any rifts on the GC. Looking to December, UBS expects 1) PEPP will not be extended beyond the end of March 2022. 2) ECB will temporarily increase APP above its current EUR 20bln/month total (could opt to increase the monthly purchase amount or set an envelope amount). 3) Extend the TLTRO-III scheme. 4) ECB will not raise the issue/r limits for its APP at this stage. 5) consider whether or not to change the eligibility rules for the APP.

PRESS CONFERENCE: Given that the upcoming meeting is expected to be light on policy announcements and there will be no updated staff macro projections, focus will likely centre on how the ECB classifies the current Eurozone outlook, particularly when it comes to inflation. Danske Bank notes that the projections unveiled in September are already outdated and therefore, some clarity will be required on how the Bank judges the landscape. On inflation, ING notes that the account of the September meeting revealed "that upside inflation risks were increasingly discussed". The Dutch Bank suggests that developments in recent weeks will only have intensified this debate on the GC. For now the Bank appears to be holding on to the view that inflationary impulses remain transitory as opined recently by President Lagarde (14th Oct) who also noted that there is no evidence of significant second-round effects via wages. That said, this is a narrative that will likely be increasingly tested as we head towards December. As a reminder, at the September press conference it was judged that "risks to the economic outlook are broadly balanced". Finally, at the press conference, President Lagarde will likely push back on current market pricing for rate lift-off by the Bank.