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# An impressive stunt

Gerhard Winzer

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The Council of the European Central Bank pulled an impressive stunt at the monetary policy meeting on 26 October. ECB President Mario Draghi announced to reduce the extremely supportive monetary policy in the near future while sounding very cautious (dovish) with regard to the process at the same time.

In response, the euro depreciated against the US dollar, share prices increased, and the yields of German government bonds and spreads for country default risk were down.

## Reduction of the bond purchase programme

The most important measure is the reduction of the bond purchase programme. Until the end of 2017, the monthly volume will remain at EUR 60bn. From January 2018 onwards, it will be halved to EUR 30bn and is to run at least until September 2018.

## Optimism about economic development

The backdrop for this measure is the growing optimism of the ECB about a gradual increase in inflation towards the central bank target of slightly below 2% in the medium run. Three reasons were cited: 1) economic growth in the Eurozone is robust and broadly based; 2) core inflation has already edged slightly higher (1.1% p.a. in September); and 3) the monetary policy is effective by keeping credit interest rates low.

## Cautious course of action

However, economic growth is still not self-supporting, and inflation pressure is low. Therefore, a high degree of monetary support remains necessary.

## Ongoing monetary support

The forward guidance, i.e. the guidance of the market participants' expectations, is an important tool used by the central bank. In the press statement, three rules seem to apply: 1) supportive level, 2) only gradual reduction, 3) no abrupt termination.

The balance sheet of the ECB has already grown to EUR 4,400bn. In September 2014, it was still at EUR 2,000. The volume of liquidity that the ECB provides to the system is therefore massive.

The bond purchase programme will be extended until September 2018, albeit in a reduced form. If necessary, it will be extended again or even expanded. The expiring bonds will be reinvested also after the end of the bond purchase programme for as long as necessary.

The key-lending rates will remain on the currently very low level after the bond purchase programme has come to an end. This puts paid to any expectations of higher key-lending rates in 2018. An initial increase in key-lending rates is now more likely to happen at the end of 2019.

## Conclusion

Economic growth in the Eurozone is strong and broadly based, but not self-supporting. At the same time, inflation is too low. This requires a moderate reduction of the very expansive monetary policy. In the short run, this environment is positive for risky asset classes such as equities. Even for credit-safe bonds such as German government bonds, the environment is not

particularly disadvantageous. The risk premium for holding bonds with long as opposed to short maturities (term premium) could increase as a result of the expiry of the bond purchase programme, but the outlook for sustainably (very) low key-lending rates is supported by the variables of the scenario in place.

Unfortunately – and paradoxically – the susceptibility to (or risk of) price slumps is higher:

1. An overheating economy could cause inflation to record an unexpectedly substantial increase. This would force the ECB to not only take the foot off the gas but in fact to hit the brakes.
2. The TINA investment approach (“There Is No Alternative”) for risky asset classes could cause the financial market to overreach.

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## **Gerhard Winzer**

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.