ECB Gets Its Messaging Right

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The ECB's decision in early December to reduce the monthly pace of its asset purchase program came as a surprise. But investors should draw considerable comfort from its commitment to maintain a "sustained presence" in euro-area markets.

The European Central Bank (ECB) delivered a carefully crafted message in the press conference that followed its December 8 policy-setting meeting. It surprised markets by announcing a reduction in the pace of its monthly asset purchases, from €80 billion to €60 billion from April 2017.

But to counter speculation that this might represent a "tapering" (or winding down) of its quantitative easing (QE) program, the ECB extended QE by a further nine months, to at least the end of December 2017. And it intends to pick up the pace of purchases again if deflationary pressures resurface in the euro area.

DEFLATION RISKS RECEDE

So an improvement in the economic backdrop since the monthly purchase pace was raised to €80 billion in March outweighed any potential ECB concerns about higher bond yields. The ECB was surprisingly relaxed about the latter, probably because the recent increase in nominal yields has been accompanied by rising inflation expectations—thus limiting the increase in real yields and tightening of financial conditions.

Nonetheless, ECB president Mario Draghi made it clear that one of the reasons for extending the program by nine months was to reassure investors that the ECB will remain a "sustained presence" in regional markets for some time to come.

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Any disappointment at the reduction in the pace of monthly purchases should be weighed against the ECB's formal commitment to buy an extra €540 billion of bonds between April and December 2017. This is a longer commitment than we expected and will bring the overall increase in ECB asset holdings in line with the US Federal Reserve and the Bank of England.

Moreover, the ECB has made it clear that it's willing to reverse its decision to slow the purchase pace if downside risks start to rise again and/or financial conditions begin to tighten.

Overall, we think the ECB delivered a very balanced message. Yes, the purchase pace will slow, but only back to where it was before the ECB thought downside risks might be crystallizing and deflation risks starting to grow. And the QE extension reduces the risk of the program being brought to a premature end.

Finally, investors should draw considerable comfort from Draghi's repeated efforts to stress that the ECB fully intends to stick around in regional markets.

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