15 July 2021

ECB Preview

Aligning forward guidance to strategic review outcome

- When ECB meets next week, the market attention turns to the implications and new communication on the back of the new strategic framework. We do not expect new policy signals coming from the change in language.
- We expect an acknowledgement of the improving data which has come in according to expectations and the positive contribution from the roll-out of the vaccines, however risks will also be mentioned, notably the by-now dominating Delta variant with a reference to still uneven and fragile recovery.
- With markets having to adjust to the new communication style and potentially also new language, there is risks of larger than usual market moves, although such moves should not be over-interpreted, especially in a less liquid seasonal summer market.
- We expect new policy signals after summer on issues such as bond buying, but are open for TLTRO liquidity operations to be coined standard already at the upcoming meeting.

Adjusting to the new target without addressing the root-cause

In *Flash: ECB Research - Strategic Review: Striving for symmetry*, 8 July, we outlined the changes to ECB new policy framework, which now is for a symmetric inflation target around the 2% level over the medium term. As the outcome of the strategic review resulted neither in the development of new monetary policy tools that could foster the achievement of the inflation target, nor changed its explicit target variable of HICP at 2%, we do not see the probability of ECB meeting its inflation objective altered by the strategic review.

For ECB the conundrum remains that underlying inflation pressures remain anchored at a too low level and without the support from other policy areas (namely fiscal policy) in a coordinated manner, ECB will continue to face challenges in living up to its inflation target in our view, be it defined as below, but close to, 2% or just 2%.

As a result, we believe that next week's meeting will mostly be focused on aligning a new, more concise 'narrative-based' monetary policy statement with the 'old' introductory statement and it will therefore be difficult to read it as either a more dovish or hawkish communication than the June statement. Wording could be focused on tying the rate path more closely to realised inflation, which also would entail tolerating a transitory inflation overshoot, in line with the new framework.

In line, but with risk

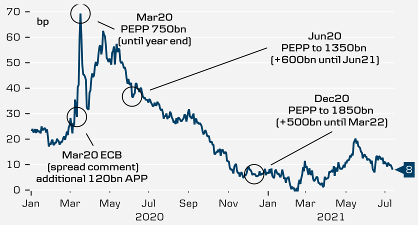
We expect ECB to confirm that since the June meeting the economic data has broadly confirmed the baseline trajectory (thereby keeping the growth risk assessment as broadly balanced), although risks from the Delta variant may feature more prominently. We do not expect a reintroduction of the risk to the inflation outlook.

No new staff projections will be released, but we will receive the Survey of Professional forecasters that we know will feature into the discussion as well as the bank lending survey. Regarding the latter, we will closely monitor if the tightening bias in expected credit conditions is set to continue in Q4.

22 July 2021

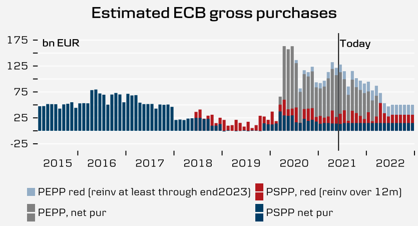
- 13:45 ECB decision
- 14:30 Press conference

10Y euro area GDP weighted yield spread to EONIA



Note: Past performance is not a reliable indicator of current or future results
Source: Bloomberg, Macrobond, Danske Bank

PEPP bond buying set to slow after Summer



Source: ECB, Macrobond and Danske Bank

Chief Strategist, ECB and Fixed Income Research
Piet Haines Christiansen
+45 45 13 20 21
phai@danskebank.com

Senior Analyst
Aila Mihr
+45 45 12 85 35
amih@danskebank.com

Hawkish or dovish? ...

The strategy review does not leave us with a conclusion on a dovish or hawkish tilt. In our view, the largest implication of the toleration of a transitory inflation overshoot is to avoid 2011-style premature rate hikes again. As such it may be perceived slightly more dovish than previously – notably if ECB decides to have a reference to the 'market pricing', which we do not believe currently reflects true policy rate expectations, but rather term and liquidity premium, see more in *COTW: Correlation between front end and 10Y Bunds*, 25 June. At the same time, with Lagarde's more inclusive leadership style, compared to her predecessor, the hawkish camp will also be taken into account to a larger extend than previously in the near term policy calibration and beyond the pandemic monetary policy stance. Previously the diverging views has led to public uproar at several occasions during Draghi's tenure, which we have not seen since Lagarde took office.

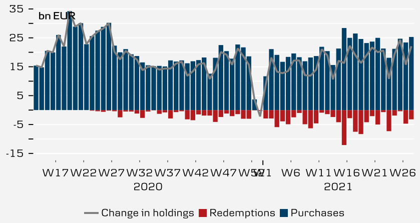
... and the near term calibration

Ultimately, the economic recovery is underway, yet the root-cause for too low inflation was still not addressed in the strategic review. Nevertheless, we still expect a discussion of the toolbox calibration after the summer, which may come already in September, where the bond buying is in focus. TLTRO will remain a key feature of the ECB policy toolbox. An announcement of a 'permanent' TLTRO at the modalities prior to the pandemic could be announced soon in our view.

Attention to financing conditions is mainly a QE 'solution'

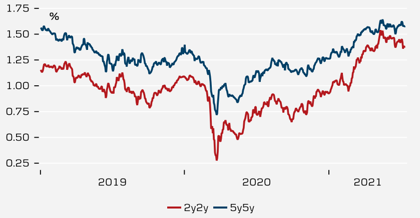
One of the key questions for the fall of 2021 is ECB's calibration of the bond buying after March 2022. As ECB can decide to adjust the programme composition, monthly purchase pace and length of the bond buying according to their will, we will continue to focus on the financing conditions. We believe that those metrics will be the key determinants to avoid any unwarranted tightening of financing conditions, where special attention to the transmission via credit conditions to non-financial corporations and households will be given. As for the sovereigns, the main question remains if Greek bonds would be included in the APP if / when PEPP ends, but in any case we expect ECB will ensure that easy financing conditions for Greece will remain. As a result, we expect a 'silent PEPP' (without new net buying) to remain part of the ECB toolbox even beyond March 2022, which could be reactivated should it be needed.

Change in weekly PEPP holdings



Source: ECB, Reuters and ECB website

Inflation swaps have stabilised



Note: Past performance is not a reliable indicator of current or future results.
Source: Bloomberg, Macrobond Financial, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Piet P. H. Christiansen, Chief Analyst and Aila Mihr, Senior Analyst.

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Expected updates

None

Date of first publication

See the front page of this research report for the date of first publication.

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