10 May 2017

ECB research

Hawkish wording but changed forward guidance less likely

- **Fading political uncertainty implies the way has been paved for more hawkish communication from the ECB at the meeting in June, bringing renewed market focus to the ECB's exit strategy.**
- **The ECB has many other options than removing the 'or lower levels' phrase in its forward guidance on policy rates and in order to avoid a tightening of financial conditions a more cautious approach seems likely.**
- **The ECB's key challenge is a lack of wage pressure and as long as there are no signs of improvement in the underlying price pressure, the ECB seems to stick to its policy stance in terms of policy rates, QE purchases and forward guidance.**

Market's attention could again turn to the ECB's exit strategy

The political risk in the euro area has been reduced considerably with Macron winning the French presidency and market's attention could again turn to the ECB's exit strategy. In our view, the way has been paved for a more hawkish communication at the next meeting on 8 June when the ECB will also have the next inflation print for May and updated inflation projections. In our view, a more hawkish wording should not be seen as a sign of near-term actually tightening. Instead, it should reflect there are a lot of soft words in the introductory statement (see next page), which need to be taken out gradually before actually tightening the monetary policy. Related to this, we still believe the ECB will extend its QE purchases by EUR40bn per month going into next year as the underlying price pressure remains weak, see *Core inflation surprised on the upside but not the first sign of higher underlying price pressure*. This also implies it is premature to believe in rate hikes any time before 2019, in our view.

There has been a lot of discussion about whether the ECB will change its forward guidance on policy rates and remove the 'or lower levels' phrase at the upcoming meeting in June. The Governing Council discussed such a change at the meeting in March after which the market priced in a 10bp deposit rate hike from the ECB already this year. If the ECB makes this change to its forward guidance, it is likely to have considerable market implications with the pricing of policy rate hikes again being moved forward. However, such a price action does not seem to be what the ECB wants already, as the communication from prominent ECB members turned much more dovish in an attempt to dampen the speculation about rate hikes after the meeting in March.

ECB current forward guidance

ECB forward guidance in five parts

(1) Level of policy rates	(2) Policy rates horizon	(3) QE magnitude	(4) QE tapering condition	(5) QE flexibility
Key ECB interest rates are expected to "remain at present or lower level"...	... " for an extended period of time, and well past the horizon of our net asset purchases"	"net asset purchases, at the new monthly pace of EUR60bn, are intended to run until the end of December 2017, or beyond, if necessary"...	..."and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim"	"If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase our asset purchase programme in terms of size and/or duration"

Source: ECB, Danske Bank

Other ECB research pieces

- *Euro area wage growth should stay subdued, not supporting core inflation significantly*
  5 May 2017
- *Core inflation surprised on the upside but not the first sign of higher underlying price pressure*
  2 May 2017
- *ECB Review: Less downside risk to growth, but no changes to inflation*
  27 April 2017

Chief Analyst
Pernille Bomholdt Henneberg
+45 45 13 20 21/+44 20 7410 8157
perni@danskebank.com

Another argument against the ECB changing its forward guidance should be that the ECB communicates it has not seen sufficient evidence to change its assessment about the inflation outlook. Related to this, Draghi has said that *'before making any alterations to the components of our stance – interest rates, asset purchases and forward guidance – we still need to build sufficient confidence that inflation will indeed converge to our aim'*. Hence, the question should be whether the reduced political uncertainty changes the ECB's inflation outlook. While there could be some positive impact on economic sentiment and hence activity, the past year's experiences are that the economic situation is resilient to political uncertainty. Added to this, a better economic outlook is not yet enough to generate higher underlying price pressure as there is a large amount of slack in the labour market. In light of this, it is key for the ECB to get wage growth up, see *Euro area wage growth should stay subdued, not supporting core inflation significantly.*.

The ECB has other options than changing forward guidance

Instead of changing the forward guidance when it remains unclear whether the inflation outlook has improved, the ECB is in our view more likely to again remove some of its dovish wording. So far this has been the strategy from the ECB, as it at the meeting in March removed a sense of urgency in taking further actions as the introductory statement no longer included *'if warranted to achieve its objective, the Governing Council will act by using all the instruments available within its mandate'*. Likewise, at the meeting in April the ECB moved in a slightly more hawkish direction as it described the risks surrounding the growth outlook as still being tilted to the downside but moving in a more balanced configuration after characterising these downside risks as being less pronounced in March.

Dovish sentences in the ECB's introductory statement (see statement below)

- *'The very favourable financing conditions that are necessary to secure a sustained convergence of inflation rates towards levels below, but close to, 2% over the medium term'* (third paragraph)
- *'Underlying inflation pressures continue to remain subdued and have yet to show a convincing upward trend'* (third paragraph)
- *'A very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up and support headline inflation in the medium term'* (fourth paragraph)
- *'The risks surrounding the euro area growth outlook, while moving towards a more balanced configuration, are still tilted to the downside and relate predominantly to global factors'* (fifth paragraph)
- *'as unutilised resourced are still weighing on domestic wage and price formation, measures of underlying inflation remain low and are expected to rise only gradually over the medium term'* (sixth paragraph)
- *'the outlook of the economic analysis with the signals coming from the monetary analysis confirmed the need for a continued very substantial degree of monetary accommodation to secure a sustained return of inflation rates towards levels that are below, but close to, 2% without undue delay'* (ninth paragraph)

Source: ECB, Danske Bank

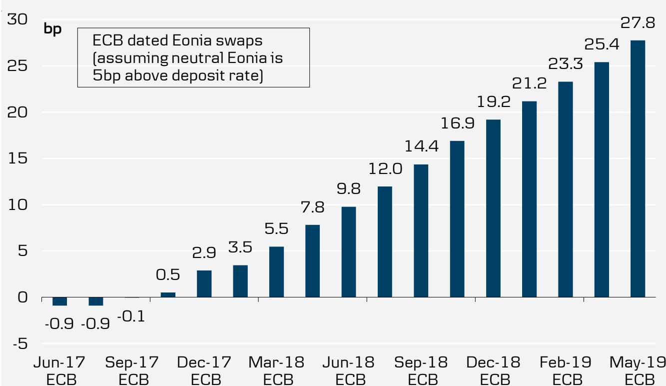
Hikes are premature as the ECB will follow its forward guidance

We have continuously argued it is premature to price hikes from the ECB as we expect the ECB to stick to its sequencing entailed in the forward guidance, thereby not hiking rates before having ended QE. Given our expectation of a QE extension of at least six months this should at the earliest happen in the second half of next year. In line with this, prominent ECB members have recently attempted to explain the reasoning behind the sequencing of the exit strategy. In a dovish speech Draghi argued that '*in a multi-country monetary union such as the euro area made up of segmented national financial markets, asset purchases are inevitably more difficult to calibrate, more complex to implement and more likely to produce side-effects than other instruments. So it is natural that we turned to them only after other, more conventional options were becoming exhausted. Similarly, lowering interest rates into negative territory in a largely bank-intermediated financial system was a step into uncharted waters'*. Along the same lines, ECB's Chief economist Peter Praet argued that *'our policy instruments act as strong complement. For instance, the downward pressure that APP exerts on term premia is strengthened by the negative interest rate policy and the rate forward guidance that offers an expected horizon for continuing that policy in the near term'*.

An argument behind the speculation about ECB hikes could reflect a perception that the ECB felt a need to support the banking sector, which should be suffering after the long period of negative policy rates. However, the ECB does not seem to consider bank profitability as a big problem as Draghi has recently said: '*As household deposit rates have been sticky at zero, banks' net interest rate margins have fallen somewhat. However, the impact on bank profitability has been offset by the positive effects of easier financial conditions on the volume of lending and the reduction in loan-loss provisions, as monetary policy has lifted economic prospects'*. During the latest press conference he reiterated this message by saying that '*the negative rates in conjunction with the other elements of our easing package have turned out to be powerful in terms of easing financial conditions and the potential negative side effects have so far been limited."*

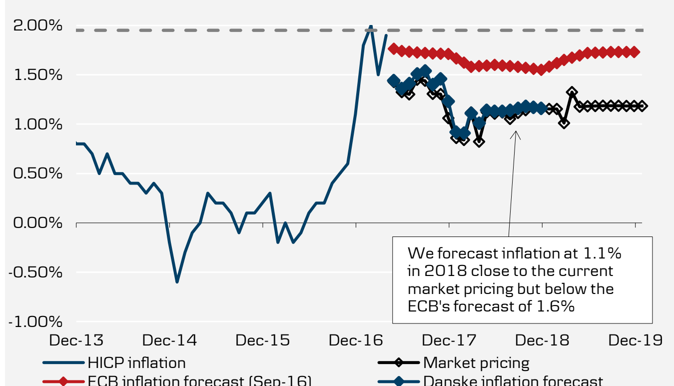
A question remains whether the ECB could later change its sequencing strategy. On this issue executive board member Benoît Cœuré said: *'The choice of sequencing of policy instruments will be the outcome of our regular assessment of the medium-term price stability outlook, reflecting the state-dependent nature of our expectations of the horizon over which our policy instruments are likely to be maintained'*. However, his view is not shared by Praet who later said: *'A deviation from the path of policy that is consistent with our past communication is not only costly in terms of policy credibility in general. It would also scale back an important source of stimulus that is behind the performance of the economy that we observe today'*.

The first deposit rate hike is already priced mid next year



Source: Bloomberg, Danske Bank

Inflation is not pricing high enough to start tightening



Source: Bloomberg, ECB, Eurostat, Danske Bank

EUROPEAN CENTRAL BANK
EUROSYSTEM

PRESS CONFERENCE

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, 27 April 2017

INTRODUCTORY STATEMENT

Jump to the transcript of the questions and answers

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. We will now report on the outcome of today's meeting of the Governing Council, which was also attended by the Commission Vice-President, Mr Dombrovskis.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. We continue to expect them to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases. Regarding **non-standard monetary policy measures**, we confirm that our net asset purchases, at the new monthly pace of €60 billion, are intended to run until the end of December 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. The net purchases will be made alongside reinvestments of the principal payments from maturing securities purchased under the asset purchase programme.

Our monetary policy measures have continued to preserve the very favourable financing conditions that are necessary to secure a sustained convergence of inflation rates towards levels below, but close to, 2% over the medium term. Incoming data since our meeting in early March confirm that the cyclical recovery of the euro area economy is becoming increasingly solid and that downside risks have further diminished. At the same time, underlying inflation pressures continue to remain subdued and have yet to show a convincing upward trend. Moreover, the ongoing volatility in headline inflation underlines the need to look through transient developments in HICP inflation, which have no implication for the medium-term outlook for price stability.

A very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up and support headline inflation in the medium term. If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, we stand ready to increase our asset purchase programme in terms of size and/or duration.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Euro area real GDP increased by 0.5%, quarter on quarter, in the fourth quarter of 2016, following a growth rate of 0.4% in the third quarter. Incoming data, notably survey results, bolster our confidence that the ongoing economic expansion will continue to firm and broaden. The pass-through of our monetary policy measures is supporting domestic demand and facilitates the ongoing deleveraging process. The recovery in investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. Employment gains, which are also benefiting from past labour market reforms, are supporting real disposable income and private consumption. Moreover, the signs of a stronger global recovery and increasing global trade suggest that foreign demand should increasingly add to the overall resilience of the economic expansion in the euro area. However, economic growth continues to be dampened by a sluggish pace of implementation of structural reforms, in particular in product markets, and by remaining balance sheet adjustment needs in a number of sectors. The risks surrounding the euro area growth outlook, while moving towards a more balanced configuration, are still tilted to the downside and relate predominantly to global factors.

Headline inflation has been recovering from the very low levels seen in 2016, largely owing to higher energy price increases. After reaching 2.0% in February 2017, euro area annual HICP inflation stood at 1.5% in March. This reflected mainly lower energy and unprocessed food price inflation, but also a decline

in services price inflation. Looking ahead, on the basis of current futures prices for oil, headline inflation is likely to increase in April and thereafter to hover around current levels until the end of this year. However, as unutilised resources are still weighing on domestic wage and price formation, measures of underlying inflation remain low and are expected to rise only gradually over the medium term, supported by our monetary policy measures, the expected continuing economic recovery and the corresponding gradual absorption of slack.

Turning to the **monetary analysis**, broad money (M3) continues to expand at a robust pace, with an annual rate of growth of 4.7% in February 2017, after 4.8% in January. As in previous months, annual growth in M3 was mainly supported by its most liquid components, with the narrow monetary aggregate M1 expanding at an annual rate of 8.4% in February 2017, unchanged from the previous month.

The recovery in loan growth to the private sector observed since the beginning of 2014 is proceeding. The annual growth rate of loans to non-financial corporations declined to 2.0% in February 2017, from 2.3% in the previous month, while the annual growth rate of loans to households remained broadly stable at 2.3% in February. At the same time, the euro area bank lending survey for the first quarter of 2017 indicates that net loan demand has increased and bank lending conditions have further eased across all loan categories. The pass-through of the monetary policy measures put in place since June 2014 continues to significantly support borrowing conditions for firms and households and credit flows across the euro area.

To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed the need for a continued very substantial degree of monetary accommodation to secure a sustained return of inflation rates towards levels that are below, but close to, 2% without undue delay.

In order to reap the full benefits from our monetary policy measures, other policy areas must contribute much more decisively to strengthening economic growth. The implementation of **structural reforms** needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost productivity and potential output growth. Regarding **fiscal policies**, all countries should intensify efforts towards achieving a more growth-friendly composition of public finances. A full and consistent implementation of the Stability and Growth Pact and of the macroeconomic imbalances procedure over time and across countries remains crucial to enhance the resilience of the euro area economy.

We are now at your disposal for questions.

Disclosure

This research report has been prepared by Danske Bank Markets, a division of Danske Bank A/S ('Danske Bank'). The author of the research report is Pernille Bomholdt Henneberg, Chief Analyst.

Analyst certification

Each research analyst responsible for the content of this research report certifies that the views expressed in the research report accurately reflect the research analyst's personal view about the financial instruments and issuers covered by the research report. Each responsible research analyst further certifies that no part of the compensation of the research analyst was, is or will be, directly or indirectly, related to the specific recommendations expressed in the research report.

Regulation

Danske Bank is authorised and subject to regulation by the Danish Financial Supervisory Authority and is subject to the rules and regulation of the relevant regulators in all other jurisdictions where it conducts business. Danske Bank is subject to limited regulation by the Financial Conduct Authority and the Prudential Regulation Authority (UK). Details on the extent of the regulation by the Financial Conduct Authority and the Prudential Regulation Authority are available from Danske Bank on request.

The research reports of Danske Bank are prepared in accordance with the recommendations of the Danish Securities Dealers Association.

Conflicts of interest

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high-quality research based on research objectivity and independence. These procedures are documented in Danske Bank's research policies. Employees within Danske Bank's Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and the Compliance Department. Danske Bank's Research Departments are organised independently from and do not report to other business areas within Danske Bank.

Research analysts are remunerated in part based on the overall profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Financial models and/or methodology used in this research report

Calculations and presentations in this research report are based on standard econometric tools and methodology as well as publicly available statistics for each individual security, issuer and/or country. Documentation can be obtained from the authors on request.

Risk warning

Major risks connected with recommendations or opinions in this research report, including a sensitivity analysis of relevant assumptions, are stated throughout the text.

Expected updates

None.

Date of first publication

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

General disclaimer

This research has been prepared by Danske Bank Markets (a division of Danske Bank A/S). It is provided for informational purposes only. It does not constitute or form part of, and shall under no circumstances be considered as, an offer to sell or a solicitation of an offer to purchase or sell any relevant financial instruments (i.e. financial instruments mentioned herein or other financial instruments of any issuer mentioned herein and/or options, warrants, rights or other interests with respect to any such financial instruments) ('Relevant Financial Instruments').

The research report has been prepared independently and solely on the basis of publicly available information that Danske Bank considers to be reliable. While reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and Danske Bank, its affiliates and subsidiaries accept no liability whatsoever for any direct or consequential loss, including without limitation any loss of profits, arising from reliance on this research report.

The opinions expressed herein are the opinions of the research analysts responsible for the research report and reflect their judgement as of the date hereof. These opinions are subject to change, and Danske Bank does not undertake to notify any recipient of this research report of any such change nor of any other changes related to the information provided in this research report.

This research report is not intended for, and may not be redistributed to, retail customers in the United Kingdom or the United States.

This research report is protected by copyright and is intended solely for the designated addressee. It may not be reproduced or distributed, in whole or in part, by any recipient for any purpose without Danske Bank's prior written consent.

Disclaimer related to distribution in the United States

This research report was created by Danske Bank A/S and is distributed in the United States by Danske Markets Inc., a U.S. registered broker-dealer and subsidiary of Danske Bank A/S, pursuant to SEC Rule 15a-6 and related interpretations issued by the U.S. Securities and Exchange Commission. The research report is intended for distribution in the United States solely to 'U.S. institutional investors' as defined in SEC Rule 15a-6. Danske Markets Inc. accepts responsibility for this research report in connection with distribution in the United States solely to 'U.S. institutional investors'.

Danske Bank is not subject to U.S. rules with regard to the preparation of research reports and the independence of research analysts. In addition, the research analysts of Danske Bank who have prepared this research report are not registered or qualified as research analysts with the NYSE or FINRA but satisfy the applicable requirements of a non-U.S. jurisdiction.

Any U.S. investor recipient of this research report who wishes to purchase or sell any Relevant Financial Instrument may do so only by contacting Danske Markets Inc. directly and should be aware that investing in non-U.S. financial instruments may entail certain risks. Financial instruments of non-U.S. issuers may not be registered with the U.S. Securities and Exchange Commission and may not be subject to the reporting and auditing standards of the U.S. Securities and Exchange Commission.