Flash

Friday, 20 January 2017

Draghi Reassures Markets, but creates some room for eventual policy change

No dramatic changes in message, but some subtle shifts in thinking

Absence of inflation pressures allows ECB to maintain 'extraordinary' support

ECB confidence in economic upturn clearly increasing

Some ambiguous elements in today's comments may hint at future ECB policy

No prospect of early policy change but scaling back of purchases possible in 2017

As markets anticipated and the ECB doubtless intended, **there was little in the way of fireworks from European Central Bank press conference.** Indeed, any impact that remarks made by Mario Draghi might have had were completely overwhelmed by strong US economic data that boosted the US dollar higher and, by feeding growing optimism about the global economy, also nudged term interest rates slightly higher on both sides of the Atlantic.

Bond purchases below deposit rate

Even the publication today of **a press release setting out more details on the circumstances in which the ECB will purchase bonds yielding less than its deposit rate proved a damp squib** with little by way of new or surprising information in this regard. As was widely expected, such purchases will be confined to public sector bonds and, where possible, the ECB will continue to purchase bonds with yields above the deposit rate. As noted a month ago, the impact of this initiative at the margin should be to steepen yield curves and widen spreads.

Draghi ease worries about tighter policy

Three elements to Mr Draghi's comments to the press today may be worthy of attention. First of all, **there is a clear acknowledgement of a stronger trend in activity in the Euro area of late** and some inclination to highlight the ECB's role in this improvement. **Second, and probably, his key message, was** a strong determination to emphasise that in spite of healthier economic conditions of late, **we remain some significant distance from** the point where markets should begin to contemplate **any material unwinding of the ECB'S current very supportive monetary stance**.

Both of these elements reflected Mr Draghi's obvious intention to send clear signals to markets (which they duly received). **We also felt there was a third**, altogether **more subtle elemen**t and deliberately ambiguous rephrasing of quite a number of elements of the policy statement **that may mean seemingly strong commitments t**o what Mr Draghi described as the current *'extraordinary level of support'* **may be less of an obstacle to a 'recalibration' in the future away from the current accommodative stance** (probably at a point that is currently unclear or at least not agreed on by the ECB'S governing council).

More upbeat on economic outlook and claiming some credit

Before we discuss this third aspect of today's press conference in more detail, we need to elaborate on the ECB's assessment of current economic conditions. Given that the ECB had undertaken a detailed review before it's December 8th meeting, one would not expect dramatic changes but today's pronouncements showed that **within the ECB confidence has increased notably in recent weeks that a clear improvement in Euro area economic conditions has taken hold of late.**

The opening press statement contained a modest but meaningful rephrasing that omitted the word '*moderate*' from December's description of the upswing and instead noted that '*we expect the expansion to firm further*'. Altogether **more assertive was Mr Draghi's listing of a wide range of economic indicators now registering multi-year highs** and his suggestion that the spread of improvement across the single currency zone was now more even than at any time since 1997.

Importantly, Mr Draghi suggested the ECB was much more than a mere witness to the emerging pick-up in Euro area growth. The opening statement notes '*the monetary policy decisions taken in December have succeeded in preserving the very favourable financing conditions*'. This is the first time we recall seeing the ECB use the words '*monetary policy'* and '*succeeded*' in the same sentence in a very long time.

In assessing the Euro area economy, **Mr Draghi also spoke a '***general satisfaction'* on the part of the Governing Council **in their discussion of the current policy stance at today's meeting.** Finally, in response to a question, Mr Draghi asked rhetorically which policies had been in place to support the recovery, adding that improvements in consumption and investment were supported by favourable financing conditions although he did acknowledge that monetary policy was '*probably not'* the only factor in the current turnaround.

We think **Mr Draghi's comments on the economy are important for three reasons**. First of all, **today's ECB'S assessment emphasizes the contribution to healthier economic activity that monetary policy is making** at a time when doubts have increased in relation to the effectiveness of unconventional monetary policies worldwide. Second, these doubts have also fuelled **an increased focus on more active and possibly aggressive fiscal policy that might have uncomfortable implications for a central bank that emphasizes its independence as much as the ECB** does. Finally and possibly even **more troublesome for the ECB is the inference that if we are currently at an economic 'sweet spot', a forward looking Central Bank should be beginning to think of a shift to a more restrictive policy**.

Key: Inflation isn't threatening tighter policy

The second and probably key take-away from today's ECB pronouncements was a determined effort to convince markets **that there is no case to worry** that the turnaround in activity and the recent uptick in headline inflation might be sufficient to threaten **that the ECB would change policy any time soon.** Mr Draghi spelled out four considerations that would influence the ECB'S assessment of the implications of inflation readings for ECB policy.

These four considerations are (i) the medium term horizon of ECB policymaking, (ii) the requirement that the pick-up in inflation be durable rather than transient,(iii) the requirement that higher inflation would be sustained even if the ECB's extraordinarily supportive stance were to be withdrawn and (iv) the requirement that higher inflation materialises across '*the whole of the Eurozone' (*a potentially vexed issue if inflation was to move notably higher in Germany*).* At this point in time, an assessment of each of these factors would imply that the threshold for an ECB policy change has been deliberately placed at an extremely high level.

Some subtle and slightly more hawkish changes to ECB comments?

While **we think the primary intention of today's ECB press conference was to downplay any market concerns that policy might be adjusted any time soon**, we think there were some subtle changes in a number of phrases that might provide greater scope for an eventual shift to a less accommodative stance.

First of all **the opening paragraph of today's press statement** no longer highlights a commitment to increase the pace of bond-buying if circumstances deteriorate. In a mechanical sense, this simply follows from the greater confidence about economic activity discussed above and a willingness to raise the size of the programme is signalled further on in today's statement. However, this repositioning **signals** at very least **a notably less forceful bias to ease**.

Potentially more important if still subtle changes in ECB thinking were hinted at in Mr Draghi's response to a number of questions. He was asked repeatedly about tapering and repeatedly said that it wasn't discussed today. However, in remarks that suggest that eventuality is starting to appear on the ECB's radar he added that at some point *'a very deep and very careful analysis'* would be undertaken before adding again that this hadn't happened today.

When further pressed about tapering, **Mr Draghi** responded in a way that **suggested that a further reduction in the monthly size of Asset Purchase programme can't entirely be ruled out at some stage during 2017. He emphasised differences between the '*recalibration'* of monthly bond purchases envisaged for April and '*tapering*' the programme.** We would interpret this as suggesting the ECB regards tapering as a continuous process that entails a possibly pre-set path along which progressively smaller amounts of bond purchases until the programme terminates whereas recalibration simply reflects a response to changing conditions.

This distinction allied to the ECB'S increasing confidence about the upswing would seem to open up the possibility that the ECB might opt to adjust downwards its monthly purchase amounts without any pre-commitment to further adjustments in the future in terms of the scale or duration of purchases.

A desire to retain future wriggle room might also be implied from other responses. Mr Draghi's was asked about what seemed to be a longstanding commitment on the part of the ECB to keep its key policy rates '*..at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases'*. On the face of it, this phrasing seemed like a fairly unambiguous commitment that interest rates would not rise until well after the bond purchase programme ended.

At one level, this ordering of policy changes simply reflects a logical sequencing that avoids potentially conflicting policy actions. Significantly**, when asked today whether policy rates could be increased before the end of the bond purchase programme, Mr Draghi responded that the matter hadn't been discussed today.**

Are markets too relaxed?

This answer at least opens up the possibility of a simultaneous change in rates and the ending of bond purchases at some point in the future. It should be emphasised that we don't envisage such an outcome or any dramatic change in the stance of ECB policy in the next few months but **today's press conference allows the ECB more room for manoeuvre than markets might currently discount.** If activity and inflation data remain on a strong trajectory in coming months, there may be scope for some unpleasant 'recalibrations' on interest rate markets

Austin Hughes, KBC Dublin
Piet Lammens, KBC Brussels

Contacts

Brussels Research (KBC)		**Global Sales Force**	
Piet Lammens	+32 2 417 59 41	**Brussels**	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Mathias van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research		France	+32 2 417 32 65
Austin Hughes	+353 1 664 6889	London	+44 207 256 4848
Shawn Britton	+353 1 664 6892	Singapore	+65 533 34 10
Prague Research (CSOB)			
Jan Cermak	+420 2 6135 3578	**Prague**	+420 2 6135 3535
Jan Bures	+420 2 6135 3574		
Petr Baca	+420 2 6135 3570		
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	**Bratislava**	+421 2 5966 8820
Budapest Research			
David Nemeth	+36 1 328 9989	**Budapest**	+36 1 328 99 85