Flash

Friday, 27 April 2018

ECB: Wondering rather than worrying

Draghi signaled that growth peak might be behind us

Monetary policy wasn't discussed!

ECB is assessing signs of slowing growth of late…

…but at this point and still 'confident' inflation will move towards target

ECB clearly in no rush to point markets towards tightening…….

There was little or no expectation that yesterday's regular ECB policy meeting would send any major policy signals. There is an almost universal expectation that the ECB will be slow to embark on what is widely seen as a very gradual path towards normalising policy. The recent sequence of softer than expected activity indicators have convinced many in financial markets that the first steps in this process could have moved even further into the future.

The sense that we are still some distance from the first material move towards tighter ECB policy was firmly conveyed by ECB president Mario Draghi's unprompted indication at the start of the Q&A session that '*the interesting thing is that* **we didn't discuss monetary policy** *per se*' at the meeting.

Softer data complicate the policy message

Mr Draghi indicated that they largely focused on a discussion of recent softer economic data. He elaborated that the ECB wanted to be sure to '*understand current developments before discussing future policy*' and went on to indicate that its reading of current developments would be very important in deciding its next steps.

It should be said **that Mr Draghi went on to say that any** '*caution*' **implied by its current stance is** '*tempered by an unchanged confidence that inflation will converge towards our aim over the medium term*'. So, there is no signal that the ECB is backtracking in terms of its future intention. ECB vice-president Constancio noted that the ECB is still moving on a path towards normalisation. However, recent developments may mean the ECB may be slower to send clear signals of its intentions than previously envisaged.

We think a couple of complementary reasons can be suggested for the note of '*caution*' sounded by Mr Draghi. First of all, **ahead of a major if likely gradual change in the stance of monetary policy, it is not unreasonable to want to clarify whether the recent softening in a range of indicators could be warning of a renewed weakening** of the Euro area economy--particularly in light of the ECB's missteps in mid-2008 and early 2011.

Second, given a still significant shortfall in inflation relative to target, **the ECB clearly wants to avoid any premature tightening of financial conditions and,** in circumstances of increased uncertainty, would probably not protest too strongly against modest market movements that offered a little more support to activity in the short term.

For these reasons, we think Mr Draghi will not be too concerned if the exchange rate of the Euro or market interest rates ease a little in current circumstances but we don't see the ECB favouring a dramatic slide in either in the absence of unexpectedly weak economic data in coming weeks. **We think the ECB is still largely of the view that the Euro area economy is set on a healthy growth path but it wants some clarification of the nature and extent of the slowdown suggested by recent indicators.**

Differences in thinking

Mr Draghi's opening press statement acknowledged '*some moderation in the pace of growth since the start of the year* **and went on to note that the ECB now sees growth being** *'solid'* **rather than the previously indicated** *'strong'.* This is consistent with an element of hesitation on the part of the ECB but we don't think it points to a fundamental change in view. The press statement also points to the healthy current momentum by referencing last year's growth rate as *'the highest since 2007'* and underscores this further by indicating that in time '*the underlying strength of the Euro area economy'* should deliver the ECB's inflation objective.

Mr Draghi gave some flavour by elaborating at some length on the discussion on current economic circumstances. He indicated that reports on recent developments had been given by representatives of the national central banks in all Euro area member states and acknowledged that the recent softening in the trajectory of growth was broad based across sectors and countries.

While Mr Draghi suggested that softer growth was largely unexpected and not fully understood, he set out a list of mitigating factors including the observation that the latest PMI data for April hinted at a possible stabilisation as well as highlighting that the pace of growth remains well above historic averages. He also mentioned a range of influences that might point towards a temporary rather than permanent slowdown of late including unusually poor weather, the impact of strikes and distorting effects related to the timing of Easter.

Having outlined a lengthy set of possible reasons why the recent slowdown would likely not prove significant, **Mr Draghi also admitted that some indicators were at least hinting at a possible softening in demand that could prove more problematic** and warranted 'monitoring'. Our sense is the latter would not be a major concern but for a significant shadow hanging over the future course of international trade relations.

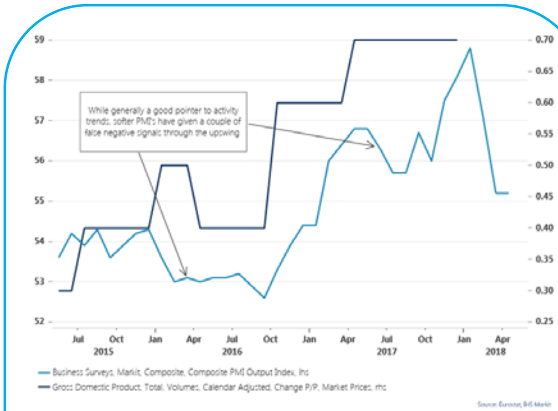
While Mr Draghi noted **problems in regard to trade prospects were** still largely confined to *'rhetoric'*, he acknowledged the threat of disruptive actions. Such a possibility is **more formally conceded in the opening press statement's** indication that although upside and downside risks to the outlook for activity remain broadly balanced, '*risks related to global factors, including the threat of increased protectionism, have become more prominent*'.

Our judgement is that **interpretations of recent softer data and their implications for the ECB's policy path likely vary significantly across the ECB's governing council. In the absence of consensus** in this regard and mindful of a continuing threat of disruptive developments in relation to global trade, **it is understandable that the ECB might** decide that discretion is the better part of valour and opt to **delay any signalling of future plans.**

An aberration rather than an apocalypse?

It is difficult to explain why the trajectory of economic growth in the Euro area (and elsewhere) **might suddenly wilt** in the absence of a marked change in economic policy or confidence drivers. It is entirely possible that the recent signs of moderation in a range of growth indicators point towards an easing towards a more sustainable if still robust rate of growth.

It is also possible that the signal to noise ratio in a range of indicators has deteriorated of late as occasionally happens. As the diagram below shows, the monthly fluctuations in PMI data (singled out here because Draghi specifically referred to them), would have signalled a number of 'false negatives' in recent years.



False dusk of faltering growth?

Policy implications may not be fully clear

More importantly, readings for the composite PMI series for the past couple of months would still appear consistent with an historically strong quarterly GDP growth rate for the Euro area close to 0.5%. **Provided that we don't see some negative shock materialise in the next couple of months, markets may have to rethink how prepared they are for even a modest path towards ECB tightening.**

A final consideration raised a couple of times by Mr Draghi **is an element of uncertainty as to how to place the current apparent slowdown in growth and the exceptional pace that preceded it in a proper context.** One possible if not entirely plausible explanation offered for the recent slowdown is the Euro area economy may already running into capacity constraints in specific areas such as construction. On that view, the path towards and along policy tightening might need to be accelerated before long.

A more interesting suggestion is that **the acceleration in growth through 2017 could be pointing towards stronger potential growth than previously envisaged**. While this might suggest more spare capacity and, hence, less urgency to tighten immediately, as Mr Draghi pointed out, this stronger growth capacity would also imply the longer term 'neutral ' or equilibrium rate that balances the economy would be somewhat higher than currently thought. **In such circumstances markets might have to consider how to balance the implications of a later departure but a more distant final destination for ECB policy rates.**

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