



Flash

Friday, 15 June 2018

## Rate delay outweighs end of APP

ECB announces APP to be scaled down in Q4 and finished by end year...but...

...Markets react more to unexpected 'lower for longer' signal for ECB rates

ECB concerned not to lead markets to expect they would tighten too soon/much

Dovish rate signal to dominate markets... but it may not be as conclusive as it seems

Inflation at target by 2020, suggesting a case for a more restrictive policy path

### Policy rates to remain lower for longer

By signaling its intention to scale back its monthly bond buying to €15bn from October and fully end its Asset Purchase Scheme (APP) by the end of this year, **The European Central Bank took an important initial step towards moving towards more normal settings for its monetary policy. However, financial markets paid much more attention to the unexpected indication by the ECB that its official interest rates will 'remain at their present levels at least through the summer of 2019 ...'.** This unexpectedly dovish forward guidance prompted a significant and speedy market reaction.

Together with a generally cautious outlook for the EMU economy from Mr Draghi, **the effective commitment not to raise policy rates until autumn of next year at the earliest served to underpin the view that the ECB will only move very slowly away from the exceptional scale and range of support it is now providing to interest rate markets.**

As markets had come to view the early announcement of the ECB's intentions in regard to the ending of its APP as a possible pointer to an earlier and faster move on interest rates, **yesterday's more explicit guidance on the timing of future rate moves came as something of a shock.**

**Markets quickly moved to re-price expectations in regard to the timing of the initial ECB rate hike from mid to end**

**2019** (implying it would be possibly implemented by a successor rather than Mr Draghi whose term as president ends in October 2019). Not surprisingly, **this re-assessment prompted a softening in Euro area market rates** as traders pushed back their expectations in regard to the timing and speed of the path of future ECB tightening moves.

In tandem with the release of strong US retail sales and a pull-back in forward guidance on policy from a generally upbeat Federal Reserve Wednesday, **the apparently significant contrast in economic performance and policy prospects on either side of the Atlantic highlighted by the ECB's pronouncements also led to a material drop in the exchange rate of the Euro against the Dollar.**

**While the immediate market reaction is entirely rational, there is some risk it may go too far.** In the very near term, market sentiment may be slow to alter but there are several aspects to yesterday's outcome that argue markets should guard against excessive complacency in regard to the future path of ECB policy.

### Was the ECB too careful?

In assessing the pronouncements, it should be recognized that **there are good reasons why the ECB would have wanted to avoid an excessively hawkish signal.** The major risk facing the ECB at present is that it would tighten too early or aggressively (as was the case in 2008 and 2011) and

be quickly forced to reverse course. Allied to this was the possibility that **unduly hawkish comments could cause market rates to move prematurely leading to an excessive tightening in financial conditions** that would weaken an already somewhat hesitant EMU growth trajectory of late.

The opening statement nods in the direction of such concerns by adding to its risk assessment that *'Moreover, the risk of persistent heightened financial market volatility warrants monitoring'*. **In these circumstances, the key requirement was to signal an eventual tightening of policy but avoid any notable rise in market interest rates or in the Euro.** That has clearly been achieved- possibly by a message that was perhaps dovish to an unintended degree?

A second consideration is that **heightened uncertainty in relation to the strength and durability of the upswing in the Euro area argues for buying a material amount of time before taking more decisive policy steps** towards a less accommodative stance. While Mr Draghi downplayed the significance of recent Italian developments at the press conference, he repeatedly noted that a *'soft patch'* in Euro area growth seen in the first quarter could last somewhat longer than initially envisaged. He also added that the latest ECB projections do not take account of trade measures not yet implemented but acknowledged any escalation in this area could be significantly negative in its impact.

The fact that the ECB has at least begun to set out the initial steps it will take to end its APP at a time when trade tensions and Italian difficulties have created significant uncertainty suggests there is an important element within the ECB'S Governing council that is pushing for a less accommodative policy stance. **In current circumstances, it would have been relatively easy for the ECB to postpone its announcement on the ending of the APP possibly for several months. However, there is clearly a view that some signaling of a move towards the exit from easy policy is now needed.**

However, it should also be emphasised that, as has been the case for some time, **opinions around the ECB Governing council table likely differ materially on when and how fast policy should change.** Mr Draghi noted on several occasions that today's decisions were *'unanimous'*. **To achieve agreement, some element of compromise was clearly needed.**

Interestingly, Mr Draghi also noted that various options for winding down the APP hadn't been discussed as significant work at committee level within the ECB had produced a widely shared view at the Governing council level. While it has little relevance for the near term policy outlook, the likelihood is that similar committee work is already underway at least in a preliminary fashion on various possible paths for policy rates through 2019 and beyond.

## How binding is the ECB's commitment?

**A notable clarification from Mr Draghi was that the ECB's commitments in terms of future policy are 'both 'state and date dependent'**. This was most clearly signaled in the opening press statement in relation to the ending of the APP which makes that action conditional on *'incoming data confirming our medium-term inflation outlook'*.

**The market reaction to the ECB pronouncements was heavily influenced by the apparent double bind of state and date commitments in relation to the forward guidance provided on key policy interest rates** that *'we (the ECB) expect them to remain at their present levels at least through the summer of 2019 and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectations of a sustained adjustment path'*.

**The intention of this phrasing is clear. However, the commitment implied by the word 'expect' may not be quite as watertight as the market assumes.** Draghi added that there was a *'desire to retain optionality'* in relation to the ECB's guidance on future policy changes. He further noted when asked if the chosen wording ruled out an initial rate move in September 2019 that *'the guidance was intended to give a time dimension but not a precise one'*.

So, **it would appear that the ECB wants to ensure that markets do not discount a rapid sequence of tightening moves.** However, this later starting point should provide the Euro area with additional stimulus which, in turn, could argue for a faster eventual pace of rate increases than would otherwise be the case.

## Projections suggest restrictive policy path

In the context of a generally dovish presentation by Mr Draghi, it is not surprising that **new ECB projections received little attention.** Significantly, a downgrade to the growth forecast for 2018 (largely reflecting the poorer Q1 outturn) did not spill over into downward revisions to 2019 or 2020 (in fact the upper end of the range for 2020 GDP was revised up marginally). Employment growth through each of the three years of the projections was also unchanged, underlining official expectations of a sustained and solid upswing in activity.

**The most interesting aspect of the new projections was an upward revision to inflation forecasts.** While the ECB press statement suggests this is *'mainly reflecting higher oil prices'*, **the detailed projections also show 'core' inflation moving up to 1.6% in 2019 from 1.5% previously and, more importantly, to 1.9% in 2020 from 1.8%.** With headline inflation at 1.7% through the projection period and core inflation at 1.9% in 2020 (while GDP growth remains above potential), **this outlook would, in isolation, seem to point**

towards the requirement for a somewhat more restrictive policy path than the ECB signaled yesterday.

The sense of an environment in which price pressure are gradually building (albeit from a low base) is also evident in a notably more upbeat assessment in the opening press statement; ‘Domestic cost pressures are strengthening amid high levels of capacity utilization, tightening labour markets and rising wages. Uncertainty around the inflation outlook is receding. Looking ahead, underlying inflation is expected to pick up towards the end of the year and thereafter to increase gradually over the medium term’.

### Dovish sentiment to prevail in near term

These conditions would seem to argue for a clearer path to a less accommodative policy than markets inferred from yesterday’s pronouncements by Mr Draghi. If they materialize, they would suggest that the ECB might need to move somewhat earlier than implied or in larger steps later. Indeed, the additional stimulus likely to come from the markets re-pricing of ECB expectations should boost activity and inflation further. In such circumstances the date and state dependency of yesterday’s guidance could be tested.

However, these are issues for another day. For now, the apparent commitment not to raise rates until the end of the third quarter of 2019 at the earliest will act as significant restraints on euro area market interest rates and on the exchange rate of the Euro.

Mathias Van der Jeugt, KBC Brussels  
Austin Hughes, KBC Dublin

## Contacts

Brussels Research (KBC)		Global Sales Force	
Mathias Van der Jeugt	+32 2 417 51 94	Corporate Desk (Brussels)	+32 2 417 45 82
Peter Wuyts	+32 2 417 32 35	Institutional Desk (Brussels)	+32 2 417 46 25
Mathias Janssens	+32 2 417 51 95	CBC Desk (Brussels)	+32 2 547 19 19
Dieter Lapeire	+32 2 417 25 47	France	+32 2 417 32 65
<b>Dublin Research</b>		London	+44 207 256 4848
Austin Hughes	+353 1 664 6889	Singapore	+65 533 34 10
Shawn Britton	+353 1 664 6892		
<b>Prague Research (CSOB)</b>		<b>Prague</b>	+420 2 6135 3535
Jan Cermak	+420 2 6135 3578		
Jan Bures	+420 2 6135 3574		
<b>Bratislava Research (CSOB)</b>		<b>Bratislava</b>	+421 2 5966 8820
Marek Gabris	+421 2 5966 8809		
<b>Budapest Research</b>		<b>Budapest</b>	+36 1 328 99 85
David Nemeth	+36 1 328 9989		

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