Flash

Thursday, 19 January 2017

# ECB Draghi to stick to his guns

Recent stronger growth and growth outlook, higher inflation and inflation expectations could mean some awkward questions for Mr Draghi…

But aren't enough for ECB to change tack and become more hawkish

We expect Draghi to be as dull as possible and still dovish,pointing to energy prices as the main and temporary driver of current inflation

Communication may be more difficult later in 2017 with good chance that the ECB comes under pressure to taper earlier

Purchases may be tapered again in September

## Plentiful decisions at Dec meeting

At the **December meeting**, the ECB took some far reaching decisions, the most important of which still need to be implemented. From the start of April, the amount of monthly APP (asset purchase programme) purchases will be lowered to €60B/month from €80B/month now. At the same time, the ECB prolonged the duration of the APP to at least the end of December 2017. Somewhat surprisingly, the December meeting also saw the ECB **attempt to solve the bond scarcity problem by** deciding that bonds with a maturity of 1 (instead of 2) year and bonds yielding less than its depo-rate would now also be eligible for its monetary operations.

## No reasons to rock the boat now

**With these measures, the ECB likely intended to ensure it could stay on the sidelines during an important 2017 election year.** The desire to signal continuity in the stance of its monetary policy was also designed to bring some stability and predictability to markets in the face of the yet unknown (or better unspecified) policy plans of the incoming US administration. One year is a long time and we think it may be wishful thinking on the part of the ECB that it can remain out of the spotlight for so long. **Nevertheless, for Thursday's meeting, no novelties are expected and Mario Draghi may try to be as dull as possible to minimize any impact on markets.** That would suggest no new signals and instead he might limit himself to repeating almost word for word the comments made at the December meeting.

Nevertheless, two recent economic developments will provide material for questions by journalists at the press conference. One possibly contentious, issue is the nature and extent of concern within the ECB in regard to the effectiveness of QE to reach its inflation goals. The clear reservations expressed by Mr Weidmann and some other senior officials have raised the possibility of a shift in ECB thinking about the benefits and costs of the APP. **The time may not be ripe for any marked shift but journalists may probe MrDraghi for any sense that opposition to the APP is on the rise.**

## Stronger growth may pose awkward questions

A second issue now emerging is increasing optimism about the Euro area economy and a growing sense that this should contribute to a stronger path for inflation than was previously expected. The manufacturing PMI rose to a lofty 54.9 in December from 53.7 previously, the fourth consecutive monthly increase, while the services PMI more or less stabilized at 53.7. Consumer confidence is doing fine to with its level near the highest levels since the financial crisis. It was not only the soft data that improved, but also the hard ones like production, which jumped 1.5% m/m in November. **This makes a 0.4% Q/Q GDP growth in Q4 a possibility with also upside risks for growth in the first half of 2017**. It is amazing how little the economy seems to have been affected by the multiple political shocks like Brexit, US elections and the Italian referendum. **This points to a stronger than usual resilience in the Euro area economy and, by extension, a more positive assessment of the outlook for 2017 and beyond.**

## As will higher inflation and inflation expectations

Inflation also surprised of late, and, in contrast to most episodes in recent years, this time to the upside. In December inflation jumped to 1.1% Y/Y from 0.7% Y/Y previously and also core inflation ticked higher to 0.9% Y/Y from 0.8% Y/Y in November. **We should interpret this upside surprise cautiously.** There is notorious volatility in inflation figures around the turn of the year and, in any event, most of the increase in prices is energy-linked. The rise of the core price might have been more a rounding affair than a genuine increase. However, **in January and February, base effects are expected to push headline inflation even higher. This might cause the ECB communication problems, especially if core inflation were to print above 1%.** It should also be noted that in addition to higher than expected recent consumer price statistics, inflation expectations have also been on the rise especially before New Year. The 5-year/5-year forward inflation expectation (SWAPS) stands now at 1.75%, 10 basis points above levels prevailing at the time of the previous ECB meeting and about 50 basis points higher since the lows in mid-2016. We think that the ECB would like to see this measure of inflation expectations slightly above 2%, levels that were considered normal in the period before 2014.

We suspect that journalists at today's press conference may ask whether the December prolongation of the APP was justified, but Mario Draghi will defend it as the right decision given the current environment and reject any suggestion that a further tapering might be likely before the end of 2017.

The Minutes of the December ECB meeting confirmed a broad consensus on the Governing council in relation to the measures taken and the need for prolonged monetary support for the Euro area economy. **As time goes by, and the economy strengthens, the possibility of inflation being closer to the ECB objective and political pressures rising could make for an increasingly uncomfortable backdrop for Mr Draghi as he defends the current ECB stance.**. Indeed, once the French elections have passed and if no populist has won the presidency, the political calculus may change. In the run-up to the German elections, which this week have been set for September 24 2017, opposition from German politicians to negative interest rates and more generally, the very accommodative ECB policy will increase and probably get notably louder and more public. Today should be relatively quiet, but the thrust of questioning at the press conference may give us a small taste of emerging concerns that mean Mr Draghi and the policies of the ECB are very unlikely to remain out of the spotlight through the coming year especially should inflation be higher and growth intact. There may be support from other EMU countries that would also like to see monetary normalization as soon as possible. **The scarcity problem may resurface too.** Indeed, the minutes of the last meeting shows that legal and institutional issues prevented the ECB to raise the issue and issuer limits. Therefore, we consider these options as closed for the future. Even at the diminished pace of purchases, there might come **more and more dislocations in the smooth working of the bond markets** (think already on the collateral problems in the repo-market). **The current solution, buying below the depo-rate and including the 1-to-2-yr sector of the bond curve will probably have been only reluctantly accepted by the central banks of the core countries.** However, buying high quantities of such bonds which generate losses for a longer period isn't an enviable matter and thus probably won't be accepted when circumstances change for the better. If the APP should be prolonged beyond 2017, the ECB might need to start buying other assets. We don't think that will be the case. **On the contrary, we expect some tapering to appear already in H2 of 2017 or at least hints in that direction are likely.** Given the date of the German elections, the September 7 ECB meeting, our educated guess for announcing or even starting tapering till now, might already be too late in political terms, but making important policy changes at the end of July meeting, while possible, isn't comfortable either for the ECB as markets might have already thinned. However, these are questions that won't pop up during today's meeting.

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