27 April 2017

ECB Review

Less downside risk to growth but no changes to inflation

The ECB kept policy rates, the QE programme and its forward guidance unchanged at today's meeting – in line with our expectations. It still expects policy rates *'to remain at present or lower levels for an extended period of time and well past the horizon of our net asset purchases'*. Additionally, regarding QE purchases, the ECB continues to have an easing bias, as it communicated that it stands ready to increase QE in terms of size and/or duration.

According to Mario Draghi, the ECB Governing Council did not discuss changing its forward guidance or the sequencing of the exit from the very accommodative monetary policy. Both of these topics have received a lot of attention following the latest ECB meeting in early March but the focus on hiking policy rates in order to support the banking sector could fade somewhat as Draghi described the potential side effects of accommodative monetary policy as being limited.

The introductory statement had a minor hawkish twist, as the ECB described the risks surrounding the euro area growth outlook as moving towards a more balanced configuration but still being skewed on the downside. However, during the Q&A session, Draghi communicated that the ECB did not discuss a better or more balance inflation outlook and made it clear that there was an important difference between these two measures.

Regarding the inflation outlook, the ECB still argued that measures of underlying inflation remain subdued. Related to this, the introductory statement also included *'the ongoing volatility in headline inflation underlines the need to look through transient developments in HICP inflation'*.

The ECB could change its forward guidance on policy rates at the meeting in June when it will have updated macroeconomic projections but, as we have previously argued, there is a risk that it will stick to a more cautious approach. This should follow as Draghi has recently said *'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'*. We still believe the ECB will announce an extension of its EUR60bn monthly QE purchases at the September meeting and continue the programme in 2018.

In fixed income markets, 2Y German yields declined, mainly reflecting Draghi's comment that the ECB did not discuss better securities lending. He stated that these facilities were primarily a task for national central banks and, although they are following central guidelines, the market is for now set to downplay expectations of any near-term changes to the repo facility. Note that this somewhat backtracks the signals from the March meeting, when Draghi said that they were monitoring the repo situation closely and would come 'back on this next time'.

EUR/USD moved up one step up (on 'downside risks diminishing') and then one step down again (on rate hikes off the table for now). EUR/USD still looks like a 1.06-1.10 range near term, as the Fed will be there to keep some downside potential intact but, in our view, there is clearly a risk that we could stand at the June meeting with an ECB that changes its forward guidance in a more hawkish direction provided the cyclical situation looks good still and provided the inflation outlook has not deteriorated markedly (beyond base effects falling out) – and EUR/USD would be more sensitive to a signal on rates than to a possible extension of QE.

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None.

Date of first publication

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