PICTET 1805

Flash Note

Euro area: monetary policy

Fine-tuning ECB communication as the recovery broadens

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The ECB delivered a fairly balanced, albeit more optimistic message at today's press conference, echoing upward revisions to the staff projections for 2017-18 euro area GDP growth and inflation. Crucially, however, the 2019 projection for inflation was left unchanged at 1.7%.

Notwithstanding the improvement in the economic outlook, the ECB's bias for rate cuts and QE extension was maintained at this stage. We think the next shoe to drop will be forward guidance on policy rates, with a more neutral statement likely at the June meeting and, possibly, a proper debate on policy normalisation.

Looking ahead, the ECB's four inflation criteria are unlikely to be fully met before year-end. We still expect the ECB to wait until September before deciding about QE extension into 2018, most likely announcing a tapering of asset purchases starting in Q1 2018. As regards policy rates, our baseline remains for a first hike in the deposit facility rate in Q4 2018.

No action, but a very soft re-calibration of communication. At today's policy meeting, the European Central Bank (ECB) delivered a fairly balanced, albeit more optimistic message, highlighting the ongoing improvement in the economy as well as the diminishing risks surrounding the outlook. The statement was adjusted at the margin (see Table 1), still consistent with a dovish bias, although the press conference did signal a gradual shift in the ECB's forward guidance toward a more neutral stance, in our view.

The ECB's staff forecasts for 2017-18 euro area GDP growth and inflation were revised higher, for the first time since June 2015. Although the balance of risks on economic activity remained "tilted to the downside", risks were said to have become "less pronounced". Importantly, **the bias for lower rates was kept** in the statement, with policy rates expected to remain "at present or lower levels for an extended period of time, and well past the horizon of net asset purchases", **but the reference to rate cuts as a policy instrument was removed**. The ECB also reiterated its commitment to implement QE until at least December 2017, and to increase the pace of asset purchases if needed.

To be sure, **the bigger picture remains unchanged – the ECB's mission is not yet complete**. Beyond political risks, the ECB's main concern is the lack of "upward adjustment" in core prices. Core inflation remains too low, below 1% in February, and wage growth remains subdued. We do not expect the ECB's inflation criteria to be fully met until Q4 2017, providing ample justification for a cautious approach to policy normalisation.

Still, a proper debate on the sequencing of policy normalisation could start in June, including on the timing of tapering and rate hikes. **Our baseline remains for QE tapering to be announced in September (starting in Q1 2018), and for a first hike in the deposit rate to be delivered in Q4 2018.**

Table 1: ECB guidance in terms of the outlook and the policy instruments

ECB guidance	Previous (January)	New (March)
Balance of risks: growth	"tilted to the downside"	"risks have become less pronounced, but remain tilted to the downside "
Balance of risks: inflation	no explicit balance of risks	no change
Broad stance	"A very substantial degree of monetary accommodation is needed [...] If warranted, the GC will act by using all the instruments available within its mandate."	"A very substantial degree of monetary accommodation is needed."
Policy rates	"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"	no change
QE	"we stand ready to increase our asset purchase programme in terms of size and/or duration"	no change

AUTHOR

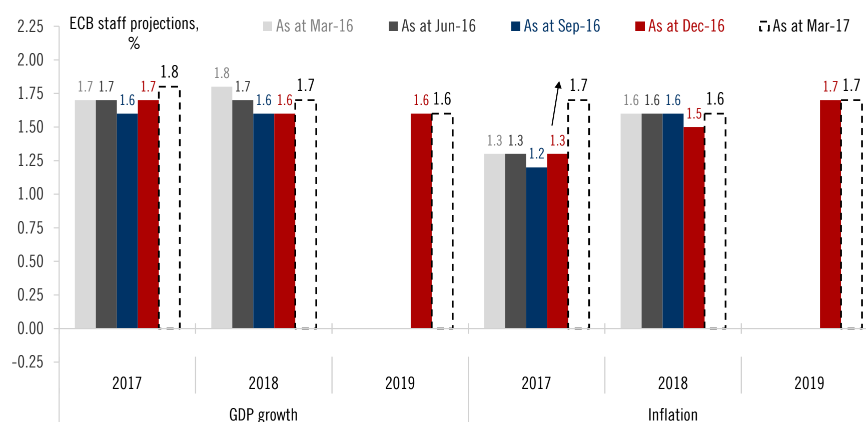
Frederik DUCROZET
fducrozet@pictet.com
+41 58 323 4582

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Looking through staff projections to the balance of risks

Upward revisions to the ECB's staff projections were largely expected, at least for this year, reflecting stronger business sentiment, bank credit flows, lower unemployment as well as a boost from looser financial conditions (with the effect of higher interest rates offset by a weaker currency). The key question was whether longer-term projections would be affected, and whether a more upbeat economic assessment would be reflected in a change to the balance of risks. The answer was an (unconvincing) 'No' in both cases.

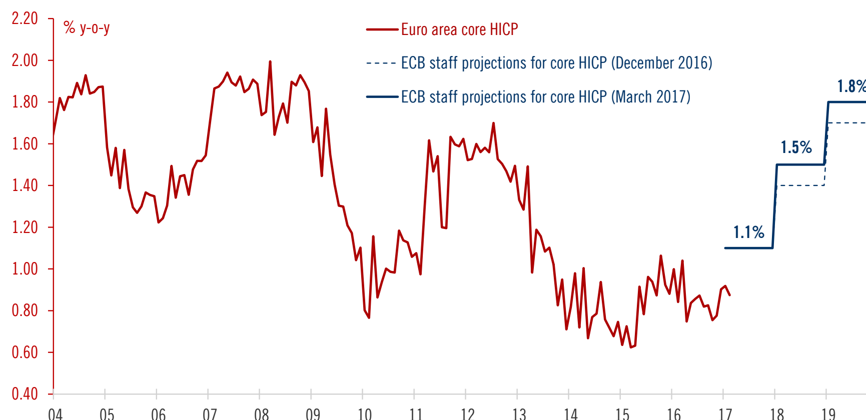
Chart 1: ECB staff projections for euro area real GDP growth and HICP inflation



Source: Pictet WM – AA&MR, ECB

As regards HICP inflation, **the staff projections were revised higher broadly in line with our expectations**, at 1.7% in 2017 (up from 1.3%), 1.6% in 2018 (up from 1.5%) and 1.7% in 2019 (unchanged). The revision to the short-term forecast was the first since June 2015. The absence of upward revision to the 2019 projection will be a disappointment to the hawks, although **core HICP inflation was revised *higher***, to 1.5% in 2018 (from 1.4%) and 1.8% in 2019 (from 1.7%). The staff mentioned a smaller unemployment gap and rising wages (including modest second-round effects from higher energy prices) as potential drivers, but this projection looks overly optimistic to us (*see Chart 2*).

Chart 2: euro area core HICP inflation and ECB staff projections



Source: Pictet WM – AA&MR, Eurostat, ECB

In short, the ECB was again disappointed by recent figures for underlying inflation and wage growth, but a faster recovery in economic output and employment has fuelled hopes that core inflation will finally move higher in the short- to medium-term.

Indeed, **real GDP growth projections were revised marginally higher from already elevated levels**, at 1.8% in 2017 (up from 1.7%), 1.7% in 2018 (from 1.6%), and 1.6% in 2019 (unchanged) – all well above potential growth. From a qualitative perspective, the ECB noted that recent data have increased their confidence that "the ongoing economic expansion will continue to firm and broaden".

Importantly, **although the balance of risks was still described as "tilted to the downside", it was said to have improved further as downside risks had become "less pronounced".** This subtle shift in the ECB's assessment was similar to the changes made in March and April 2015, right after the ECB launched its expanded asset purchase programme. Barring an accident at the domestic of international level, **it now looks likely that the ECB will soon move more formally toward a more neutral stance** as regards growth.

Unfortunately, the same cannot be said for the outlook for price stability. **The ECB has stopped providing an explicit balance of risks for inflation since September 2014**. Since then, the statement has either noted that the Governing Council would "closely monitor" the evolution of the outlook for price stability, or made no mention of it at all. Meanwhile, the ECB's concerns over subdued dynamics of wages and underlying consumer prices have increased.

Looking ahead, based on the four inflation criteria described by ECB President Mario Draghi at the January press conference, we still think that the conditions for a proper debate on QE exit and broader policy normalisation will not be fully met until Q4 2017, at best. The only criterion that has been met is the broad-based nature of the inflation adjustment, with roughly 75% of the region now recording a headline inflation rate above 1.5% (see table 2 and our Flash Note "Inflation and the ECB: the four criteria" for details).

Table 2: inflation adjustment criteria to be met by year-end

Inflation adjustment criteria	Gauge	Latest	Taper threshold	Estimated date when criteria will be met
Medium-term horizon	Long-term ECB staff projection (headline HICP)	1.70%	1.90%	June 2017
Durable	6-month average of core HICP inflation	0.84%	1.1-1.2%	Q4 2017
Self-sustained	Long-term staff projection excluding QE effect	1.40%	1.75%	September 2017
Broad-based	Share of countries with HICP inflation >1.5%	75%	66%	Already met

Source: Pictet WM – AA&MR, Eurostat

This should provide the doves with ample justification for a cautious approach to policy normalisation when the proper debate starts. In the meantime, the ECB will continue to "look through" the spike in headline inflation rates that are largely, if not only due to higher imported prices.

Calibrating the ECB's statement and forward guidance – *rendez-vous* in June

The cautiously optimistic assessment from the staff projections was reflected in the ECB's introductory statement, although the bias for even more negative rates and QE extension has been maintained at this stage. The Governing Council continues to expect policy rates "to remain at present or lower levels for an extended period of time, and well past the horizon of [ECB's] net asset purchases". The latter will continue until the December 2017 (at a reduced EUR60bn pace from April), "or beyond, if necessary", and in any case until the ECB sees "a sustained adjustment in the path of inflation". Last but not least, the Governing Council still "stands ready to increase the programme in terms of size and/or duration".

The ECB also maintained its committment to preserving **a "very substantial degree of monetary accommodation"** for now, although, interestingly, **the reference to "all instruments within the mandate" has been removed**, suggesting that the Governing Council would rely on QE only in case downside risk materialised. This makes the bias for rate cuts even more difficult to justify, in our view, and indeed **we think the next shoe to drop will be the reference to "lower rates" in the statement as the ECB shifts to a more neutral guidance at the June meeting.**

Near-term, though, the fact that the bias for even more negative rates was maintained will remove a potential boost to banks' demand for the final Targeted Longer-Term Refinancing Operation (TLTRO) scheduled later this month (allotment results on 23 March). There was no discussion about new operations, although Draghi admitted that TLTROs could still be used if needed. In fairness, it should not make a huge difference, since no one is expecting the ECB to cut rates anyway, and the March TLTRO provides a last opportunity for banks to lock in a cheap (-0.40%) source of funding at a 4-year maturity. **Our expectation remains for a fairly large allotment, above the previous operation (EUR62bn in December 2016)**, helping to mitigate the cost of negative deposit rates for commercial banks in aggregate.

No debate on the exit, and no change on QE modalities

Draghi faced some questions on QE implementation, but he did not give much away. Remember that the accounts of the January meeting created some confusion in markets, noting that "there was some room for a trade-off between relative deviations from the capital key across jurisdictions and limiting the extent of purchases below the deposit facility rate". Draghi did not elaborate on this point, confirming our view that the ECB is very unlikely to signal a change in policy at this stage. He also reaffirmed that QE was proceeding smoothly, both "time-wise" and "quantity-wise", downplaying concerns over bond scarcity.

Moreover, the sharp moves lower in short-dated German bond yields have raised concerns over QE-led market distortions and potential constraints in terms of the Bundesbank's ability to meet the monthly targets. On this, Draghi said that the ECB was monitoring the situation closely and that it could still address the underlying problems eventually. A further loosening in the terms of the various securities lending facilities looks likely in June.

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