

Flash Note

Euro area: monetary policy

ECB hints at October decision on QE

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The ECB left its assessment and communication broadly unchanged at today's meeting. Draghi confirmed that "the bulk of the decisions" on QE extension should be made at the 26 October meeting.

The statement mentioned recent currency volatility as "a source of uncertainty" to be monitored in the future, and the staff projections for inflation were revised down due to EUR appreciation. However, the ECB also believes that the EUR is appreciating for good reasons. In the end, the medium-term outlook for inflation was broadly unchanged.

At this stage, our impression is that the ECB is leaning towards a reduction in QE size (to EUR40bn in H1 2018) and a change in QE composition and parameters, possibly favouring private debt at the expense of sovereign debt purchases. The biggest wild card remains a potential shift from capital keys, but a formal change in rules looks unlikely at this stage.

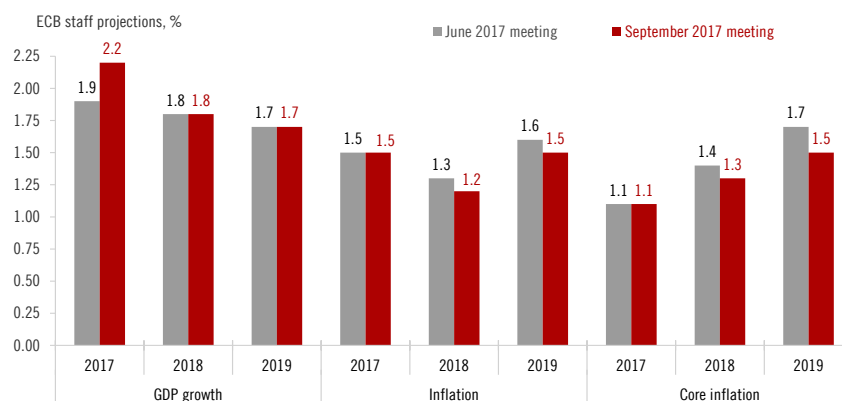
At today's policy meeting, the ECB confirmed that a decision on QE extension will come this Autumn. More precisely, **"the bulk" of the decision on the calibration of policy instruments is expected in October**, while the announcement of some technical details could be postponed to December.

As regards the currency, Draghi played it by the book. The statement mentioned recent currency volatility as "a source of uncertainty" requiring "monitoring". This amounts to light verbal intervention *à la* Jean-Claude Trichet. Unless the EUR appreciates further on a trade-weighted basis, we expect the ECB to stick with this strategy.

Moreover, revisions to ECB staff projections were much smaller than what standard estimates of FX pass-through would have suggested, and even smaller than the cautious adjustments we envisaged following the 5% appreciation in the currency (see Chart 1). Notwithstanding concerns over EUR overshooting, **the ECB sees the currency glass as half-full**, largely reflecting a positive endogenous demand shock, and rightly so in our view.

We see no reason to change our baseline scenario. We continue to expect asset purchases to be scaled down to EUR40bn (from EUR60bn currently) between January and June 2018, and to be gradually wound down to zero in H2 2018. Our impression is that the ECB is heading towards **a change in QE composition favouring private debt** at the expense of sovereign debt purchases as well as **a greater use of the programme's flexibility** in 2018. Although tapering can be a challenge for markets, those exit sweeteners would help mitigate the impact of the ECB's normalisation process.

Chart 1: smaller-than-expected revisions overall to ECB staff forecasts



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

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Broad assessment: still confident

The ECB's assessment of the medium-term outlook for inflation was "broadly unchanged", Draghi said from the very beginning. Generally speaking, the ECB's broad strategy has been communicated to markets in a rather consistent way in recent months. Today's press conference was no exception notwithstanding some legitimate excitement about the EUR. Indeed it looks as if the ECB launched a new CPPP programme this year, standing for "Confidence, Patience, Persistence, Prudence". We expect this line of communication to continue as the ECB aims at "adjusting policy parameters", considering the whole range of measures, in order to keep the monetary stance "broadly unchanged" as the recovery strengthens.

Two examples illustrate the ECB's growing confidence, in our view. First, Draghi mentioned (twice) the recent modest improvement in underlying inflation, with all the 'CPPP' caveats applying, in line with our view that [upward momentum in core inflation is building](#) in the short-term. Second, facing yet another question on the currency, the President said "I don't think that we are in a period of great uncertainty." Those are comments Draghi never would have made even one year ago.

Introductory statement, forward guidance and the EUR

The first paragraph of the introductory statement was copy-pasted from the July statement. **Forward guidance was left unchanged as regards QE** (which the ECB "stands ready to increase in terms of size and/or duration") **as well as policy rates** (which are expected to remain "at their present levels for an extended period of time, and well past the horizon of net asset purchases"). As regards the former, at least, the decision not to make any change today could have been motivated by the risk of EUR overshooting.

Concerns over "recent volatility" in the exchange rate made it into the first part of the ECB's statement, which in itself indicated a fairly high level of importance, at least compared with the July meeting when the EUR only received "some attention". The "volatility" word was frequently used by Jean-Claude Trichet, although today's ECB statement did not qualify it as "excessive", suggesting a potential for stronger rhetoric in the future. The statement mentioned the need to "monitor" the currency "with regard to its possible implications for the medium-term outlook for price stability".

This is fully in line with the ECB's 'not-a-policy-target-but-an-important-input' mantra, but the difference today lies with the credibility of the threat, or lack thereof. Monetary policy is getting closer to the limits, and Draghi refused to elaborate on what the policy response to an unwarranted tightening of financial conditions would be. A threat to cut rates deeper into negative territory would contradict the ECB's forward guidance and risk backfiring, in our view. **In the event of EUR overshooting over 1.20 against the USD on a sustained basis, we would expect some ECB officials to float the idea of an extension of QE at the current EUR60bn pace into 2018.**

The other important difference with previous episodes of currency appreciation is the economic outlook. A "robust and broad-based" recovery as the ECB describes it should make the economy more resilient to a stronger EUR. Draghi's comments as well as [Box 3 in ECB staff projections](#) suggest that the ECB is leaning towards a constructive assessment of EUR

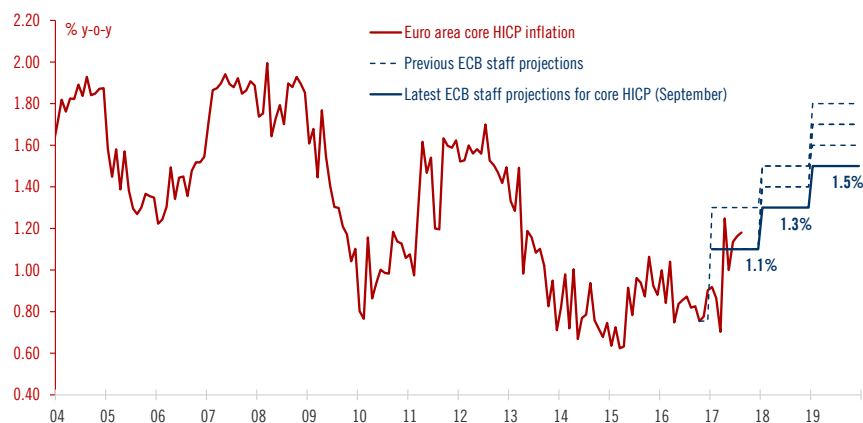
appreciation, one that is predominantly endogenous, linked to the strength of the region and related capital flows, and that implies a **lower FX pass-through on growth and inflation that the one derived from standard model elasticities** (see [“The ECB and the EUR, from Amsterdam to Sintra”](#) with our full analysis on this issue).

Staff forecasts

The quarterly revisions to ECB staff projections were broadly in line with our expectations, pushing the GDP profile slightly higher and the HICP inflation profile slightly lower, with much smaller revisions than some had feared.

As shown in Chart 1, the median forecast for headline HICP inflation was unchanged for 2017 (1.5%) but revised down by 10bp for both 2018 and 2019 (to 1.2% and 1.5%, respectively). **Core HICP inflation** (excluding energy and food) **was revised down by 10bp for 2018 (to 1.3%) and by 20bp for 2019 (to 1.5%)**. We would argue that the former set of projections was always too optimistic anyway, and that today’s revisions bring the medium-term projections for inflation closer in line with the unemployment rate which was revised significantly lower once again, to 8.1% by 2019. Importantly, the end-point for inflation projections (Q4 2019) was broadly unchanged, at 1.6% versus 1.7% in the June forecasts.

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



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

As regards GDP growth, the ECB staff marked its 2017 forecast to market, to 2.2% (up from 1.9% in June) while leaving the 2018 and 2019 forecasts unchanged at 1.8% and 1.7%, respectively. Here again, the fact that the staff did not include a larger drag from the currency does suggest a fairly high degree of confidence over the medium-term outlook. Additional charts with ECB staff projections can be found below.

Preparing for an October decision on QE

During the Q&A, Draghi said that the ECB had tasked the relevant committee to study policy options to recalibrate their policy instruments beyond the end of the year. He refused to commit to a specific date while acknowledging that “the bulk” of the decisions should be made in October.

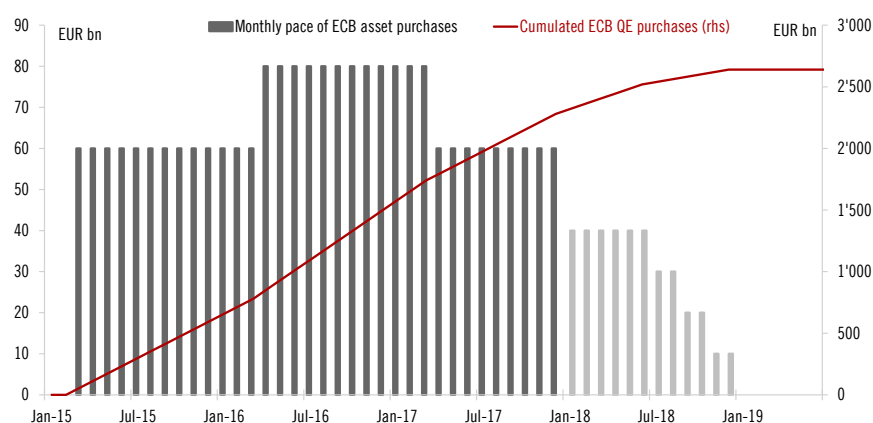
The last time the ECB tasked its committees to evaluate policy options (September 2016), the decision was made three months later (December

2016), but the deadline for QE was another three months away (March 2017). This time, **we expect the ECB to provide the most important elements of its strategy at the 26 October meeting**, and leave some technical details to be discussed and announced at the 14 December meeting, if needed.

Draghi provided some colour in terms of the early exit debate at the Governing Council. In particular, he said that **a change in the exit sequencing was not discussed** – first QE tapering, then rate hikes. **Neither was a change in self-imposed 33% issuer limits**. Interestingly, he did *not* explicitly rule out some changes to capital keys from this list. Although we would not read too much into this omission, we continue to believe that the ECB should and will use the programme’s flexibility in full in 2018, beyond what Draghi mentioned during the press conference (he basically only referred to temporary deviations from capital keys due to some countries being excluded from the programme and due to liquidity considerations).

Draghi said that the Governing Council started to look at a set of scenarios in terms of size, duration, and composition of asset purchases, while mentioning (twice) the importance of their respective transmission channels. Assuming a decreasing marginal return of public QE amid scarcity constraints, our interpretation is that **this could be a first hint at private debt purchase programmes (CSPP; CBPP3; ABSPP) potentially favoured over public debt purchases**. For instance, the share of private debt purchases could be increase and/or they could continue after public QE is tapered in full. One justification could be to ensure a complete restoration of the bank lending and credit channel. The ECB’s biggest wild card remains a potential shift from capital keys, although a formal change in rules looks unlikely until well into 2018 at best. The closer the ECB gets to the end of sovereign debt purchases, the less politically toxic it will be to deviate from capital keys.

Chart 3: ECB asset purchases and a possible phasing out scenario over 2018



Source: Pictet WM – AA&MR, ECB

We will investigate the various QE scenarios in more details, but **our baseline remains unchanged at this stage**. We expect the ECB to announce a 6-month QE extension (until June 2018, or beyond if necessary) alongside a reduction in the size of asset purchases (from EUR60bn to EUR40bn) and a change in QE composition and parameters.

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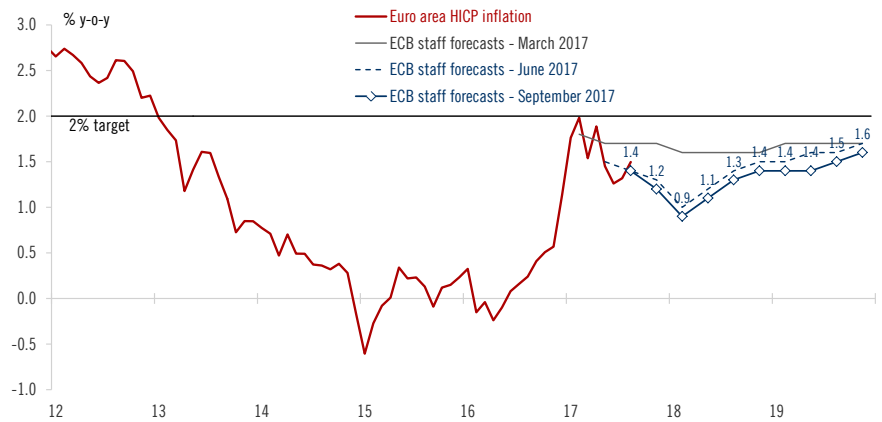
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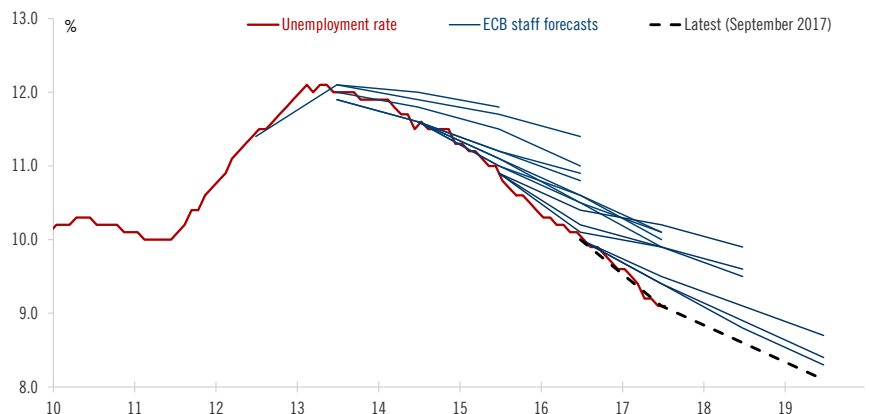
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Chart 4: ECB staff projections including quarterly projections for HICP inflation



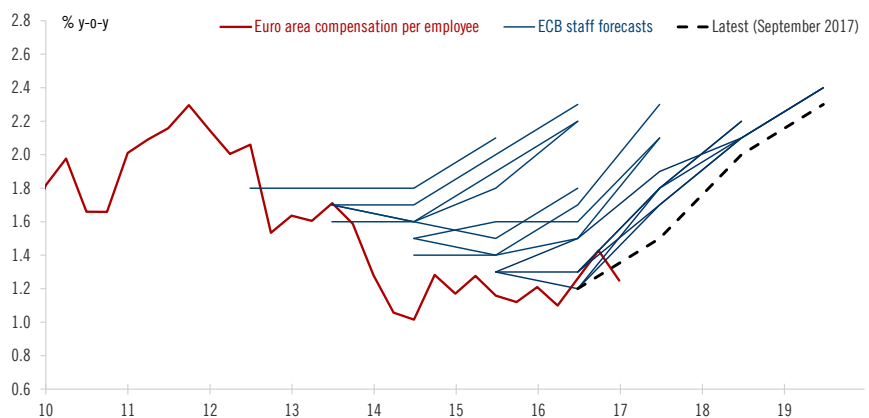
Source: Pictet WM – AA&MR, ECB, Eurostat

Chart 5: unemployment and ECB staff projections



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

Chart 6: wage growth and ECB staff projections



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