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# Flash Note

# Euro area: monetary policy

## ECB preview: slow-motion exit

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The ECB will likely prepare for a cautious, flexible, slow-motion exit at the September meeting, tasking its committees to study all policy options for 2018. We continue to expect an announcement in October that QE will be extended for six months at a reduced EUR40bn pace, before further adjustments are decided.

The appreciation of the EUR will push 2018 inflation projections lower and may force Draghi to step up the "unwarranted tightening" rhetoric to some extent. But, we think he will refrain from more aggressive intervention at this stage.

The ECB could use a number of 'exit sweeteners' in the coming months in order to avoid market overshooting, including a further delay of exit announcements, or a prolonged bias for an increase in QE size. We think the best option would be for the ECB to hint at increased flexibility in terms of QE implementation, including larger deviations from capital keys.

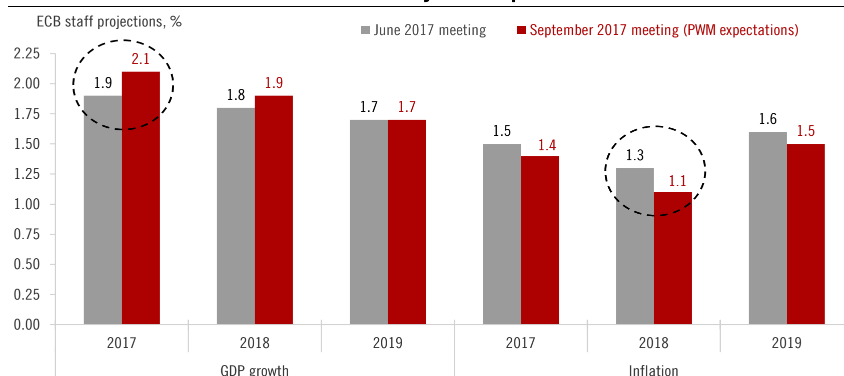
Our ECB scenario remains unchanged. We expect an announcement in October that the monthly pace of asset purchases will be scaled down to EUR40bn (from EUR60bn currently), between January and June 2018, before further adjustments are decided. At next week's meeting, we expect the ECB to lay the ground for these decisions to be made by year-end, **tasking its committees to study all policy options for 2018**.

The broad strategy has been well flagged. The ECB aims at **"adjusting policy parameters"** in order to keep the monetary stance "broadly unchanged" as the recovery strengthens, all **within the new CPPP framework** (Confidence, Patience, Persistence, Prudence).

The stronger EUR will mechanically push staff projections for inflation lower and complicate the ECB's communication, but it should not derail the exit. We expect small changes to the statement to reflect a stronger monitoring of FX developments, noting that **the EUR is "not a policy target" yet an important input**, in an old-fashioned Trichet style. Draghi could be more explicit saying that an unwarranted tightening would delay the exit. But, we think he will refrain from more aggressive intervention at this stage.

If need be, **the ECB could use a number of 'exit sweeteners' in the coming months in order to avoid market overshooting**, including a further delay of exit announcements to December, or a prolonged bias for an increase in QE size. Stronger forward guidance on policy rates would be less efficient, in our view, especially if is not backed by a unanimous decision. We still think the best option would be for **the ECB to hint at increased flexibility in terms of QE implementation**, including larger deviations from capital keys.

**Chart 1: revisions to staff forecasts likely to complicate ECB's communication**




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

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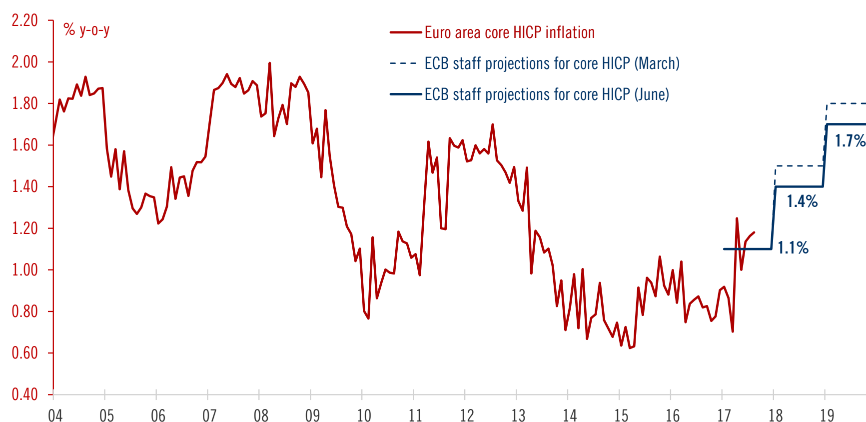
## Focus #1: the staff forecasts and the EUR

The revisions to the ECB staff projections stemming from the 4.8% appreciation in the trade-weighted EUR since the June meeting will be the main focus of the September meeting. Our best guess is presented in chart 1, with more details provided in our note "The ECB and the EUR, from Amsterdam to Sintra", published on 11 August.

The staff projections are derived from the ECB's models using recent data and financial inputs, in a very mechanical way. There is little leeway for the staff to escape the EUR drag on growth and inflation except for the offsetting impact of lower unemployment (which we expect to be brought down significantly further in the September projections).

We expect the net revisions to result in higher growth and lower inflation for 2017-18, although **the long-term forecasts are likely to be little changed, especially in terms of the projections' end-point (Q4 2019)**. This would suggest that 2020 forecasts are still likely to converge closer to ECB's target when they are first published in December.

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




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

Importantly, we expect Draghi to take some distance relative to the staff projections during the Q&A session, highlighting the quality of growth ("broad-based and robust") as well as **the early signs of an upward adjustment to core consumer prices**. Needless to say, it is too early for the ECB to take comfort from inflation levels. Headline HICP rose to 1.5% y-o-y in August and core HICP remained stable at 1.2%. Draghi's four inflation criteria are unlikely to be fully met before the end of this year *at best*, and the Governing Council is still likely to wait until it sees the 'whites of the eyes' of core inflation before it debates the final exit steps.

But momentum matters, and we suspect that the ECB, monitoring price developments very closely as it is, will **welcome the mini regime shift we are witnessing below the surface of core inflation numbers** (see "Upward momentum in core inflation is building", published on 31 August).

## Focus #2: exit sweeteners

With all this in mind, we believe that **the ECB will head towards a cautious, flexible, slow-motion, exit**. There are several options for **a dovish normalisation path**.

First, the final technical details of the exit announcement could be delayed to December, although this would leave little time for market to adjust and would effectively rule out a hawkish surprise. Either way, the scaling down of QE would be described as no tapering, with no mention of an end of asset purchases at this stage, and certainly not presented as outright monetary tightening. The ECB will also continue to highlight the importance of the whole package of policy measures, including the reinvestments of QE proceeds, which we estimate could peak at over EUR10bn per month, supporting flows in addition to the stock effects.

Second, we expected the ECB's bias for an increase in QE *size* to be removed before the reduction in asset purchases is announced, but given risks of EUR overshooting it could be kept for longer as a policy option.

But, in the end, **we still think the best option would be for the ECB to hint at increased flexibility in terms of QE implementation** in the future, in order to ensure that the programme can last for as long as necessary. Indeed, we have long argued that QE was finite due to bond scarcity constraints, but that the ECB could still extend the programme until the end of 2018, if not into 2019, by using the programme's flexibility in full. Looking ahead, once the ECB has embarked on the exit from unconventional measures, **it should be less politically sensitive to make further technical changes to QE rules, provided that an end is in sight**.

To be perfectly clear, the 33% issue(r) limits and capital key rules are likely to remain in place, but within this framework the ECB could allow for a number of changes that would help deal with scarcity and, incidentally, would likely be positive for debt markets. Those changes could include a change in the composition of asset purchases with **a higher share of supranational bonds and/or corporate bonds** as well as, crucially, **larger deviations from capital keys**, up to around 10% of the total PSPP volume. We will cover all the ECB's exit options in an upcoming note.

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