

January ECB meeting: QE sudden stop in September cannot be ruled out but rate hike this year unlikely

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- As widely expected, at its regular monetary policy meeting on Thursday 25 January, the ECB Governing Council (GC) maintained key policy interest rates unchanged and its asymmetry to QE guidance intact, reiterating that it would be ready to increase the size and/or the duration of the APP should the inflation outlook become less favorable. Furthermore, the GC kept its forward guidance on interest rates, repeating that key policy rates would remain at current low levels “well past” the horizon of net asset purchases and ECB President Mario Draghi emphasizing that, given the current state of the economy, there are “very few chances at all” of a rate rise this year. Although the account of the December meeting stated that its forward guidance would need to be revisited early in 2018, the ECB President noted that the market reaction showed that the statement may have been misinterpreted. At the press conference that followed the conclusion of the meeting, he made clear that the December minutes had actually intended to signal that the discussion on possible amendments to the ECB’s forward guidance would start soon -not meaning that the forward guidance would be adjusted soon- highlighting that the said discussion “has not really started”.
- President Mario Draghi sounded relatively hawkish on the euro area growth outlook, noting that the pace of economic expansion has accelerated more than expected in the second half of 2017, strengthening the GC’s confidence that inflation will gradually converge towards the inflation target of below, but close to, 2%. Apart from robust domestic demand, net exports remain supportive for growth overshadowing the recent euro appreciation. The broad synchronized global upsurge provides an impetus to euro area exports, while the risks surrounding the domestic economic outlook are seen as broadly balanced.
- With respect to the recent volatility in the exchange rate, the introductory statement read that the issue represents a source of concern that requires monitoring with regard to its possible implications for the medium-term outlook of price stability. Note that the aforementioned sentence has not been included in the official ECB policy statement since the September 7, 2017 meeting when EUR nominal trade-weighted 38 (EER-38) had increased by c. 4.5% in the period between July 20 (when the last meeting was held) and September 7 (*Graph 1*). Responding to a relevant question in the Q&A session, the ECB President revealed that the Governing Council discussed about the EUR’s recent strengthening and considered three reasons behind this development: (i) endogenous reasons that include the unquestionable strengthening of the euro area economy; (ii) the heightened market sensitivity to perceived changes in the ECB’s communication; and (iii) non-ECB communication related essentially to the exchange rate. Mario Draghi explicitly criticized recent FX related comments (from US government officials), saying openly that they violate the terms of reference agreed on October 14, 2017 at the IMF in Washington, according to which competitive devaluations should be avoided. The ECB President warned that, if this were to lead to unwanted tightening of monetary policy, then the Central Bank may need to reconsider its monetary policy strategy, pointing to risks of more gradual policy normalization.

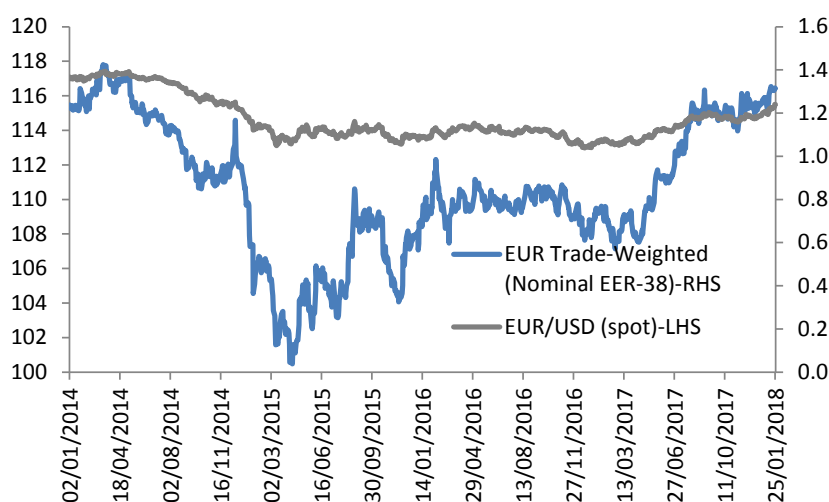
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Shrugging off Mario Draghi's FX related concerns, the EUR extended its recent gains across the board, supported by the ECB's positive assessment on the euro area economy. The EUR/USD hit a fresh three-year high of 1.2536 during the ECB press conference on Thursday, before pulling back to levels around 1.2440/50 in late European trade on Friday on remarks by US President Donald Trump that "ultimately" he wants to see a stronger USD, contradicting comments by US Treasury Steven Mnuchin just a day earlier that a weak USD is good for the US economy. Interestingly, market participants are presumably on the view that, in spite of the ECB's attempt to halt/slow down the pace of the EUR's strengthening, the Central Bank is not particularly worried over current EUR/USD levels. Indeed, even though the EUR/USD has strengthened by around 5% since the last ECB meeting in December, EUR nominal trade-weighted 38 (EER-38) has risen by a far slower pace of around 1.0% over the same period. This is because a main theme in the FX market is not only EUR-appreciation but also USD-weakness on the back of, among others, fears about US protectionist policies, increased uncertainty about the direction of US politics and the prevailing market view that the USD will gradually lose its yield advantage amid expectations for higher interest rates in other major economies outside the US.

- Looking ahead, President Mario Draghi explained that the GC would need to have a discussion concerning the end of the QE, monitoring three options when the current QE programme expires at the end of September 2018: i) sudden stop of net asset purchases; ii) an extension; or iii) a gradual taper. We share the view that, although continuing reinvestments of maturing securities for the next couple of years, it is likely for the ECB to end its APP in September 2018, provided that the euro area remains on a recovery path and inflation shows clear signs of a sustainable upward trend since then. We are also of the view that the ECB will probably adjust its forward guidance in the second quarter of the year, after the release of the updated ECB staff projections in March, perhaps removing the asymmetry to QE guidance, assuming that economic indicators continue surprising on the upside. We don't envisage a rate hike before Q1 2019, given that inflationary pressures remain subdued. To this end, Bundesbank President Jens Weidmann, one of the most hawkish members of the ECB's GC, recently stated that current analyst expectations for a first rate hike no earlier than min-2019 are largely in line with the ECB's forward guidance.

Figure 1: EUR/USD has increased at a far slower pace than EUR TW-38 in recent weeks



Source: ECB, Eurobank Economic Research

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