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FOCUS NOTES

September ECB meeting: Setting the ground for tapering announcement in October

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- At its regular monetary policy meeting on Thursday 7 September, the ECB Governing Council kept key policy interest rates unchanged and its asset purchase programme of EUR60bn intact until December 2017 (or beyond if necessary), as widely expected. Nevertheless, at the press conference that followed the conclusion of the meeting, ECB President Mario Draghi confirmed that the bulk of the decisions regarding its QE programme will likely be taken at the October 26 meeting. Although the sequencing of policy normalization was not discussed, Mr. Draghi reiterated that the ECB will not raise its key policy rates until after asset purchases end.

- Focus centred on the exchange rate developments, with President Mario Draghi highlighting that the recent volatility in the exchange rate represents a source of uncertainty that requires monitoring for its potential implications for the medium term outlook for price stability. He added that the recent appreciation of the euro was one of the main topics of discussion at the September meeting, making it clear that the euro exchange rate would play an important role in the decisions related to the future of the QE programme.

- Mainly due to the euro appreciation, the ECB's inflation projection for both 2018 and 2019 was downwardly revised by 0.1pp to 1.2% and 1.5%, respectively, while the 2017 inflation forecast was left unchanged at 1.5%. Core inflation was also revised down by 0.2pp to 1.3% for 2018 and by 0.2pp to 1.5% for 2019. Given the stronger-than-expected growth momentum in H1 and indications of robust growth going forward, the ECB lifted its GDP growth forecast for 2017 to 2.2% from 1.9%, while the projections for 2018 and 2019 were left unchanged at 1.8% and 1.7%, respectively.

- Despite Mario Draghi's effort to halt the EUR's upward momentum by stressing the negative impact of the stronger euro on the inflation outlook , the EUR/USD surged to a fresh 2 ½ year high of 1.2092 in European trade on Friday. The ECB President's confirmation that "probably, the bulk of the decisions would be taken in October" and the upward revision in 2017 GDP growth projection were the main drivers behind the EUR's latest upward move, with the EUR/USD marking cumulative gains of ca. 15% so far this year on the back of the perceived divergence in the euro area/US growth outlook as well as in monetary policy deliberations between the ECB and the Fed.

- Reacting to the downward revision in the inflation outlook, German Bunds continued their recent rally with the 10-yr falling in European trade on Friday below 0.30% for the first time since the end of June, and the 2/10-yr yield curve undertaking some bullish flattening. The fixed income market in the periphery reacted positively to the message of Mario Draghi that the euro is being closely monitored regarding ECB's future exit strategy, mitigating concerns about a sudden end to the ECB's QE program. Yield premiums of euro area periphery government bonds vs their German peers narrowed, with Italy and Spain outperforming.

- We expect the ECB to announce on 26th October its intention to extent its asset purchase program though H1 2018 at a reduced pace of ca. €40bn per month starting in January 2018, followed by a further extension of QE before June 2018 to H2 2018 at a pace of ca. €20bn. The current forward guidance on policy rates is not expected to change before H2 2018, with the decision on the depo rate largely dependent on the development of the euro exchange rate, taking into account US policies and Fed's future monetary stance. Should the euro appreciate further in the coming months due to -among others- a more dovish-than-expected stance by the Fed, then the ECB might not be willing to proceed with a deposit rate increase before 2019. All in all, the recent appreciation of the euro and subdued inflationary pressures suggest that the risks are skewed towards a more gradual exit strategy.

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