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Article

Draghi's game plan

The ECB President, Mario Draghi, will try to strike a cautious balance at Thursday's meeting

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We expect Draghi to strike a cautious balance between giving the first clear hint at upcoming tapering and adopting a dovish tone in order to calm FX markets.

Dovish tapering, if any, is likely to be to escape the “euro trap”.

The general macro picture still shows a strong economic recovery, which looks set to continue well into 2018, albeit at a somewhat slower pace than in the first half of 2017. So far, the stronger euro has not affected confidence indicators. At the same time, inflation increased over the summer months but, at 1.5% YoY in August, remains far below the ECB's target. Even worse, the latest uptick in inflation is mainly the result of base effects from oil prices. In the coming months, headline inflation could actually decline again.

Back in July, Draghi said that the ECB would discuss the future of QE beyond December in 'the Fall'. With the drop in temperatures, this week's meeting could qualify for Fall. At the same time, however, the stronger euro could lead to such a heated debate that the ECB could postpone “the Fall” until the Indian summer period in late October. Either way, the big question for this week's meeting is whether Draghi will shed some light on the ECB's game plan for tapering.

Since early summer, the ECB has been struggling with the right game plan. The risk of deflation has disappeared, the economy is going well, inflation remains too low (partly due to structural reasons) and the issue of bond scarcity will become more pressing next year. Finding the right narrative and timing for tapering has been a challenge. Now, the stronger euro is complicating things further. Spelling out the tapering game plan could lead to a stronger euro, eventually undermining the recovery, while officially postponing tapering would probably send the euro lower.

In the discussion on the game plan, we note that, due to bond scarcity, some kind of tapering in 2018 is almost unavoidable. We still think the ECB is looking into options for dovish tapering, reducing monthly purchases by €20-30bn from January 2018 until at least June 2018, combined with an extension of the list of eligible assets for QE purchases and sticking to the easing bias for QE. This could be precisely what the minutes of the last ECB meeting described as “*the Governing Council needed to gain more policy space and flexibility to adjust policy and the degree of monetary policy accommodation, if and when needed, in either direction*”. An even stronger euro could lower the first (monthly) reduction to only €10bn.

With the stronger euro, the ECB is likely to be more cautious with its tapering communication. In fact, there are two options: either announce the details of a very dovish tapering starting January 2018, this week, hoping that full clarity restores calm, or strike a cautious balance between giving the first hint at upcoming tapering and adopting dovish tones, such as warning against

unwarranted tightening of financial conditions in order to calm FX markets. As the ECB is probably not yet unanimous on the first option, we expect that Thursday's meeting will again be about what Draghi did not say, rather than what he did.

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