

ECB preview: Happy at the sidelines

This week's ECB meeting should not bring any new policy action but will once again test Christine Lagarde's communication skills.



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If anything, both short-term and longer-term risks have become more accentuated since the last ECB meeting in December. As regards the shorter-term outlook, risks are now tilted further to the downside than in December, with extended and stricter lockdowns across the eurozone. Also, at least the start of many vaccination programmes has turned out to be more problematic than initially thought. In sum, with longer and stricter lockdowns, the risk of another contraction of the eurozone economy in 1Q 21, and hence the risk of a technical recession, has clearly increased.

At the same time, however, the potentially positive drivers for eurozone growth in the second half of this year have improved since the December meeting. Just think of the relatively smooth Brexit trade deal, another fiscal package in the US and the prospects of a large investment package under the new Biden administration this year. Also, more and more vaccine producers are entering the market, European governments have stepped up their purchases and production capacities are being increased. The ECB's underlying assumption that herd immunity in the eurozone will be reached before the end of the year remains intact.

As regards inflation, incoming data since the December meeting has only confirmed negative inflation rates in December. At the same time, inflation expectations remain low. However, looking ahead, 2021 could be the first year in a long while in which the ECB's own inflation projections turn out to be too low, not too high. In December, the ECB staff projections predicted headline inflation

to gradually increase from 0.3% YoY in 1Q 21 to 1.5% in 4Q 21. In our view, the actual outcome could be higher. The one-off factors keeping inflation low in 2020 are set to reverse in 2021. Lower inflation stemming from negative base effects from lower energy prices, the German VAT reduction and social restrictions deflation are all set to turn into drivers, pushing headline inflation towards 2% this year. Even if, in our view, headline inflation is about to fall back to a range of 1% - 1.5%, some financial market spikes and controversies at the ECB on how to deal with changed expectations could be an unexpected theme in 2021.

Finally, the minutes of the December meeting illustrated that the stronger euro is getting more and more attention as "it was pointed out that the nominal effective exchange rate currently stood at an all-time high and that the recent appreciation could contribute significantly to the subdued inflation outlook". Also, the minutes said that "concerns were voiced over risks related to developments in the exchange rate that might have negative consequences for the inflation outlook".

What to expect on Thursday

With the December decisions, it is clear that the ECB will want to stay on the sidelines for as long as possible. By extending and partly increasing the level of monetary policy accommodation until early 2022, there is very little the ECB can, and would want, to do. The short-term path of the eurozone economy will be determined by the virus, vaccines, lockdowns, and fiscal stimulus, not additional monetary stimulus. In fact, and absent any additional major economic accident, there are in our view only two factors which could complicate the ECB's preferred life at the sidelines, not this week but in the coming months: a further rapid strengthening of the euro and an unexpected surge in inflation expectations in financial markets. While the ECB would in our view definitely look through any temporary surge in headline inflation, a stronger euro could eventually trigger additional monetary easing, including possibly even a rate cut.

Against this background, this week's meeting will be mainly dominated by two communication challenges at the press conference: how to deal with Italian politics and how to deal with a stronger euro. The experience of the March and September meetings last year should remind everyone that communication matters.

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