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ECB preview: Praet's pivot pirouette

Despite growing uncertainties around the strength of the eurozone recovery, little underlying inflationary pressure and possible further market turmoil, the ECB seems determined to demonstrate its focus on long-term trends. After Praet's remarkable speech, we expect a very exciting meeting on 14 June

Source: European Central Bank, Flickr

Until recently, the ECB had remained tight-lipped about its next steps for monetary policy, particularly quantitative easing (QE) beyond September this year.

Remember after the April meeting, when the ECB president Mario Draghi went as far as saying the ECB had not discussed next steps for monetary policy at all. This approach seems to have changed. The latest speech by the ECB chief economist Peter Praet suggested the discussion on an end to quantitative easing (QE) could gain lots of traction at next week's meeting. Even ECB doves seem to be fine with a gradual end to QE this year.

Whether the ECB is getting cold feet and wants to unwind QE *before it gets too late or whether it simply wants to prove that it is entirely focused on macro facts is still unclear*

In his speech, Peter Praet signalled the ECB's criteria for assessing whether there is a sustained adjustment in the path of inflation towards target: convergence, confidence, and resilience - were almost fulfilled. Contrary to earlier statements by many ECB officials and even the minutes of recent ECB meetings, Praet no longer mentioned doubts about inflation really picking up. Praet also stressed the underlying strength of the eurozone economy, suggesting the ECB considers the recent weakness in the eurozone data transitory.

Praet speech

Praet's assessment will hardly change in the coming days and therefore be similar at next week's ECB meeting.

In addition, a fresh round of ECB staff projections will be available at the meeting. In our view, the discussion will first of all focus on the right assessment of the outlook for growth and inflation and in this regards, there seem to be three main challenges for the ECB:

1 Soft patch vs downswing

At face value, the growth slowdown in the first quarter was mild enough to be filed away as a "soft patch" instead of a "downswing". Economic fundamentals have also not changed over the last few months. However, soft indicators have not yet recovered, available hard data has been rather disappointing, the fading eu(ro)phoria could dent further optimism, and the external environment has become a risk rather than an opportunity.

Even though Peter Praet sounded optimistic, there is still too little information for the ECB to take a clear position in the soft patch versus downswing discussion. Consequently, we expect the ECB to stick to its positive take on the Eurozone recovery, but at the same time stressing increased uncertainty and the need for more evidence.

2 The double-edged sword called oil

The surge in oil prices since the beginning of the year is probably the single biggest problem for the ECB. Since February, oil prices have increased by more than 20%. Add the effect of the weaker euro exchange rate, oil prices denominated in euro have increased by almost 30%. As so often in the past, higher oil prices are a double-edged sword for the ECB.

On the one hand, higher oil prices could dent the recovery (according to our back-of-the-envelope estimates, higher oil prices could allow one-third of the wage increases in Germany evaporate in thin air). On the other hand, they should push up the ECB's inflation projections. The ECB uses future prices as a technical assumption. If oil (and their respective future) prices were to stay at their current levels, headline inflation could come to 0.4 percentage points higher in 2019, from 1.4% in the March projections. At the same time, GDP growth forecast could be revised downwards by some 0.2 percentage points. All of this means that only due to changes in the technical assumptions, a benign outlook for headline inflation could quickly become a close-to-target forecast.

Normally, the ECB tends to look through energy-driven volatility in headline inflation and instead focus on core inflation measures as higher oil prices have a disinflationary impact on the recovery. This is why we expect the ECB to stress the reflation process will only be over once inflation has sustainably converged towards a target and that it would only react to possible second-round effects. Still, an upward revision in headline inflation could make a few hawks at the ECB and some market participants slightly uncomfortable.

3 Italian politics

Obviously, Italian politics is the new kid on the block when it comes to challenges for the ECB. We don't expect ECB president Mario Draghi to comment on this. The ECB will rather focus on developments in the eurozone as a whole.

Nevertheless, in the back of some ECB officials' minds, Italian politics and possibly returning market volatility could still affect the timing of the ECB's next steps.

Mutual agreement to end QE but no end-date

As observed already earlier, there is a growing majority within the ECB's governing council favouring an end to QE by the end of the year. Maybe an ironic outcome of the Italian market tensions is that the weaker euro is making it even easier to engage in QE tapering. After the Praet speech, it looks as if the discussion at the June meeting will be more heated than we previously thought. It is the famous devil who will be in the detail, and the controversial topics will be:

- **When to communicate?**
  Should the ECB present an explicit roadmap for the next QE steps at the 14 June meeting or should it wait until the end of July to get more and better information on the state of the eurozone recovery?
- **An explicit end date?**
  Should the future path for QE be communicated with an upfront end-date or should it remain open for as long as possible, thereby creating more flexibility?
- **From thirty to zero?**
  Should the period beyond September 2018 be a tapering period, reducing the monthly purchases gradually from €30 billion to zero or should there be another transitory period of a reduced pace?

What to expect from next week's meeting

We still don't think the ECB will easily give away flexibility and room for manoeuvre on QE in a situation where downside risks to the economic outlook have increased and political risks (be it from Italy or later this year from Brexit) could easily reemerge.

Against this background, it looks very unlikely the ECB will announce an end date for QE any time soon. Keeping in mind that Peter Praet will put a policy proposal on the table, we expect the ECB to announce another recalibration of QE already next week, i.e. an extension of QE at a reduced pace of 10bn euro per month at least until December 2018. This would follow the pattern of the first recalibration of QE from 80bn euro to 60bn euro, which was announced three months in advance. Whether the ECB is getting cold feet and wants to unwind QE before it gets too late or whether it simply wants to prove that it is entirely focused on macro facts is still unclear.

However, Peter Praet's remarkable turn promises a very exciting meeting in Riga on 14 June.

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