

ECB: The long and winding road to normality

A dovish Draghi announces details of ECB's first taper attempt. The "lower for longer" recalibration is a gentle step towards the exit



Source: Andrej Klizan

The European Central Bank announced the start of a very gentle exit process for its QE programme. Obviously, there was no change in interest rates, but the official rate decision accompanied ECB's plans to reduce its monthly QE purchases, or, in ECB terms, how it intends to recalibrate its QE programme.

What the ECB decided?

In short, the ECB will reduce its monthly QE purchases from 60bn euro currently, down to 30bn euro, starting January 2018 until September 2018 at least. Don't forget that on top of these 30bn euro, the ECB will still reinvest the principal payments from maturing securities. Also, the ECB will continue with the full allotment procedure on main refinancing operations and three-month longer-term refinancing operations at least until the end of 2019.

Recalibration of QE and forward guidance means that ECB will not

*hike rates before 2019***Recovery continues but no signs of inflationary pressure**

Today's decision was taken on the back of a continued strong Eurozone recovery. The ECB still sounds very optimistic seeing "unabated growth momentum in the second half of this year". Risks surrounding the growth outlook remain balanced. Interestingly, last month's phrase that the ECB would monitor foreign exchange rate volatility was no longer mentioned today. Even though "developments in foreign exchange markets" are still regarded as a downside risk to the growth outlook. As regards inflation, the ECB sounds still unsatisfied with recent developments and the outlook, reflected in phrases like measures of underlying inflation "have yet to show more convincing signs of a sustained upward trend". In short, the ECB is still facing a cyclical recovery without any inflationary pressure.

But ECB still not convinced

Despite the positive growth assessment, the ECB still seems to have suspicions about the sustainability of the recovery as well as a sustainable pick-up in inflation. This explains why the ECB still thinks that an "ample" degree of stimulus is needed. It also suggests that the ECB does not consider the disinflationary impact of factors like globalisation or digitalisation to be structural but rather temporary. Consequently, the ECB is now trying only very gradually to reduce monetary stimulus.

Three main take-aways from today's decision

1. The tapering announcement is in line with expectations and QE will continue at least until September 2018. In fact, Draghi's comments during the press conference that there would be no abrupt end to QE suggest that there could be another stage of tapering after September. Also, the ECB kept the easing bias on QE.
2. Don't expect any rate hike before 2019. The ECB emphasised "sequencing", i.e. the fact that interest rate will remain low well past the end of the QE programme. This forward guidance on interest rates will in our view remain the ECB's most powerful tool to keep future interest rate expectations at bay.
3. But rates can be increased, even though the ECB still purchases bonds. This sounds counterintuitive but is an important technical issue as Draghi clearly tried to make a distinction between "net asset purchases" and the "reinvestments of the principal payments". Which in our view means, rate hikes will be possible in 2019 even if the ECB is still buying bonds.

Gentle exit, no big bang

In short, today's decision is the first real baby step towards a very gentle exit from the ECB's crisis mode, but it is definitely not a big-bang u-turn. In fact, the QE recalibration illustrates the ECB wants to start the exit as cautiously as possible, ideally without seeing the euro appreciate or bond yields increase.

It is like stealing away from a party through the backyard, hoping no one notices that party hero is on its way out.

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