

The ECB's euro trap: 4 things to watch

The stronger euro is making the ECB's taper tiptoeing even more complicated



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ECB meeting on September 7th

While a clear tapering hint at this week's ECB meeting could send the euro even higher, potentially undermining the recovery, room to postpone tapering is limited due to bond scarcity. Therefore, we expect Draghi to strike a cautious balance between giving first clear hints about the upcoming tapering and dovish sounds in order to calm FX markets.

1 Growth with a bit more inflation

The general macro picture still shows a strong economic recovery, which looks set to continue well into 2018, albeit at a somewhat lower pace than in the first half of 2017. The stronger euro has so far not affected confidence indicators. At the same time inflation increased over the summer months, but at 1.5% YoY in August, it 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 come down again.

2 Is it already Autumn?

Back in July, ECB president Draghi said the ECB would have discussions on QE beyond December in the Fall. With the drop in temperatures, this week's meeting could qualify for "Fall". At the same time, the stronger euro could lead to such a heated debate that the ECB could postpone "Fall" to 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.

3 ECB in the euro trap

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 was the main challenge. Now, the stronger euro has complicated things further. Spelling out the tapering game-plan could lead to a stronger euro, eventually undermining the recovery, while at the same time only officially postponing tapering would probably send the euro lower.

4 Tapering is (almost) unavoidable.

In the discussion on the game plan, let's not forget that due to bond scarcity some kind of tapering in 2018 is almost unavoidable. We still think that the ECB is looking into options for a so-called 'dovish tapering', reducing the monthly purchases by 20bn to 30bn euro in January 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 exactly be 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 reduction to only 10bn euro.

	Bull ↑	Bear ↓	ING →
Monetary stance	There has been little change to the monetary stance over the last few weeks.	Cyclical upswing argues in favour of some withdrawal of monetary accommodation.	Economic data argues for a wait-and-see stance.
Inflation	Low core inflation and the expected downward revision of inflation projections still argue in favour of further easing.	With deflationary risks having disappeared, some might argue in favour of less monetary stimulus.	Deflationary risks have disappeared, but no inflationary risks are in sight.
Economic growth	Although growth in the Eurozone has been positive for several quarters in a row, structural problems are capping the upside potential. The stronger euro could further undermine the recovery.	Weak growth rates need more structural reforms and fiscal stimulus, but no additional monetary easing.	The Eurozone economy continues to grow, without producing inflationary pressure.
Exchange rate and asset prices	Further monetary easing could reverse the recent appreciation of the euro.	Removing monetary stimulus comes at the risk of a further euro strengthening, eventually threatening the recovery.	Despite the recent strengthening, the euro exchange rate remains favourable for Eurozone exports.
Politics and fiscal policy	Political uncertainty and the lack of fiscal stimulus argue in favour of more monetary easing.	Loose monetary policies undermine the incentive to implement structural reforms.	With interest rates at record low levels, any changes would only have a marginal impact on fiscal policies.

What to expect this week

With the stronger euro, the ECB will be more cautious with its tapering communication. In fact, there are two options: either announcing the details of a very dovish tapering starting in

January hoping that full clarity brings back calm. Or, strike a cautious balance between giving first hints at the upcoming tapering and dovish sounds, like warning against the 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 will again be about what Draghi doesn't say, rather than what he does say.

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