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ECB: Looking through inflation (and platitudes)

A front-loading of asset purchases and a very nebulous reaction function. This is not only the European Central Bank's answer to higher bond yields but probably also the outcome of a controversial discussion at the ECB's Governing Council

How will the ECB react to the recent increase in inflation and bond yields? This was the main question ahead of today's ECB meeting. The announced decision to front-load asset purchases in the coming months and the press conference with ECB President Christine Lagarde suggest that the ECB is split on how to continue.

Fresh round of macro projections

In its broader general macro assessment, the ECB has not really changed its mind. Despite delays in the vaccination rollout and longer-than-expected lockdowns, the ECB's GDP growth forecasts remained almost unchanged from December, with the ECB now expecting GDP growth to come in at 4% in 2021, 4.1% in 2022 and 2.1% in 2023. The ECB remains optimistic that fiscal policy support and the reopening of economies will lead to a significant pick-up in the course of this year.

Remarkably, the ECB changed its risk assessment from 'tilted to the downside but less pronounced' to 'more balanced'.

As regards inflation, the ECB seems to have updated its oil price assumption and actual inflation data for January and February but is not expecting an uncontrollable acceleration in inflation. At 1.5% for 2021, 1.2% in 2022 and 1.4% in 2023, the ECB sees just temporary and one-off factors driving inflation. According to Lagarde's comments during the press conference, the ECB will look through any temporary acceleration in prices. She also stressed the high level of slack in the eurozone economy which would prevent any wage pressures from emerging.

Explaining the ECB's reaction function

With the latest increase in bond yields, financial market participants had expected the ECB to better clarify its current reaction function. The decision to front-load its asset purchases over the next quarter took away some of the pressure, indicating that the ECB was willing to put a cap on yields. The comments during the press conference, however, were more confusing rather than providing any clarity.

What is clear is that the ECB will continue focusing on 'preserving favourable financing conditions'; no yield curve control as Lagarde stated during the press conference. According to the ECB, 'financing conditions are defined by a "holistic" and "multifaceted" set of indicators, spanning the entire transmission chain of monetary policy from risk-free interest rates and sovereign yields to corporate bond yields and bank credit conditions. The comments during the press conference, however, added confusion and no additional clarity. Holistic, multifaceted, upstream, downstream, anchor and compass. A series of platitudes my editor would not allow me to use; at least not this prolifically.

Three key takeaways

What to make of this festival of platitudes? Let's take a step back, forget the platitudes and just look at the facts. There are, in our view, three main takeaways from today's ECB meeting: i) the ECB will look through any temporary acceleration of inflation and expects inflation to slow down again next year; ii) the ECB will front-load asset purchases in the coming months to underline its willingness to look through higher inflation and limit further bond yield increases; iii) the change of the balance of risk for the economic outlook suggests that any increase in the total size of the asset purchases is still far out and unlikely. Instead, today's decision looks like a compromise of a split Governing Council.

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