

The ECB's 'reaction function' clarified in March minutes

The ECB's last news conference left many market participants a bit puzzled about the ECB's exact reaction function. The just-released minutes of the meeting shed more light on what the bank's thinking



ECB President, Christine Lagarde

Here are the most remarkable passages from the ECB's minutes:

- **Risks to the growth outlook** had become more balanced. This was a significant change in the communication after the March meeting. The minutes of the meeting illustrate that there must have been a lively debate, almost as in any economic research department currently, with some ECB members pointing to more positive factors for growth and others to more negative factors. It is remarkable how often reference was made to the US fiscal stimulus as a potential source of higher growth in the eurozone. Remember that during the press conference, ECB president Christine Lagarde had simply said that the Biden plan had not been factored into the ECB staff projections. This is technically correct, but it would not have been the first time that the Governing Council could have taken a slightly different stance on the economy than the staff projections. But they didn't.
- **As for inflation**, it is still remarkable that the Governing Council seems to have been surprised by the higher inflation prints since the start of the year. However, higher inflation is still mainly seen as a temporary phenomenon.

- **The decision to front-load asset purchases** was not unanimous, as the phrase *“there was broad consensus among members that the recent rises in risk-free rates and GDP-weighted sovereign bond yields required a scaling-up of the pace of the purchases under the PEPP.”*
- There will be a quarterly assessment of **financing conditions and the inflation outlook** *“in order to determine the pace of purchases needed to keep financing conditions favourable”*. It remains to be seen whether financial markets stick to such a quarterly rhythm. We would argue that markets tend to be a bit faster.

Front-loading, soft and moving caps on yields

The ECB's last news conference left many market participants a little puzzled about the exact shape of the ECB's reaction function. There were simply too many 'holistics', 'multifaceted', 'downstreams' and 'upstreams' rather than a clear description of how the ECB would react to higher inflation and higher bond yields. Fortunately, several speeches and some blog entries since the March press conference have clarified the ECB's current thinking. In our view, a recent speech by ECB board member Isabel Schnabel has become the best compass we could find to see where the ECB's needle is currently pointing to.

In fact, what Schnabel told us and what the minutes of the March meeting also reflect was that the ECB accepts higher longer-term nominal rates as a result of higher inflation expectations. So, as long as real rates remain stable, everything is fine. Any increase in real rates will only be tolerated by the ECB if it reflects improved growth prospects. Consequently, the ECB's current reaction function can be summarised as: so long as bond yields rise for good reasons, the ECB is relaxed. If they start rising for the wrong reasons, the ECB will intervene. This is no real yield curve control but rather a soft and moving cap on yields.

The debate or even fear of surging bond yields was a bit of a storm in a teacup

In the end, the debate or even fear of surging bond yields was a bit of a storm in a teacup. Or put differently, financial markets quickly understood that the acceleration of eurozone inflation was - and will be - mainly the result of one-off factors. This kind of inflation is rather deflationary and definitely no reason for the ECB to react with any premature tightening. On the contrary, the ECB has made clear that it will look through any temporary increase in inflation and would not tolerate an unwarranted tightening of financing conditions.

This is where the front-loading of asset purchases came from. As illustrated by yesterday's comments from the Dutch central bank governor, Klaas Knot, this discussion about soft or hard caps on bond yields could change quickly once the recovery has gained momentum and become sustainable. Once this is the case, the ECB will be even clearer on what the right and what the wrong reasons for higher bond yields are. In our view, there won't be any reloading after the front-loading of the crisis asset purchases.

Author

Carsten Brzeski

Global Head of Macro

carsten.brzeski@ing.de

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. (“ING”) solely for information purposes without regard to any particular user’s investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit www.ing.com.