

Snap | 25 January 2018

## ECB: Oh Lord, don't let me be misunderstood?

Without saying anything new, ECB president Draghi moves markets. But probably not in the intended direction



Source: Andrej Klizan

### No changes to macro assessment; inflation pick-up still more wish than reality

There had been lots of speculation about what the ECB could change or say at today's meeting. The interesting conclusion after the press conference is that market participants seem to be more puzzled than before. Even though the ECB did not change its policies and also did not change its key communication, bond yields increased and the euro strengthened.

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*The ECB still seems to look at inflation like many parents look at their kids: lots of upward potential but few signs the upward trend has begun*

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In fact, the ECB's assessment of growth and inflation has not changed at all, compared with the December meeting. The ECB still sees a strong recovery with balanced risks, while at the same time the ECB reiterated its conviction that inflation will converge towards 2%. During the Q&A session, ECB president Draghi repeated the ECB's earlier criteria for inflation convergence, ie a sustainable and self-sustained convergence of inflation towards 2%.

## What about the exchange rate?

Prior to today's meeting, there had been lots of market speculations about the ECB's take on the current strengthening of the euro exchange rate. Initially, the ECB reinforced and sharpened the communication, saying that "the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability".

In the course of the Q&A session, ECB president Draghi became even more explicit, going as far as saying that if the stronger euro leads to a worsening of monetary and financial conditions, the ECB could reconsider its current monetary policy stance. Also, Draghi referred to an IMF statement from 2017, in which all IMF member states had agreed that "*excessive volatility or disorderly movements in exchange rates can have adverse implications for economic and financial stability. We will refrain from competitive devaluations, and will not target our exchange rates for competitive purposes*"; a clear condemnation of the recent comments from the US administration.

## Draghi misses opportunity to give QE guidance

Regarding the ECB's communication and key words, the minutes of the December meeting had suggested that the ECB could change its communication on QE and forward guidance "*at the beginning of the new year*". Today, Draghi did not seem to be in a hurry to change anything. At various occasions, he stressed sequencing and the fact that interest rates would remain at low levels, well past the end of the QE programme. He even went as far as saying that he saw little chance of a rate hike this year. As regards the end of QE, however, Draghi dodged the question of whether he would repeat his October comment that there would not be a sudden end to QE in September. Instead, he talked about three options: sudden stop, an extension of QE or a gradual tapering.

## What to make of today's ECB meeting?

Obviously, Draghi went into today's press conference highly determined to convey an unchanged message and to get the genie of speculation about the timing of an end to QE back into the bottle. At the same time, the ECB must have had the intention of dampening the recent euro appreciation. Judging from the imminent market reaction, the ECB will not be satisfied. Mario Draghi might think of the lyrics of an old song by The Animals "*I'm just a soul whose intentions are good. Oh Lord, please don't let me be misunderstood*". In fact, the development in the euro exchange rate and bond yields since the December meeting has already led to a less accommodative monetary policy stance. We would not be surprised if ECB officials start a dovish communication wave in the coming weeks. If markets get ahead of themselves, chances of another extension of QE rather than an early end are increasing.

**Looking through the short-term market noise, we stick to our base case scenario of at least another 'lower for longer' beyond September, before putting QE probably to an end in December.**

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