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Dragahing feet

ECB post-meeting comment

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Summary

- Risks to the growth outlook were assessed as being tilted to the downside – mostly because of persisting uncertainties, which may ultimately weigh on confidence.
- Despite this downgrade of the balance of risks, no policy response was considered.
- Draghi appeared reluctant to steer towards new policy measures, but the Council may need to act if the economic weakness persists.
- TLTROs were now raised by "several" members, suggesting that this may be the preferred first policy response if data remains weak.

Policy decisions

- The ECB kept its key rates on hold, with the deposit rate at -0.40% and the refi rate at 0.00%.
- Forward guidance on rates was left unchanged at *"at least through the summer of 2019"*.
- Forward guidance on reinvestments was confirmed as *"an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary"*.
- No other new policy initiatives were introduced.

Downside risks

Amidst ongoing weakness in economic data, the Governing Council shifted its assessment of risks to the growth outlook to the downside. These risks were seen as mainly stemming from external sources –e.g. the recent growth slowdown in China, protectionism and Brexit– as well as some country or sector-specific factors, such as the ongoing troubles in the German auto industry.

However, even though the Council unanimously agreed that growth risks were tilted to the downside, there appears to be a division amongst the members over the odds that these risks will actually materialise. Several members are still not convinced that the slowdown is more than merely a temporary phenomenon. Specifically, Mr. Draghi cited confidence that measures taken by the Chinese authorities will support the Chinese economy, which means that much of the weakness in the export sector should "wash out". The Council also expects some of the idiosyncratic factors in the domestic economy –such as the car industry– to fade.

Additionally, the ECB appears to be quite pleased with the labour market developments as well as their current monetary policy stance – which they consider to be accommodative still– and the resulting favourable financing conditions. Moreover, the banking sector is much more resilient now. As a result, Mr. Draghi noted that a potential realisation of (some of) these risks would mainly cause longer weakness in economic momentum, leading to a slower convergence of inflation towards the ECB's goal. Risks of a recession, however, are still perceived to be low, a sentiment that was shared unanimously according to Mr. Draghi.

Remaining calm

In other words, the ECB currently doesn't quite see the need to intervene – not urgently anyway. President Draghi's attitude in the press conference clearly reflected this view. Apart from the announcement that the balance of risks was changed, the ECB president did not push

a substantially dovish message to the markets, even if he easily could have done so. Quite the contrary, even. Mr. Draghi seemed to advocate patience and calm.

Part of this may have been driven by the fact that the Council has only just ended the asset purchases, meaning that a stronger response could have been interpreted as a signal that the Eurozone economy is not on the right track – making it counterproductive. But Mr. Draghi may also have been mindful that part of the Council still expects these headwinds to fade. President Draghi's neutral stance certainly allows the Council to shift their risk assessment back to neutral if risk factors like the Chinese economy and the German car sector wane, whilst at the same time they now have the option of making changes in the policy stance as early as March if necessary.

First assessment then response

As the ECB is waiting to see how the economic developments pan out, no thoughts were put into a potential policy response to the current prevailing risks. What stood out from today's press conference were 1) that the ECB president emphasised the broad toolkit of the ECB rather than just its rates policy – even though the latter was supposed to have grown in importance; and 2) that the current policy settings are already seen as accommodative. Liquidity is abundant and the market's interpretation of the ECB's reaction function almost automatically provides more (sufficient?) easing in case the slowdown is just a soft patch. In this regard, the ECB president explicitly cited things like lower term premiums and a flatter yield curve.

Unless it is absolutely necessary, the Governing Council may not see compelling reasons to change its current stance. Obviously this view cannot be maintained forever, but it does leave additional time to assess the situation. Another implication of the two points mentioned above is that the interest rate instrument (i.e. guidance) may in fact not be the first to be deployed. Rather, we feel that –also given the frequent mentions of the instrument– a new VLTRO could be used by Draghi in the course of this year as a "fresh" response to combat any signs of protracted weakness, especially if this weakness is concentrated in certain parts of the euro area where the state of the banking sector could impede the transmission of the current accommodative stance. That still does not rule out a delay in the hiking cycle, but it may buy the ECB some extra time before it would need to change tack.

Our take: still September (2019)

Considering today's comments in the press conference, which –in our view– were not yet convincingly pointing towards an imminent change in policy stance, we are holding on to our view that the first rate hike could still take place this September. This view is clearly not shared by the market, but we believe the market is underestimating the ECB's resolve to get rid of its negative deposit rate as soon as they find a suitable window for that.

Because of this, we think a new VLTRO is still very much on the cards – potentially as soon as March if the economic data remain soft. However, we would caution against assuming that such a VLTRO announcement also by default signals a postponement of the first hike. It could equally well create the necessary room for the ECB to push through its rate normalisation plan.

That being said, if the data weaken substantially further in the coming weeks, the ECB may see no other option but to rephrase their forward guidance and delay the hiking cycle.

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