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ECB MINUTES: STEADY HAND, BUT RISKS MORE BALANCED

Berenberg Macro Flash

After a rather uneventful meeting and press conference on 19 January, reading the tea leaves at the ECB minutes was unlikely to provide materially new information.

Still, the minutes did shed some revealing light on the current monetary policy stance of Draghi and his Governing Council colleagues:

1. **The ECB may deviate from the capital key when it comes to purchases of sovereign bonds as part of QE**
2. **Downside risks to economic outlook have receded**

The transcript of the discussion of the Governing Council meeting showed why **the ECB maintained a "steady hand" of monetary stimulus**. While at the time of the meeting the January inflation figures – showing a surge in annual rates across the Eurozone – had not yet been released, the minutes proved that there was "broad agreement" to look through higher headline inflation. The members "widely shared" the assessment that "underlying inflation pressures had remained subdued" and scaling back the monetary accommodation would jeopardize the inflation progress. Also, as expected these minutes included, like every ECB speech of the recent years, criticism about the sluggish implementation of structural reforms by national governments.

Most interesting for markets was probably the comment that, when it comes to purchases of sovereign bonds as part of QE, "limited and temporary deviations" from the ECB's capital key "were possible and inevitable". As a reaction Spanish, Italian and French bond yields fell by a couple of bps, German bond yields rose. The ECB stressed that "there was some room for a trade-off between relative deviations from the capital key across jurisdictions and limiting the extent of purchases below the deposit rate". While "priority should be given to purchases of assets with yields above the deposit rate", "purchases below the deposit facility rate should, in the first instance, be guided by the application of the capital key across jurisdictions" – limiting the amount by which the ECB could actually deviate from the capital key. A reason why periphery bonds corrected some of their gains after the initial positive reaction.

The minutes did not allude to the possibility of a deposit rate hike before the asset purchase programme was actually concluded. Draghi had dodged such a question in the press conference in January. If credit growth were to continue picking-up this year, the ECB could eventually consider raising the deposit rate, sort of as a gift to the troubled banking sector. Symmetry with the other policy rates (main refinancing rate at 0.0% and marginal lending rate at 0.25%) suggests a deposit rate of -0.25%, rather than the current -0.4%. Futures imply a 26% probability of a deposit rate hike by December 2017 (72% until December 2018). This is actually slightly below the probability of a main refinancing rate hike (29% and 73%, respectively). The question is whether this is necessary anyway. Since the ECB has started purchasing assets with a maturity also below 2 years in mid-January, even if they return less than the -0.4% deposit rate ceiling, the yield curve has steepened somewhat which has made life easier for banks involved in maturity transformation. ECB board member Mersch, in a speech on 10 February said that "some of the banks will have to adapt their business models" – lowering expectations that the ECB may react to calls of raising the deposit rate anytime soon.

On tapering, there was no reference to scaling back asset purchases any time soon in the minutes. So President Draghi was absolutely right when he said during the press conference that "We didn't discuss tapering last time, we didn't discuss tapering this time".

But interestingly, the minutes reveal that the ECB risk assessment to its growth and inflation outlook is shifting. As long as the current environment of a firming recovery continues, the ECB will start spending more capacity about planning the normalisation and exit of its accommodative monetary stance.

- While the Governing Council members said that the "**balance of risks to the economic outlook** was seen as remaining on the downside", they nevertheless noted that "**downside risks had receded somewhat, and … overall the risks … were starting to become more balanced.**" The risks that remained were related to uncertainties surrounding the prospects for foreign demand growth (geopolitical developments, policy choice by the new US administration, Brexit negotiations, financial market volatility and growing protectionist pressures). The latter forced the ECB Governing council to stress that "it was seen as important to preserve a continued commitment to open markets and free trade".

- **With respect to the inflation outlook, the minutes include 5 references to indirect or second-round effects, compared to none in the previous minutes.** Yes, the ECB notes that "recent increases in energy prices had thus far not translated into indirect or second-round effects on broader inflation". But they need to be monitored carefully, and the ECB disclosed that they would have a close look at wage dynamics and the factors that would shape those dynamics. The wage formation is largely a backward-looking process in most parts of the Eurozone, and wage agreements are staggered over time and have a multi-year horizon. This means that any second-round effects unfold slowly – but steadily. For an insight into second-round effects, the ECB will scrutinize heavily upcoming union wage settlements. For any early warning signals, we and the ECB look out for producer prices of non-food consumer goods and survey-based selling price expectations – so far they have increased only slightly and remained at low levels.

Does the shift in the assessment cause the ECB to change its staff projections in March? Probably, not. While the ECB acknowledged that growth and inflation developments were moving in the right direction, "uncertainties had not receded". For that very reason the ECB may be reluctant to drop the assessment of risks being tilted to the downside – it may just be too early for that, at a time when Brexit negotiations and presidential elections in France are about to begin, and concerns of a Grexit may intensify. So, we do not expect major changes to the growth and inflation outlook. The ECB may be less reluctant to upgrade, however, its unemployment forecast. Even though labour market progress has been only limited in some countries in France and Italy, in most parts employment growth and the drop in the unemployment rate has been more dynamic than expected (as the ECB itself stressed in January).

We expect the ECB to announce in September or shortly afterwards that it will start to reduce its asset purchases from January 2018. After ending these purchases in the summer of 2018, the ECB will probably follow up with the first hike in its main refinancing rate in September 2019 or slightly earlier, that is before Draghi's term expires at the end of October 2019. In the absence of serious inflationary pressure, the ECB can and should reduce the scale of its stimulus cautiously.

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