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ECB MINUTES SHOW CONCERN ABOUT EURO OVERSHOOT, NOT CURRENT LEVEL OF EURO

Berenberg Macro Flash

The consequence of success: ECB policy has supported a sustained recovery in the Eurozone. This has made markets more confident about the Eurozone's prospects, which, in turn, has caused the euro to appreciate. But of course, while the ECB welcomes the stronger demand growth, the stronger euro may weigh on import prices and inflation, and could undermine the ECB's efforts to return inflation to its target of close to, but below 2%. The latest minutes of the July 19-20 Governing Council's monetary policy meeting echoed these concerns. The account did not provide much more guidance on when the ECB will discuss tapering. We still expect it will be in autumn as the ECB has said previously. Acknowledging the firmer economic recovery and showing confidence that underlying inflation will gradually head up, the ECB will confirm in September that it is studying the options and likely announce in October more details. We expect the ECB to reduce its asset purchases from a monthly rate of €60 bn to €45bn as of January 2018 and scale back the asset purchases in further steps of €15bn every three months thereafter, with some risk that it will take slightly longer.

ECB is concerned about an euro overshoot in the future: Markets picked up on the concerns the ECB expressed regarding the exchange rate, with the Euro stumbling immediately after the release of the minutes to below 1.17 versus the US dollar. The Euro has bounced back and is currently (15:00 London time) trading above 1.17 again. Concerns were not expressed about the level of the exchange rate. The Governing Council merely said that it would be at unease about the "risk of the exchange rate overshooting in the future". Expressing concerns about the level and risk of an overshoot of the exchange rate are two different things. More importantly, the ECB pointed out that the appreciation could be seen as "reflecting changes in relative fundamentals in the euro area vis-à-vis the rest of the world." The euro is appreciating for good reasons, as capital outflows turn into inflows. In the wake of continued Brexit uncertainty and doubts about US President Trump's ability to stimulate the US economy, the Eurozone is turning more attractive. This implies that a stronger exchange rate may come in line with actually more favourable rather than tighter financing conditions. Generally speaking, financing conditions remain broadly supportive.

No news on timing of tapering: The account did not cast more light on the timing of tapering. So, we still do not know any precise date when the ECB discusses changes. Draghi pointed out in July's press conference that it should take place in autumn. In any case, the ECB will adjust its communication. The account was relatively explicit when stressing that "some consideration be given to an incremental adjustment in the language on forward guidance". Some may see this as a late concession to the hawks in the Governing Council that were arguing that "postponing an adjustment for too long ... could trigger more pronounced volatility in financial markets when communication eventually had to shift."

Small downward revision of ECB inflation forecasts should not change tapering outlook: The ECB will likely announce in September that they are considering a number of options of tapering and will provide more details, the when, the how, the how much, in October. With reference to the euro's appreciation the account stresses that the "asset purchase program would continue to be a key instrument if the Governing Council assessed the sustained adjustment of inflation at risk".



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It lends fresh support to Draghi stressing that the ECB wants to avoid any “unwanted tightening of the financing conditions”. This was a reason why the ECB has kept its QE bias of standing “ready to increase the asset purchase programme in terms of size and/or duration”.

The current level of the exchange rate will probably weigh on the new round of ECB's inflation and growth forecasts presented in September. The size of the forecast revision will likely be small enough to not impact the ECB's expected path for monetary policy. Since the exchange rate has stabilised recently it may not be such an issue after all. In the unlikely case that the exchange rate gains renewed momentum, tapering could last longer than we currently expect, say 12 months instead of 9 months. In the very unlikely case of an overshoot such as the euro crossing 1.20-1.25 the start of tapering could take even longer or the start could be delayed. In any case, the ECB can stress that even in a tapering world or one without QE, the stance will remain very accommodative for a long time. The ECB will unlikely change its main policy rate, the refi rate, before September 2019.

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