ECB takes another dovish step

- **The ECB maintained status quo on expected lines but delivered another dovish surprise by indicating that it would increase the pace of its weekly purchases over March-June under its PEPP program from the pace recorded over January-February**
- **The central bank continued to emphasize that it is focused on ensuring that financial conditions are not disrupted as the economy gradually recovers from the pandemic**
- **The guidance provided on the economy was relatively unchanged as risks to the outlook were described as being to the 'downside'**
- **GDP growth projections for the forecast horizon of 2021-23 were kept unchanged, although concerns were expressed about the near-term outlook. We think another contraction in output in Q12021 is possible as lockdowns remain in place and vaccination pace in the region has been slower than expected**
- **Inflation projections were raised modestly over 2021-22 taking in to account a higher global crude oil price trajectory as well as temporary factors while 2023 forecasts were left unchanged. However, during the forecast horizon the ECB does not expect a break above the 2% mark to take place implying that policy will remain accommodative for a considerable period of time**
- **Going forward, we think that the ECB policy is on auto-pilot mode. However, more accommodation in case of unwarranted tightening of financial conditions or a further build-up of downside risks to the outlook cannot be ruled out**
- **We think that the ECB re-affirming the need for sustained accommodation and the dovish surprise provided will work as a bearish factor for the EUR/USD pair while EU yields could moderate across the curve**

ECB keeps its accommodative framework in place: The ECB maintained status quo on its policy framework on the following aspects:

- The size of Pandemic Emergency Purchases Program (PEPP) was kept unchanged at EUR 1850 bn that will continue till at least March-2022. Maturing proceeds of securities under the PEPP program will be reinvested at least until end-2023. The program will also remain flexible in nature. It can be increased or reduced contingent on developments in the markets and economy.
- The size of monthly QE purchases program of EUR 20 bn was kept unchanged that will continue as long as 'necessary'. Reinvesting of maturing proceeds will also continue for a considerable period of time.
- Policy rates were kept unchanged with the deposit rate at -0.5% with reassurances provided that they will remain at these levels until the central bank is close to achieving its price stability mandate.
- The TLTRO III program that was initiated in response to the pandemic will continue to remain in place.

However, PEPP weekly purchases will increase: While the accommodative framework was kept unchanged, the ECB did explicitly indicate that it would look to increase the size of its weekly purchases under the PEPP program. The main reason for the renewed guidance was an increase in concerns about financial conditions, specifically about recent movements in long-end bond yield movements. The ECB believes that more support is warranted to counter the rise in bond yield movements as that could weigh on lending conditions and the state of the economy especially as the central bank is concerned about the near-term outlook. The increase in purchases will remain in place for another quarter and a further review will be made in the June policy meeting. The ECB has considerable fire-power under its PEPP program to support the economy. Weekly purchases under the PEPP program have moderated over 2021 but that could reverse going forward.

ECB emphasis need for favourable financial conditions: In the post policy press conference, the ECB Governor Lagarde emphasized that the central bank is focussed on ensuring that financial conditions remain supportive. In examining financial conditions, the central bank will look at the markets:

- From a holistic perspective by examining yields/rate movements across tenors to ensure that there is no disruption of the passage of accommodative monetary policy to broader interest rates in the economy.
- To examine a multifaceted set of indicators to assess the state of financial conditions.

The guidance provided makes us believe that the central bank will periodically intervene if financial conditions show signs of deteriorating.

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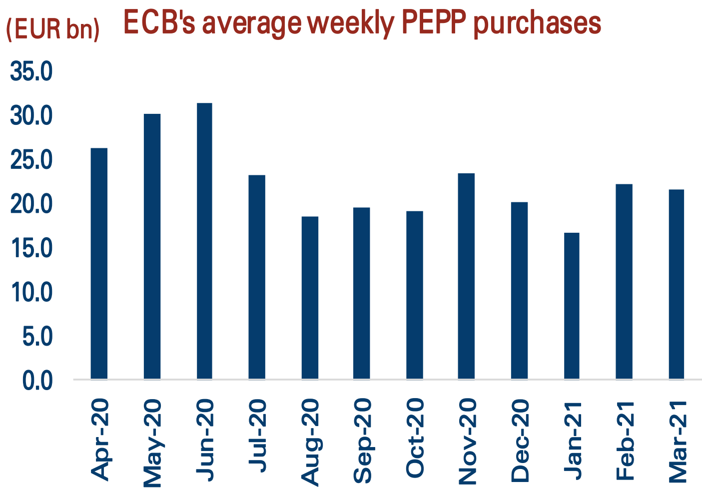
Chart 1: Inflation projections were revised marginally higher but growth projections were left unchanged

ECB EZ GDP Projections (% YoY)	2020	2021	2022	2023
Mar-20	0.8	1.3	1.4	NA
Jun-20	-8.7	5.2	3.3	NA
Sep-20	-8.0	5.0	3.2	NA
Dec-20	-7.3	3.9	4.2	2.1
Mar-21	-6.9	4.0	4.1	2.1

ECB EZ Inflation Projections (% YoY)	2020	2021	2022	2023
Mar-20	1.1	1.4	1.6	NA
Jun-20	0.3	0.8	1.3	NA
Sep-20	0.3	1.0	1.3	NA
Dec-20	0.2	1.0	1.1	1.4
Mar-21	0.3	1.5	1.2	1.4

Source: ECB & ICICI Bank Research

Chart 2: ECB PEPP purchases have moderated a bit over Q42020 and Q12021



Source: Bloomberg & ICICI Bank Research

Commentary on the economy was kept unchanged: In terms of the assessment on the economy, there were no significant changes seen in the policy statement or in the guidance provided by ECB Governor during her press conference. **Near-term growth outlook was seen as being challenged but the central bank expects a rebound in the medium-term reflecting policy support, step-up in vaccination drive and increase in pent-up demand.** Hence, growth projections were left relatively unchanged for the forecast horizon over 2021-2023, although the central bank is expecting another contraction in Q12021 in response to the lockdowns and tight restrictions that have remained in place in the region. The ECB continued to emphasize that risks to the outlook remain to the 'downside'.

Inflation forecasts were raised higher from 1% YoY to 1.5% YoY for 2021 and from 1.1% YoY to 1.2% YoY in 2022 while forecasts for 2023 were kept unchanged at 1.4% YoY. The upward revisions over 2021-2022 reflect higher energy price expectations and temporary as well as transitory factors such as base-effects and unwinding of temporary tax cuts that were delivered in 2020. The ECB Governor stated that there is a possibility of a temporary inflation overshoot above these levels over 2021 but that will largely be ignored. From a forecasting perspective, the fact that inflation is not projected to break consistently above the 2% mark even as far in to 2023 indicates that overall policy will have to remain accommodative for a sustained period of time.

The ECB Governor Lagarde also urged governments to step forward with implementing the recovery fund to ensure that there is more than adequate fiscal support being provided to the real economy.

Monetary policy outlook: We remain concerned about the outlook for the region. Lockdowns and restrictions have remained in place that has curbed economic activity. Most leading and coincident indicators shows that underlying demand remains fairly weak as the spread of the virus and new variants of the virus have emerged as sources of concern. The pace of vaccination has been relatively slower than previously expected that could mean a more gradual lift-off in growth than what we would expect in the US and the UK. Hence, the dovish tilt of in this policy meeting was warranted.

We think that the ECB will be on auto-pilot mode over April-June policy meetings. We assign higher odds of the ECB turning further accommodative if required in case financial conditions tighten abruptly or the economic outlook going in to Q22021 is weaker than is currently being assumed. More accommodation if warranted could come in the form of a further step-up in the size of the PEPP program. We also think that going in to 2022 if the effects of the pandemic start to moderate requiring a tapering or end to PEPP purchases, the ECB will likely increase the size of its QE purchases program. Although the ECB continued to emphasize that it is monitoring the exchange rate in terms of its effect on price pressures, we assign a very low probability of an additional rate cut.

The ECB is also due to conclude a review of its monetary policy framework later in 2021. We wait to see whether there is any change that would incorporate a more accommodative framework in the medium to longer term.

Market impact: From a market's perspective, we think the outcome is dovish with ECB further reinforcing the need for incremental more accommodation providing limited support to the EUR/USD pair in the near-term. We see the pair trading in the 1.18-1.22 range in H12021. European bond yields should moderate and there could be some spread compression across the curve and compression between German and Italian sovereign bond yields as the central bank steps up its purchases under PEPP.

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