ECB review: Not ready to taper, as yet

- The European Central Bank (ECB) maintained status quo on expected lines
- The key-take-away was that the weekly purchases under the Pandemic Emergency Purchases Programme (PEPP) will remain unchanged. At the same time, the ECB President downplayed the possibility of 'tapering of purchases' under PEPP and said that the pace of purchases seen over Q22021 will continue over Q32021
- The ECB also upgraded its outlook on the economy, reflecting a robust foreign demand and re-opening of the economy
- However, guidance on inflation remains fairly weak. After an interim spike in 2021 driven by 'temporary factors', the Consumer Price Index (CPI) inflation was expected to undershoot the ECB's 2% target, over the 2021-23 horizon
- Hence, we expect the ECB to maintain an accommodative framework. While PEPP could get wound down by Mar 2022, as the pandemic recedes, we think there could be an increase in the size of the Quantitative Easing (QE) programme that could get announced later in 2021 or early in 2022, ensuring that the balance sheet expansion remains in place
- For the rates market, the outcome is dovish that should ensure that EUR yields trade with a downside bias
- For the Forex (FX) market, we see a limited downside potential in the EUR/USD pair in the near-term, as investors position for a dovish FOMC. However, we retain our medium-term bearish call on the pair.

ECB provides a dovish guidance: The ECB maintained its status quo—on policy rates, forward guidance, Asset Purchases programme (Quantitative Easing programme & PEPP) and its reinvestment strategy—but that was on expected lines. Instead, the main focus for investors was on the messaging that the Central Bank provides on its PEPP programme and whether it is ready to taper purchases on this front.

Firstly, the size of the envelope was kept unchanged at EUR 1.85 trillion, with the programme scheduled to expire on schedule by Mar 2022. Given that there is still ample room left, the ECB did not have to take a decision to raise the quantum in this policy meeting.

Second, the ECB emphasised that the programme will remain flexible in nature. Hence, the Central Bank could asymmetrically increase purchases of a particular sovereign and in that process also keep adjusting forecasts on a weekly basis, as is required contingent on developments in the economy and markets.

Most importantly, the ECB signalled that it was not willing to consider tapering its weekly purchases, under the PEPP programme. In Q12021, the pace of ECB purchases, under the PEPP programme, moderated to ~EUR 15 billion per week, from ~EUR 20 billion per week, in 2020. However, the reduction in purchases had an adverse impact on the functioning of the European fixed income market in that period. In response to the April policy meeting, a changed guidance was provided that the pace of purchases under PEPP would be 'conducted at a significantly higher pace than during the first months of the year'. Hence, weekly purchases under PEPP increased back to ~EUR 20 billion, per week. In the June policy statement, the guidance provided was that the pace of purchases seen over Q22021 will be retained going forward. The ECB Governor Ms Lagarde also downplayed any discussion on tapering by referring it to as being 'premature' at this point in time.

Financial conditions remain critical for the ECB: The guidance provided in the post policy statement, as well as during the press conference was that the focus of the Central Bank remains on ensuring that the 'financing conditions remain favourable'. Concerns were expressed about the rise in bond yields that were seen in Q12021, that could in turn adversely affect the lending rates in the local credit markets. Hence, the idea of the ECB of maintaining its sizeable purchases was to ensure that financial conditions do not get distorted.

The ECB will also have to remain mindful of the fact that the European Union (EU) next generation recovery fund could become operational next month. Hence, the European Union (EU) will be issuing bonds to meet spending commitments. With the EU credit rating higher than some of the weaker sovereigns, such as Italy and Spain, it could somewhat distort market functioning. Hence, the ECB will monitor the effect that an increased paper supply would have on regional bond markets. This could also be an important consideration for the Central Bank in its future decision making.

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Jun 11, 2021

ECB has become more constructive on the outlook of the economy: An important change in the policy meeting was on the outlook provided on the economy. The ECB described the balance of risks to the growth outlook as being 'balanced' in this policy statement, as compared to being described as 'downside in the near-term and more balanced in the medium-term', as in the previous policy meeting. This was also the first time that the balance of risks has been revised since Dec 2018. Hence, it is a fairly significant development. The change in assessment can be attributed to: (a) a strong global trade, (b) vaccination campaign that is picking up and (c) a favourable fiscal/monetary environment.

GDP projections were revised higher over 2021-22. For 2021, the incremental supporting factor is expected to be global trade, as the Central Bank took into account Biden's fiscal stimulus measures in its projections. For 2022, private consumption was expected to rebound sharply, as the pandemic is expected to recede by that period. The ECB now also expects the regions to go back to its pre-pandemic levels by end-2021, as against previous expectations of Q12022.

However, the only big concern for the ECB appeared to be the labour market. The ECB Governor was quick to point out that furloughed schemes introduced by several Governments in the region could be masking the real level of unemployment. Hence, concerns were expressed that once these schemes expire in 2021, there could be a massive pick-up in unemployment going in to 2021 and 2022. It is for this reason that wage inflation was expected to remain weak over 2021-22 in the forecasts that the ECB provided.

Chart 1: Growth projections were revise higher...

ECB EZ GDP Projections (% YoY)

	2021	2022	2023
Jun-20	5.2	3.3	NA
Sep-20	5.0	3.2	NA
Dec-20	3.9	4.2	2.1
Mar-21	4.0	4.1	2.1
Jun-21	4.6	4.7	2.1

Source: ECB & ICICI Bank Research

Chart 2: ...but inflation is expected to remain soft

ECB EZ CPI Inflation Projections (% YoY)

	2021	2022	2023
Jun-20	0.8	1.3	NA
Sep-20	1.0	1.3	NA
Dec-20	1.0	1.1	1.4
Mar-21	1.5	1.2	1.4
Jun-21	1.9	1.5	1.4

Source: Bloomberg & ICICI Bank Research

Dovish message on inflation: In its forecasts, the CPI inflation projections were revised higher in 2021 from 1.5% YoY in the March policy meeting to 1.9% YoY in the June policy meeting. The upward revisions made were a function of temporary factors, such as low base of last year, sharp rise in commodity prices and expiration of tax cuts that were delivered in 2020. However, CPI inflation projections were expected to fall to 1.5% by end-2023. Core inflation was expected to gradually drift higher from 0.9% YoY in 2021 to 1.4% YoY in 2023 but that is still well below the 2% target set by the ECB. Soft wage inflation, as well as, considerable slack in the economy are expected to work as disinflationary forces in the medium-term. In short, the ECB continues to expect inflation to undershoot its target level for a considerable period of time.

Monetary accommodation will remain in place for some time: The upshot is that the ECB will continue to keep policy accommodative. At some point, in Q42021 there could be some tapering in purchases under PEPP. The Central Bank could look to wind down the PEPP programme by Mar 2022, if the pandemic recedes, as expected. After all, PEPP was introduced as a tool to fight the pandemic.

However, the weak medium-term inflation outlook being forecasted by the Central Bank will mean that asset purchases will continue for most of 2022. We think that PEPP could be replaced by an alternative revamped QE programme. The ECB is purchasing about EUR 20 billion per month, under the QE programme that has been in place, since prior to the pandemic. We think that the size of the QE programme will be increased considerably in 2022, to ensure that the monetary conditions remain accommodative. The ECB is also due to conclude its 'strategy review' in which it could outline these steps, possibly around the September-October period.

Market implications: For the rates market, the outcome is dovish given the medium-term forecasts on inflation. Longer-end bond yields were already trading lower prior to the ECB policy meeting, in response to its fall in the developed market bond yields. However, we see a further softening bias in the near-term. The German 10-year bond is likely to trade in the -0.20% to -0.35% range in the near-term.

For the EUR/USD pair, the impact was limited, as investors are also positioning for a dovish FOMC outcome in the June policy meeting. Hence, the USD is trading weaker in the global markets that is providing an upside support to the EUR/USD pair. We see a range of 1.20-1.23 in the near-term. However, we remain bearish on the pair in the medium-term as yield and growth differentials between the two regions could widen sharply in Q42021 and going in to 2022.

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