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Looking beyond QE

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- There were dovish and hawkish elements in the latest press conference, and Draghi did the market a favour in offering a clear (net) conclusion – that with the data available today, the market is fairly priced with the first rate hike in mid-2019. Prior to that conclusion, the strongest message we took from the press conference was that the sequencing of exit and the insistence that policy rate will remain unchanged "well past" the end of net asset purchases are not just carved in stone but are triple underlined in stone. There will be changes to QE forward guidance in the coming months. The end of net asset purchases by year-end feels inevitable — the Council debate is about when to act, not whether it should — and the ECB apparently wants to ensure that financial conditions decouple from the QE exit process by insisting that policy rates are not up for debate at all.

Looking beyond QE

There were several dovish elements to the press conference:

- **Council surprised by hawkish interpretation**. Draghi said several members of the Governing Council were surprised by how the market interpreted the December minutes, specifically the suggestion that forward guidance would be discussed in early 2018. First, Draghi argued that his comments had already hinted at the probability that guidance would need to change, hence there was no extra information in the minutes. Second, Draghi said there has been no discussion yet on how forward guidance would change.
- **Exogenous FX appreciation**. In terms of drivers of EUR exchange rate appreciation, Draghi saw the improving economy — an endogenous driver of appreciation — being only partly responsible. Several times he mentioned others' use of language on exchange rates that is inconsistent with global agreements, a veiled reference to recent comments from the US on the dollar. To the extent that there are exogenous drivers of EUR appreciation like this, the costs to euro area growth and inflation may be higher than otherwise. Draghi said that if FX appreciation leads to an unwarranted tightening of financial conditions, the ECB would need to think about its monetary policy strategy.
- **Inflation still not meeting requirements for exit**. Draghi argued that not much has changed in the economic outlook over the last few months. Growth is a little stronger, but the risks to the growth outlook remain balanced and the evidence that inflation is converging to target remains unconvincing. Inflation is not satisfying the ECB's exit requirements yet.
- **Caution interpreting wages**. While there is some recognition of an improvement in labour compensation, Draghi said this is mostly wage drift rather than underlying wage settlements. He would also be cautious about extrapolating wage settlements in Germany to other countries.

There were also hawkish elements:

- **QE cliff-ending is an option**. Draghi denied that he previously said a sudden end to QE was unlikely, claiming this was a misinterpretation. The three options for QE (extension, taper and sudden end) are all on the table.
- **Council consensus stronger than it appears**. Draghi said the differences in opinion across the Council members should not be exaggerated ("normal differences"). He said the debate is not about what to do/say but when to do it/say it. If that is the case and since the hawks are most vocal on "what" to do (i.e., no further extension of QE), there is perhaps more consensus on QE exit than it appears and the only question is when the ECB announces changes.
- **Press statement marginally more positive**. The press statement was virtually a word-for-word repeat of the December statement with two exceptions. First, there was an explicit reference to the recent movement

of the euro exchange rate. However, the language on FX was exactly the same as in the September statement, implying the ECB's concerns were no greater or smaller than they were then. Second, the statement mentioned a "further strengthening of confidence" that inflation will converge towards target. The December statement mentioned "greater confidence", so the change is modest but nevertheless positive; the drivers of this growing confidence now include rising capacity utilisation (previously just cyclical momentum and the reduction of economic slack).

- **FX pass-through may have declined**. Draghi said some argue that FX pass-through is less than it was in the past. In other words, there may be less to fear from FX appreciation.

Market fairly priced. Despite the mixed hawkish and dovish messages, Draghi at least gave a clear conclusion. At the end of the press conference he was asked about Weidmann's recent comment that a rate hike in mid-2019 is consistent with the data. Draghi confirmed that this timing was broadly appropriate given what is known today. In other words, Draghi endorsed current market pricing. Despite the ebb and flow of the press conference, the end point was that the market has been reading the ECB fairly.

Our baseline view. This remains unchanged. Gradualism and unchanged sequencing remain key principles. In March 2018 we expect the ECB to redefine the QE reaction function, reducing the likelihood that the ECB responds to economic and financial shocks with QE. In June 2018, we expect the ECB to change its QE expectations, specifically by announcing the conclusion of net purchases with a taper in Q4-18. In June 2019 we expect the first quarter point policy rate hike and the tightening cycle to proceed at a rate of 50bp per year. See our latest ECB Preview for more details on the specific steps we expect in the evolution of forward guidance.

Risks. The ECB exit will be determined by data, events and financial conditions. In terms of risks, the potential for more disorderly FX movements, and hence tighter euro area financial conditions, may be rising if global agreements to avoid competitive devaluations are breaking down. We would also draw attention to financial stability risks. These have been steadily growing in prominence in the Council minutes in recent months (the concerns appear in the minutes rather than at the press conferences). So far, the ECB sees macro-prudential policy as the appropriate response to these risks. However, if the signal from our modified Taylor Rule is correct – that the period for unconventional monetary policy has already come to an end – the assumed gradual exit may be too gradual to contain all financial risks and the pressure for exit will grow.

Appendix 1

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