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Lost in translation

ECB post-meeting comment

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Summary

- The ECB's guidance on rates received a slightly dovish update, as expected.
- By shifting their focus on reaching the 2% aim "well ahead" of the end of their projection horizon, the ECB conveyed the message that its monetary accommodation will be persistent.
- We believe that the ECB's reaction function has not changed materially.
- However, with more emphasis on the midpoint of the staff projections, the ECB may have added some downward bias to the markets' response to inflation data and forecasts.

Policy decisions

- The ECB left the **deposit rate unchanged at -0.50%**, while keeping the refi rate at 0.00%.
- The **PEPP envelope remains at EUR 1,850bn**.
- The ECB confirmed PEPP purchases to **continue at *"a significantly higher pace"* this quarter**.

As widely expected, the ECB did not announce new stimulus in pursuit of its updated inflation aim. However, by shifting the focus on inflation reaching the 2% target *"well ahead"* of the end of its projection horizon, the ECB emphasised it will be persistent in providing monetary stimulus. Moreover, while it may not have materially changed the ECB's reaction function, it may have added some downward bias to the markets' reaction function to inflation forecasts, with the end-point of the staff projections becoming less indicative for future rate hikes.

Forward guidance: new words, same story?

The ECB now expects rates to *"remain at present or lower levels until it sees inflation reaching two per cent well ahead of the end of its projection horizon, and durably for the rest of the projection horizon."* While this still leaves ample of room for different interpretations of 'well ahead' – is that a year, or even two?– it does emphasise that the ECB will be persistent when it comes to keeping monetary policy accommodative. That said, we doubt that it really marks a shift in the ECB's reaction function.

Compare that new rates guidance to the previous one, which required *"robust convergence [of inflation to the target]* ***within*** *its projection horizon"* (emphasis ours). The projection horizon usually spans 2.5-3 years ahead, so the old forward guidance suggested that inflation should return to its aim within that time. The introduction of the phrase "well ahead" suggests that the ECB's nearer term inflation forecasts now also need to be closer to 2% before the bank considers any rate hikes.

Note that the strategy review did not alter the medium-term orientation of the inflation target, nor did it change the horizon of the staff projections. Furthermore, the ECB reconfirmed today that *"[durable convergence of inflation] may also imply a transitory period in which inflation is moderately above target"*. Considering that the staff projections provide annual inflation forecasts, **this new guidance suggests to us that the ECB will at least tolerate one year of above-target inflation.**

That said, the change from 'within' to 'well ahead of' was not the only update to the forward guidance on rates. At risk of putting too much weight on a word-by-word comparison, we would add that the old statement specifically called for *"robust convergence"* within the horizon, while the new statement calls for convergence well ahead of the horizon, *"and durably for the rest of the horizon"*. In other words, both statements require the staff projections to confirm a more or less similar period of convergence, before the Council will consider hiking its key policy rates. **So we don't believe that this update marks a material change in the ECB's reaction function. Nor does it really affect our expectations of the timing of a first rate hike, which we had already pencilled in only far into the future.**

Introducing asymmetric sensitivity to inflation

As noted above, the ECB's reaction function may not have changed materially, despite the updated forward guidance. **However, the new guidance may introduce an asymmetric bias in the markets' response to new inflation data, and –more importantly– updates to the ECB staff projections.**

The phrasing "well ahead" effectively shifts the markets' attention to the nearer term inflation projections provided by the ECB: rather than looking at the last year being forecast, the focal point will likely shift to the second-to-last year. We believe that this may reduce the markets' sensitivity to higher realised inflation, and to higher inflation forecasts when new ECB projections are released.

To illustrate this idea, let's look at some hypothetical situations. In December, the staff projections will be extended to include an inflation forecast for 2024. Under the previous guidance, this data point would get all the attention, as a near 2% reading could feed into the prospect of rate hikes around that time; as long as the market estimates that this 2% inflation is of the durable type.

However, now that the ECB has updated its forward guidance to require convergence well ahead of the end of the forecast horizon –and maintained in the remainder of the projection window– seeing a 2 in 2024 suddenly becomes much less scary: the guidance suggests that it would take at least another year before that forecast is within the Council's new focal point, and uncertainty about the ECB's inflation expectations past that last forecast could limit the market's sensitivity to an on-target, or even above-target forecast.

Conversely, the new guidance may add some emphasis on lower inflation readings: if the December staff projections are extended with another 1.5% forecast for 2024, this suggests that it will take at least *two* more years –or substantial upgrades in subsequent forecasts– before inflation meets the conditions set out in the new guidance.

So while the ECB may not have intended for the new guidance to sound more dovish than its predecessor and although the market currently doesn't see it as such, in practice we believe that this could lead to a more dovish reaction function of the market. Moreover, it may make the staff projections less of a useful guide to policy, as the market is left guessing the ECB's inflation expectations for the year *after* the last forecast period.

Table 1: Shifting the focus?

	2021	*2022*	*2023*
ECB, headline HICP	1.9	1.5	1.4
Markets' 'focal point'		*"well ahead"*	*"within"*

Source: Rabobank

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