Central Banks

Dovish and hawkish tones in the same package

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July 22 2021

- **Changes in forward guidance on rates towards a more dovish exit, given stronger conditions to ensure that inflation meets the new target**
- **However, there was no decision on QE and a potential transition to avoid the cliff of PEPP withdrawal in March 2022, as it was expected**
- **Risks are balance on an outlook which is more positive but with the uncertainty of the Delta variant of Covid**

ECB's first policy meeting after its monetary policy strategy review was marked by a **lack of unanimity**, likely reflecting an **intense discussion between the doves and the hawks. On the one hand, the hawks seem to have so far won the QE battle given the lack of decision on next steps on PEPP program**, which was generally expected, with the ECB just providing an implicit reference to maintaining "favourable financing conditions across sectors". On the other hand, **the new forward guidance on interest rates exiting the zero lower bound has a more dovish flavour -** rates unchanged until inflation is seen to reach 2% well before projection horizon and until core inflation points to its sustainability.

In particular, on this later point the ECB states that **rates would remain at their present, or lower levels based on three key criteria in support of ECB's newly formed symmetric 2% inflation target:** 1) 'well ahead of the end of ECB's projection horizon', which would be the 'mid-point' of the ECB projection horizon, currently 2021-23, 2) 'durably for the rest of the projection horizon' , meaning, ECB's projections will have to reflect inflation at 2% at the end of the forecast horizon as well, currently 2023 and 3) to ensure core inflation leads the ECB to stabilize inflation at 2% over the medium term. Emphasizing her distaste for interpreting the new forward guidance as a clear signal towards 'lower for longer rates', Lagarde instead clarified that the 'patience' on rates between the midpoint and the end of the forecast horizon is meant to avoid premature tightening**;** in other words, a 'steady hand'. In this regard, the ECB would likely leverage upon its inflation forecasts and related Governing Council judgments to condition market expectations and signal any potential shifts in its monetary policy.

Regarding other **key policy tools, including the PEPP, the APP and TLTROs were left unchanged despite expectations.** In the recent strategy review, the ECB has not provided any guidance or details on how these tools will be instrumentalized in the future, and recent comments of Mrs Lagarge suggested that they could announce something on that front as soon as today. In particular, on the PEPP, the ECB disappointed most analysts, who were expecting decisions on the transition to avoid a QE cliff after PEPP expires in March-22. **Mrs Lagarde maintained the same wording and said that there had been no discussion about this and it is premature to talk about the exit of the program**, admitting that while the it would continue until at least March 2022, with purchases over current quarter to be conducted at significantly higher pace than during the first months of the year, its future prospects are clouded by the uncertainty posed by the evolution of the pandemic in light of the delta variant.

The ECB sounded optimistic over ongoing economic recovery as it expects the Euro Area economy to remain on track for strong growth over the rest of this year, led by manufacturing and aided by a strong bounce back of services, which is boosting business optimism and aiding a pre-crisis level return of economic activity by early next year. **That said, the ECB flagged that Delta variant is a source of uncertainty** given that it could dampen recovery in services, especially in the tourism and hospitality sector. **On inflation, the recent rebound is seen mostly as**

transitory (due to energy prices, German VAT and base effects). Inflation is expected to moderate in 2022 as most of these factors fade. Finally, the ECB sees near term **risks as broadly balanced**. While the ECB sounded confident about the near-term economic rebound, it flagged medium-term uncertainty, marked by the course of the pandemic, in the wake of Delta variant, as well as vaccine rollout. On the financial front, it cautioned that although liquidity remains abundant, any worsening of the economy could threaten over-indebted firms and could reinforce tightening financing conditions. The ECB remained **committed to maintaining favourable financing conditions "across sectors**", which implicitly may signal that also all countries will be supported.

Overall, we see today's ECB policy meeting outcome as one setting the path straight for **more battles ahead after the summer, particularly on the transition plan after the end of PEPP programme on March 22. In this aspect,** there seems to be a **clear bias towards late rate rises.**

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