CIO Memo

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ECB struggles to address EUR problem

Key take aways

- The ECB has left its monetary policy stance unchanged. The Governing Council has indicated that it is monitoring recent exchange rate movements closely.
- The market reaction was limited as investors had not expected any policy changes.
- A quick outcome from the strategic policy review of the ECB is not expected.

1. What happened?

At its meeting today the Governing Council of the ECB did not change its monetary policy stance. The ECB reconfirmed its commitment to adjust all instruments as necessary in the future. All main policy rates remain unchanged. The overall size of the Pandemic Emergency Purchase Programme (PEPP) stays at EUR 1350bn. President Lagarde made it clear that the full envelope of the PEPP will likely be used. Increasing the volume of the PEPP was not discussed.

An important new component of the ECB statement was an assurance that the ECB is monitoring the EUR exchange rate and its long term implications for the inflation rate. EUR/USD briefly went above 1.20 in August, for the first time in over two years, and has appreciated more than 11% against the USD from its March low of 1.07.

The ECB has only slightly changed its economic outlook. The ECB projects annual HICP inflation to decline from 1.2% in 2019 to 0.3% in 2020 before rising to 1.0% and 1.3% in 2021 and 2022, respectively. Real GDP is forecasted to decline by -8.0% in 2020 and rise by 5.0% in 2021 and by 3.2% in 2022. Both growth and inflation outlooks are marginally better than previously. The ECB also announced that two economic scenarios would be published in the future.

The ECB however presumes macro risks are still tilted to the downside. It expects inflation to be depressed until the end of this year as lower oil prices, labour market slack and the VAT reduction in Germany continue dampen prices. President Lagarde reconfirmed that monetary accommodation is still necessary and critical for the ECB's long-term inflation goals.

2. How did markets react?

Since the ECB did not change its monetary policy, market reaction was limited. EUR/USD however appreciated to 1.19 after the ECB President Lagarde's press conference. Equity markets stayed essentially flat (Eurostoxx 50 +0.1%). 10 year German Bund yields traded at -0.44%.

3. What does it mean for investors?

Markets had not expected any policy changes, and their focus was instead very much on the strength of the EUR and its implications for Eurozone consumer price inflation – which had fallen to -0.2% YoY in August. ECB chief economist Philip Lane had previously noted that EUR exchange rate would matter for the Eurozone inflation outlook.

In simple terms, a stronger EUR could exert downwards pressure on inflation, through making imports less expensive in EUR terms with deflation also potentially dampening down overall demand. A strong EUR could also erode the competitiveness of Eurozone exporters. At 1.19, EUR/USD is however still slightly below its long-term 1.20 average since the currency's inception. More pertinently, the EUR has not appreciated recently against most other G10 currencies.

Eurozone/U.S. policy divergence could become an increasingly important issue. With the recent adjustment in the Fed's policy framework to (in effect) an average inflation target and a more accommodative labour market policy, the Fed has set the path for an even longer period of expansionary monetary policy, in theory helping to weaken the USD. On the other hand, the ECB is still undertaking its strategic policy review and an outcome is not expected until the middle of next year. Uncertainty around policy could become more worrisome if currency movements continue. During the Q&A session, ECB President Lagarde made it clear that the definition of what price stability will mean for the ECB will sit at the centre of the strategic review – perhaps an indication that the ECB could eventually follow the path of the Fed.

Markets were not surprised by the ECB's decision to leave monetary policy unchanged. Regarding the PEPP, the ECB stays in monitoring mode and has could intervene to boost the programme if the economic recovery loses further momentum. December's ECB meeting could be an opportune time to prolong or increase stimulus, as 2023 forecasts will be published then for the first time. Do not expect a quick outcome from the strategic policy review.

Glossary

Bunds are longer-term bonds issued by the German government.

The European Central Bank (ECB) is the central bank for the Eurozone.

EUR is the currency code for the euro, the currency of the Eurozone.

The EuroStoxx 50 Index tracks the performance of blue-chip stocks in the Eurozone and includes the super-sector leaders in terms of market capitalization.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

USD is the currency code for the U.S. Dollar.

A value-added tax (VAT) is levied on the value added at each stage of the production process.

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