Sounding constructive, after all

With monetary policy on autopilot after the December announcements, today's ECB meeting did not bring major news. The Governing Council (GC) thinks that their baseline scenario remains broadly on track and ECB President Christine Lagarde sounded cautious, but constructive, on the outlook, although confirming that risks remain tilted to the downside. The ECB continues to carefully monitor financial conditions to make sure they remain consistent with its inflation aim, and stands ready to adjust its policy when needed. FX rhetoric did not change, confirming that the euro has not yet approached the GC's pain threshold.

- Today's ECB meeting was fairly uneventful. Following the boost to the PEPP and TLTROs in December, the ECB is now in a wait-and-see mode. Ms. Lagarde regarded developments since the December meeting as broadly consistent with the ECB's latest macroeconomic projections, including the assumptions of restrictions to activity and mobility remaining in place throughout 1Q21, and only gradual vaccination progress. And while risks remain tilted to the downside – especially in the short term, with a high likelihood of a technical recession – today Ms. Lagarde sounded constructive overall, based on the beginning of the vaccination campaign, a Brexit deal (in its December forecasting exercise, the ECB had assumed no deal), legal certainty about the Recovery Fund, a manufacturing sector in good shape and recent political developments in the US. Also, Ms. Lagarde was less vocal than she had been just last week in regard to the risk of a premature withdrawal of fiscal and monetary stimulus. Overall, today Ms. Lagarde was slightly less dovish than we had expected. The next update of the ECB's macroeconomic forecasts in March will be the first important test to understand whether her tone will be vindicated.
- The ECB remains squarely focused on preserving favorable financial conditions and the smooth functioning of the transmission mechanism of monetary policy. From the perspective of the central bank, this implies keeping a broad set of financial market variables within a "comfort zone", with the main aim of allowing governments and the private sector to raise adequate funds at affordable rates. Within this set of variables, government bond yields play a very important role as they represent the benchmark for private-sector pricing. When asked to comment on Italy's political crisis, the market reaction to it and yield-curve control by the central bank, Ms. Lagarde predictably denied the ECB is "controlling" government bond curves, and stated that current developments do not hinder the ECB's accommodative stance for the eurozone as a whole. In other words (and unsurprisingly), the ECB is not alarmed and it is not planning to increase its purchases to counter recent volatility on the BTP curve.
- Last but not least, FX rhetoric did not change much, thus confirming that the exchange rate has not yet reached the ECB's pain threshold. We continue to think that the central bank does not have any easy tool it is willing to deploy to stem euro appreciation, if this were to become unwarranted. The ECB's forward guidance stating that policy rates can be lowered further does not look convincing to us, due to the side effects of such move. The fact that cuts in the deposit rate have not been deployed so far in the COVID-19 crisis seems a clear indication that the majority of the GC shares our view.

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This report was completed and first published on 21 January 2021 at 17:39.

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