ECB takes another tiny step

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Economic growth in the Eurozone has embarked on a clear upward trend. At the same time, the fear of falling wages and prices has disappeared for now. The worries over a possible break-up of the European Union have also eased. Against this backdrop, the ECB President Draghi issued a slightly more optimistic growth forecast yet again on 27 April at the press conference of the European Central Bank. This is another tiny step indicating a possible reduction of the monetary support in the medium term.

Solid economy

Numerous economic indicators suggest a further acceleration of real economic growth in the Eurozone. As an example, the business climate index published by the European Commission hit the highest value in six years in April. After +2% in Q4 2016, economic growth could speed up to +2.3% in Q1 and +2.5% in Q2. While the ECB still sees a certain degree of downside risks in its forecasts, they have decreased due to the solid cyclical development. This means that upside and downside risks are moving towards equilibrium. Also, the risks are of an external nature.

Revision of forward guidance

The ECB has thus slightly changed its forward guidance for the assessment of the future monetary policy. In a next step, the ECB will probably call the economic risks balanced. However, the importance of the assessment of inflation trumps that of the assessment of economic growth.

Four inflation criteria

Mr. Draghi uses four criteria to assess whether the currently excessively low inflation is in tune with the goal of price stability (i.e. an inflation rate of slightly below 2%).

- Sustainable: the acceleration of inflation in the past months has been driven by the temporary increase in prices of energy and food
- Self-supporting: inflation has to remain on target also without monetary support.
- Total perspective: the inflation target applies to the Eurozone as a whole and not to every individual country.
- Medium-term: the inflation target is set for the medium term and not for a year-on-year perspective.

None of these criteria have seen an improvement lately. In March, the underlying inflation (i.e. core inflation) was at a low 0.7% year-on-year. At least the deflation risk has fallen, which is also the main reason for the reduction of the bond purchase programme from EUR 80bn per month to EUR 60bn in April.

Conclusion

The solid economic development, the low inflation, and the monetary policy, which is very supportive to the economy, are positive for risky asset classes.

Also, the reduction in tail risks for deflation and the break-up of the European Union (presidential election in France) are two important hurdles that have now been cleared. The ECB has slightly adjusted its forward guidance. While this has no immediate bearing on the capital market, the sum of many tiny steps will ultimately translate into one significant overall change.

Our most likely scenario: step-by-step, open-ended reduction of the bond purchase programme (“further reduction from x to y, until [month / year], or beyond that if needed”).

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