

ECB opts for a “steady hand” on policy

16 June 2021

IN BRIEF

- At its June policy meeting, the European Central Bank (ECB) revised up its growth and inflation forecasts for 2021 and 2022, though the longer-term inflation forecast remains unchanged at 1.4%.
- Despite the revisions, the central bank made no changes to its policies and confirmed its dovish stance until it sees more evidence of sustained growth.
- Market reaction was muted but volatility could pick up over the summer if the US debate around tapering heats up.
- With a flat money market curve for the foreseeable future, euro cash investors will want to optimise cash strategies to maximise returns, while remaining focused on liquidity and security.

At its monthly policy meeting in June, the ECB revised its growth and inflation forecasts upwards, but confirmed its “very accommodative monetary policy stance”¹. Continued dovish policy and declining to talk tapering were broadly in-line with market expectations, but reinforce the need for euro cash investors to optimise cash strategies to maximise returns, while remaining focused on liquidity and security.

EUROPE’S ECONOMY SET TO REBOUND

As vaccinations ramp up across Europe, so does optimism that the eurozone economy can rebound strongly during the second half of 2021: consumer confidence has soared to a three year high², while business confidence has also surged - the composite Purchasing Managers’ Index (PMI) added more than eight points in the last three months, reaching 57.1. Short-term work schemes kept unemployment relatively low - April’s measure was 8.0% versus a peak of 8.5% in September 2020 - and have helped prevent long-term economic damage. The successful ratification of the European Union (EU) Recovery Fund, combined with the continued recovery in global demand, should create additional economic tailwinds.

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¹ ECB Monetary Policy Statement, 10 June 2021.

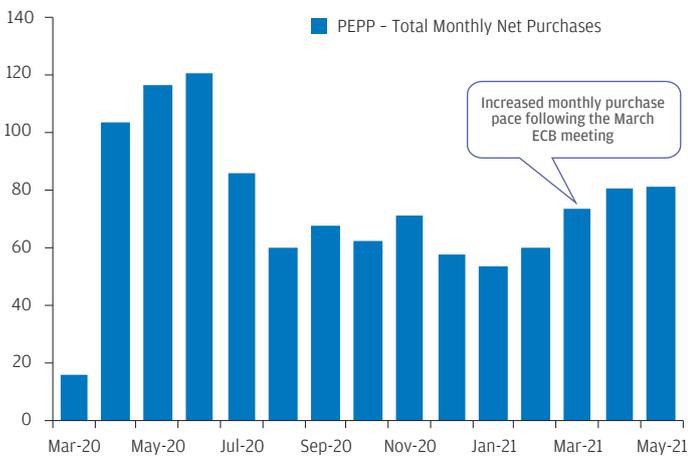
² EC’s Consumer Confidence Indicator rose to -5.1 in May.

ECB BUMPS UP FORECASTS BUT POLICY STAYS STEADY

The ECB appeared more optimistic on the economic outlook where the risks are now seen as “broadly balanced.” The central bank upgraded its growth forecast to 4.6% in 2021 and 4.7% in 2022 versus the 4% and 4.1% respective forecasts in March. In addition, the ECB’s Harmonized Index of Consumer Prices (HICP) is now forecast to average close to the ECB’s target in 2021 at 1.9% (versus 1.5% forecast in March), and the core inflation forecast increased marginally for 2023 to 1.4% (from 1.3% previously).

Despite the improved forecasts, the central bank left interest rates on its main refinancing operations, marginal lending facility and deposit facility unchanged and pledged to conduct Pandemic Emergency Purchase Programme (PEPP) purchases “at a significantly higher pace than during the first months of the year” and maintain the program until at least the end of March 2022. This mirrors the decision taken at the March Meeting (**EXHIBIT 1**).

EXHIBIT 1: YEAR-TO-DATE PEPP PURCHASES HAVE INCREASED SIGNIFICANTLY (EUR BN)



Source: Bloomberg, as at 11 June 2021.

Seemingly more in line with the policy, the longer-term HICP forecast is unchanged for 2023 at 1.4%, and all inflation predictions remain well below the ECB’s target of close to but below 2%. This allowed Christine Lagarde, President of the ECB, to fend off questions about longer-term plans for monetary stimulus, saying the discussion about exiting emergency measures would come “in due course.” She suggested that the results of the ECB’s Strategic Review, expected in second half of 2021, would provide further insight and clarity on the future direction of ECB policy.

MARKETS SHRUG

If the ECB’s aim was limited market reaction, it succeeded. Longer-term Bund yields and the euro barely moved on the news.

While the outcome of the meeting was close to market expectations, due to a string of dovish comments from the ECB in recent weeks, market participants will continue to debate whether an improved economic outlook could be the basis for tapering the pace of PEPP purchases after the summer months. Though today’s decision was unanimous, Lagarde acknowledged some debate on the pace of purchases and divergent views on the Governing Council. Ultimately, the ECB wants to see the recovery more firmly established and remains wary of any unwarranted tightening of financial conditions that could derail this goal.

Markets remain steady but volatility could increase during the summer, especially if the concurrent debate on tapering in the US heats up. The impact would more likely be seen in longer-term yields, but the debate could influence the ECB’s actions and discussions.

MONEY MARKET IMPLICATIONS AND OUTLOOK

The ECB's June decision has few implications for the short-end rates, which remain well anchored. EURIBOR rates remain near record lows (**EXHIBIT 2**) while the curve remains close to multi-year highs (**EXHIBIT 3**). Currently the market is not pricing the first 10-basis-point (bps) hike in the deposit rate until the end of 2023. Given the ECB's dovish policy stance and the shortfall in its 2023 inflation forecast relative to target, this could be premature.

For euro cash investors, the money market curve is likely to remain very flat for the foreseeable future, limiting opportunities to boost returns and exacerbating the opportunity costs associated with very high levels of liquidity and principal protection. Good cash forecasting procedures can help investors segment cash and then optimise cash investments, such as diversifying into step-out strategies that can help improve returns without excessively increasing risk or volatility.

EXHIBIT 2: EURIBOR YIELDS REMAIN CLOSE TO RECORD LOWS

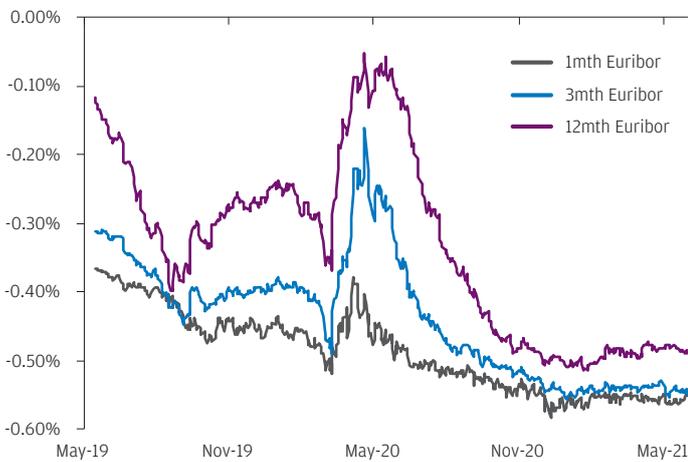
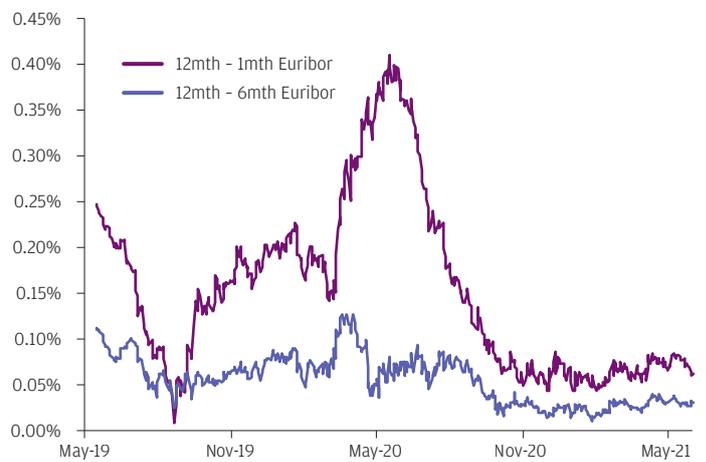


EXHIBIT 3: EURIBOR CURVE REMAINS RELATIVELY FLAT



Source: Bloomberg, as at 11 June 2021.

LIQUIDITY INSIGHTS

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LV-JPM53251 | 06/21 | 0903c02a82b2a78e