LLOYDS BANK

HEADS-UP
NEED TO KNOW EVENT PREVIEWS

Friday 1 September 2017

ECB Preview (7th September) – Focus on euro appreciation

- ECB policymakers to start discussing the future of policy stimulus measures (beyond this year), but no decisions are expected to be announced until October at the earliest.
- As such, key interest rates, asset purchases (€60bn a month until the end of the year) and forward guidance are all expected to be left unchanged.
- There will be intense scrutiny of whether Mr Draghi expresses concerns about potential euro "overshooting". We expect him to say recent euro strength reflects stronger economic fundamentals, but to warn against excessive moves.
- A stronger euro is expected to result in slight downward revisions to the ECB's inflation forecasts, while growth forecasts are expected to remain largely unchanged.

ECB WORKING ON FUTURE POLICY MIX

At the last policy meeting on 20th July, President Draghi confirmed the ECB's intention to continue with its monthly asset purchases of €60bn until the end of the year. The key message was that a discussion on the future of the QE programme, from next year, will take place in the "autumn". We believe it is too early for any details to be announced at next week's meeting on 7th September. In our view, the most likely outcome in terms of policy is a hint from Mr Draghi that the current pace of asset purchases and the overall mix of policy will be reassessed at next month's meeting on 26th October, when concrete policy options are likely to be presented.

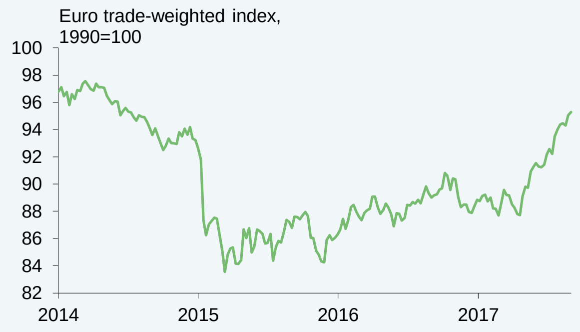
The minutes of the July meeting stated the desire to "gain more policy space and flexibility to adjust policy and the degree of monetary policy accommodation, if and when needed, in either direction". This suggests that, as the upturn gains further traction, the ECB is looking to move towards a more flexible, data-dependent orientation for policy. The most likely outcome in early 2018 is probably a further reduction in the pace of asset purchases, without committing yet to tapering towards zero. With underlying price pressures still considered to be subdued, Mr Draghi could repeat the need for "patience, persistence and prudence". Hence, any withdrawal of stimulus is likely to be gradual.

WILL DRAGHI COMMENT ON RECENT EURO STRENGTH?

Next week's meeting will be framed by updated economic forecasts and the marked appreciation of the euro in recent months. Since the last set of economic forecasts three months ago, the euro has risen by nearly 10% against the US dollar and around 5% in trade-weighted terms. The minutes of the July meeting expressed concerns about "possible overshooting" in the foreign currency markets. Markets will therefore be watching the press conference with Mr Draghi, starting at 13:30BST, very closely for any comments on the currency.

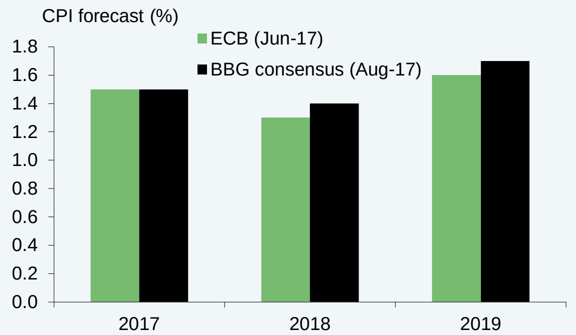
We anticipate he will indicate that a key reason for the euro's appreciation is the improved outlook for the Eurozone economy. In that sense, its strengthening is a vote of confidence in the Eurozone's economic prospects. Nevertheless, given the euro's reaction to his lack

Chart 1: The euro has appreciated significantly in recent months and is back above pre-QE levels



Source: BoE, Bloomberg, Lloyds Bank Commercial Banking analytics as of 1 Sep 2017

Chart 2: Consensus forecasts for Eurozone inflation are higher than the ECB's, despite the stronger euro



Source: ECB, Bloomberg, Lloyds Bank Commercial Banking analytics as of 1 Sep 2017 of comment on the currency at the Jackson Hole symposium last month, we expect him to warn against excessive moves which raise the risk of 'overshooting' and could delay the sustained return of inflation towards the ECB's goal.

RESILIENT GROWTH MEANS LIMITED INFLATION DOWNGRADE

Economic indicators suggest that the economy has remained resilient so far to the currency's appreciation. The export component of the Eurozone manufacturing PMI, for instance, increased in August to the strongest level since 2011. We expect the ECB's growth forecast – previously 1.9% this year, 1.8% in 2018 and 1.7% in 2019 – will be kept broadly unchanged. Given that the stronger euro is, to a significant degree, a reflection of more positive economic prospects, there is some uncertainty on the extent to which lower import prices will feed through to lower consumer price inflation. On balance, we expect downward revisions to headline CPI inflation – previously projected to average 1.5% this year, 1.3% in 2018 and 1.6% in 2019 – will probably be marginal. Nevertheless, it would reinforce the expectation that policy will remain accommodative going into 2018.

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