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Stronger currency and weaker economic data pose a challenge for the ECB

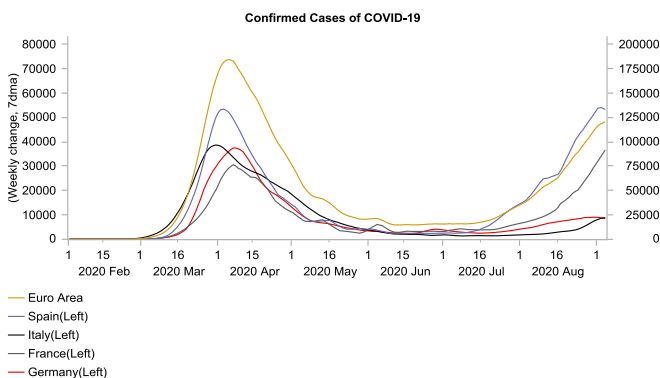
07 September 2020

Signs that the recovery may be losing some momentum

The uptick in confirmed cases of Covid continues in the euro area but thankfully it is not translating into hospitalisations or deaths at the same rate as at the start of the crisis.

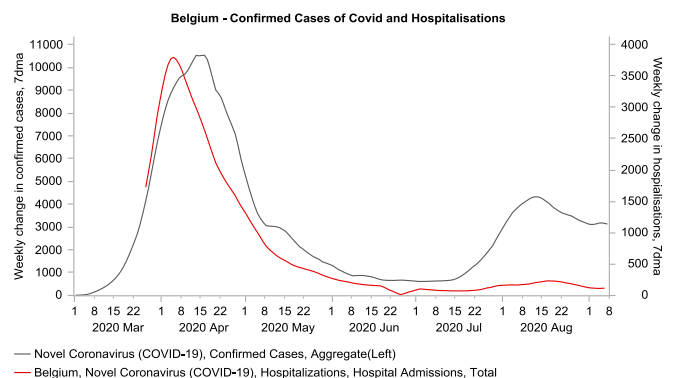
There are some signs that the renewed spread of the virus is relevant for the economic recovery, however. Spain has seen the sharpest rise in discovered cases over the last month. The Spanish PMI duly dipped into contraction territory last week, while Google high frequency mobility data suggests that the slow return to 'normal' in the country has stalled, if not gone into reverse. Across the euro area as a whole, the recovery in consumer confidence has lost steam and growth in retail sales (which had been looking quite 'V-shaped') slipped back in July.

CONFIRMED CASES CONTINUE TO RISE...



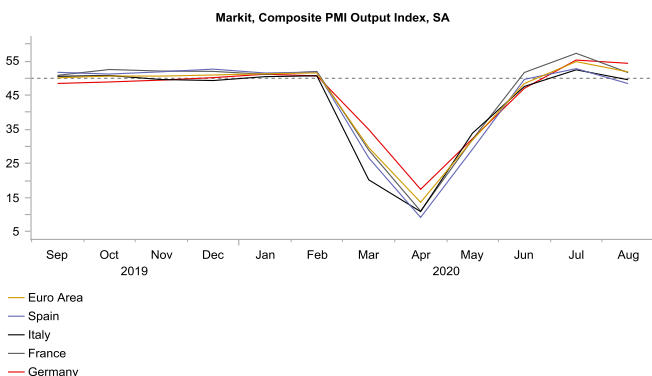
Source: EDPC, MUFG Economic Research

...BUT HOSPITALISATIONS REMAIN LOW



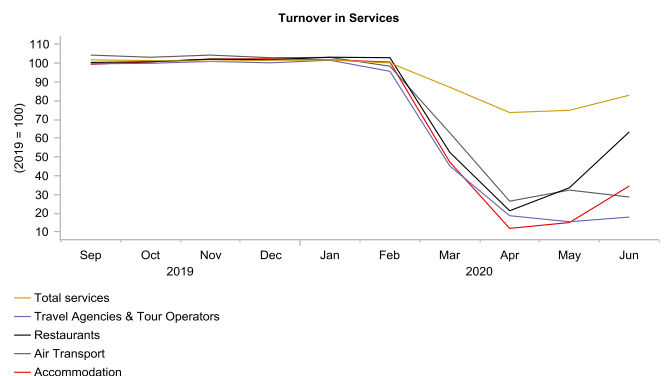
Source: EDPC, Sciensano, MUFG Economic Research

PMIS SLIP BACK



Source: IHS Markit, MUFG Economic Research

TRAVEL AND HOSPITALITY DRAG ON SERVICES SPEND



Source: Eurostat, MUFG Economic Research

Looking beyond retail trade, which accounts for less than half of total consumer spending, the picture is worse. Turnover in services remains well below the pre-virus level with the slump in travel and tourism particularly pronounced.

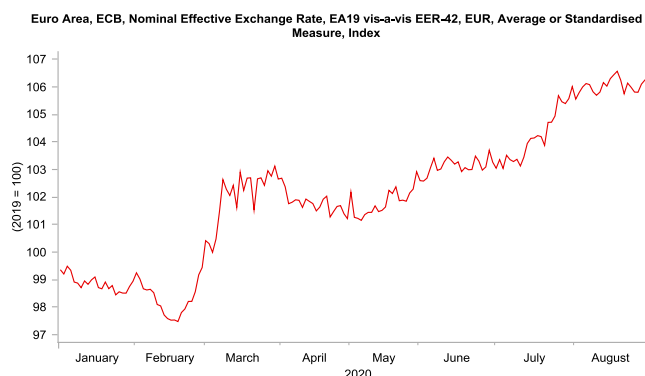
Communication test for Lagarde as ECB acknowledges issue of EUR strength

Taken together, recent data releases serve as a reminder that a full economic recovery is unlikely until the virus can be brought under control. To that end, the public health response remains more important than any monetary or fiscal manoeuvres.

But this week's ECB meeting still looks to be an interesting one, even though major policy changes are unlikely. Last week's inflation release showed that headline price growth dipped into negative territory (-0.2% YoY in August) for the first time since 2016. Against that background, Lagarde will expect plenty of questions about recent euro strength (EUR is up 5% against the dollar since the ECB's June meeting). A stronger currency drags on import prices which then passes through to headline inflation. It also reduces export demand which could drag on the economic recovery.

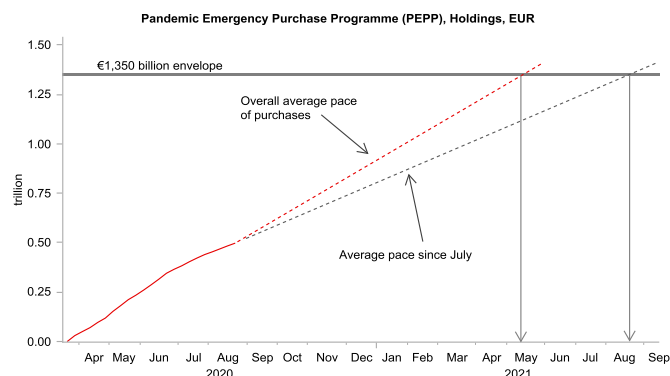
The ECB has already acknowledged the problem: Philip Lane, its chief economist, said last week that "the euro-dollar rate does matter". He also hinted that ECB may have to do more to "restore momentum to inflation dynamics".

EUR STRENGTH



Source: ECB, MUFG Economic Research

PEPP PROCEEDING IN LINE WITH ITS PARAMETERS



Source: ECB, MUFG Economic Research

However, the current parameters of the PEPP – the tool of choice for any further easing at the moment due to its flexibility – seem appropriate. The ECB has said that purchases will be conducted until at least June 2021. An extrapolation of the average pace of purchases since the start of the programme would see the €1350bn envelope used up by May 2021. Purchases were frontloaded to an extent, though. Since July purchases have slowed (perhaps also reflecting easing market conditions since the agreement of the EU recovery fund). This slower pace would last until late summer next year. Either way, "at least June 2021" still looks about right. Any changes at this stage are likely to be small tweaks to the parameters.

The ECB could extend the guidance and say purchases will be conducted until the end of 2021, but it wouldn't be an obviously dovish move as it would imply a slower pace of purchases unless the envelope is increased too. Another possible tweak would be to say that the €1350bn is a rough target rather than a ceiling. This would open the door to higher purchases if market conditions (i.e. the peripheral bond spreads) worsen. However, the ECB does not need to urgently address the format of the PEPP, so we think that changes at this meeting are unlikely.

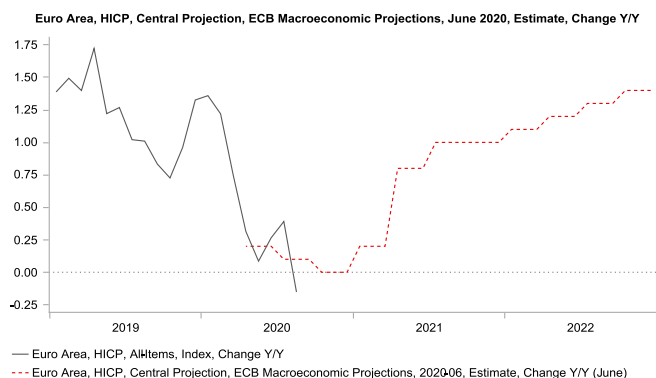
In other circumstances the central bank might be in ‘wait and see’ mode until December, perhaps, by which point there’s likely to be more clarity on the length and pace of the economic recovery. Instead, if there are not any dovish adjustments to the PEPP parameters, the task for Lagarde is to jawbone EUR lower by making action in December seem likely already. It will be a communication test, particularly after her missteps at the March meeting.

At any rate, we suspect that the recent signs of a spluttering recovery are the precursor to a protracted and fragmented path back to pre-virus levels of total output. To that end, extra monetary stimulus in December – most likely pumping up the PEPP again – would be very appropriate.

Inflation outlook in focus

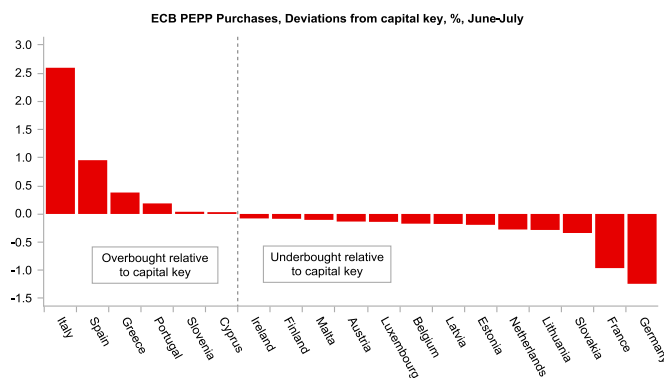
The latest ECB staff projections will also be released. Despite EUR strength, inflation developments have actually been broadly in line with the last set of figures from June. In September’s projections, the lower-than-expected August number and effect of EUR weakness is likely to be offset to some extent by oil prices working in the other direction, but some downward revision is likely. In terms of GDP outlook, the Q2 figures were also consistent with the June projections (which didn’t incorporate the EU recovery fund) so there probably won’t be major changes. But Lagarde may choose to emphasise the downside risks or reasons to doubt a ‘V-shaped’ recovery, whether in light of recent data releases or in an attempt to weaken the EUR.

INFLATION IS UNDERSHOOTING THE LATEST STAFF PROJECTIONS



Source: ECB, Eurostat, MUFG Economic Research

EXTRA SUPPORT FOR PERIPHERALS FROM THE PEPP



Source: ECB, MUFG Economic Research

Lastly, a contribution to this EUR strength (or rather, USD weakness) has been the US Fed’s shift to an average inflation target, announced at Jackson Hole. There are likely to be questions on whether the ECB would consider a similar change to its monetary policy framework. We suspect Lagarde will simply point to the ongoing strategy review. The conclusion of the review has been postponed until mid-2021 due to the pandemic and it’s unlikely that there will be any changes to the framework before then.

KEY RELEASES AND MUFG FORECASTS – WEEK BEGINNING 7 SEPTEMBER

Day	BST	Region	Indicator/Event	Period	Prev.	Cons.	MUFG
Thu 10 Sep	12:45	EC	ECB Main Refinancing Rate	10 Sep	0.00	0.00	0.00
Thu 10 Sep	12:45	EC	ECB Marginal Lending Facility	10 Sep	0.25	0.25	0.25
Thu 10 Sep	12:45	EC	ECB Deposit Facility Rate	10 Sep	-0.50	-0.50	-0.50

Source: Bloomberg

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