



THE ECB'S STEADY HAND

VERY PATIENTLY STAYING THE COURSE

July 23, 2021

The European Central Bank (ECB) has had a busy month so far. A few weeks ago it concluded its strategy review and changed the definition of its inflation target. This week it followed up with a recalibration of its policy mix. The main takeaway from all of this is that the ECB is going to be very patient before tightening policy.

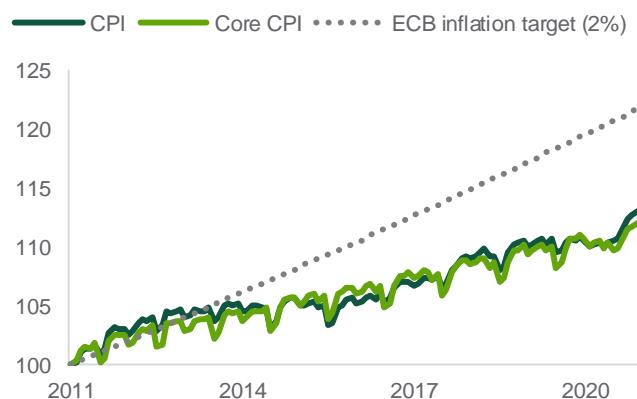
Strategy review gives the ECB more leeway. The most important outcome of the strategy review was the change in the ECB's inflation target from "close but below 2%" to "symmetric around 2%." Although that may not seem like a big change, it is for an institution built on the hawkish inflation heritage of the Bundesbank. The new approach means both upside and downside deviations from 2% are to be addressed with equal importance, whereas previously upside deviations carried more weight. This aligns the ECB with the Federal Reserve and Bank of Japan among others, and effectively removes a hawkish tilt in its mandate.

An important reason for the ECB to make this change is its flagging credibility. After a decade of falling far short of 2% inflation (as seen in the left-hand chart below, the Consumer Price Index [CPI] has averaged only 1.2% annually) neither the markets nor professional forecasters expect the ECB to succeed in getting inflation sustainably back to 2% (see right-hand chart below). The ECB hopes that increasing its inflation target will change the perception that it is unable to deliver and will give it cover to provide more stimulus if needed. In fact, in a best case scenario the two will reinforce each other and turn into a self-fulfilling prophecy. For now, however, that is wishful thinking and the ECB knows it. It has to deliver something tangible first.

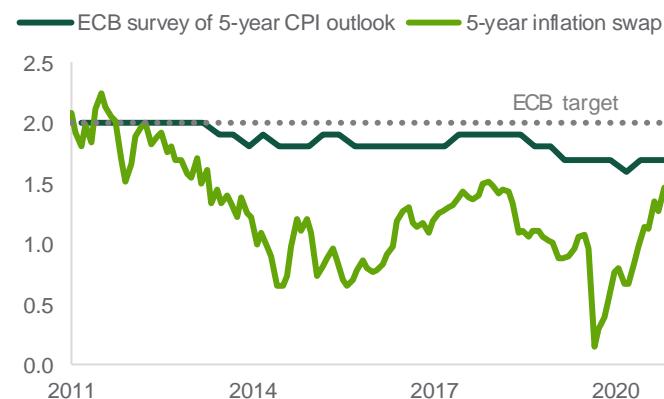
EXHIBIT 1: NOT SO FAST

Europe's stuckflation of the past decade endorses a very patient approach to monetary policy.

EUROZONE INFLATION (INDEXED TO 100)



EUROZONE INFLATION EXPECTATIONS (%)



Source: Northern Trust Asset Management, Refinitiv Datastream. Left: Indexed to 100 on 7/29/2011. Data through 6/30/2021.

A high hurdle. That tangible deliverable was presented on July 22 in the press conference following the Governing Council meeting. ECB President Christine Lagarde laid out that the ECB has decided to change its forward guidance for interest rates in response to the outcome of the strategy review. In effect, the ECB put a very high hurdle in place before it will even consider hiking interest rates. Three criteria need to be met: 1) see inflation reach 2% well before the end of the three-year projection horizon; 2) expect inflation to stay durably above 2% for the rest of the projection horizon; and 3) see inflation stabilizing at 2% over the medium term. Truth be told, it is very hard to foresee these three criteria being met in the next two-to-three years, and maybe even longer. But that is exactly the point. The ECB is using this hurdle to signal it will patiently maintain its current course, conduct monetary policy with a very steady hand and prevent itself from tightening prematurely.

With interest rate changes off the table for even longer, this new forward guidance constitutes a small dovish surprise. More importantly, investors need to learn how this new framework will extend to other parts of the policy mix, most notably the ECB's quantitative easing program. Lagarde made it clear the Pandemic Emergency Purchase Program (PEPP) was not a topic of conversation, calling it premature to even consider slowing the monthly pace of bond purchases. But with the new economic projections due in September and the recovery still going strong, that will change. It will be interesting to see if the ECB uses the new framework as an argument to not only keep the monthly purchases going at the same rate, but also to keep them going after their current March deadline. Our expectation is that it will, but to what extent is hard to estimate.

What it means for investors. A dovish surprise from the ECB and a higher probability for more dovish surprises down the road support our tactical overweight to European equities (also achieved through developed ex-U.S. equities). Combining newfound dovishness with the strong recovery from the COVID-19 recession, continued fiscal stimulus through the NextGenerationEU package and European equities' global growth exposure further supports this tactical viewpoint.

What do you think of this commentary? Click one: [Like it](#) — [Just okay](#) — [Don't like it](#)

© 2021 Northern Trust Corporation. Head Office: 50 South La Salle Street, Chicago, Illinois 60603 U.S.A.

IMPORTANT INFORMATION. **For Asia-Pacific markets, this information is directed to institutional, professional and wholesale clients or investors only and should not be relied upon by retail clients or investors.** The information is not intended for distribution or use by any person in any jurisdiction where such distribution would be contrary to local law or regulation. Northern Trust and its affiliates may have positions in and may effect transactions in the markets, contracts and related investments different than described in this information. This information is obtained from sources believed to be reliable, and its accuracy and completeness are not guaranteed. Information does not constitute a recommendation of any investment strategy, is not intended as investment advice and does not take into account all the circumstances of each investor. Opinions and forecasts discussed are those of the author, do not necessarily reflect the views of Northern Trust and are subject to change without notice.

This report is provided for informational purposes only and is not intended to be, and should not be construed as, an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Recipients should not rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. Information is subject to change based on market or other conditions.

Past performance is no guarantee of future results. Performance returns and the principal value of an investment will fluctuate. Performance returns contained herein are subject to revision by Northern Trust. Comparative indices shown are provided as an indication of the performance of a particular segment of the capital markets and/or alternative strategies in general. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Gross performance returns contained herein include reinvestment of dividends and other earnings, transaction costs, and all fees and expenses other than investment management fees, unless indicated otherwise.

Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, Northern Trust Fund Managers (Ireland) Limited, Northern Trust Global Investments Japan, K.K., NT Global Advisors Inc., 50 South Capital Advisors, LLC, Belvedere Advisors LLC and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.