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ECB—Surprisingly Dovish on Several Counts

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If anyone thought the European Central Bank (ECB) would approach the current economic soft patch as business as usual, the ECB swiftly proved them wrong. **The central bank surprised the market with a package that is designed to impress and stamp out skepticism that the ECB may be out of ammunition with policy rates already in much-criticized negative territory and having just stopped its bond purchases at year end.**

There are surprise elements on several counts. The downgrade of the economic outlook was widely anticipated, and the cut of the ECB's real growth forecast to 1.1% (from 1.7%) this year is well within the current consensus ballpark. **However, the reduction of the year-end inflation forecast to 1.2% (from 1.6%) combined with the downward revision of the medium-term (2021) forecast to 1.5% reflects expectations that the ECB will find it difficult to meet its inflation target (of "close to but below 2%") for at least another three years.** Combined with its assessment that the risks to the growth outlook remain tilted to the downside, these forecasts foreshadow the distinct possibility of more policy action, if needed.

The extension of the forward guidance on policy rates was probably the biggest surprise. **The ECB is now committed to refraining from any rate hikes through the end of this year (and not just through the end of the summer). Thereby, the Governing Council has set policy beyond President Draghi's term that is set to end in October 2019, effectively tying the hands of his successor.** This step sends a strong signal that the Draghi succession—and all the uncertainties surrounding it—will not impede the institution's readiness to shore up the economy.

The decision on the TLTRO III, the successor facility for the Targeted LTROs II, in and of itself was less surprising, but its swift announcement came at an earlier time than many expected. That said, with some €725 billion in central bank financing scheduled to begin to run off in mid-2020, the need for a successor facility was beyond any doubt, especially considering that the Italian and Spanish banking systems alone took up little more than half of this funding and thus remain on life support. **The conditions of the TLTRO III financing appropriately signal the continued desire for gradual monetary policy normalization—the maturity of the "replacement loans" has been halved to two years and the interest rate is floating (rather than fixed as for the TLTRO II loans) in case the ECB may yet raise its policy rate.**

The market reacted swiftly to the ECB's policy reversal. **Rather than focusing on the benefits of more monetary policy accommodation, the market seems to be focused on the risks, giving credence to the ECB's assessment that the risks decidedly remain tilted to the downside.** As a result, the euro dropped a full figure—it traded above $1.13 prior to the meeting and weakened toward $1.12 after the announcements—and global fixed income rallied with 10-year Bund yields halving to 6 bps and now eerily close to turning negative again. Meanwhile, equity markets digested the substantial downward revision of growth forecasts and traded in negative territory.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of March 7, 2019

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