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EUROZONE

Quieter on the ECB front – monetary policy now set to remain on hold for a longish spell

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Today's price and labor market data confirm our picture: inflation and the economy are heading in the right direction, thus arguing against any further loosening of monetary policy. But both are not so dynamic that they might prompt the ECB to ponder tightening. With its forward guidance, the ECB is likely to wait until the second half of the year before preparing the markets for a probable tapering starting in March 2017.

According to today's flash estimate for May, eurozone year-on-year inflation was still in negative territory at -0.1%, but this probably corresponds to a seasonally adjusted increase of 0.4% on the previous month. On the heels of a similar increase in March, this suggests that the trend is now turning positive (primarily due to the oil price). Annual rates, however, will probably not bid farewell to the zero line until the third quarter and reach around 1% towards the end of the year. We see the need for a slight tweak to the ECB's projections of eurozone inflation of 0.1% this year and 1.3% in 2017 (our forecasts: 0.3% and 1.6% respectively). With our forecasts of economic growth of 1.7% this year and 1.8% next, we are also more upbeat than the ECB to date (2016: 1.4%; 2017:1.7%).

The unemployment rate in the eurozone was unchanged in April at 10.2% (whereby the downward trend remains intact). This brings it back down to the 2010/2011 level, but it remains well above the pre-crisis low of 7.2% seen in

March 2008. Current ECB projections of average unemployment of 10.4% in 2016 and 10.2% next year are behind the curve. It could be that the ECB models are underestimating the responsiveness of the labor market to an economic pickup on the back of reforms implemented in a number of eurozone countries. We see a steady continuation of the improvement on the labor market, with the unemployment rate falling to around 9 ½ % by the end of 2017.

Against this backdrop, monetary policy surprises are not on the cards. Following the recent batch of additional easing measures, the ECB is likely to remain on hold for the foreseeable future with regard to both key rates and unconventional measures. As communicated by the ECB, the monthly bond purchases will probably continue until March 2017. On the forward guidance front it would be good if, as the year progresses, the ECB were to prepare markets for a likely tapering from March 2017. Given the outlook for inflation and the economy, we think an earlier exit is unlikely even though we regard the negative side effects of QE as increasingly worrying. In order to avoid excessive jumps in yields, it will require nimble communication of tapering/the start of the ECB's exit from its ultra-loose monetary policy – particularly as prospective US monetary policy and the trend in yields there are already likely to exert upward pressure on European long-term interest rates.

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