Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

ECB PREVIEW: TIPTOEING TOWARDS THE EXIT

Berenberg Macro Flash

An easy trip to beautiful Tallinn. At its meeting in Estonia next Thursday, the ECB Governing Council needs to take no major policy decision beyond tweaking its guidance a little to keep up with the Eurozone's broad-based and resilient economic recovery. We expect the ECB to suggest that a further rate cut has become highly unlikely and that the internal debate is slowly turning towards the modalities of a future exit from its current stance without divulging any details about the future course of policy yet. The ECB will likely describe the risks to growth as balanced rather than as tilted to the downside without changing its assessment that inflation risks remain subdued. On balance, the ECB may surprise markets a little on the dovish side.

The economic backdrop for the ECB is as favourable as it gets in real life:

- **Economic growth** in the Eurozone has accelerated from an average pace of 1.7% in the last two years to an annualised pace of 1.9% in the last two quarters, with a good chance of an upward revision to an annualised pace of 2% shortly. Sentiment surveys project steady and solid growth ahead.
- Although **unemployment** remains elevated, the number of unemployed continues to decline at a steady clip of 1.5 million per year.
- Despite some headline-grabbing gyrations caused by oil prices and the unusually late Easter holiday, **inflation** remains firmly anchored. In May, core inflation fell back to its 2014-2016 average of a mere 0.9%.
- **Credit growth** continues to edge up on trend. But with loans to households and non-financial corporations rising by 2.4% yoy in April, it still remains tepid.

In short, the Eurozone is enjoying satisfactory growth at low inflation with no trace of a credit-bubble. Judging by these results, the ECB has pursued exactly the right policies ever since it finally stopped the euro confidence crisis in the summer of 2012. The data do not indicate a need for a sudden change of policy. Instead, the ECB can calmly lay the ground for a very gradual return to a less accommodative stance over time, in line with the guidance the bank has provided so far.

ECONOMIC PROJECTIONS

Since the ECB published its last staff projections in March, most economic data have, on balance, exceeded expectations slightly. We thus expect the ECB to raise its **GDP growth** forecast for 2017 marginally from 1.8% to 1.9%. However, core inflation has not started to rise from the 0.9% average of recent years towards the 1.1% which the ECB so far projects for 2017 as a whole. With oil prices mostly stable and the euro slightly stronger, we thus expect the ECB to lower its **inflation** forecast for 2017 slightly from 1.7% to 1.6% or possibly even to 1.5% (our current forecast). The ECB may make similar small changes to its GDP and inflation projections for 2018 and 2019. In their impact on the suitable stance of monetary policy, these revisions would largely offset each other. The ECB can thus stay on the course it has charted before in its guidance, tiptoeing towards a winding down of asset purchases in 2018 and a first hike in its refinancing rate well thereafter, that is probably not before early 2019.

TWEAKING THE LANGUAGE

The ECB has vowed to maintain the current pace of asset purchases of €60bn per month at least until the end of 2017 and to not stop them abruptly thereafter. As the economy is holding up nicely and as late 2017 is drawing closer, we look for the ECB to tweak its statement in a number of ways:

Risks to growth: having already explained in April that downside risk to growth have diminished, the ECB will likely drop the notion that risks to growth are tilted to the downside and adopt a balanced risk assessment instead.

Outlook for inflation: the ECB will likely maintain its view that "underlying inflation pressures ... remain subdued and have yet to show a convincing upward trend".

Outlook for rates: we expect the ECB to de-emphasise the possibility of a further rate cut. The ECB could do so by committing to keeping rates at "present" instead of " present or lower" levels for "an extended period of time". Of course, the ECB won't rule out a further rate cut. In case "the outlook becomes less favourable", the ECB currently stands "ready to increase (its) asset purchase programme in terms of size and/or duration" The ECB could broaden that sentence to suggest that, in case of an unexpected economic or financial setback, the ECB could relax its monetary stance further. That would include the option of a potential rate cut but in a more low-key way than before.

Outlook for asset purchases. We do not expect the ECB to suggest in its opening statement in June already that asset purchases will likely be phased out in 2018. The notion that asset purchases could continue beyond the end of 2017 if required will likely stay. Instead, ECB president Draghi will probably report in the Q&A session that the ECB council is starting to discuss the exit strategy without already committing the ECB in any way to a particular course of action.

We look for the ECB to use its new set of economic projections in September to confirm that it will start to scale back its asset purchases in January 2018.

Forecasts for Eurozone Inflation	2017	2018	2019
ECB (March projections)	1.7	1.6	1.7
Bloomberg consensus new	1.6	1.5	1.7
Berenberg new	1.5	1.6	

Yoy change in %. Source: ECB, Bloomberg, Berenberg

Forecasts for Eurozone Real GDP	2017	2018	2019
ECB (March projections)	1.8	1.7	1.6
Bloomberg consensus new	1.7	1.6	1.4
Berenberg new	1.8	1.7	

Yoy change in %. Source: ECB, Bloomberg, Berenberg

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com