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A HAWKISH ECB? NOT REALLY

Berenberg Macro Flash

Time for a reality check. Equities and bonds have sold off somewhat and the euro has strengthened a little amid concerns that the ECB may scale back its monetary stimulus too early. How much do we need to worry?

Economists tend to look through any short-term volatility in markets. After a long rally, some correction in equity markets is par for the course. Bonds now look a little less mispriced than they were before the back-up in yields over the last three days and the euro remains far below its long-term fair value of around €1.25 per US dollar. These market moves are far too small to cloud the economic outlook for the Eurozone.

That leaves one major concern: could the ECB tighten its monetary policy prematurely? That seems highly unlikely, to put it mildly. At the ECB's annual Sintra forum, ECB president Mario Draghi explained on Tuesday the basis for the ECB's inflation projections and its policy guidance in a remarkably thorough and thoughtful way. The market took his speech as hawkish. Having listened to the speech in Sintra, I do not share this assessment. Draghi explained why the ECB expects core inflation to drift up gradually in response to the firmer economic upswing. But such an updrift is part of the ECB projections anyway. Draghi emphasised that the ECB must be persistent in applying its stimulus in order to nudge inflation closer to its target and that the ECB must be prudent instead of acting too early.

I do not see the well-balanced speech as a reason to reconsider our forecast that the ECB will continue to move towards the exit from its very loose policies at a snail's pace. More precisely, we expect the ECB

- to suggest in September that it will scale back its asset purchases in January 2018,
- to announce at its late October meeting that it will buy €45bn instead of €60bn per month in the first quarter of 2018,
- to reduce the monthly purchase volume by a further €15bn per quarter thereafter until the purchases cease at the end of September 2018, and
- to hike the main refinancing rate for the first time in September 2019, that is shortly before Draghi's non-renewable eight-year term ends at the end of October 2019.

The risk to our forecast is that the ECB may end asset purchases at the end of Q2 rather than Q3 2018 and may first raise the refi rate in June (or March) rather than September 2019.

Whether or not the ECB may move back to a symmetric rate corridor around its 0% refi rate by lifting the deposit rate from -0.4% to -0.25% while leaving the emergency lending rate at 0.25% before the bank ends its asset purchases remains a wild card. Whereas that could be a smart political compromise between hawks and doves, it would probably be highly contentious within the ECB.

Abstracting from the short-term volatility which calendar effects exert on the prices for package tour, core inflation seems to have drifted up to 1.0% in the last few months after oscillating around 0.9% in the four years before. Most observers including us as well as the ECB look for a further gradual increase. In Sintra, Draghi spelled out the reasons for that call in a sophisticated way. Over the last six years, however, core inflation has usually come in lower than we and the ECB had projected. That underpins one key conclusion: if in doubt, the ECB will follow the US Fed and err on the side of caution, reducing its stimulus only when the data clearly point that way.

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In the end, market concerns that the ECB may choke off the economic revovery by scaling back its stimulus too early should be largely self-correcting. If any resulting rise in bond yields or the exchange rate would be grave enough to potentially impair the outlook for growth and inflation, the ECB would simply maintain its full monetary stimulus for longer. No need to worry about that. The ECB will do all it can to keep the economic recovery and hence the outlook for employment as well as corporate profits on track. The one accident which could force the ECB to scale back its stimulus fast, namely an abrupt and sustained surge in core inflation, simply does not seem to be on the cards. Economic fundamentals suggests that Goldilocks can stay in the Eurozone for years to come.

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