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ECB PREVIEW: AUTUMN IS COMING

Berenberg Macro Flash

The ECB autumn is coming. Back in the summer, the ECB said it would decide about the future course of its monetary policy in autumn. According to the meteorological calendar, autumn started on 1 September. This Thursday, the ECB will take its first step. It will likely announce that the Governing Council has tasked the relevant committees to evaluate the possible options to adjust its policy stance going forward. But the ECB is unlikely to provide any details or commit to a reduced pace of asset purchases as of January 2018 at this stage already. The next step will follow on 26 October, with some details possibly not unveiled before 14 December. The ECB will take care to not give the euro exchange rate another boost.

Firm growth at moderate Inflation: In the first half of this year, the Eurozone recovery gathered momentum with GDP growing at an annualised pace of 2.3% – beating the ECB's and our expectations. For the second half of this year, we expect some moderation in growth to 1.9%, still well above the 1.5% trend rate. Unemployment is falling, credit is growing and sentiment is high. Inflation has remained well below the ECB's target of "below, but close to 2%" over the medium term for a range of reasons such as temporary external price shocks, more slack in the labour market than previously expected and a weaker impact of slack on inflation.

Why scale back the stimulus? Underlying inflation shows signs of life. Monetary policy works with a lag of roughly two years. When the ECB discusses the appropriate monetary conditions for the economy, it looks towards 2019 and later, not this year. While the often overstated deflation risks have receded further, underlying price pressures have been building very gradually this year. Core inflation, the measure that strips out volatile components such as food and energy, has accelerated from 0.9% in January to 1.2% in August. The closing of the output gap will continue to raise the core rate gently over time. Underlying price pressures have shown signs of life even though the recent appreciation of the euro may have made the imports of foreign goods cheaper. Inflation of non-energy industrial goods of which a considerable amount is imported has remained stable. This is at least indicative of a less subdued pricing power among providers of such goods. Stronger demand for goods seems to have offset the lower costs stemming from the exchange rate.

ECB forecasts: Two factors will likely shape the new ECB staff projections for growth and inflation. 1) The recent data for growth and headline inflation have been slightly higher than the ECB had expected in its June 2017 projections. 2) The euro has appreciated by more than 6% vis-à-vis a trade-weighted basket of currencies so far this year, and by almost 5% between the cut-off dates for the June and September ECB projections. That could weigh on growth and inflation forecasts for 2018 and, even more so, for 2019. On balance, we expect the ECB to increase its **growth forecasts** by 0.2ppt for this year and possibly by 0.1ppt for 2018 from the current rates of 1.9% and 1.8%, respectively. The ECB will likely leave the call for 2019 unchanged at 1.7% with a risk of a downward revision to 1.6%. While the appreciation of the euro limits the upside potential of exports, stronger foreign demand seems to have more than offset this loss of price competitiveness so far. While we do not expect the ECB to change its **inflation projections** for 2017 and 2018 significantly (the ECB is already below consensus for next year), the ECB may lower its 2019 inflation call by 0.1-0.2ppt. The ECB will also revise down its estimate for unemployment.

Forecasts for Eurozone Inflation	2017	2018	2019
ECB (June projections)	1.5	1.3	1.6
Bloomberg consensus	1.5	1.4	1.7
Berenberg	1.5	1.4	1.6

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

Forecasts for Eurozone Real GDP	2017	2018	2019
ECB (June projections)	1.9	1.8	1.7
Bloomberg consensus	2.0	1.7	1.5
Berenberg	2.1	1.9	1.7

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

Policy outlook: The ECB is confident about the Eurozone recovery and that inflation will respond to the recovery. As long as inflation remains subdued, the ECB will only tiptoe on its normalisation path to not cause an unwarranted tightening of financial conditions. In its own words, the ECB will be "persistent, patient and prudent". We, thus, expect the ECB to:

- declare this Thursday that it is studying the possible options to reduce its asset purchases in 2018 – without dropping the easing bias in terms of duration and size of its purchases
- announce on 26 October that it will reduce asset purchases from a monthly rate of €60bn to €45bn as of January 2018 and maintain that new pace for at least three months while stressing that the programme remains open-ended
- scale back the asset purchases in further steps of €15bn every three months thereafter if growth and inflation stay on track until purchase stop at the end of September 2018,
- raise the deposit rate from -0.4% to -0.25% in late 2018, and
- hike the refinancing rate from 0.0% to 0.25% in September 2019.

Of course, the strength of the euro has introduced a clear risk that tapering will last longer (12-15 months) and that the ECB will raise the deposit rate 3-6 months later than in our base case. The ECB has already expressed concerns about a potential exchange rate overshoot. Draghi may use the press conference for some comments on the stronger euro without going much beyond the minutes of the last meeting such as that the exchange rate is not the ECB's mandate but that the ECB was surprised about the pace of appreciation.

Technical obstacles such as finding enough bonds can constrain the ECB's policy choices somewhat, but probably not decisively. If the ECB could no longer find German bunds to buy we would expect them to raise the amount of corporate bonds relative to public bonds. It will, however, unlikely touch the capital key rule or the 33% issuer/issuance limit.

Could the ECB delay its decisions about the pace of asset purchases in early 2018 from late October to December? Yes. Last year, the ECB tasked the relevant committees in September about how to extend quantitative easing – and announced its decision in the following December based on a new round of forecasts. The same could happen this year. In December forecasts for 2020 would also be available. In a similar vein, the US Fed decided in December 2013 to start tapering in January 2014. Is it likely that the ECB will delay decisions until December 2017? No, at least not yet. The ECB is wary about market reactions and would probably prefer to provide some clarity in October already. So far they have not convincingly leaned against the market expectations that the ECB will scale back its asset purchases in January 2018. A risk remains, though.

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