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ECB: TIPTOEING TOWARDS THE EXIT DESPITE CONCERNS ABOUT EURO STRENGTH

Berenberg Macro Flash

Step by step, the European Central Bank is heading for the exit from its aggressive stance. But to which extent the ECB will reduce its asset purchases at the beginning of 2018 will depend on the exchange rate of the euro. At its September press conference, the ECB announced that the Governing Council will "discuss the calibration of our policy instruments beyond the end of the year" this autumn. On the one hand, the Council noted the unexpected strength of economic growth in the first half of the year as well as the modest pick-up in core inflation in the last few months. On the other hand, the ECB emphasised prominently, that is already in the second paragraph of Draghi's introductory statement to the press conference, that the exchange rate presents "a source of uncertainty … for the medium-term outlook for price stability". By ECB standards, that counts as a significant verbal intervention into foreign exchange markets.

According to Draghi, the ECB Council today had a "very preliminary" discussion of the duration of its asset purchase programme and the size of its monthly purchases. Draghi expects to present the "bulk" of the decisions about early 2018 asset purchases at its 26 October meeting, possibly leaving some details until 14 December. As expected, the ECB Council today asked the relevant ECB committees to continue to work on various options to re-calibrate the ECB's asset purchases in early 2018. However, the ECB did not question the pre-announced sequence of the steps to reduce the degree of its monetary accommodation. Once again, Draghi stressed that the ECB will not raise rates until well after the end of its asset purchases. The ECB also did not discuss a change in issuer limits for its bond purchases.

All in all, the ECB did not spring a major surprise today. However, some of the ECB comments on both growth ("solid, robust and broad-based") and the exchange rate ("source of uncertainty") were worded rather clearly. The ECB embarked on a difficult balancing act. Acknowledging that the robust recovery strengthens the conviction that inflation will gradually converge towards the ECB's target of just below 2%, the ECB made a clear case for abandoning its exceptionally loose monetary policy stance soon. However, emphasising the importance of the exchange rate for the medium-term outlook for inflation, the ECB also tried hard to calm foreign exchange markets. Whether or not that strategy will be successful will depend to some extent on factors well beyond the ECB's control, notably on the US Fed and the vagaries of US politics.

As explained before, we expect the ECB to

- 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 the gradual winding down of asset purchases will last longer (12-15 months) and that the ECB will raise the deposit rate 3-6 months later than in our base case. For example, the ECB may decide to scale back its monthly asset purchases to €40bn in early 2018 but maintain that new pace for at least six rather than just months. According to Draghi, the Council today discussed the "trade offs" between various options for the future size and duration of asset purchases.

Although Draghi said that "scarcity issues were not discussed today", 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. Instead, the ECB will "be able to exploit all the flexibility of the programme" according to Draghi.

Answering the standard German questions about the risk of asset bubbles and other negative side effects of its current policy stance, Draghi pointed out that the positive effects of ECB policies, namely strong growth at low inflation, far outweigh any negative side effects. Also, the moderate pace of credit growth suggests that the ECB is not yet blowing up dangerous asset bubbles. Nonetheless, strong economic growth suggests in my view that the case for maintaining the current policy stance is becoming weaker. To the extent that the return of the euro from significantly undervalued to a level closer to its long-term fair value of around 1.25 to the US dollar reflects the pace of the eurozone recovery, it should not be an argument to delay the scaling down of asset purchases. Of course, in line with the ECB statement today, the risk that any unexpectedly hawkish move from the ECB could unsettle foreign exchange markets should impact the precise pace at which the ECB scales back its stimulus. More importantly, it means that the ECB should try to avoid surprising markets. That is what they tried today.

STRONG GROWTH AT MODERATE INFLATION

Except for its call for 2017 GDP, the ECB made only marginal changes to its economic outlook. Reflecting strong growth in the first half of 2017 and the continuing momentum visible in survey data, the ECB raised its 2017 staff projection for growth from 1.9% to 2.2% while leaving the calls for 2018 and 2019 unchanged. For inflation, the ECB did the opposite. While leaving the 2017 projection unchanged at 1.5% the ECB took account of the stronger euro by shaving its calls for 2018 and 2019 by 0.1 point each to 1.2% for next year and 1.5% for 2019. These projections are based on a dollar exchange rate of roughly 1.18 per euro.

Forecasts for Eurozone Inflation	2017	2018	2019
ECB (September projections)	1.5	1.2	1.5
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 Real GDP growth	2017	2018	2019
ECB (September projections)	2.2	1.8	1.7
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

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