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ECB: TAKING THE BIG STEPS SLOWLY

Berenberg Macro Flash

Life cannot get much better for the European Central Bank (ECB). Helped by the ECB's aggressive monetary stance, the Eurozone economy is expanding at a pace well above its 1.5% trend rate and shows no sign of losing momentum. At the same time, core inflation of currently 1.1% remains so subdued and is edging up only so slowly that the ECB can afford to phase out its aggressive policies in a slow and orderly fashion. Having prepared markets well, the ECB today managed to announce that it will halve its asset purchases as of January 2018 without ruffling many feathers. Markets even took it as slightly dovish.

We do not expect today's decision to have a major and sustained impact on the Eurozone economy and financial markets. Instead of buying €60bn per month, the ECB will slash its purchases to €30bn as of January 2018 and maintain that new pace at least through September 2018. The ECB did not give a firm end date for purchases but emphasised again that, if need be, it could increase its purchases in terms of size and duration. The ECB left its guidance on interest rates unchanged, promising to maintain its current rates until well beyond the end of its asset purchases. In the trade-off between size and duration of further asset purchases, the ECB leaned towards the "less for longer" camp today. Relative to the alternative which we had favoured, namely a cut in asset purchases to €40bn for six months that may have been followed by purchases of €20bn for three to six months thereafter, the overall difference over the first nine months of 2018 is small (€10bn less).

Although some council members today argued for indicating an end date for purchases, a "large majority" of council members preferred to keep the programme open-ended according to ECB president Mario Draghi. He also emphasised that the ECB does not want to stop purchases "suddenly". This suggests that the ECB will probably reduce purchases further in October 2018 but will not end them completely before December of that year.

We continue to expect the ECB to end its purchases in late 2018, probably in December, followed by a first hike in the refinancing rate in September 2019. We see a good chance that the ECB may ease the penalty it imposes on bank deposits a little beforehand by raising its deposit rate from -0.4% to -0.25% in the spring or summer of 2019.

Markets have often worried that the ECB may run out of German bonds to buy over the course of 2018. To avoid shortages of bonds of some sovereigns, we expect the cut in the ECB's purchase programme in January to fall largely on sovereign bonds. The ECB did not provide details on the future composition of its purchases under its programme. Still, the suggestion in a subsequent ECB press release that "the purchase volume under the three private sector programmes ... will remain sizeable" points to a major cut in the somewhat contentious sovereign bond purchases in January 2018. The ECB may provide more details at its December meeting.

A MATTER OF SEQUENCE

The ECB today added two elements to its policy statement: First, it promised to reinvest the principal from maturing bonds for "an extended period of time after the end of its net asset purchases, and in any case for as long as necessary". Second, it announced that it will conduct its main short-term as well as its three-month refinancing operations as fixed rate tenders with full allotment until at least the end of 2019. Both elements suggest that the ECB will continue to adjust its stance only very gradually in the future and provide generous amounts of liquidity on the way.

The stock of assets the ECB has bought under its purchase programme will rise to €2.3trn by the end of 2017 and €2.57trn by September 2018. This - and the Fed decision to no longer reinvest all proceeds from maturing bonds - puts the focus on the ECB's reinvestment policy. Draghi did not answer the question whether the ECB will follow the example of the US Fed and start to reduce its stock of assets only after it has started to raise rates. He merely stressed that rates will stay unchanged well past the end of asset purchases. As the Fed has so far fared rather well with its sequence, namely to continue to replace all maturing bonds well after the start of a rate hike cycle, we expect the ECB to follow the same sequence in the end. If the ECB raises the refi rate for the first time in September 2019, it may take up to two years before the ECB starts to slowly shrink its balance sheet.

CONFIDENT BUT PRUDENT

Judging by its statement and Draghi's comments at the press conference, the ECB has become more confident in the strength of the Eurozone economy, with the opening statement to the press conference referring to "unabated growth momentum in the second half of this year". According to the ECB, recent gains in sentiment indicators "could lead to further positive growth surprises". However, this upbeat view – which we fully share - did not translate into any change in the ECB's assessment of the inflation outlook. As before, the ECB notes that measures of underlying inflation "have yet to show more convincing signs of a sustained upward trend" despite having ticked up "moderately" since early 2017. In the words of Draghi, this justifies an ECB stance that is "patient and prudent". As the euro exchange has moved largely sideways in recent week, the ECB downgraded its reference to the risk which the exchange rate may pose to the outlook for growth and inflation.

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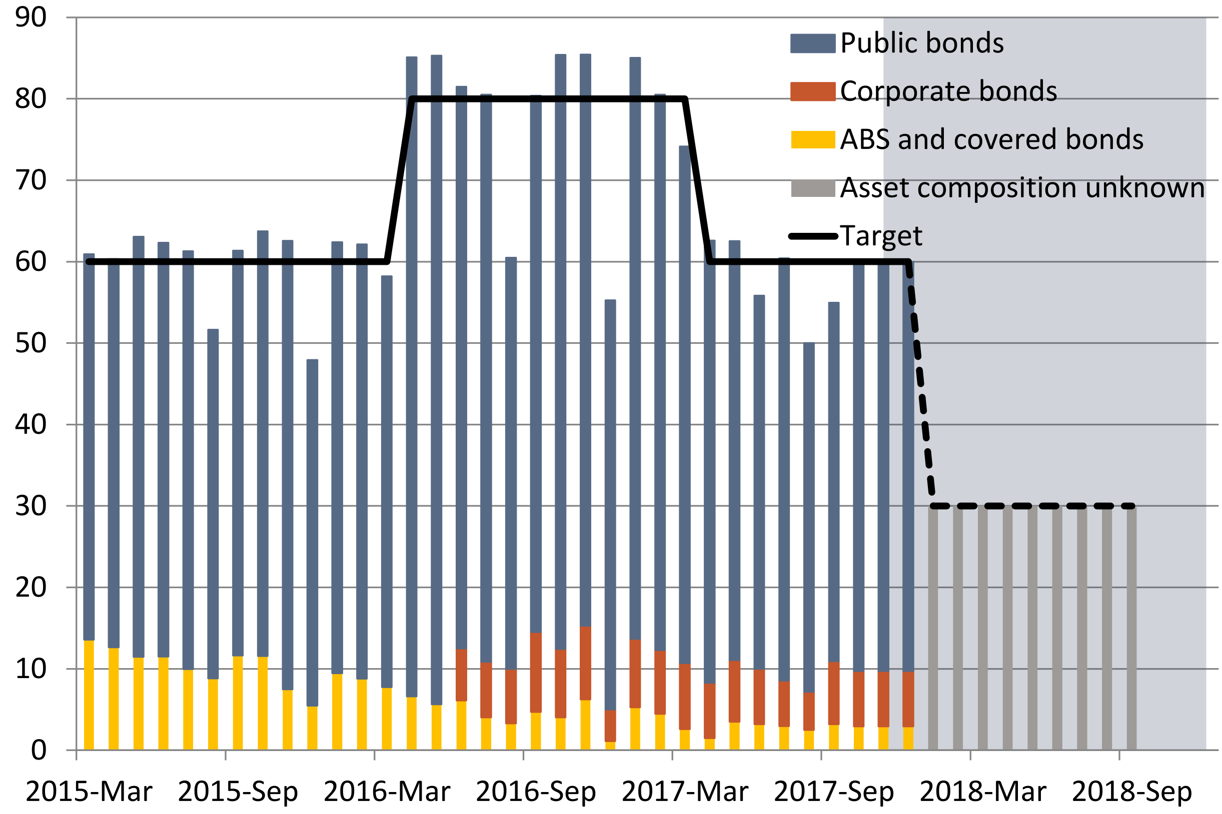
ECB net asset purchases, monthly volume in € bn



Source: ECB

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