Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

ECB PREVIEW: 2020 FORECAST IS KEY FOR RATE PATH

Berenberg Macro Flash

The year is not over yet. At its meeting this Thursday, the ECB will offer insights into its policy outlook that could be as important as its October decision to cut asset purchases by half as of January and continue them until at least September 2018. Specifically, the ECB will

- include its first estimates for 2020 in its new staff macroeconomic projections, and
- provide details on the composition of asset purchases in 2018.

We expect the ECB to project growth well above trend for the next three years without an inflation overshoot and to let the cut in asset purchases fall largely on public bonds. The ECB could use a "below, but close to 2%" inflation forecast for 2020 to signal that they expect to end asset purchases in late 2018 and raise rates in 2019. The ECB may also tweak its formal policy guidance slightly, although a major change may have to wait until H1 2018.

Economic backdrop – very favourable: GDP growth in the Eurozone has accelerated to an annualised pace of 2.6% in the first three quarters of 2017. The surge in sentiment surveys to new multi-year highs projects further growth well above trend. Although the unemployment rate remains elevated at 8.8%, more than twice as high as in the US and UK, the number of unemployed continues to decline at a steady clip of 1.5 million per year. Underlying inflation remains firmly anchored. Credit growth continues to edge up. With loans to households and non-financial corporations rising by 2.9% yoy in October, it is, however, far away from the pre-Lehman exuberance.

ECB forecast revisions – growth up, core inflation down: Since the ECB published its last staff projections in September, economic data have exceeded expectations, especially forward-looking survey data. We thus expect the ECB to raise its current below-consensus **GDP** growth forecasts from 2.2% to 2.4% for 2017, from 1.8% to at least 2.1% for 2018 and from 1.7% to 1.9% for 2019. **Headline inflation** has come in a bit higher due to a rise in oil prices by more than 20% while the euro has remained fairly flat against a trade-weighted basket of currencies between the cut-off date of the September projections, 14 August, and the likely cut-off date of the December projections, 21 November. While the ECB will likely leave its 2017 headline inflation projection untouched, it will probably nudge up those for 2018 (from 1.2% to 1.4%) and 2019 (from 1.5% to 1.6%). Contrary to the rise in headline inflation, the **core rate** fell back to the 0.9% average of 2014-2016 in October and November. Reflecting the lower starting level, the ECB will probably lower its core inflation projections for 2017 and 2018 slightly, but keep those for 2019 unchanged on the back of faster growth.

Premiere of 2020 projections: Crucially for the policy outlook, the ECB will publish its first estimates for 2020. How close the headline inflation call for 2020 will come to the ECB's "below, but close to 2%" definition of price stability will provide important insights into the ECB's policy over the next two years. We expect a forecast of 1.8%. That would pave the way for a gradual scaling back of the ECB's stimulus in line with its current guidance. A number below 1.8% would raise the risk of an extension of asset purchases beyond September 2018. This looks unlikely, though.

Eurozone headline inflation	**2017**	**2018**	**2019**	**2020**
ECB (Dec projections – our estimates)	*1.5*	*1.4*	*1.6*	*1.8*
ECB (Sep projections)	1.5	1.2	1.5	
Bloomberg consensus	1.5	1.5	1.6	
Berenberg	1.5	1.5	1.7	

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

Eurozone real GDP	**2017**	**2018**	**2019**	**2020**
ECB (Dec projections – our estimates)	*2.4*	*2.1*	*1.9*	*1.7*
ECB (Sep projections)	2.2	1.8	1.7	
Bloomberg consensus	2.3	2.0	1.7	
Berenberg	2.4	2.4	2.1	

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

Composition of purchases – fewer public bonds: Markets have often worried that the ECB may run out of some sovereign bonds to buy over the course of 2018. To avoid shortages of bonds of some sovereigns and gain more flexibility, we expect the ECB to decide that the cut in the purchase programme in January will fall largely on sovereign bonds – if not completely from currently €50bn monthly down to €20bn in 2018, with €10bn monthly for the sum of corporate bonds, covered bonds and ABS. An ECB press release that followed the October press conference saying "the purchase volume under the three private sector programmes … will remain sizeable" suggested a cut of sovereign bond purchases.

Policy outlook – turning ever less dovish: The Eurozone is enjoying a broad-based, job-rich recovery with no serious inflationary pressures or a credit-bubble just yet. The ECB can thus still stick to its October policy guidance: it will buy €30bn of bonds at least through September 2018 and will keep its rates at current levels until well after the end of these asset purchases. But with growth well above trend, even the doves at the ECB will feel uneasy about extending asset purchases beyond September 2018 and maintaining a negative deposit rate in 2019. We, therefore, expect the ECB to take small steps towards the exit, starting with tweaking its guidance gradually over the course of the first nine months of 2018.

Outlook on asset purchases: First, the ECB could downgrade the commitment that it is "ready to increase the programme in size and/or duration" by dropping the reference to an increased size or by referring in more general terms to a readiness to adjust the programme if need be. While the ECB may possibly do this on Thursday already, we expect the bank to wait until March 2018. Second, in June 2018, it could announce that it will not prolong its net purchases beyond September 2018. The ECB could, of course, wind them down gradually from October to December 2018. Some may argue this would be more in line with the pledge not to taper the programme abruptly. However, we see little point in a minor amount of purchases beyond September. The need to reinvest maturing bonds will keep the ECB in the market anyway.

Outlook on rates: The ECB will likely keep the pledge to maintain rates at present levels "well past" the horizon of QE until September 2018. For now, the ECB increasingly wants to draw the attention away from net asset purchases towards interest rates, the reinvestment of maturing bonds and the stock of assets already purchased. Comments by ECB Governing Council members Peter Praet and Benoit Coeure point in that direction. While the ECB can possibly reduce the penalty on bank deposits at the ECB from -0.4% to, say, -0.25% perhaps in March 2019, it cannot put the deposit rate back to zero without lifting its main refi-

nancing rate from its current 0.0% as well. Otherwise, there would be no corridor between the two rates. We, therefore, project that the ECB will raise its refi rate for the first time in this current cycle in June 2019, followed by a further move in December 2019.

At its meeting this Thursday, the ECB will stress that the overall monetary stance remains accommodative and will turn only slowly less accommodative. The withdrawal of monetary stimulus will correspond with a rise in credit demand as the recovery continues to take a firmer hold while real policy rates remain negative.

This message has been produced for information purposes for institutional investors or market professionals, it is not a financial analysis within the meaning of § 34b or § 31 of the German Securities Trading Act (Wertpapierhandelsgesetz), no investment advice or recommendation to buy financial instruments. The message does not claim completeness regarding the information on the developments referred to in it. On no account should it be regarded as a substitute for the recipient's procuring information for himself or exercising his own judgements. The message may include certain descriptions, statements, estimates, and conclusions underlining potential development based on assumptions, which may turn out to be incorrect. Berenberg and/or its employees accept no liability whatsoever for any direct or consequential loss or damages of any kind arising out of the use of this message or any part of its content. -- For full economics reports please visit our website or contact capitalmarkets@berenberg.de.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com