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ECB: LEAN BACK AND ENJOY THE MOMENTUM

Berenberg Macro Flash

A merry Christmas at the European Central Bank. While the Eurozone economy continues to recover rapidly, beating almost all previous expectations in the process, subdued core inflation allows the central bankers to lean back and enjoy the momentum. At today's meeting, the ECB left its policy stance and forward guidance unchanged. Upbeat forecasts on growth suggest that the bank will end its asset purchases on schedule in September 2018 and start to raise rates in the first half of 2019. However, the ECB did not drop any hint that, in response to stronger demand momentum, it may deviate from its current guidance and accelerate the process further. Instead, the ECB kept its inflation projection for the policy-relevant time horizon, that is for 2019, unchanged at 1.5% and added a still muted inflation forecast of 1.7% for 2020, with a core inflation rate of 1.8% for that year. De facto, this re-affirms the ECB's current schedule. We expect the ECB to adjust its language in coming meetings step-by-step to pave the way for a smooth exit from its extraordinarily relaxed policy stance. Like the ECB and other observers, we look for core inflation to edge up gradually over time.

The new ECB projections provide some fodder for both hawks (strong growth now) and doves (just 1.7% inflation in 2020). After an unexpected surge in growth in 2017 and 2018, the ECB looks for the upswing to lose a little momentum in 2019 and 2020. While the ECB raised its projection for growth in 2018 substantially from 1.8% to 2.3% and thus close to our 2.4% forecast and lifted its 2019 call from 1.7% to 1.9%, it added a less exuberant 1.7% growth forecast for 2020. Reflecting the very slow updrift in core inflation this year, the ECB did not take the strong growth momentum as a reason to raise its inflation projections except for an oil- and food-driven adjustment to 2018 inflation from 1.2% to 1.4%. While celebrating the "strong" current cyclical momentum and emphasising a "greater confidence that inflation will converge to our inflation aim" of close to but below 2%, the projected path for headline and core inflation provides the ECB with an argument to not change its policy outlook. In October, the ECB had noted "an uptick in measures of underlying inflation". The ECB did not repeat this assessment in December, following core inflation readings of a mere 0.9% for October and November. ECB president Mario Draghi dodged the question whether he judged 1.7% inflation as in line with the ECB's "below, but close to 2%" definition of price stability. Instead, he merely said that the ECB would look more at how strong the convergence of inflation would be to a self-sustained path –an answer that provides no hint as to the policy outlook.

With growth well above trend for the entire forecast horizon including 2020, even the ECB doves will find it increasingly difficult to justify a negative deposit rate over time. Whether or not the negative rate has helped or hindered the transmission of the ECB's monetary stimulus through the banking system to the real economy is debatable. However, the upturn in credit growth to the private sector (2.9% yoy in October) indicates that the rationale for the negative rate is getting weaker. Still, given the ECB's strong guidance that it will only raise its rates "well past" the end of its asset purchases, it would take a major inflation surprise to trigger an early hike in that rate. As inflation remains well behaved, the deposit rate is likely to stay at its current level throughout 2018. Although rising, credit growth so far remains far below long-term averages. The Eurozone remains far away from large-scale credit-fuelled bubbles that could jeopardize economic stability eventually.

To pave the way for a smooth exit, we expect the ECB to adjust its guidance step-by-step in coming quarters, followed by a gradual change in the policy stance. More precisely, we look for the ECB to

- drop the notion that it may increase its asset purchases in size and duration in March 2018, leaving only the more general commitment to continue asset purchases beyond September 2018 "if necessary",
- announce in June 2018 that it expects to end asset purchases in September 2018,
- raise the deposit rate from -0.4% to -0.25% in March 2019, re-establishing a symmetric rate corridor of 25bp either way around the 0.0% main refinancing rate, and
- lift the entire rate corridor by 25bp in June 2019, followed by a further 25bp rate hike in December 2019 and roughly three further such steps in 2020.

Judging by the economic momentum, the risk to our calls could be that the ECB acts a little earlier on rates. However, judging by the ECB's rhetoric today, we have to acknowledge a risk that the ECB may even wait a little longer than we project.

MACROECONOMIC PROJECTIONS FOR THE EUROZONE

Eurozone headline inflation	**2017**	**2018**	**2019**	**2020**
ECB (Dec projections)	1.5	1.4	1.5	1.7
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)	2.4	2.3	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

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