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ECB: STAYING CALM IN VOLATILE TIMES

Berenberg Macro Flash

In volatile times, doing very little can sometimes be the best course of action. While celebrating the unexpectedly strong cyclical recovery in the Eurozone, the European Central Bank today adopted no more than a very mild form of verbal intervention to arrest the rise in the euro exchange rate. In the introductory statement to its press conference, the ECB warned that the rise in the euro "represents a source of uncertainty that requires monitoring". The ECB had used the same words in September 2017 already. Discussing the reasons for the recent rise in the exchange rate, apart from stressing the stronger economy, ECB president Mario Draghi indirectly chided US Treasury Secretary Steven Mnuchin for deviating in Davos from the international agreement to not target exchange rates for competitive purposes. Draghi laid out that several members expressed concerns over US policies and the general state of international relationships.

The ECB did not alter its assessment that risks to its outlook for growth remain balanced, with upside risks stemming from the strong cyclical momentum and downside risks relating "primarily to global factors" such as the exchange rate.

The ECB made no change to its formal guidance, re-iterating the commitment:

- to continue its monthly asset purchases of €30bn until the end of September 2018, or beyond,
- to increase the size and duration of the programme, if required, and
- to keep its interest rates at their current levels "well past" the end of its asset purchases.

In the press conference, ECB president Mario Draghi stressed that he would see very few chances for a rate increase this year. Draghi offered no clear hint whether the ECB would suddenly stop its asset purchases, extend them, or phase them out gradually. By admitting that this is part of the debate at the ECB, he opened the door for a sudden end of asset purchases in eight months from now.

In line with the data flow, the ECB upgraded its assessment of the economy situation while noting that price pressures remain subdued. On the one hand, the ECB now views the economic recovery as "robust", acknowledging that growth in the second half of 2017 has surprised the ECB to the upside. On the other hand, the ECB emphasised that domestic price pressures remain muted and have yet to show convincing signs of an upward trend – in fact there had not been much of a change since October, Draghi said during the press conference.

ECB outlook – QE ends in September 2018, rate cycle starts in March 2019: 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

- adjust its guidance by dropping the specific 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 at the end of September 2018,
- adjust in September 2018 the pledge to maintain rates at present levels "well past" the horizon of QE,
- 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.

If growth continues to surprise to the upside while core inflation edges up, the ECB may raise all three rates rather than just its deposit rate in March 2019 already. Of course, if core inflation fails to edge up over the course of the year and/or if the euro strengthens to such an extent that it would dampen the outlook for growth and inflation significantly, the ECB may wait a little longer before eventually reducing its monetary stimulus. In particular, if the euro continues to rise in coming weeks, the ECB may well delay any significant change in its formal guidance until after its 8 March meeting.

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