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ECB CONCERNED ABOUT INCREASING RISK OF TRADE CONFLICTS

Berenberg Macro Flash

The account of the last ECB meeting on 8 March (published today) shows that removing the easing bias was a "natural step" for the Governing Council (GC). The hawkish tilt reflected the GC's increased confidence that inflation will sustainably rise towards the ECB's target of "below, close to but below 2%" over the medium term. However, the minutes show that GC members were concerned about the increasing risk that trade conflicts begin to weigh on confidence and growth. That was five weeks ago. Since then, the former has already happened. Trade tensions have escalated significantly and a slew of Eurozone data have dimmed visibly. The ECB's concern is probably higher now. For now, the trade-war risk is just that, a risk. In the end, we expect the US and China to strike a deal that prevents a full blown trade war while Eurozone cyclical dynamics could rebound in the summer 2018. The medium-term outlook has not changed in such a way that we would expect the ECB to adjust its policy. In our base case, we expect the ECB to let asset purchases run out at the end of this year before hiking the refi rate for the first time in June 2019.

Why did the ECB tilt its guidance? Despite concerns about trade tensions, the ECB took a further step towards the exit from its ultra-loose monetary stance at its March meeting. The ECB policy statement no longer included the guidance that it "stands ready to increase the asset purchase programme in terms of size and/or duration" if required. We had not expected the ECB to do this until its April meeting. The account confirms that "all members agreed" on removing the easing bias, which shows the strong conviction across the GC that the on-going Eurozone expansion is strong and probably will not need a further increase in monetary stimulus. But the ECB has not completely closed the door on this option. The account says the move to take away the easing bias in the guidance "should not be misunderstood as restricting the GC's capacity to react to shocks and contingencies if necessary". It underlines the ECB continued readiness to step in and act as a buffer if, for example, trade tensions were to escalate or the likely dip in Q1 GDP became a more protracted trend.

The ECB believes it is (almost) on track for 2% inflation: Above-trend demand growth should eventually push headline Eurozone inflation from its current rate of 1.4% yoy to the ECB's mandate of "below, but close to 2%" over the medium-term. The account of the March meeting notes that the criteria for a sustained adjustment in the path of inflation – though "still not sufficient" and some GC members argued that slack may be bigger than previously thought – could be "assessed as close to being satisfied over the medium-term horizon". While the ECB can continue to take it slowly and reiterate its mantra "prudence, patience and persistence", this statement carries important guidance: Currently, the ECB links the horizon of its (net) asset purchases to that "sustained adjustment". The ECB is basically telling markets that it is making progress on the inflation front to such an extent that they can let asset purchases run out over the course of this year – as current inflation follows a sustained, upwards path. If the core inflation rate were to rise from its current level of 1.0% yoy (March) to say 1.2% in the summer, the ECB may also deemphasise further the link between inflation and its net asset purchases, instead linking the inflation outlook to the entire policy package, especially interest rates and their future path. Going forward, we expect the ECB to adjust its guidance and its policy stance in a series of baby steps.

The ECB monitors the euro closely: Following the recent stability in the exchange rate, the ECB had slightly toned down its warning that a stronger euro may represent a risk to growth, mentioning the exchange rate as a factor to be monitored rather than as a source of uncertainty, as it had done on 25 January 2018. The account voiced GC members' caution that exchange rate movements seemed to relate "less to im-

provements in the macroeconomic outlook". This could have a "more negative impact on inflation". In 2017, the euro's appreciation was mainly triggered by a favourable demand shock. The dampening effects of the appreciation on inflation was, therefore, limited. In the case of a further appreciation of the exchange rate that is not accompanied by yet again stronger growth in domestic demand, which could be the case in 2018, the impact would be more negative.

ECB outlook: If growth and inflation stay on track, the ECB will probably:

- announce on 26 July that it will scale back the amount of monthly asset purchases from the current €30bn from October onwards and link its guidance on interest rates more closely to the inflation outlook;
- declare on 13 September that it will purchase assets of €15bn net per month from October onwards until at least the end of December 2018;
- announce on 13 December that asset purchases will indeed end in December 2018, with a chance that the ECB may disclose this on 25 October already;
- raise the refi rate by 25bp in June 2019 coupled with a hike in the deposit rate to 0% and the marginal lending rate to 0.5%;
- increase rates again by 25bp in December 2019, followed by roughly three further such steps in 2020. During the process, the ECB may also widen the corridor between the marginal lending rate and the deposit rate.

If the data keeps coming in poor and core inflation fails to edge up over the course of the year, the ECB may wait longer before eventually tightening its policy.

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