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ECB: SLIGHTLY MORE CAUTIOUS BUT POLICY OUTLOOK "ROBUST"

Berenberg Macro Flash

Trade tensions and the crises in some emerging markets are taking a small toll on the export-dependent Eurozone economy. In the key sentence of its press statement today, the ECB noted that “uncertainties relating to rising protectionism, vulnerabilities in emerging markets and financial market volatility have gained more prominence recently”. Six weeks ago, the ECB Council had merely reported that uncertainties relating mostly to trade “remain prominent”. Nonetheless, the ECB continues to assess the risk to its economic outlook as “still balanced”. Accordingly, the ECB shaved its staff projections for growth only slightly, from 2.1% to 2.0% for 2018 and from 1.9% to 1.8% for 2019. The ECB did not change its outlook for inflation at all, projecting a 1.7% average annual increase in the price level for 2018 through 2020 (see tables below). While energy prices will contribute less to headline inflation going forward, the ECB expects a significant rise in core inflation over time on the back of stronger capacity utilisation and further gains in employment and private consumption. As before, the ECB observed that uncertainty surrounding its inflation projections seems to be receding. We broadly agree. On balance, the ECB may have been slightly less dovish than many market participants may have expected.

Importantly, ECB president Draghi explained in response to a question that the ECB Council sees the present outlook for its policy stance as “robust”. Even if there are limited changes in underlying parameters such as the outlook for growth and inflation, the policy stance would not change. Draghi presented this as the unanimous view of the Council.

We maintain our ECB calls: following the cut in net asset purchases from €30bn to €15bn in October, as the ECB firmly announced today, the ECB will end its purchases on schedule at the end of December. After holding rates steady “through the summer of 2019”, we look for the ECB to raise rates in two small steps in late 2019. In September 2019, the ECB may return to a symmetrical rate corridor by raising its deposit rate from -0.4% to -0.15% while lifting the main refi rate and the marginal lending rate by 10bp each from 0.0% to 0.1% and 0.25% to 0.35%, respectively. In December, the ECB may then lift all rates by 15bp, putting an end to a negative deposit rate and reaching a refi rate of 0.25%. Draghi today deflected question as to how the ECB may raise rates eventually, calling these questions “premature”.

ITALY HAS TO HELP ITSELF

Of course, as the Italian budget debate is heating up, Draghi could not avoid questions about his home country. Shrewdly, he noted that the Italian prime minister and economics minister have pledged to respect fiscal rules. He also drew a distinction between “words” that had contributed to a significant rise in Italian borrowing costs and the facts that are still not known as the presentation of the budget and the parliamentary debate about it are still ahead. Reading just a little between the lines, Draghi thus warned Italy that a budget more in line with the radical parties’ initial unaffordable election promises than with the recent pledges to respect the rules could cause significant problems for Italy. Draghi also noted that the rise in Italian yield had sparked little contagion to other bond markets in the Eurozone. Asked about an Italian concern that, after the end of ECB asset purchases, Italy could be “left alone”, he replied calmly that the ECB has a mandate to safeguard price stability but that its mandate is “not to ensure that government deficits are financed under all conditions”. Put differently: Italy has to help itself.The ECB focusses on the macroeconomic outlook for Eurozone as a whole.

WATCHING TRADE AND TRUMP

Explaining the potential impact of trade tensions on the Eurozone economy, ECB president Mario Draghi noted three dimensions, (i) the extent of the escalation and the direct impact on trade volumes and prices, (ii) the potential confidence effect of extended trade tensions, and (iii) the implications for international value chains. Amid these uncertainties, the ECB remains confident that the Eurozone economy will hold up. Mitigating the external risks, Draghi noted that fiscal policy looks set to become "less neutral" (a change towards modest expansion that he did not seem to fully approve judging by the way he put it) and that labour markets and other parts of the domestic economy are exhibiting some underlying strength.

On a side note, Draghi criticised the current US fiscal expansion as "procyclical". Upon assessing the global outlook, the ECB Council thus discussed whether the US economy may lose some momentum next year if the fiscal stimulus recedes while US rates go up further. He clearly has a point. However, even with a modest loss in momentum, we believe that the US can probably still muster growth of above 2.5% next year.

Table 1: Eurozone real GDP

	2018	2019	2020
ECB (Sep 2018 projections)	2.0	1.8	1.7
ECB (June 2018 projections)	2.1	1.9	1.7
Bloomberg consensus	2.1	1.8	1.6
Berenberg forecasts	2.0	1.9	1.8

Yoy change in %. Bloomberg consensus taken on 13 September. Source: ECB, Bloomberg, Berenberg

Table 2: Eurozone headline inflation

	2018	2019	2020
ECB (Sep 2018 projections)	1.7	1.7	1.7
ECB (June 2018 projections)	1.7	1.7	1.7
Bloomberg consensus	1.7	1.7	1.7
Berenberg forecasts	1.7	1.6	1.9

Yoy change in %. Bloomberg consensus taken on 13 September. Source: ECB, Bloomberg, Berenberg

Table 3: Eurozone core inflation

	2018	2019	2020
ECB (Sep 2018 projections)	1.1	1.6	1.9
ECB (June 2018 projections)	1.1	1.6	1.9
Bloomberg consensus	-	-	-
Berenberg forecasts	1.1	1.4	-

Yoy change in %. Source: ECB, Berenberg

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