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ECB PREVIEW: PONDERING THE RISKS

Berenberg Macro Flash

Six weeks make a difference – not enough to change policy, though: Amid heightened risks, the ECB Governing Council will likely strike a slightly more dovish tone than in September and could revisit its risk assessment to the outlook this Thursday. The ECB will take stock of data that has been anything but great for the Eurozone economy over the last six weeks. Beyond a stronger focus on downside risks in the ECB statement, a change in ECB policies or policy guidance seems unlikely.

For three reasons, we expect the ECB to largely look through the softer data of the last six weeks and confirm the scheduled end of its net asset purchases in December 2018:

1. **"Robust to small changes":** The account of the 12-13 September meeting highlighted wide agreement among Council members that the "current configuration of the monetary policy stance" was not sensitive to "small changes" in the economic outlook. While the data has not been great, the changes to the outlook have not been big enough to warrant a policy shift. October's market woes added to an already strong cocktail of risks consisting of a further escalation of the US-China trade war, a disorderly hard Brexit and Italian accident waiting to happen. But while these risks continue to weigh on sentiment and activity, they are just risks so far that have not materialised yet, or, at least, not fully. Meanwhile, solid domestic fundamentals suggest the Eurozone's healthy upswing should largely continue.
2. **It is about the inflation outlook:** The ECB's plan to end its net asset purchases in December 2018 is "subject to incoming data confirming the medium-term inflation outlook ". While core inflation in September surprised on the downside, dropping from 1% yoy to 0.9% versus expectations of 1.1%, one reading does not change the medium-term outlook. We look for the core rate to rebound to 1.1% yoy, if not 1.2%, in October (published on 31 October). That said, the ECB may well have to nudge down its 2018 call (from 1.1% to 1.0%) with the next projections in December. At a later stage, more likely in March 2019 than in December 2018, the ECB may reconsider whether the vigorous uptick in its core inflation projections to 1.8% yoy in 2020 (see chart 1) is really on the cards. We are yet to see higher input cost (wages and materials) growth translating into stronger price inflation.
3. **Let us stop asset purchases:** The ECB seems determined to end its net asset purchases – almost no matter what. Ever since June when the ECB spelled out its future course of action in detail, it set the bar high for a downside surprise in growth and/or inflation to reconsider its tapering decision. The recent data, though not great, did not knock the bar down. Also, the ECB wants to shift to a more normal policy setting with policy rates being front and centre. If the data would turn considerably worse between now and the 13 December meeting, the ECB would probably adjust its interest rate guidance rather than extending its net asset purchases.

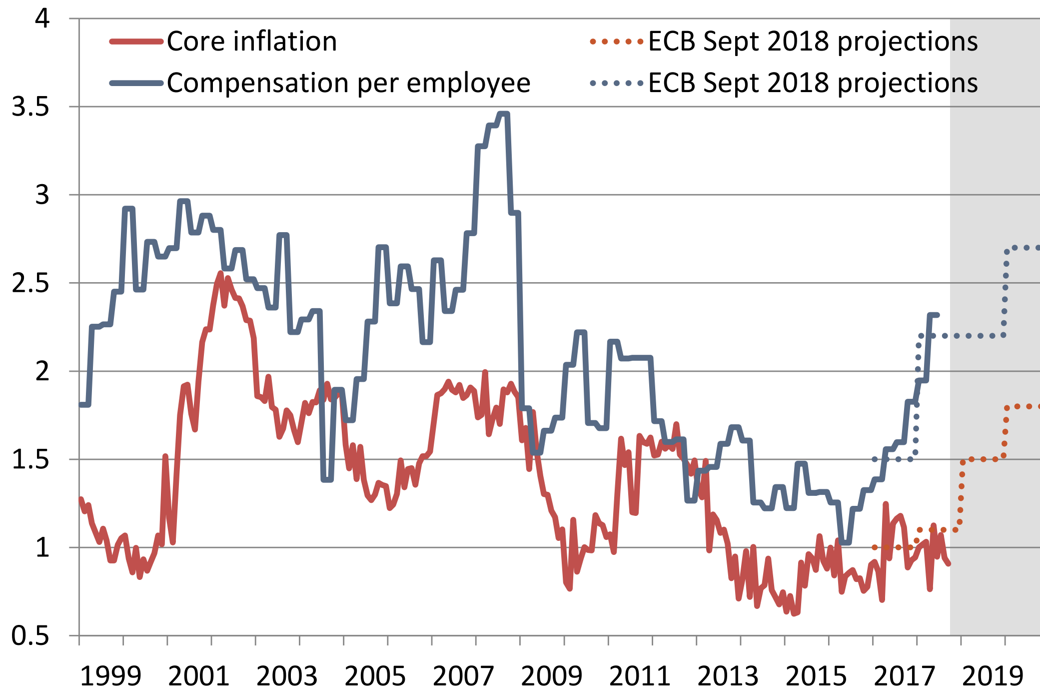
If anything, expect a re-assessment of risks: The ECB could downgrade the risks to the outlook from broadly balanced to tilted to the downside. At least one Council member proposed this already during the September meeting. But that is not a sure thing. Adopting an assured tone with a "broadly balanced" risk assessment even if downside risks dominate upside risks – or mentioning only downside risks in the formal statement – seems to be a recurring theme for the ECB

this year. As before, we judge the risks to growth tilted to the downside. The ECB should follow suit this Thursday.

Still on track for a rate hike in late 2019: After ending its monthly net asset purchases of €15bn on schedule at the end of December and holding its policy 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 only 10bp each from 0.0% to 0.1% and from 0.25% to 0.35%, respectively. In December 2019, 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%. In Q2 and Q4 2020, we expect two more rate hikes of the whole corridor, with the main refi rate rising to 0.75% at the end of 2020. We, thus, expect one more 25bp rate hike until the end of 2020 than the market (Bloomberg survey published 19 October). Our call rests on the assumption that, by spring 2019, the current key risks (trade war, Italy, hard Brexit, emerging markets) will have faded somewhat, allowing growth to rebound somewhat from the current dip. In line with consensus, we forecast the ECB to reinvest maturing debt until at least 2020, so at least for two years after the end of net asset purchases.

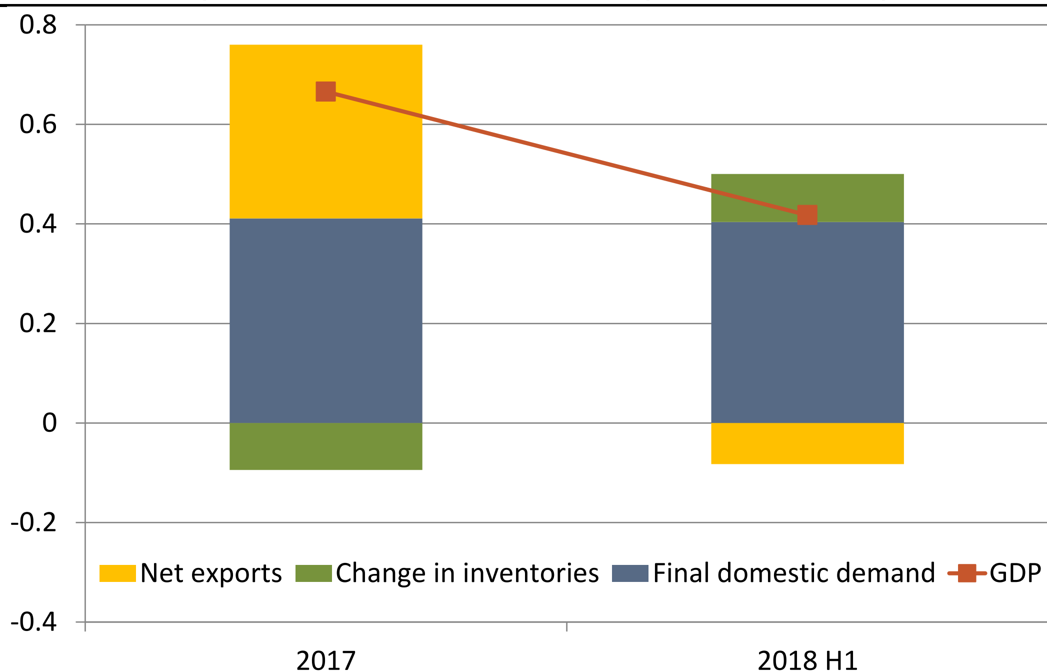
What to look out for during the press conference: We will listen closely if ECB President Mario Draghi provides a new take on how the more challenging external environment is affecting the domestic economy. So far this year, solid fundamentals at home have been the bedrock of Eurozone growth. The growth contribution of final domestic demand in H1 2018 to GDP was unchanged from 2017 (see chart 2). The moderation in overall GDP growth from 2.5% in 2017 to 1.7% annualised in H1 2018 stemmed only from net trade. The question is whether consumption and investment will remain resilient. There are good reasons (further improving labour market and high levels of capacity utilisation) to believe so for 2019 although higher oil prices will probably restrain consumption growth somewhat in 2H 2018. However, if heightened uncertainty across the globe causes a further major drop in business and consumer sentiment and businesses react by delaying investment decisions, the current cocktail of risks could hit the Eurozone domestic economy more significantly.

Chart 1: "Relatively vigorous" – core inflation and compensation per employee



Yoy, in %. Sources: Eurostat, ECB

Chart 2: GDP components – domestic demand stable, sharp correction in net exports



Average qoq change in %. Sources: Eurostat, Berenberg

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