Florian Hense, Economist | florian.hense@berenberg.com | +44 20 3207 7859

ECB KEEPS CALM AND MAINTAINS BALANCED RISK ASSESSMENT

Berenberg Macro Flash

The ECB remains comfortable with its monetary policy stance: While the ECB noted the "somewhat weaker than expected" data, it stopped short of changing its policies. As widely expected, it confirmed the scheduled end of its net asset purchases in December 2018. The ECB also maintained the "broadly balanced" assessment of the risks to the economic outlook as the economy would currently experience "weaker momentum", but "not a slowdown", according to ECB President Mario Draghi.

Determined to end asset purchases in 2018: 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. If the data would turn considerably worse going forward, we expect the ECB to rather adjust its rate guidance than extending/restarting its net asset purchases. Another option would be to offer some new long-term loans or even just rolling loans over to prevent the end of TLTROs shrinking the ECB's balance sheet, an option raised by two Governing Council members today.

Looking largely through the data: Unlike the ECB, we judge the risks to the economic outlook as tilted to the downside. An Italian accident waiting to happen, a disorderly hard Brexit, a further escalation of the US-China trade war, renewed emerging market turbulence make up a strong cocktail of risks. October's market sell-off has emerged as another risk. Soft and hard data over the past six weeks suggest that the external headwinds have started to leave their mark on the domestic economy. While the ECB acknowledged the disappointing recent data and judged risks to "remain prominent", it kept calm noting that overall the current conditions would be "consistent with an ongoing broad-based expansion and gradually rising inflation pressures".

Signalling effect from keeping calm: In our preview we had stressed that 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. Of course, none of the major risks has materialised, yet, at least not fully, and many indicators still remain above historical averages. ECB President Draghi is also right in blaming temporary, country-specific ("idiosyncratic") factors for some Eurozone wide data misses (such as the German car sector's struggle with stricter emission testing standards). But, in our view, the current cocktail of risks will cause a further drop in sentiment and a delay of investment decisions. As a consequence of that, the hit to the Eurozone domestic economy could turn out to be more significant with growth falling below trend. Probably, against the background of an ever cloudier outlook while being determined to end asset purchases the ECB may have chosen (once again) to send out a message of calm and confidence today.

Policy outlook: After ending its monthly net asset purchases of €15bn on schedule at the end of December and specifying its interest rate guidance of "at least through the summer of 2019" from Q2 2019 onwards, we look for the ECB to start raising rates 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. This is in line with consensus which lately has raised its expectations to match ours (Bloomberg survey median per 25 October).

Our call rests on the assumption that, by spring 2019, the current key risks will have faded somewhat, allowing growth to rebound slightly from the current dip. It would take a major shock for the ECB to extend the guarantee that rates will stay at their current level "at least through the summer of 2019".

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. The ECB may specify already at the December 2018 meeting what "extended period" and/or "as long as necessary" in its reinvestment guidance mean. To maintain the smooth functioning of the QE programme, the ECB may also opt to extend the time frame over which reinvestments can be made from the current three months.

No comfort for Italy: Asked about Italy, ECB President Draghi pointed out that lending rates for Italy had come up, and continued to do so. Ultimately, higher borrowing costs would weigh on both credit and GDP growth, and would limit the space of fiscal expansion. Draghi reiterated his veiled criticism of Italy's expansionary budget, emphasising that countries should use the current expansion to rebuild fiscal buffers. Adhering to the fiscal rules matters especially for highly indebted countries. The logic is clear: Only Italy can save itself. It cannot expect any leniency from the ECB – especially as spillovers to other Eurozone countries remain limited. The ECB may avoid making things worse for Italy, though. First, following the five-year revision of the capital key structure, Italy's capital key share will probably fall in 2019. The capital key – and hence the share of any country's bonds in the ECB's asset purchase programme – reflect each Eurozone country's GDP and population. If Italy's share falls while Germany's share rises, the ECB will have to decide whether to adjust its bond holdings by using some of the proceeds from maturing Italian bonds to buy Bunds instead of BTPs. A potential decision to not adjust its asset holdings to a new capital key would be a relief for Italy. Another option would be to buy longer-dated bonds to extend the overall duration of the portfolio. However, both of these options would be highly controversial as they may raise the suspicion that the ECB is doing Italy a favour.

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7859
www.berenberg.com
florian.hense@berenberg.com