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ECB: a clear message amid new uncertainties

- **The European Central Bank (ECB) has announced that asset purchases will end in December 2018, with no rate hike before September 2019.**
- **Although downside risks to growth have become "more prominent", the ECB has become more confident that underlying inflation will trend up gradually.**
- **Forecast change: As the ECB has ruled out a June 2019 move, we now look for a first ECB rate hike for September 2019.**
- Amid heightened uncertainty about the near-term outlook for economic growth, the ECB today sent an unexpectedly clear message. The bank intends to reduce its monthly asset purchases from €30bn to €15bn at the end of September and stop these purchases at the end of December 2018. Whereas such tapering of purchases is in line with our and the market's expectations, we had not looked for the ECB to yet commit to this in such clear terms today.
- More than balancing the message on the conclusion of net asset purchases, the ECB today said that it would wait with the first rate hike until at least the end of summer 2019 in the absence of any major economic surprise. The ECB's intention may well have been to prevent markets pricing in a rate hike sooner and, therefore, keeping borrowing costs low. So far, we had expected the ECB to raise rates in June 2019. Following its statement, the first possible date for an ECB rate increase would be September 2019. We adjust our forecasts accordingly.
- To us, the major surprise today was the unexpected degree of clarity. Of course, the ECB left a back door open, making its decision on the phasing out of asset purchases "subject to incoming data confirming the Governing Council's medium-term inflation outlook". However, after spelling out its future course of action in such detail, it would take a major downside surprise in growth and/or inflation to let the ECB reconsider its tapering decision.
- For markets, the message is somewhat reassuring.
  - First, the unexpected degree of clarity anchors expectations. Rates are unlikely to rise before the autumn of 2019.
  - Second, the ECB remains confident that growth will remain solid enough even if the economy will not return to the very strong gains of 2017. Upon reducing its staff projections for growth in 2018 from 2.4% to 2.1%, the ECB noted an "increase in uncertainty and some temporary and supply-side factors at both the global and domestic level" that is weighing on the near-term outlook for demand. Still, the ECB expressed confidence in the medium-term outlook and emphasised that even the weaker recent data remain "consistent with solid and broad-based economic growth". We agree.
  - Third, from now on, ECB watching could become fairly boring for a while. Short of any dramatic change in circumstances, the ECB will simply stay the course it has now charted until, by spring 2019, the question as to whether the ECB will indeed raise rates after the summer of 2019, becomes pertinent.
- With its decisions today, the ECB de facto shifted to a more normal policy setting. From now on, attention will focus on the outlook for rates rather than for net asset purchases. The conditionality which so far had been attached to the guidance for asset purchases now refers to the ECB's outlook for interest rates.
- **Draghi to Italy – do not destroy the progress made so far:** Asked about the recent turmoil in Italy, ECB President Mario Draghi, of course, refused to be drawn into a detailed discussion. Noting that the ECB Council did not have a "meaningful discussion" of Italy today, he still sent a cautionary message to the new Italian government. Referring to discussions about policy changes, Draghi emphasised that it is "important that these discussions do not destroy the progress achieved" after a lot of hardship before. Again, we agree with this assessment.

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Policy outlook

In response to the detailed policy outlook that the ECB provided today, we adjust our own ECB forecasts. Instead of a first 25bp hike in the refi rate in June 2019, we now look for the ECB to raise its rates in September 2019, probably with a 25bp increase in the deposit rate from -0.4% to -0.15%, while adjusting its main refinancing rate and its marginal lending rate by 10bp at the same time to 0.1% and 0.35%, respectively. That would restore a symmetrical 25bp corridor around the main refi rate. The move may be followed by a further 15bp increase in all three rates in December 2019 and two 25bp rate hikes in 2020. As before, we consider it as highly likely that the ECB will start the rate hike cycle before Draghi's eight-year term expires at the end of October next year. As long as economic circumstances warrant such a move, Draghi would like to initiate it himself instead of leaving that task to his successor.

As usual, we need to watch the risks to our outlook. If the economy suffers a longer slowdown and/or if core inflation fails to edge up over the course of the year, the ECB may delay its first rate hike beyond September 2019. The ECB may also decide to raise only the deposit rate in September 2019 and leave the main refi rate unchanged until December next year.

ECB projections for growth and inflation

Responding to the recent softness in many data and higher oil prices, the ECB adjusted its staff projections for growth and inflation. While shaving the forecast for real GDP growth in 2018 from 2.4% to 2.1%, the ECB left its outlook for 2019 and 2020 unchanged at 1.9% and 1.7%, respectively (see Table 1). For headline inflation, the ECB raised its 2018 and 2019 calls from 1.4% to 1.7% while leaving 2020 at 1.7% (see Table 2). The change in the near-term inflation outlook largely reflects higher oil prices.

Remarkably, the ECB raised its call for core inflation in 2019 from 1.5% to 1.6% and for 2020 from 1.8% to 1.9% (see Table 3). In the staff projections, the ECB explains this with supply constraints, especially labour shortages, that have become increasingly binding in the form of stronger growth in both wages and – as productivity gains are not accelerating in tandem – unit labour costs. Despite slower growth in real GDP in 2018 and a greater ECB emphasis on downside risks to the economic outlook, the ECB has apparently become more confident that the desired gradual increase in underlying inflation pressures is on its way. In the press conference, Draghi explicitly noted that the "uncertainty about the inflation outlook is receding".

Of course, expressing such confidence can be a two-edged sword. If core inflation were to remain well below ECB projections next year, the ECB may find it more difficult to start a tightening cycle in late 2019.

As before, the ECB views the risks to its projections for GDP growth as "broadly balanced". However, the formal ECB statement mentions only downside risks and notes that "uncertainties related to global factors, including the threat of increased protectionism, have become more prominent". Reading between the lines, this suggests that the ECB thinks the risks to growth are probably more tilted to the downside than to the upside. According to Draghi, the ECB's staff projections do not contain the potential effects of trade measures not yet implemented. Put differently, escalating trade tensions would probably depress growth below the pace which the ECB currently projects.

Table 1: Eurozone real GDP

	2018	2019	2020
ECB (June 2018 projections)	2.1	1.9	1.7
ECB (March 2018 projections)	2.4	1.9	1.7
Bloomberg consensus	2.3	1.9	1.7
Berenberg forecasts	2.1	2.0	-

Yoy change in %. Bloomberg consensus taken on 14 June. Source: ECB, Bloomberg, Berenberg

Table 2: Eurozone headline inflation

	2018	2019	2020
ECB (June 2018 projections)	1.7	1.7	1.7
ECB (March 2018 projections)	1.4	1.4	1.7
Bloomberg consensus	1.5	1.6	1.8
Berenberg forecasts	1.7	1.6	-

Yoy change in %. Bloomberg consensus taken on 14 June. Source: ECB, Bloomberg, Berenberg

Table 3: Eurozone core inflation

	2018	2019	2020
ECB (June 2018 projections)	1.1	1.6	1.9
ECB (March 2018 projections)	1.1	1.5	1.8
Bloomberg consensus	-	-	-
Berenberg forecasts	1.1	1.4	-

Yoy change in %. Bloomberg consensus taken on 14 June. Source: ECB, Bloomberg, Berenberg

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