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ECB PREVIEW: STILL HOPING FOR THE BEST

Berenberg Macro Flash

Watching the slowdown: In its first meeting after the end of net asset purchases, the ECB will likely acknowledge rising downside risks to the outlook for growth without shifting its policy stance or rate guidance significantly. We expect President Mario Draghi and his Governing Council colleagues to argue that the current pronounced weakness in most data still reflects a temporary slowdown rather than a more serious downturn. Of course, the ECB will also emphasise that, if things were to deteriorate badly, the ECB would stand ready to step in. At this stage and ahead of a new set of ECB projections for growth and inflation due in March, the ECB probably does not want to sound too alarmed lest that might unsettle nervous markets even further. In addition, the Fed has probably made the ECB's job a little easier already by shifting to a more dovish stance recently. However, the ECB could please markets looking for a dovish signal by indicating that it is studying options for a new round of targeted longer-term refinancing operations (TLTROs) into the banking system.

Risks are mounting that the current slowdown could be longer and deeper than the ECB had expected: Almost all data since the ECB's last meeting on 13 December has been disappointingly weak with no sign that the current slowdown could peter out soon. The Eurozone PMIs and German Ifo due on Thursday and Friday, respectively, will probably show that the late 2018 weakness has continued into 2019. Against this backdrop, the ECB's 1.7% call for GDP growth in 2019 seems overly optimistic. We forecast 1.1%, well below the Bloomberg consensus of 1.5%. The downside risks that the current weakness may last longer and become more entrenched have increased further since the ECB's 13 December meeting. We look for the ECB to acknowledge this in a somewhat muted form, perhaps by acknowledging that the risk to the ECB's December projections for growth are now clearly tilted to the downside.

ECB to follow the Fed's shift to more dovish stance? In the absence of serious inflation risks, central banks can be the counter-cyclical buffer. The Fed has already adjusted its policy guidance over the last couple of weeks. Although recent economic data suggest that the ECB should follow suit, the ECB will probably do so in a muted form only. Mario Draghi suggested in a speech on 16 January that "it's a slowdown, which is not headed toward a recession". Other Governing Council members have warned against overreacting against the slowdown.

Domestic fundamentals still look ok: While overall momentum is softening significantly, some key drivers of domestic demand are still holding up. Employment growth has so far softened only modestly. As employment continues to expand, wage growth has edged up, supporting the ECB's call that core inflation will pick up in 2019 from its current rate of around 1%.

Rebound possible in 2019: We expect the ECB to stress that many of the factors currently weighing on activity are country-specific and temporary. The ECB will have to wait and see, therefore. We largely share this assessment. While we expect further weakness in Q1 2019, throughout 2019

we expect the economy to rebound as one-offs fade and confidence returns to healthier levels. Meanwhile, not before spring the ECB can gauge how the economy is reacting to the end of net asset purchases.

ECB does not want to sound the alarm too much: The ECB is well aware of the power of negative feedback loops. A major risk currently is that the fear factor may take on a life of its own for a while. Instead of stoking fears of an impending Eurozone recession, the ECB prefers to be a bastion of calm. Once again, the ECB could, therefore, tread very carefully and adjust the wording of its statement only modestly.

The Fed has already done part of the job: Amid signs of slower growth, significant downside risks and contained inflation pressures, the Fed has moved from hawkish to being on hold over the last couple of weeks. Since then, global and Eurozone financial markets have breathed a sigh of relief. This also lowers the pressure for the ECB to come out on the very dovish side.

Towards a TLTRO successor: In uncertain times, the ECB will want to avoid any liquidity shortages that may arise from the maturing of previous TLTROs between mid 2020 and early 2021. While this seems still far away, there is a catch: banks' funding costs will be affected already this year (mid-2019), because only funding with a maturity of at least one year is eligible for banks to use in their net stable funding ratios. As early as this week, the Governing Council could task its staff ("relevant committees") to "revisit the contribution of targeted longer-term refinancing operations to the monetary policy stance" (as per account of 13 December meeting). A decision could follow in March or April with a new round starting in June or H2 to maintain present level of policy accommodation. The ECB usually takes TLTRO decisions only after a fresh round of forecasts (TLTRO I was decided in June 2014 and TLTRO II in March 2016). So look out for March and June for more concrete steps.

POLICY OUTLOOK

Besides the rising likelihood of a new TLTRO announcement soon, we maintain our further ECB calls:

- From Q2 2019 onwards, the ECB will specify its guidance of unchanged rates "at least through the summer of 2019", pointing markets to a start of the hiking cycle in late 2019 (December) at the earliest rather than already in autumn (September).
- In December 2019, we expect the ECB to return to a symmetrical rate corridor by raising its deposit rate from -0.4% to -0.25%, while keeping the main refi rate and the marginal lending rate unchanged at 0% and 0.25%, respectively. While such a move will tighten financing conditions for some borrowers, it will be neutral in its overall impact as it also helps banks.
- In Q2 and Q4 2020, the ECB may lift all rates by 25bp each, putting an end to a negative deposit rate and reaching a refi rate of 0.5% by the end of 2010. According to a pre-meeting Bloomberg survey, consensus also expects two hikes in 2020.
- Until at least 2020, the ECB will fully reinvest the proceeds from maturing debt, keeping its bond portfolio constant for two years after the end of net asset purchases.

These calls rest on two assumptions: (1) by spring 2019, the external shocks and political risks will start to fade somewhat, allowing Eurozone growth to return to trend from the current slowdown and, (2) core inflation will edge up gradually throughout 2019.

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