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ECB ACKNOWLEDGES DOWNSIDE RISKS - COME BACK IN MARCH

Berenberg Macro Flash

No major surprises: A more alert ECB finally acknowledged that risks to the outlook of the Eurozone economy had moved to the downside while keeping its policy stance and rate guidance unchanged. In December the ECB had assessed the risks as still broadly balanced. Explaining today's shift on the risk assessment ECB President Mario Draghi stressed in the press conference the "persistence of uncertainties" arising from a long list of negative factors. These included the increase of general uncertainty, geopolitical factors, threats of protectionism and a slowdown in the Chinese economy. In the absence of any serious inflation risks, Draghi reiterated that the ECB's monetary policy stance could and would, therefore, remain loose for the time being. With full reinvestments probably continuing over the next two years (with monthly gross purchases at 17bn euros in 2019 at roughly half the amount of the 2018 average of 39bn euros, see chart 1) the stock of assets purchased will likely remain constant until 2021.

A balancing act: In his statement Draghi treaded carefully, though, not to sound too dovish. What the ECB currently fears most is probably fear itself. The ECB did not want to stoke fears of an impending recession further. While the ECB suggested that economic momentum could be weaker beyond the near-term, it judged the likelihood of a recession as low. Draghi also pointed out that favourable financing conditions, a strong labour market and lower energy prices would continue to underpin the economic expansion and a return of inflation towards target. With no major surprises there was no strong market reaction. Both the euro and bund yields remained fairly unchanged after the press conference.

First assessment, then action: Draghi was thin-lipped on the policy implications of the downgraded risk balance. A new round of cheap, long-term loans (TLTROs) was not discussed. Draghi explained that, contrary to the Fed which had adjusted its guidance over the last couple of weeks, the ECB would be in assessment mode, rather than thinking about the implications already. The policy implications could come as early as March, though, when the Governing Council has updated forecasts at hand.

MARCH PREVIEW

For the next ECB meeting in March we look for two things:

1. First, for the ECB to downgrade its growth projections. 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% (see chart 2) with growth expanding by a mere 0.1% qoq in Q1. We also see a risk that the pronounced weakness could carry into the second quarter. Today's published weak Eurozone PMIs probably intensified the discussion among Governing Council members that the ECB will have to follow the Fed suit in adjusting its policy guidance.
2. Second, momentum is building for a new round of **TLTROs**. After "a couple" and "some" Governing Council members raised the issue in October and December, at this meeting "several" did. As early as March, the Governing Council could decide unanimously on a new round of TLTROs starting in June or H2 to maintain a similar level of the current poli-

cy accommodation. To wean the banks off the cheap funding gradually, the new round will probably be smaller, shorter and (slightly) more expensive than the terms of the current TLTROs. Also, as the tensions between Rome and Brussels have eased after the truce over Italy's budget plans, there could be a policy window of opportunity to go ahead with cheap money without seemingly giving in to Rome. The window could close very soon as a longer and deeper slowdown could put the current growth forecasts at risk and intensify the tensions with the EU again.

Dovish surprise in March? Less likely the ECB could consider a dovish move and adjust its **rate guidance** of keeping rates unchanged through the whole 2019, rather than only "through the summer of 2019". Draghi dodged the question about markets not pricing in a first rate hike before mid-2020 by saying that eventually the ECB would have to "validate" these expectations.

Our base case remains that a guidance shift will not come before Q2. Another reason to wait with such a shift until Q2 is probably that the debate about costs starting to outweigh the benefits of a negative deposit rate has gathered traction recently. The ECB will probably accommodate for this eventually by lifting its depo rate well before the main refi rate. Draghi said again today that the negative effects on the net interest rate margin are more than offset by the benefits of the asset purchases having driven a stronger recovery and lowering non-performing loans.

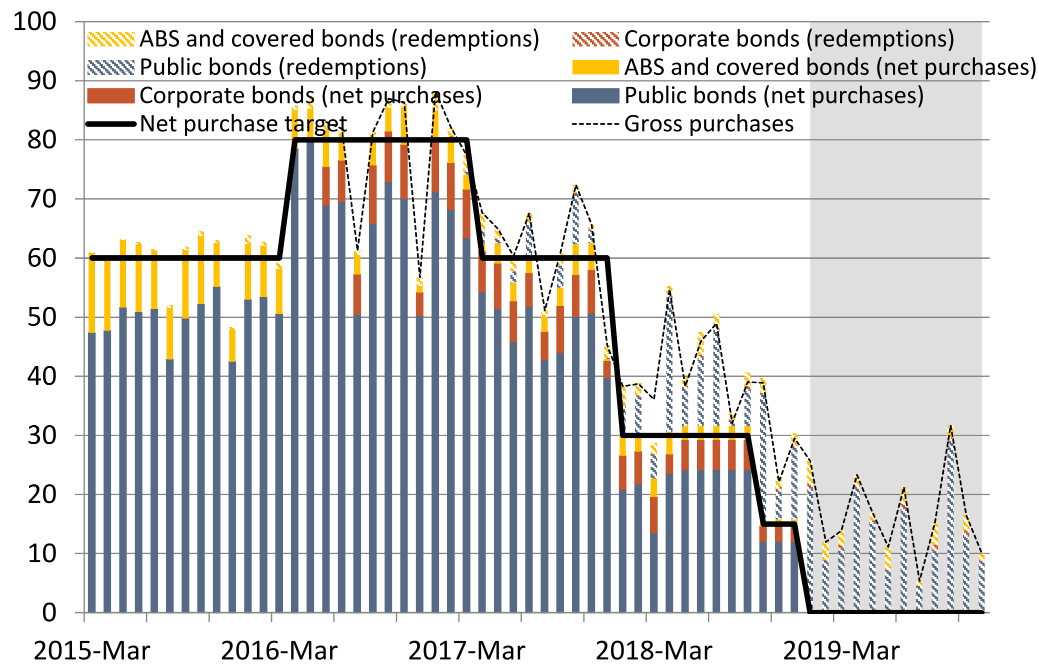
POLICY OUTLOOK

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 2020. Bloomberg consensus has two hikes in 2020 (see chart 3).
- 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.

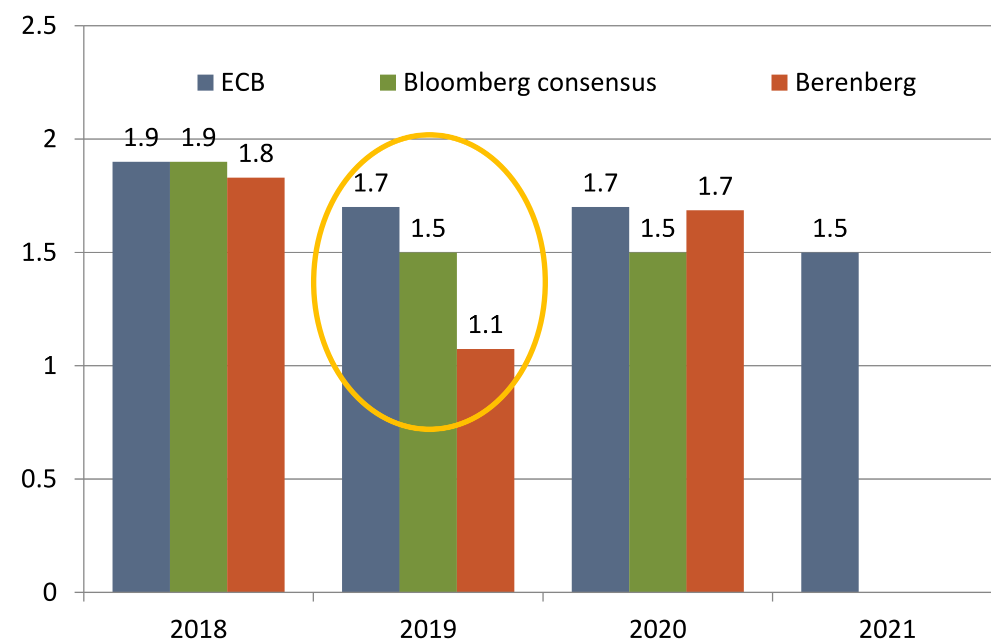
These calls rest on two assumptions: (1) by spring 2019, the external shocks and political risks will start to fade somewhat, allowing Eurozone growth to return to trend from the current slowdown and, (2) core inflation will edge up gradually throughout 2019.

Chart 1: ECB asset purchase programme



In bn euros. Source: ECB

Chart 2: Real GDP growth projections (in %)



Sources: ECB, Bloomberg, Berenberg

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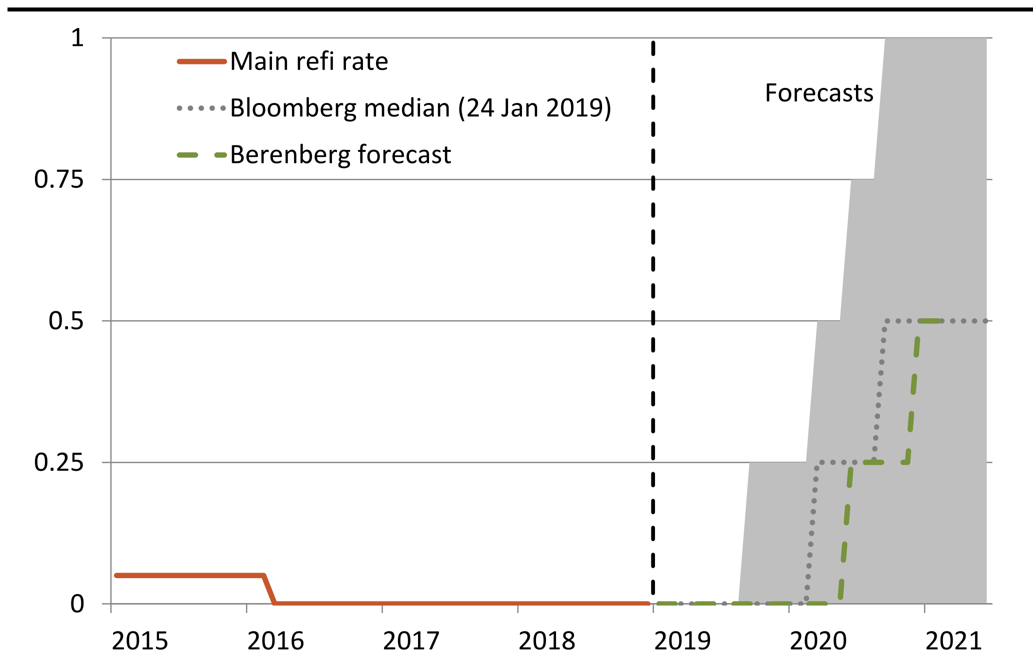
Chart 3: Actual and expected main refi rate (in %)



The shaded area indicates the range of Bloomberg forecasts. Sources: ECB, Bloomberg, Berenberg

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