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PARTNERSHIP SINCE 1590

MACRO NEWS 10/04/19

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

ECB PREVIEW: NO TIERS BEFORE (MORE) TEARS

Berenberg Macro Flash

Having reacted to the weaker economic outlook already in early March, today's ECB meeting could be boring. We expect the Governing Council to re-affirm that rates will be on hold this year and that the ECB will offer new quarterly rounds of long-term liquidity injections (TLTROs) from September onwards. The ECB will likely announce the TLTROs pricing details in June. The ECB will probably be thin-lipped on possibly moving towards a two-tiered system for bank reserves as it still ponders the benefits and costs of such a move to ease the pain of banks. As long as the ECB could expect short-term rates to not rise by much following such a move, the ECB may go for a tiered system if credit conditions start to tighten or economic growth fails to rebound later this year as we and the ECB expect.

Eurozone data has been a mixed bag: The drop in the manufacturing PMI for the Eurozone to a six-year low in March with new orders falling at the fastest rate since late 2012 suggests the industrial recession is still deepening. It has not spread to the domestic economy yet. The gap between the domestic and external economy cannot last for much longer, though. Based on better news out of China, an easing of trade tensions at least between the US and China, the UK dodging the hard Brexit risk and a continued resilience of domestic demand in the Eurozone, we expect Eurozone growth to recover to a pace around trend of 0.4% qoq in H2 in line with the ECB's March projections. We expect the ECB to argue largely along these lines and stress that the risks to their calls remain on the downside.

ECB waiting for a Godot who never comes? Even though the late Easter effect distorted the inflation rate in March to the downside, it is a stretch to argue that the convergence of inflation towards the 2% target is "delayed rather than derailed" as ECB President Mario Draghi put it a few weeks ago. Still, we share the ECB's current assessment that there are reasons to believe inflation will pick-up eventually.

Wait until summer for TLTRO III details: With the launch of a new round of TLTROs the ECB avoids any possible cliff edge issues when the current TLTROs mature. Still, as the new round of TLTROs is shorter and linked to the main refinancing rate (rather than fixed at a low rate), the new TLTROs could still help to wean the banks off the cheap, long-term funding very gradually. Like the current TLTROs, the new round will feature "built-in incentives for credit conditions to remain favourable". Recent speeches by Governing Council members suggest the ECB will probably prefer to reveal TLTRO details only in June or even July. We expect that some banks could benefit from a rate as low as the deposit rate, in other words earning up to 40bps currently for tapping these new long-term funds.

No tiers before (more) tears: The current buzzword in ECB discussions is a two-tiered system for bank reserves. As such, the ECB may apply its negative interest rate of 0.4% only to deposits which exceed a threshold defined by the ECB. The Swiss National Bank (SNB) for instance applies a threshold of 10 times the required minimum reserves. Judging by the account of the March meeting and comments by both President Mario Draghi and Chief Economist Peter Praet, the ECB is looking more closely than before at the side effects of the negative deposit rate. The ECB has pointed out that the impact on bank profitability is anything but clear-cut, and, whatever the impact, a "monetary case" would be needed to act upon it. We see two potential "monetary case" scenarios that could trigger the ECB to move to a tiered system for bank reserves: (1) The negative deposit rate lowers margins for banks to such an extent that loan supply falls – this could happen at some point eventually. (2) If the economy unexpectedly fails to rebound later this year and worsens the ECB could consider cutting the deposit rate further. A tiered system would make such a step easier. Consequently, in either of those two cases, tiers from the ECB may require (more) tears beforehand.

POLICY OUTLOOK

In our view, ECB policies may roughly take the following path:

- In September 2019, the ECB may update its current guidance of unchanged rates "at least through the end of 2019", pointing markets to a first main refinancing rate hike in spring 2020 at the earliest.
- In December 2019, the ECB may announce a return to a symmetrical rate corridor by raising its deposit rate from -0.4% to -0.25% in Q1 2020 while still keeping the main refinancing rate and the marginal lending rate unchanged at 0% and 0.25%, respectively. Alternatively, the ECB may introduce a tiered system under which it will levy the full penalty on deposits held at the ECB only beyond some threshold.
- 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 main refinancing rate of 0.5% by the end of 2020.
- Until at least the end of 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 summer 2019, Eurozone growth returns to trend from the current slowdown and, (2) core inflation will edge up gradually throughout 2019.

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