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ECB PREVIEW: THE FIVE THINGS TO WATCH OUT FOR TOMORROW

Berenberg Macro Flash

Amid heightened risks to the Eurozone economy, the ECB will likely send a dovish message to markets following the meeting of its Governing Council tomorrow. As inflationary pressures remain subdued and inflation expectations are falling towards all-time lows, a dovish tilt would make sense. Upon slightly nudging down its short-term GDP growth forecasts, the ECB will probably announce generous terms for its new round of long-term loans (TLTRO-III). More importantly, expect the ECB to repeat its message that it stands ready to use all instruments if push comes to shove. Although for the time being it will likely stop short of any new action, whether it may strengthen its already dovish guidance further in light of recent developments remains an open question.

Five things to watch out for tomorrow:

1. TLTROs – 25bps below refi rate?
In April the ECB signalled that at one of the forthcoming meetings it would disclose further details on the new round of 2-year TLTROs planned for September. To address the increased downside risks to growth, the ECB will likely reveal already tomorrow – rather than wait for July – that the interest rate on such paper could drop to 25bps below the main refinancing rate for those banks that fulfil the conditions (see Table 1 for the terms of TLTRO-III versus those of the previous two rounds). Indexed – rather than fixed – to the main refinancing rate, the TLTROs are a "potential tool for adjusting the monetary policy stance". If rates were to rise or fall before the start of the seventh and last TLTRO-III tranche in March 2021, the rates on the TLTROs would adjust accordingly. To satisfy those Governing Council members looking for a "backstop, providing insurance in times of elevated uncertainty", the ECB could stress that the rate could always be set lower.

2. Negative rates – more tears before tiers
The bar always seemed high for the ECB to move to a tiered system for bank reserves and apply its negative interest rate of 0.4% only to deposits which exceed a threshold, say 10 times the minimum reserve amount. The bank-based transmission mechanism of monetary policy continues to remain effective in the Eurozone. The most recent bank lending survey for Q2 indicated that negative rates were "still contributing to increased lending volumes". The hard data confirms that credit is growing at a healthy pace. Recently, the bar for a move to a tiered system seems to have risen further: Bank of France Governor, Francois Villeroy de Galhau, an early supporter, has softened his initial push for such a system.

3. Rate guidance – wait for September
Eventually, the ECB will have to push out its rate guidance, from the current "through 2019" to "through the summer of 2020". This week is too early for that move, in our view. The September meeting would be more appropriate. While a potential shift in the Fed's monetary stance to eas-

ing would help the Eurozone economy, it would also make rate hikes by the ECB even less likely in the foreseeable future. It would be a dovish surprise if the ECB were to endorse market expectations of no hike in the next two years at its June meeting already. We expect the ECB to reserve the signalling effect of low(er) rates for longer for significantly weaker economic and credit conditions.

4. Forecasts – changes to short-term calls only

The ECB will likely reiterate that risks to the economic outlook remain tilted to the downside while stressing that the risks have become even more prominent than before amid escalating US-Chinese trade tensions. Small downward revisions to growth in Q2 and Q3 will probably offset the better-than-expected Q1, resulting in an unchanged 2019 forecast of 1.1% for real GDP (see Chart 1). Due to a smaller carry-over effect from 2019, the ECB will probably nudge down its 2020 call from 1.6% to 1.5%, while keeping the 2021 call at 1.5%. The ECB will probably adjust its 2019 inflation call to the higher-than-expected inflation this year so far (1.3% instead of 1.2%), but will leave 2020 and 2021 untouched at 1.5% and 1.6%, respectively.

5. Inflation expectations

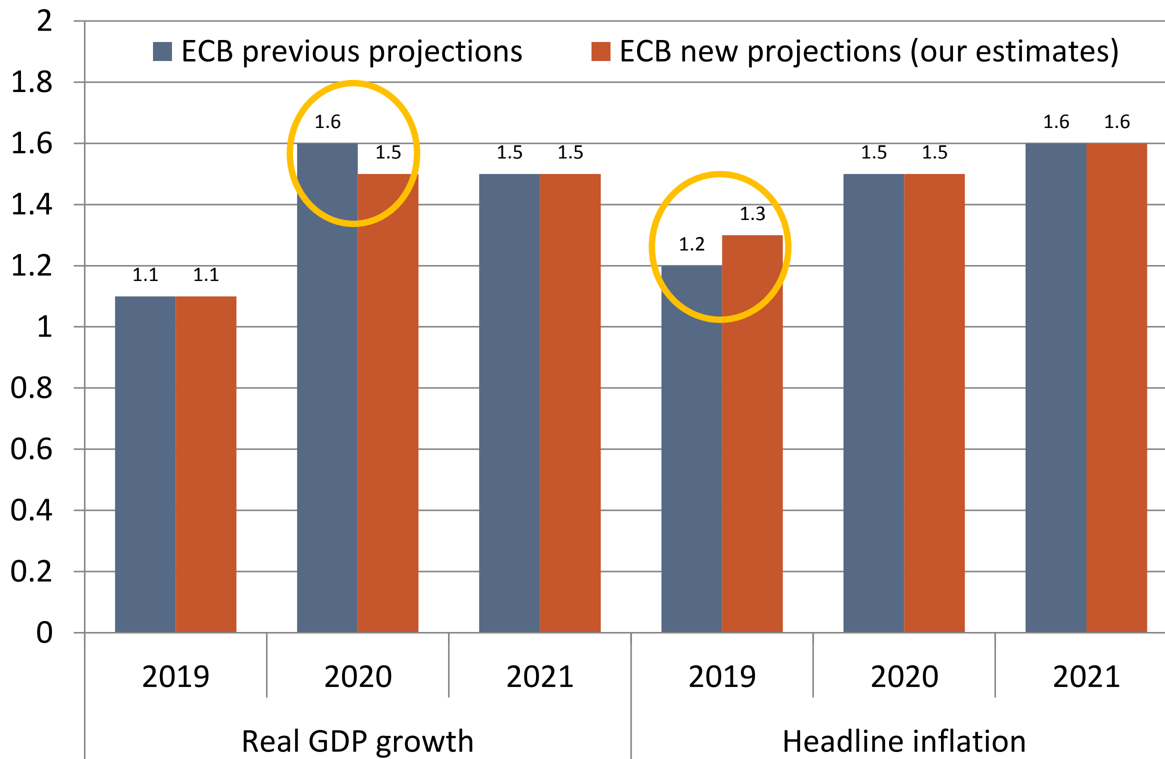
Long-term inflation expectations have fallen (close) to all-time lows. Taken at face value, they signal that the ECB has become less credible with respect to its mandate of CPI inflation of 'close to but below 2% yoy'. If GDP growth and inflation expectations head further south, offering cheap funding may not be sufficient to stem the tide. Even pushing the rate guidance further out may not be enough then. Instead, the ECB could be forced to do a major turn. ECB President Mario Draghi will be questioned on an updated take on inflation expectations. Any comment as to when and how the ECB would step in is, however, unlikely. More likely, he will stick to the ECB's general commitment that it stands ready to use all instruments if push comes to shove.

Table 1: TLTRO-III versus previous two TLTRO rounds

	TLTRO-I	TLTRO-II	TLTRO-III
Date announced	5 June 2014	10 March 2016	7 March 2019
No. of tranches	8	4	7
Period	Sep-2014 until Jun-2016	Jun-2016 until Mar-2017	Sep-2019 until Mar-2021
Maturity	2-4 years	4 years	2 years
Interest rate	Variable rate indexed to refi +10bp, later cut to refi	Fixed rate as low as the deposit rate (-0.4%)	Variable rate indexed to refi (as low as 25bps below refi?)
Total amount	432bn euros	740bn euros	?

Source: ECB, Berenberg

Chart 1: ECB previous projections vs. our estimates of new ECB projections (yoy, in %)



Sources: ECB, Berenberg.

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