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ECB PREVIEW: A TASTE OF SUCCESS

Berenberg Macro Flash

The economy is expanding at a satisfactory clip, the hypothetical deflation threat has receded and none of the risks that had roiled markets early this year has materialised. At its meeting in Vienna this Thursday, the ECB Council will not need to take any major decision. Instead, we expect the ECB to upgrade its projections for growth and inflation, to unveil more details of its upcoming corporate bond purchases and to promise Greek banks normal access to ECB liquidity once Eurogroup finance ministers have concluded the first review of the current Greek bailout programme. While the ECB will not rule out further easing, the Council will likely emphasise that its previous stimuli seem to be working. As much of the effect of the big March easing package is still in the pipeline, a "wait and see" stance makes sense. This should also help to put to rest the weird debate about "helicopter money" which had erupted much more outside than inside the ECB.

OUTLOOK FOR GROWTH AND INFLATION

In Q1, the Eurozone expanded by 0.5%, well above the 0.3% qoq pace which the ECB (and we) had expected back in March. In addition, most survey data have moved up somewhat in the last two months. Even if growth slips temporarily to 0.3% qoq in Q2 before settling at a 0.4% quarterly pace thereafter, **real GDP** will expand by 1.5% for 2016 as a whole. We thus expect the ECB to raise its staff projections for economic growth from 1.4% to 1.5% for this year while leaving the calls for 2017 and 2018 unchanged at 1.7% and 1.8%, respectively. Those would be healthy rates of expansion, marginally above our own forecasts for 1.6% growth for 2017 and 2018.

In its last quarterly forecasting round in March, the ECB had based its **inflation projections** on the 15 February futures prices for Brent oil of $34.9 per barrel on average in 2016, $41.2 in 2017 and $44.9 in 2018. Due to the rebound in oil prices since then and firmer growth in early 2016, the ECB will likely raise its inflation projections from 0.1% to 0.3% for 2016, from 1.3% to 1.5% for 2017 and from 1.6% to 1.7% for 2018, with a risk that the 2017 call may be one notch higher at 1.6% instead. Although higher oil prices will restrain the rise in real disposable income, the ECB will likely celebrate the less subdued inflation outlook as good news. A firmer labour market and a modest fiscal stimulus are helping to offset the impact of less subdued oil prices on domestic demand.

POLICY OUTLOOK

While the upward revisions to growth and inflation are welcome, they are not significant enough to warrant a change in the policy outlook. We expect the ECB to re-iterate its guidance:

- **Asset purchases** of €80bn per month "are intended to run until the end of March 2017, or beyond, if necessary".
- The ECB Council expects ECB **interest rates** "to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases".

While keeping all options open, the major message will likely be "wait and see".

If the economy lives up to our expectations, settling at an annualised growth rate of around 1.6% from mid-2016 onwards amid a gradual rise in core inflation and a continuing firming of the labour market, we would not expect the ECB to extend its asset purchases of €80 bn per month beyond the end of March 2017. Instead, the ECB will likely scale them back gradually from April 2017 onwards before ending them in late

2017. After such "tapering" of asset purchases, the first rate hike could then follow in the second half of 2018, almost three years after the first Fed hike of December 2015.

THE BREXIT RISK

Before market attention could turn to a potential ECB exit strategy if growth and inflation develop roughly in line with projections, we first have to brave some serious risks, most prominently the risk of "Brexit". We see a 30% risk that Britain will vote to leave the EU on 23 June. If so, this could spark serious trouble for Britain as well as significant concerns about the future cohesion of the EU and the Eurozone amid calls from populists outside the UK for copycat votes on EU or euro membership. In the end, doubts about the political cohesion of the Eurozone would require a political rather than an ECB response. In our view, core Europe would eventually deliver such a response.

The ECB's role would be to provide sufficient liquidity to banking systems in case of financial turbulence. For the ECB, that should be easy. To counteract an immediate and major spike in risk aversion and liquidity demand, the ECB could offer short-term liquidity injections. More importantly, the ECB will hold the first of its new and ultra-generous 4-year target liquidity operations (TLTROs) at the end of June. If a vote for Brexit were to cause significant frictions, banks would ask for more liquidity at these TLTROs. Beyond short-term liquidity management, the ECB might not need to come up with a further policy response to potential market volatility in the wake of a Brexit.

Of course, if the Eurozone economy were to tank after a Brexit vote, the ECB may have to go beyond its TLTROs and consider further easing steps, possibly including the purchase of baskets of bank bonds. That would open a new can of worms for the ECB including a potential conflict of interest between its monetary policy and its bank supervisory roles. Fortunately, the need for such additional drastic policy steps will probably not arise.

THE GREEK ISSUE

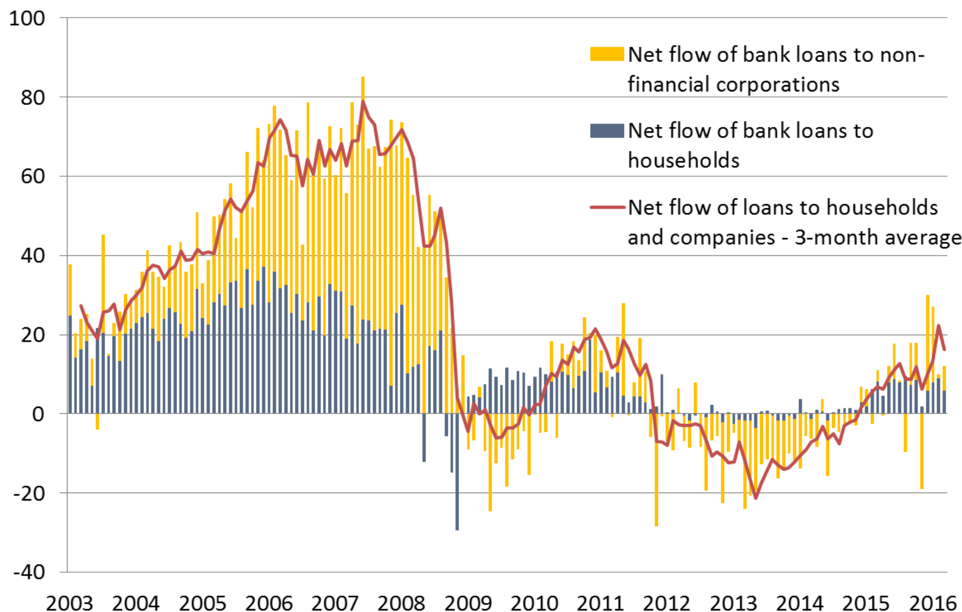
Once Greece has successfully concluded the first review of its bailout programme, the ECB will likely accept Greek sovereign bonds as collateral for its liquidity operations with Greek banks. Bank could then switch from the expensive emergency liquidity assistance provided by the Greek central bank under the supervision of the ECB for cheaper ECB loans. Technically speaking, the ECB would "re-instate the waiver" for Greek banks which allows them to post Greek sovereign paper as collateral although it does not meet the usual rating requirements of the ECB. While the Governing Council will probably decide to so this Thursday, the decision may not come into force before Eurogroup finance ministers have confirmed to the ECB that Greece has met all prior conditions for the disbursement of the next tranche of ESM support funds. As the Greek parliament may vote on the required changes this week, the waiver could be re-instated shortly. For Greece, that would be a much needed signal of a return to more normal times after the turmoil that had started with Tsipras and Varoufakis in early 2015. Before the ECB could also include Greece in its €80bn monthly bond buying programme, Greece would need to pass a debt sustainability analysis by the ECB. That might be tricky exercise. For the time being, the ECB may shy away from that.

MODEST PICKUP IN CREDIT GROWTH

Since early 2013m the credit cycle has turned up gradually in the Eurozone (see chart). In a sign that business investment is picking up a little, the growth rate for loans to non-financial companies edged up to 1.2% yoy after 1.1% in March and 1.0% in February. However, loans for households fell back marginally to 1.5% yoy, reversing the increase from 1.5% in February to 1.6% in March. Monthly flows in new loans were

somewhat subdued with €6bn each for loans to households and to non-financial companies in April (all data on loans adjusted for sales and securitisations).

Chart 1: Credit cycle turned up gradually



Monthly flows of new loans to households and non-financial corporations, adjusted for sales and securitisations, in €bn. Red line: three month moving average. Source: ECB

Monthly data are too volatile too read much into them. On balance, the gradual upturn in loan growth seems to be intact despite somewhat weaker monthly flows of new loans in March and April. At the same time, the demand for liquidity increased at a less buoyant pace. The rate of M1 money supply growth decelerated further to a still-strong 9.7% in April after 10.1% in March and 10.3% in February. Taken at face value, the M1 data could herald somewhat less robust gains in domestic demand for early 2017. But as M1 growth is still very strong, the modest lessening in its rate of expansion may just signal an easing of tensions and hence less need to build up further precautionary liquidity balances.

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