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ECB PREVIEW: NO COMPELLING NEED TO ACT NOW

Berenberg Macro Flash

The pace of recovery in the Eurozone remains "unsatisfactory" according to ECB board member Yves Mersch. Does that mean that the ECB will have to act again this Thursday? Not necessarily. As Mersch himself pointed out in his largely academic speech in Cernobbio on Saturday, governments will need to pursue domestic reforms, complete the banking union and dispel concerns about the future of the EU to strengthen the underlying pace of economic growth. The data suggest no compelling need for the ECB to ease its monetary policy further at this stage. Of course, the ECB may nonetheless decide to announce an extension of its asset purchase programme beyond March 2017 this Thursday already. I see a 40% probability for such a move.

ECONOMIC OUTLOOK: NO MAJOR CHANGE

The Eurozone economy has expanded at an annualised pace of around 1.6% in the last six quarters. While this is unsatisfactory relative to previous economic recoveries, the ECB cannot do much about it. Short of major pro-growth structural reforms, 1.6% seems to be the underlying trend for the time being. Leading indicators such as economic sentiment and the composite purchasing managers' index have receded somewhat in August in response to Brexit uncertainties and some domestic political risks. However, they remain slightly above their long-term averages. For two reasons, the August survey data are also difficult to interpret. First, the precise timing of summer holidays can affect the August data. Second, the August drop may partly reflect the post-Brexit anxiety that gripped the UK in July. As calm has returned and UK survey data have rebounded in August, the Brexit factor may weigh less on future survey readings in the UK's top trading partner, the Eurozone. All in all, the economic outlook for the Eurozone has not deteriorated significantly since the last ECB press conference on 21 July.

The ECB will base its decisions this Thursday on new staff projections for growth and inflation. The table below compares the ECB most recent projections from June to the current Berenberg and consensus forecasts. Following the Brexit vote, the ECB will likely have to reduce its calls for growth in the second half of 2016 from 0.4% qoq to 0.3% qoq or slightly less. That would bring the ECB's full-year projections down from 1.6% to 1.5% for 2016 and from 1.7% to 1.4% or 1.5% for 2017, roughly in line with our calls. Despite the post-Brexit drop in sterling, the effective exchange rate of the euro is virtually unchanged on its May 2016 average. Neither the hard economic data for recent months nor the survey data warrant a more pronounced downgrade of growth projections.

For inflation, the ECB's June projections are in line with the current consensus. At most, the recent softness in core inflation ex energy and food (0.8% yoy in August after a 0.9% yoy average for 1H 2016) and a modest downgrade to the ECB's GDP projections could justify shaving the inflation forecasts by 0.1ppt from 1.3% to 1.2% for 2017 and from 1.6% to 1.5% for 2018. As oil price futures for Brent crude are now slightly above those which the ECB used in June, commodity prices should not be a reason for the ECB to adjust its inflation outlook.

Projections for GDP growth and inflation

	GDP			Inflation		
	2016	2017	2018	2016	2017	2018
ECB June 2016 staff projections	1.6	1.7	1.7	0.2	1.3	1.6
Berenberg	1.5	1.4		0.2	1.4	
Consensus	1.5	1.2	1.5	0.3	1.3	1.6

Annual average change in Eurozone real GDP and consumer prices in %. Source: ECB, Berenberg, Bloomberg consensus

A CASE FOR IMMEDIATE ACTION?

The ECB has pledged to maintain its monthly asset purchases of €80 billion "until the end of March 2017, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim" of close to but below 2%. If the ECB wanted to, it could use the likely revisions to staff projections and the lack of a sustained increase in inflation to explain an extension of its asset purchase programme by, say, six months. However, the revisions are too modest to really justify a major new policy initiative. Just repeating the readiness to act if need be would suffice. With almost eight months to go until the end of March 2017, the ECB could easily wait until December before it decides whether it will continue to buy €80billion of assets per month after March or perhaps start to scale down these purchases from next April onwards. At its December meeting, the ECB will have a much clearer idea about the near-term impact of the Brexit vote as well as about the key political risks (US election 8 November, Italian constitutional referendum likely to be held in November).

WHAT COULD THE ECB DO?

If the ECB wanted to act nonetheless, what could the bank do? Extending the duration of the asset purchase programme would be the easiest option. Given the scarcity of eligible paper, scaling up the volume of monthly purchases beyond €80 bn would be more difficult. Amid a global discussion about potential negative side effects of negative interest rates, a further cut in the deposit rate from the current -0.4% would be the least palatable option. Changing the composition of bond purchases by moving away from the capital key in favour of a system based for instance on the size of the bond markets could strain the ECB's mandate and unleash a major political backlash. The same would hold for a decision to buy bank bonds as the ECB itself is a major regulator of banks. Only a pronounced economic crisis could justify breaching these political taboos, in my view. The Eurozone is nowhere close to that.

On a more technical level, the ECB could finetune some details or eligibility criteria for its bond purchases. For example, the ECB could raise the limit of any issue it is buying beyond 33% for some additional bonds. Or the ECB could allow itself some flexibility in the country distribution of sovereign bond purchases over time, for instance buying fewer Bunds now but more of them later. But none of these adjustments would amount to an additional monetary stimulus.

The ECB will probably extend its asset purchase programme beyond March 2017 in the end, either with the full €80 billion per month or a reduced amount. However, I see no convincing need for the ECB to scale up its monetary stimulus this Thursday already. Of course, a significant chance remains that the ECB will nonetheless want to act now instead of waiting until December.

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