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MACRO UPDATE: ECB PREVIEW, ITALY

Berenberg Macro Flash

ECB PREVIEW

Expect the European Central Bank to send a two-pronged message this Thursday. First, The ECB wants to maintain a highly accommodative stance. Second, as headline inflation is edging up, the ECB has started to think about scaling back its asset purchases eventually. Amid the serious political uncertainty caused by Italy's referendum result, the emphasis will likely be more on the former than the latter part of the message.

For once, the ECB will have little reason to revise its staff projections for growth and inflation significantly. As the tables below show, the ECB projections from September are roughly in line with our own calls and the Bloomberg consensus. The Eurozone recovery is on track. After a minor dip in some leading indicators right after the Brexit vote, most indicators have firmed again in the last few months. While strong consumer confidence bodes well for domestic demand, a slightly weaker euro exchange rate and bets on a major US fiscal boost to come support the export outlook. The Eurozone economy can continue to expand at a rate close to its 1.5% trend. As the ultra-low oil prices of late 2015 and early 2016 drop out of the year-on-year comparison, headline inflation looks set to rebound further. Over time, a gradual increase in wage inflation and continuing gains in private consumption should also nudge up headline inflation modestly. Chances are that headline inflation will rise back to the ECB's target of just below 2% by early 2019.

Forecasts for Eurozone Inflation	2016	2017	2018
ECB (September projections)	0.2	1.2	1.6
Bloomberg consensus	0.2	1.3	1.5
Berenberg	0.2	1.3	1.6

Yoy, in %. Source: ECB, Bloomberg, Berenberg

Forecasts for Eurozone Real GDP	2016	2017	2018
ECB (September projections)	1.7	1.6	1.6
Bloomberg consensus	1.6	1.3	1.5
Berenberg	1.6	1.5	1.5

Yoy change in %. Source: ECB, Bloomberg, Berenberg

In March 2016, the ECB had raised its monthly asset purchases from €60bn to €80bn amid widespread – if overdone – concerns about deflation risks. These concerns have now faded. Instead, the discussion about potential negative side effects of the ECB's aggressive stance have intensified. The ECB thus has a clear argument to reduce its asset purchases when the current commitment to full-scale quantitative easing expires at the end of March 2017. The ECB has promised to announce the result of a review of its asset purchase programme this Thursday. However, many ECB members seem to consider a tapering as of April 2017 premature. Also, markets have not been prepared for this. Among elevated political risks with potential financial implications, including those for Italian banks, the ECB will want to tread carefully. In theory, the ECB could send its two-pronged message by reducing its asset purchases from April onwards (hawkish surprise) while offsetting that with a commitment to taper only very very slowly, for instance by maintaining a somewhat reduced level of asset purchases for much more than three months before the next decision may be taken (dovish surprise). More likely, the ECB will prolong the current pace of asset purchases of



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€80bn per month by three or six months and drop a somewhat clearer hint than before that tapering may start thereafter. Of course, the ECB will maintain the overall message that it will pursue asset purchases as long as necessary for a sustained rise in inflation back to target.

The recent rise in bond yields has made it easier for the ECB to find enough German paper to buy as part of its programme. Nonetheless, the ECB may make some technical adjustments to its purchase programme without changing the capital key distribution. Raising the issuer and issuance limit of 33% for top-rated paper could be the politically least controversial option.

ITALIAN POLITICS: RISK OF EARLY ELECTIONS

The tail risk that Italy may be heading for early elections in spring 2017, one year ahead of the scheduled elections in May 2018, seems to be rising. Interior minister Alfano, who heads a small centre-right group in coalition with prime minister Renzi's centre-left, yesterday joined calls from the radical fringes (Five Stars, Lega Nord) for elections as early as next February. I still expect president Mattarella to try to delay new elections. The election law "Italicum" needs to be reformed anyway in the wake of the referendum, partly because it may be unconstitutional in its current form which would give an automatic majority in the lower house to the strongest party. The Italian Constitutional Court intends to hold a hearing on the law on 24 January. If the mainstream parties could agree on a reform of the election law fast, early elections would become feasible. Much will depend on the discussion within Renzi's centre-left party. The party has little to gain from early new elections and may prefer to find an arrangement on a new government instead, probably seeking support from Berlusconi's centre-right Forza Italia. But the situation looks fluid. Early new elections would bring Italian political risks to a head. Some parties (Five Stars, Lega Nord) would likely campaign with a demand for a euro referendum which, however, would have no basis in the Italian constitution.

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