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ECB DECEMBER MINUTES INDICATE DIVISION AND UNCERTAINTY FOR ROAD AHEAD

Berenberg Macro Flash

The minutes of the December Governing Council meeting suggest a shift in the ECB's assessment of the balance of risks. The shift led the ECB to send a balanced message of continued support for longer, at a reduced amount. As Draghi had stressed already in the press conference following the monetary policy decision there was no discussion of tapering. The inflation outlook will determine whether the ECB's current assessment shifts substantially further: If inflationary pressures remain under control, core inflation edges up gradually and growth is on track, it could mean watching the ECB will be unusually boring throughout 2017. If reflation spreads the globe, Draghi and his colleagues will have to (re-)enter the centre stage. **In any case, we expect the reflation risks to force the ECB to announce tapering starting January 2018 in September this year or shortly thereafter. The ECB will not end QE ahead of schedule or raise the main policy rate, but give some indications on how it will scale back its asset purchases in 2018 and even consider bringing the deposit rate out of the deep negative territory.**

These minutes reflect the discussion that led to the compromise to reduce the monthly amount of purchases from €80bn to €60bn, but maintain such purchases throughout 2017. They suggest that the Governing Council was presented with "two broadly equivalent" options, to extend QE at €80bn for 6 months, or to extend QE at €60bn for 9 months. "A few members could not support either of the two options" shows the divide between some of the governors of Southern central banks likely wanting more than €60bn and/or the 9-month extension, while German members and other hawks pushed for an even lower monthly purchases and/or a shorter extension. Eventually, as Draghi put it already in the press conference, the Governing Council decided with a "very broad support" for option 2.

Support for lower, but longer – with likely intention of continued decoupling of US and Eurozone rates. The Governing Council stressed that "the scenario of a gradual uptrend in inflation still relied, to a considerable degree, on accommodative monetary-policy support", and for that reason "a more sustained market presence" was necessary. While acknowledging expectations of major changes in US economic policy with positive and negative implications, for the Governing Council it seemed crucial to clarify to investors and consumers that financing conditions in the Eurozone would continue to be "very favourable" for the economic environment over the next 12 months. ECB board member Benoit Coeure elaborated this point in an interview two weeks ago alluding to while "higher yields and wider spreads recreate scope for a proper assessment of risks" there was a need for "decoupling" between US and Eurozone rates. Put differently, **by extending asset purchases by 12 more months, the ECB attempts to mitigate the impact of rising global yields on refinancing rates in the Eurozone for the full year.**

No discussion of tapering. Really. Apart from the division which is likely to stay, what is clear is that the ECB's assessment of the balance of risks, including for inflation, is shifting – but only to the extent that the ECB wanted to adjust, without signalling an exit of the asset purchase programme. Wary of the possible repercussions of a taper tantrum, at the meeting in December the central bankers in Frankfurt found a different way of scaling back its asset purchases than the Fed more than three years ago when such plans send tremors through financial markets. And like ECB president Mario Draghi stressed in the press conference, tapering – which in his own words, means that "purchases turn eventually to zero" – wasn't discussed at the meeting, at least if you take Draghi by his words and the ECB by their minutes. **The key message was and still is to show that tapering isn't in sight for 2017.**

From today's perspective the planned policy path of record-low rates and at least 12-months of committed asset purchases seem very accommodative amid recent data pointing to a pick-up in activity, with both growth and inflation on the rise. Retail sales have improved by 0.9% for the months October and November compared to Q3. Surveys for services (PMI, EC services confidence) suggest a recovery from the uncertainty dent following the Brexit vote and strength heading into 2017, which bodes well for a positive contribution to GDP growth. Industrial production was up by 1.0% in Q4 vs. the previous quarter (based on the average of October and November with output in France and Spain especially upbeat growing by +2.2% and +1.7%, while Germany and Italy underperforming with 0.3% and 0.7%, respectively), the European Commission's sentiment gauge showed that industrial confidence turned positive for the first time since July 2011 and the PMI manufacturing reached the highest level since April 2011. For the ECB of particular interest, CPI inflation rose to 1.1% yoy in December after 0.6% in November. While this doesn't require any immediate action, as the rise was mainly due to higher fuel and oil prices alongside increased import costs due to a weaker euro exchange rate, also the for underlying pressures more telling gauge of core inflation also edged up to 0.9% from 0.8% in November. And surveys show that price increases will likely accelerate as selling price expectations in some sectors (especially retail) are on the rise – whether these expectations solidify will depend on whether global growth picks up materially and whether price increases in commodities translate to domestic inflation. **Given the latest data one may wonder whether the ECB would have taken a similar decision, especially committing itself to 12 months of asset purchases. Probably yes, as the ECB fears political and economic uncertainty continuing to weigh on growth prospects as the ECB pointed out that "the overall situation remained one of considerable uncertainty".**

Will we see changes to the policy path, or is the ECB just going to lean back in 2017? Yes and no. While we expect inflation to rise from 0.2% in 2016 to 1.3% this year, ECB board member Yves Mersch said just last week that talking about exiting the stimulus "is probably still premature, given the fragility of the European growth path". The ECB will be keen not to repeat the mistake of 2011, when a pre-emptive rate hike worsened the economic downturn – the political risks (a slew of with a new round of populists eager seizing power and the start of Brexit negotiations) will provide sufficient reasons to look through inflation rises. Save a Le Pen victory in France and a referendum in Italy on the Euro, the conviction among Draghi and his colleagues is that they have done enough for their part and will watch core inflation drift up gradually. **So, watching the ECB could be unusually boring, at least for the first half of this year. Still, 2017 is surely no year for Draghi and the likes to lean back. The ECB may still have a reason to act and turn less dovish – if the inflation outlook were to change materially.** Say the inflation were to overshoot and rise above the ECB's target of "below but close to 2%", in such a case probably not only the German members and other hawks in the Governing Council would stress the need for policy adjustments. While the ECB will very unlikely start tapering ahead of the current expectation or raise the main policy rate (since the ECB has stressed that rates will stay low beyond the asset purchase programme horizon), we expect the ECB to communicate its tapering strategy eventually and even consider moving the deposit rate (currently at -0.4%) out of the deep negative territory. So, the year could turn out to be slightly more interesting than the ECB full year asset purchase commitment of December 2016 suggests.

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