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ECB: TOWARDS THE EXIT AT A SNAIL'S PACE

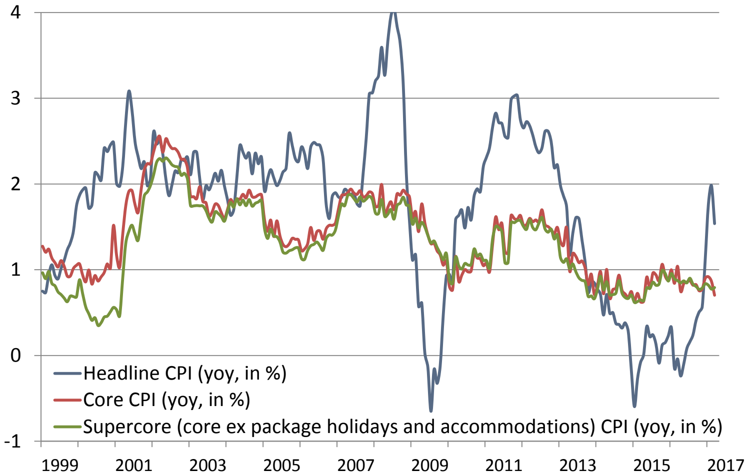
Berenberg Macro Flash

The ECB is edging closer to the exit at a snail's pace. However, it is still far away from it. Ten days ahead of the decisive round of the French presidential election, the ECB today decided to keep policy on hold and maintain its dovish guidance despite the recent advance in forward-looking economic indicators. While the ECB acknowledged that "downside risks to economic growth have diminished further", the ECB still sees the risks to growth as "tilted to the downside". As a result, the ECB maintains an easing bias, promising to buy €60bn of assets per months until the end of 2017, "or beyond" and to keep "the key ECB interest rates at current or lower levels…well past the horizon of net asset purchases".

The ECB will probably not stick to this position for much longer, though. At the previous ECB meeting in early March, the hawks already asked to start winding down the current monetary accommodation soon and to signal such an impending shift to markets immediately by "removing the downward bias regarding interest rates" according to the minutes of the March meeting. Since then, a wide array of positive data such as the rise of the European Commissions' sentiment index to its highest level since August 2007, the stronger PMI readings and Eurostat's upward revision to Q4 GDP from 0.4% to 0.5% qoq have strengthened the arguments of the hawks. After a controversial discussion over the balance of risks today, the Governing council tweaked its assessment of downside risks to growth by adding that these risks "are moving towards a more balanced configuration". The ECB now puts more trust in the strength and resilience of domestic demand than before, calling the recovery "solid and broad". As discussed before, we look for the ECB to shift to a neutral balance of risks in June and to tweak its forward guidance accordingly.

The ECB does have some reason for caution. First, the hard economic data have not yet followed the survey data up convincingly. Second, the ECB probably does not want to repeat the mistake it made almost exactly 6 years ago when it prematurely hiked rates just before the Eurozone crisis erupted shortly afterwards. Third, Draghi emphasised that the outlook for inflation has not changed. Underlying inflation has not yet reacted to the firmer and broader economic recovery. For example, our measure of supercore inflation – which not only strips away the volatile energy and food components of the consumer's basket but also package holidays (Easter travel), which recently have caused significant volatility ion the headline rate - has fluctuated around 0.8% over the last three years, being even more stable than core inflation ex energy and food.

Headline, core and supercore inflation (yoy, in %)



Core excluding energy and food; supercore also excludes package tours and accommodation costs. Source: Eurostat

ECB OUTLOOK

We look for core inflation to edge up from 0.8% in Q1 2017 to 1.2% by the end of the year and to rise gradually further thereafter, reaching 1.9% not before mid-2019. If so, the ECB will likely adjust its guidance and its policies in various small steps:

- Once the key political risk, the French presidential election, is out of the way, the ECB will likely adopt a balanced assessment of risks to growth and tone down its easing basis in June 2017 based on fresh staff macroeconomic projections.
- In September or October this year, the ECB will probably announce a reduced pace of asset purchases as of January 2018 followed by further reductions until the purchases end in the autumn of 2018.
- The first ECB hike in the refinancing rate may follow in spring 2019.
- If bank lending continues to edge up, the ECB may see less need to penalise banks for parking liquidity at the ECB. If so, we still think that the ECB could ease the penalty rate on such bank deposits from -0.4% to -0.25% in late 2017. In today's press conference, Draghi once again dodged the question of whether the ECB might raise the deposit rate before the end of asset purchases, as he had done in the previous meetings. Although Draghi's comments today and in the weeks before do not point towards such a step, he at least left the door a little open to easing the burden the ECB places on banks with surplus liquidity and – by extension – on some bank clients.

KEEPING ALOOF FROM POLITICS – SORT OF

Of course, Draghi declined to comment on the potential impact of the French election on the Eurozone economy and the outlook for inflation and ECB policies. But he did emphasise that indicators of political risk enter the ECB's assessment, noting that some global risks including the potential harm that Brexit may do to the UK economy have increased. Without commenting directly on the first 98 days of president Trump in the US, he also observed that risks of global protectionism now look a little less pronounced than they did some weeks ago.

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