Florian Hense, Senior Economist | florian.hense@berenberg.com | +44 20 3207 7859

ECB PREVIEW FOR THURSDAY, AND 2021

Berenberg Macro View

At its meeting this Thursday, the ECB will do what it will likely keep doing for the rest of 2021:

1. leave its policy stance (broadly) unchanged;
2. welcome the (gradual) rise in (medium-term) inflation;
3. stress that it can always do more;
4. highlight that fiscal policy should remain in the driver's seat.

ECB in wait-and-see mode

- Six weeks after its **December meeting,** the ECB is still taking stock of the impact of its then decision to broadly maintain its policy stance well into 2022.
- **The financial and economic backdrop suggests that the ECB can afford to do so. Financial conditions** have remained very favourable for the past 6 weeks (indicators of market volatility or the broad exchange rate) or have turned even more favourable (equity indices have climbed higher while real bond yields have trended lower) than 6 weeks ago.
- The **economic data** for Q4 has come in roughly in line with ECB projections. The ECB forecast of a GDP contraction of 2.2% qoq is very similar to our projection of 2.5%. With respect to Q1, the situation is different, though. If January is any guide, restrictions will likely be tighter in Q1 than what the ECB projections account for. Faster-spreading virus mutations further heighten the risk of even harsher lockdowns. Thus, the ECB is probably too optimistic about Q1. The ECB projects +0.6% qoq vs. our -0.6% call. Nevertheless, we agree with ECB president Christine Lagarde assessment from 13 January that projections remain "still very clearly plausible" – albeit only with respect to the medium-term. In our view, the Q1 setback should be partly offset by faster catch-up gains from spring onwards. Even bigger pent-up demand add to the already improving situation as more people are vaccinated and better weather heralds the retreat of the virus. While we forecast a different profile for Eurozone GDP than the ECB over the next two years, we end up largely at the same level in Q4 2022.

Stronger forward guidance

- **Eurozone inflation will likely recover in 2021.** We and the ECB project Eurozone inflation to rise from -0.3% in Q4 2020 to 0.9% yoy in Q2 2021, and climb higher throughout H2 2021. Driven by one-offs – the return to (higher) normal VAT rates, the introduction of an emissions-pricing scheme in Germany and energy price base effects – the initial rebound could be very fast. Capacity constraints in international supply chains add to that. Keep an eye out for the preliminary January readings on 28 January (Germany) and 3 February (Eurozone). Pent-up demand can fuel price gains for (food, drink, hotel, travel, entertainment etc.) services from spring onwards as restrictions are eased.
- **But this year's strong rebound should not be mistaken for a rapid rise in underlying price pressures. Underlying inflation will increase only gradually over the medium-term.** In 2022, inflation will – if anything – rise much more slowly and possibly even fall

at the start of the year as positive base effects fade. More fundamentally, capacity utilisation will take time to return to pre-pandemic levels despite strong demand growth. Unemployment and insolvencies will likely first rise before they fall, keeping a lid on wage and price growth. A further strengthening euro – possibly to 1.25 vs. the USD by end-2021 – could also contain price gains. By the end of 2022, inflation will likely be still well short of the ECB's "below, but close to, 2%" target.

- This week and for the rest of 2021, the ECB will and should thus bring home the following messages: that 1) this year's strong rise in inflation should not be extrapolated, 2) inflation will rise only gradually over the medium-term, 3) **a gradual rise in inflation towards target is positive and 4) monetary policy will remain supportive even when inflation hits its target.**

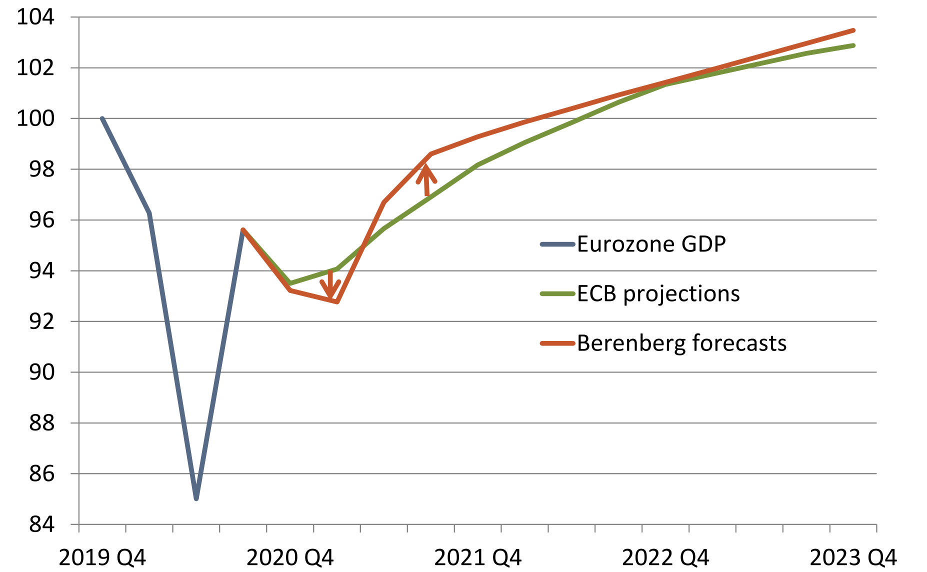
Ready to do more, if need be

- The ECB will stress that it can always do more and the PEPP is flexible enough to maintain very favourable financial conditions and thereby underpin the rise in inflation.
- Going forward, if the economy recovers from spring onwards as well as either rising inflation expectations and/or higher real rates yields threaten to push nominal yields higher, **the ECB may well raise its asset purchases to contain the rise in nominal rates.**
- Dissent will likely grow in the Governing Council as some members will question the logic of raising purchases despite the on-going recovery in economic activity and inflation (expectations). But we expect a majority of Governing Council members to press ahead with very supportive monetary policy – probably until the labour market has recovered sufficiently.

Euro – only soft verbal intervention for the time being

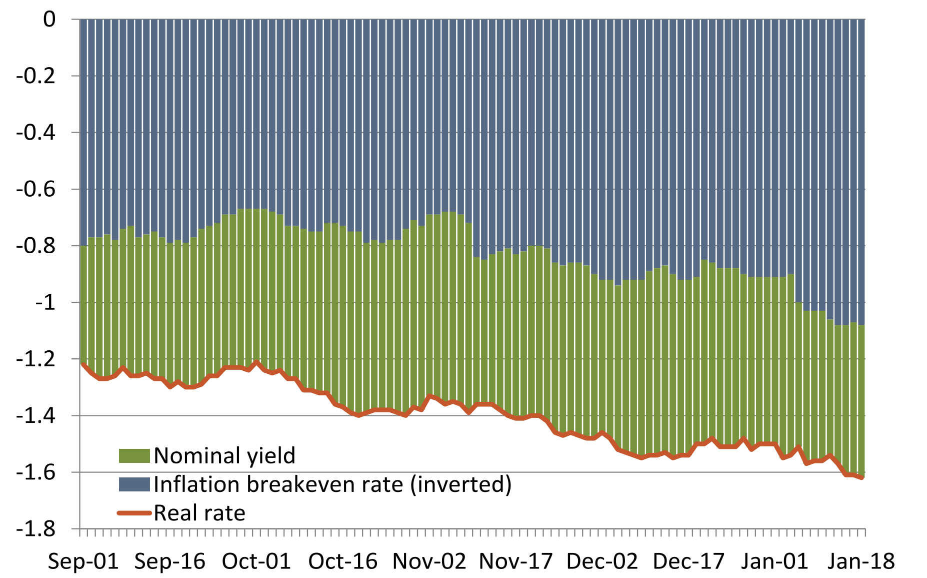
- At close to 1.20 vs. the USD, the euro has not reached a level where the ECB would step in. Lagarde maintained the ECB's cautious tone earlier this year. Despite big moves around the turn of the year, it has also remained broadly flat relative to broad basket of currencies since the last meeting.
- Only if the euro were to quickly appreciate to 1.25 vs. the USD and a bigger US fiscal package rather than an upside surprise by the Eurozone economy would be the driver, the ECB could turn more nervous. An interest rate cut in response to a stronger euro still seems like a very long shot.

Chart 1: Eurozone GDP – ECB December projections versus our estimate



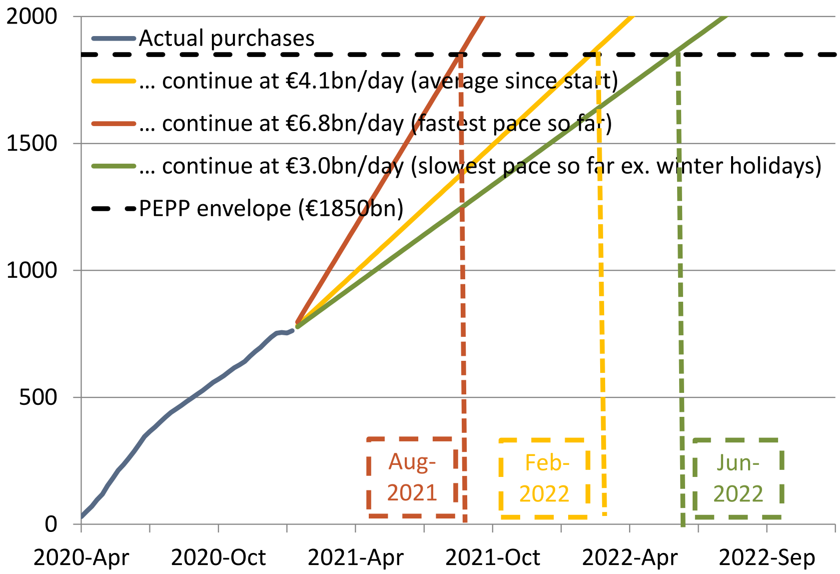
Indexed at 2019 Q4=100. Source: Eurostat, ECB, Berenberg

Chart 2: 10-year German inflation breakeven rate and German bond yields (in %)



Source: Deutsche Bundesbank, Berenberg

Chart 3: Projections of when ECB will hit new PEPP target



In bn euros. Sources: ECB, Berenberg