Holger Schmieding, Chief economist | holger.schmieding@berenberg.com | +44 20 3207 7889

ECB PREVIEW: A TIME TO PREPARE, NOT TO ACT

Berenberg Macro View

The European Central Bank (ECB) can take it easy this Thursday. The economy and inflation are roughly on track, financing conditions are favourable and markets are calm. The ECB Council need not take any policy-relevant decision or change its guidance in any way. Although the ECB may tweak the precise wording of its statement here and there, we do not expect the ECB to send any a new signal. Instead, the council can take its time to discuss the more strategic decisions it will need to take later on.

Real economy

The ECB's March staff projections for Eurozone GDP growth of 4.0% for 2021 and 4.1% for 2021 are modestly below our own current forecasts of 4.2% and 4.5%, respectively. Whereas the Eurozone economy probably contracted slightly in Q1 2021 in line with the ECB's March assumptions, the extended semi-lockdowns to contain the spread of the more contagious B.1.1.7 variant of the virus in parts of the Eurozone cloud the outlook for Q2. However, this should be roughly offset by a strong boost from abroad as reflected in buoyant readings for the manufacturing PMI. In addition, domestic consumers look set to open their wallets eagerly once they can do so again, presumably from May onwards, as excess savings meet pent-up demand. As a result, the ECB need not rethink its economic outlook at this stage. In June, the ECB and markets will have a much better idea about the severity of the current wave of infections and restrictions as well as the progress of the vaccination campaign and its impact on the economic outlook.

Inflation

Driven largely by the base effect from the collapse of oil prices at the start of the pandemic a year ago, headline inflation has risen from 0.9% yoy in January and February to 1.3% in March. But core inflation ex energy and food has subsided from a spike to 1.4% in January to 0.9% in March. Following a temporary dip in 2H 2020 caused partly by the cut in German VAT, the core rate is now back to its post-2013 average. We expect a host of special factors (see chart 1) to raise inflation to a peak of 2.5% in Q3 before receding to 1.5% in the first half of 2022 as the one-off factors fade. Our call for 2.0% average inflation this year exceeds the ECB's 1.5% projection from March. Although some of the one-off factors such as temporary supply bottlenecks are probably more pronounced than the ECB had thought in March, we see little evidence yet that underlying inflation may soon pick up more than expected. For example, recent wage settlements in the German metal engineering industry were once again very moderate despite the cyclical rebound which has already started in that sector. As a result, the ECB can continue to emphasise that it will look through such special factors and not change its policy guidance or stance in response to a temporary inflation hump.

Financing costs

Following a rapid rebound in benchmark bond yields in January and February from the extremely depressed levels of late 2020, yields have moved largely sideways since then. The ECB's decision of 11 March to step up the pace of bond purchases within its ultra-flexible Pandemic Emergency Purchase Programme (PEPP) for at least a quarter has worked. Of course, other factors such as global influences have contributed to the new stability. That the overall trend in nominal bond yields remains slightly up need not be a concern for the ECB. Although opinions on the council probably differ, many at the ECB may welcome rather than fear a slow and mostly smooth return to more normal yield levels over time. By and large, overall financing conditions for households, companies and sovereigns remain very favourable. Low risk spreads and buoyant equity markets contribute to that.

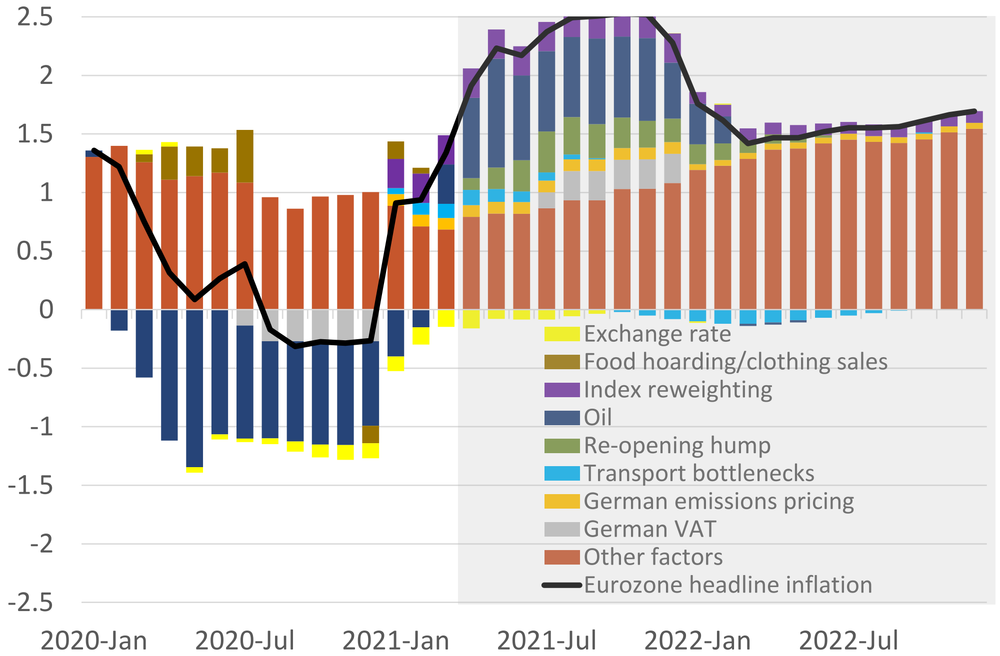
The tapering debate

If the economy recovers from the Covid-19 recession and underlying inflation picks up gradually, the ECB will eventually have to address the question as to when and how is should scale back its asset purchases in the future. Because the ECB buys bonds mostly under its ultra-flexible PEPP programme, this need not present any significant problem for the ECB for at least the next six months. The main purpose of the PEPP programme is not to inject a certain amount of liquidity. Instead, PEPP is meant to secure the transmission of the ECB's aggressive monetary stimulus to the real economy through ultra-favourable financing conditions. If the ECB can achieve this purpose with fewer purchases, fine. Unlike in the case of the US "taper tantrum" of 2013, such resizing of this particular emergency purchase programme would not signal a genuine policy shift to come shortly.

Upon presenting its new projections for growth and inflation on 10 June, the ECB will have to tell markets whether or not it will maintain its faster pace of PEPP asset purchases thereafter or return to the slower pace it had maintained until early March. We see no need for ECB President Christine Lagarde to provide even a tentative answer to the question this Thursday already. As she did in March, she will probably explain at length the various factors that contribute to the ECB's assessment of financing conditions without providing any guidance as to what may actually follow from such an assessment.

The PEPP programme is scheduled to run until at least the end of March 2022. The ECB can easily wait until December 2021 before it signals (i) whether or not it will extend the programme and/or (ii) increase the size of its regular asset purchase programme (APP) upon phasing out the PEPP. For now, the ECB can lean back and ponder the hard questions without having to take any decisions yet. The same holds for the full-scale review of its monetary policy strategy. With no new decisions to announce and no major market misperception to correct, the ECB press conference might well be reassuringly boring this time.

Chart 1: Key drivers of Eurozone inflation: beware the 2021 hump



Key contributors to yoy rate of Eurozone inflation, in ppt. Clothing/footwear sales pattern distorted by lock-downs. Sources: Eurostat, Berenberg