Economics

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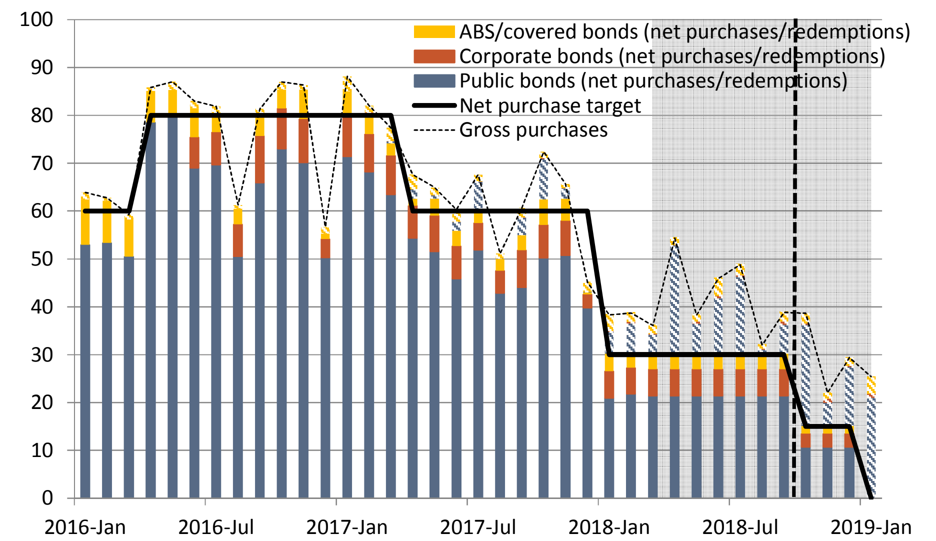
ECB preview: baby steps towards normalisation

- At this Thursday's meeting of the ECB Governing Council, the doves and hawks will decide whether to take another step towards policy normalisation.
- The hawks will stress that inflation will follow demand growth higher: because there is a risk of falling behind the curve, the ECB should, in their view, take the next step and drop the notion that it could increase the monthly amount of assets purchased. The doves, however, will point to the still subdued price pressures, stressing that there is no hurry and that the ECB can wait until April to adjust its guidance. With a further improved growth outlook and an unchanged inflation outlook, both camps will argue that the data is on their side.
- After a slightly more intense debate than before, we expect the doves to hold off the hawks and the ECB to leave its guidance unchanged. The doves may win over some of the hawks by arguing that the ECB should monitor two key risks: the Italian election and US-led protectionism. We forecast the ECB to drop its bias to increase asset purchases in size, if necessary, in April.
- For the rest of the year, we believe the ECB is likely to normalise its monetary stance via further baby steps. In the summer, we expect the ECB to link the adjustment of inflation with the whole policy package (stock of purchases, reinvestments and rates). This will give the ECB more policy flexibility, including the possibility of stopping its net purchases at a time when its inflation criteria have not yet been fulfilled, which may still take a little while.
- With prominent hawks appearing to have given the green light to asset purchases beyond September, we have slightly modified our call for the asset purchase programme: we now expect that the ECB will not stop asset purchases at the end of September, but will cut net purchases to half the current monthly amount (from €30bn to €15bn) from October, and end net purchases in December (see chart below).
- As the ECB stops its net purchases, guidance on the future path of policy rates will become more important. In line with what ECB board members have recently suggested, we expect the rate guidance to turn more specific in H2 2018.
- We forecast a first refi rate hike in June 2019, of 25bp. We forecast another lift of the rate corridor in December 2019, followed by roughly three more steps in 2020.

Chart: ECB's baby steps towards policy normalisation



Monthly purchases by type of asset, including actual and expected redemptions, in billions of euros. Source: ECB

Key macro reports

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It is not hard to lose track these days: while digesting a hung parliament in Italy, fatter Brexit tail risks and the increased risk of a US-led protectionist wave, one might easily forget about the ECB meeting this week. While the ECB is unlikely to make major policy changes on Thursday (policy decisions will be published at 12:45 GMT, followed by a press conference at 13:30 GMT), it will still be interesting to find out how the differences between the various members of the ECB play out. While doves and hawks agree on the policy direction, namely that further normalisation to a less accommodative monetary stance is warranted, they disagree on the pace at which such steps should be taken.

Agreement on further policy normalisation – the question is, how quickly

Will the ECB drop the bias to increase the monthly purchase amount?

At the centre of debate lies the QE easing bias – the ECB's commitment to be ready to increase its asset purchases in size and/or duration if the outlook for growth or inflation becomes less favourable. It seems highly unlikely that the ECB would drop the "duration" part of the easing bias and/or provide more specific guidance on the length of its asset purchase programme (currently until at least September 2018). We do not expect more explicit guidance on the end of asset purchases before the summer. The ECB could, however, get rid off the "size" part of the bias. The notion laid out in the previous two meetings (January and December) that the current stance could be adjusted in early 2018 can largely be regarded as an indication that the option to increase the monthly net purchase target of €30bn could be dropped this week.

Previous accounts suggested a revisit in early 2018

Hawks look at growth and say yes

Looking at GDP growth, the "size" bias seems to be out of date. The economy is expanding robustly, well above trend and, if anything, has continued to surprise on the upside since the last round of staff macroeconomic projections in December 2017. The corrections in survey data in January and February will not stop the ECB from upgrading its GDP growth forecasts slightly (see table 1). Meanwhile, the ECB is turning ever more confident that the above-trend GDP growth will translate into higher inflation. Higher core inflation readings for the last four months support this argument. The hawks argued along these lines already in January when "some members expressed a preference for dropping the easing bias regarding the APP". This week this group of members could increase enough to tilt the power in the hawks' favour and trigger an end to the easing bias.

Hawks could argue that QE size easing bias should be dropped

Doves look at inflation and say no

While growth is on a good run, the eurozone economy is yet to see price pressures building up in a fashion to the ECB's liking. The doves will tread carefully until the following three inflation criteria are fulfilled: 1) inflation actually getting closer to the target of "below, but close to 2%"; 2) doing so in a sustained fashion, notwithstanding any one-off ups and downs; and 3) doing so even if monetary support is removed.

Doves will point to the still subdued price pressures...

While inflation came in a bit weaker than expected in February, if it were to rebound in March, which is what we and the ECB expect, inflation in Q1 2019 would be fairly in line with the central projections of the December forecast round. The doves may still prefer to wait for another month of inflation reading. So, while the hawks will stress the improved growth outlook, the doves will point to the unchanged inflation outlook (see table 2). If it were not for the oil price (5.3% higher than the price used in the December 2017 staff macroeconomic projections), the stronger euro (the trade-weighted effective exchange rate has risen 1.5% from the rate used in December) would have dragged the inflation outlook even lower.

...and may prefer to wait a little more

Table 1: Eurozone real GDP

	2018	2019	2020
ECB (March 2019 projections – Berenberg estimates)	*2.4*	*2.0*	*1.7*
ECB (December 2018 projections)	2.3	1.9	1.7
Bloomberg consensus	2.3	1.9	1.8
Berenberg	2.5	2.1	

Yoy change in %. Bloomberg consensus taken on 5 March. Source: ECB, Bloomberg, Berenberg

Table 2: Eurozone headline inflation

	2018	2019	2020
ECB (March 2019 projections – Berenberg estimates)	*1.4*	*1.5*	*1.7*
ECB (December 2018 projections)	1.4	1.5	1.7
Bloomberg consensus	1.5	1.6	1.6
Berenberg	1.5	1.7	

Yoy change in %. Bloomberg consensus taken on 5 March. Source: ECB, Bloomberg, Berenberg

No change in forward guidance yet

No guidance change this time since there is no hurry and political risks suggest caution

We expect the doves to outnumber the hawks by arguing that the upgrade of the growth outlook does not yet require – and the still subdued inflation readings do not yet justify – a change in the forward guidance. The hawks in the Governing Council may also agree with the doves that the ECB should wait for more insights into how the Italian elections and the intensified threat of a US-led protectionism play out. Both risks could result in a growth downgrade, and therefore warrant an even slower pace of policy normalisation. Press reports over the last two weeks confirm our expectations that the doves will keep the upper hand, with no policy changes decided this week.

The next steps

Next steps pushed further into the future

Does it matter whether the ECB adjusts its guidance this time or next? Not really, but it could push the next steps further into the future. We expect the next step will be to delink the upward adjustment of inflation towards the target from the end of its asset purchases (September 2018) and align it more to the whole policy package (the stock of purchases, reinvestments and rates). This step would give the ECB more policy flexibility, including stopping its asset purchases, even if its three inflation criteria have not yet been fulfilled, which may still take a little while.

Effective guidance on policy rates will become more important and more specific in H2 2018

ECB board member Benoît Cœuré played down the impact of stopping (net) asset purchases as the stock of assets purchased exerted a persistent easing effect (via the compression of term premium). If the free float share of eurozone sovereign bonds, in other words the share of eurozone sovereign bonds not owned by the ECB, was small enough, which was the case in the eurozone, additional purchases would not be as necessary as before – when the free float share was bigger – to safeguard low bond yields. Cœuré agreed with his colleague Peter Praet that when stopping net purchases “effective guidance on the future path of short-term interest rates” would be essential. So far, we know only that rates will remain at their current levels “well past” the end of net asset purchases. We expect more details on the rate path in H2 2018.

ECB policy outlook

Policy normalisation continues with net purchases halved between October and December and first refi rate hike in summer 2019

For the rest of the year, we expect the ECB to continue to normalise its monetary stance further, but to do so in baby steps. Since there seems to be only limited support for an abrupt end to asset purchases at the end of September – even prominent hawks Bundesbank President Jens Weidmann and Dutch central bank president Klaas Knot seem to have given the green light to continue purchases in Q4 – we have slightly modified our call for the asset purchase programme. We now expect the ECB not to stop asset purchases at the end of September, but to halve the monthly amount once again (from €30bn to €15bn) from October onwards and to end all net purchases in December 2018 (see chart on page 1). While the ECB may choose not to provide a definitive end to those purchases as soon as September, we expect it to signal to markets that December will very likely be the last month of net purchases.

More precisely, we expect the ECB to take the following steps:

- **April:** to drop the specific notion that it may increase its asset purchases in size, but leave the notion that it may increase its asset purchases in “duration” and the more general commitment to continue asset purchases beyond September 2018 “if necessary”;
- **June:** to align the upward adjustment of inflation towards the target with the whole policy package (stock of purchases, reinvestments and rates) rather than just the end of its asset purchases;

- **July:** to announce that it will halve the amount of monthly asset purchases from €30bn to €15bn from October with the goal to end them by December;
- **September:** to provide more details on the pledge to maintain rates at present levels "well past" the horizon of net purchases, such as a certain period or conditionality;
- **November:** to declare that asset purchases will end in December;
- **June 2019:** to raise the refi rate by 25bp;
- **December 2019:** to raise the rate corridor once again, followed by roughly three further such steps in 2020.

To reinstate the symmetry of the three policy rates (refi, deposit and marginal) throughout 2019, the ECB may raise the deposit rate as soon as March 2019, from -0.4% to -0.25% or by more than the refi rate in June and/or December 2019.

Depending on core inflation ECB could go slower or faster

If core inflation fails to edge up over the course of the year, and remains rather flat, the ECB may wait even longer before eventually tightening its policy. If growth continues to surprise on the upside while core inflation edges up, the ECB may raise its refi rate as soon as March 2019.

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