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Eurozone: Sequencing problems

Markets have been abuzz with speculation on the possibility of an early rate hike in the Eurozone, after a member of the ECB's Governing Council, Nowotny discussed the possibility of a deposit rate hike before the end of the QE programme. However, the ECB's Chief Economist Peter Praet, retorted that the communication was very clear on the sequencing of monetary policy, expecting interest rates "to remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases".

Markets starting to pencil in the possibility of a change

One can understand why markets are progressively starting to pencil in the possibility of a change in monetary policy in the not too distant future. Economic data continue to be upbeat. The flash composite PMI rose to its highest level in 6 years, while the German Ifo-index also climbed higher in March. While not all hard data are as positive, we see certainly an upward risk to our forecast for the first half of the year.

After all, the political hurdles might not be as big a drag on growth as one might have feared. In the Netherlands, the far-right Freedom Party obtained a good result, coming in second, but the party of Prime Minister Rutte remained with a solid margin the biggest party. In Germany, the elections seem to be a contest between the two big traditional parties, with populists playing only a marginal role. In France, the first round of the presidential elections is fast approaching. The centrist candidate Macron seems the favourite to win, though voter turnout could still cause a surprise in the second round.

Early Italian elections are now off the table

In our view, the most interesting development is that early Italian elections are now off the table, meaning that parliamentary elections are not foreseen before the first quarter of 2018. While this takes away some of the short-term political risk, the longer-term risk has not disappeared at all. The Italian political landscape and electorate has, in the wake of the dismal growth performance of the last 10 years, become increasingly disillusioned with the euro and the European Union. The Italian elections are therefore far more dangerous for the stability of the Eurozone those in France or Germany.

Meanwhile Target2 imbalances are on the rise again

Meanwhile Target2 imbalances are on the rise again, potentially signaling capital flight out of the weaker member states (as Target2 balances represent the booking of international capital flows within the Eurosystem). The German Target2 surplus is now at higher levels than at the peak of the euro-crisis in 2012. However, as the BIS explained, this is to some extent the consequence of the ECB's QE programme. For example, when the Banca d'Italia buys Italian governments from a foreign bank, a Target2 imbalance arises. As many non-Eurozone banks connect to the ECB's Target2 system via a German correspondent bank (60% of all Eurosystem bond purchases happen via banks that are connected to the Target2 system via the Bundesbank) and the money stays on a bank account in Germany, then the German Target2 surplus increases. So for the time being, this doesn't reflect growing tensions within the Eurozone, though in case of break-up it would of course constitute a problem.

Expect HICP inflation rate fall back below 2%

As for inflation, we expect the HICP inflation rate to fall back below 2% in the coming months, now that energy prices have stabilized and core inflation is still hovering around 1%. While most surveys indicate that pipeline inflation is picking up, we still think that core inflation is likely to remain below 1.5% in 2018. In that regard the ECB has little reason to change its monetary policy. On top of that, with Italian elections in the first half of 2018, it will be difficult for the ECB to withdraw stimulus at a moment of potential tension within the Eurozone.

We therefore stand by our call that QE will be extended for another 6 months (albeit with some tapering), while the deposit rate is to be increased in the second half of 2018 at the earliest. The ECB could start hinting at this very gradual exit in the months after the French elections. Only if the ECB comes to the conclusion that the negative deposit rate hike is actually constraining credit growth (as it can be considered as a tax on the banks) and markets only interpret it as a pure technical move, not the start of a normalization cycle, then an earlier move could be possible. However, that is not our base case.

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