

## Our ECB decision day guide

Here's what our economists and strategists are thinking ahead of today's ECB meeting.

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Recent euro strengthening should help Mario Draghi tame hawkish fantasies at next week's ECB meeting

By Carsten Brzeski

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## ECB preview: Taming the hawks

Recent euro strengthening should help Mario Draghi tame hawkish fantasies at next week's ECB meeting



Source: Shutterstock

At the start of the New Year, the ECB could currently feel as if it was in the middle of the set of a movie combining the scripts of “Groundhog Day” and “Aladdin”. Every time the ECB thinks that it bought some time and quiet, either macro developments or some ECB members’ statements (or sometimes both) undermine these plans and let the genie of speculations about policy changes out of the bottle. While the ECB had actually tried to hush any exit speculation with the October decision for “lower for longer”, strong macro data, a general fear in financial markets that inflation is not dead and could return faster than anticipated as well as some ECB officials’ talks have recently again fueled new speculation about the future of QE.

### Don't get carried away by hawkish comments

The always-returning speculation on whether the ECB could stop QE in September was not only fueled by recent statements by Bundesbank President Weidmann and ECB Executive Board member Coeuré but also by the minutes of the ECB's December meeting. In fact, the strong economic upswing combined with a series of indicators pointing to the possibility of increasing inflation seem to build the case against an extension of QE beyond September. However, there are at least three reasons why we expect Mario Draghi to resist the hawkish sirens:

- Structural factors are keeping inflation low. The minutes of the December meeting showed that the ECB itself still has doubts that strong growth really translates into higher inflation. It should but structural factors like globalisation, digitalisation and labour market slack could distort textbook relationships between growth and inflation. Also, the German experience of a very mature cycle providing very little wage inflation gives reasons to be cautious. In this regards, the ECB is clearly having a close eye on the ongoing wage negotiations in Germany.
- The catch 22 argument. Every time, hawkish comments dominate the ECB debate, the euro appreciates and immediately provides ammunition for the ECB doves. Even though the ECB thinks that a stronger euro has a smaller negative impact on growth than in the past, they are definitely concerned about the impact on inflation. From a pure technical perspective, the latest strengthening of the euro (if sustained) would lower the ECB's inflation assumptions for 2018 and 2019 by some 0.2 percentage points, making the case for an early end to QE less compelling.
- The read-my-lips argument. The biggest argument against an early end to QE are Mario Draghi's words. Back in October, Draghi said that "it's never been our view that things should stop suddenly". A strong statement. However, Draghi made this statement during the Q&A session, it was not part of the introductory statement, and might not have been the agreed wording of the entire Governing Council.

## Another 'lower for longer' beyond September remains our base case

We stick to our previous view that the ECB will not stop QE in September but will rather decide on another "lower for longer" beyond September, probably until the end of the year. Given that even the hawks are currently emphasising sequencing, a first rate hike will not be on the cards before mid-2019. Interestingly, the ECB has picked up the narrative from Draghi's Sintra speech and is more and more focusing on growth, considering inflation only as a derivative of growth developments.

### Draghi's magic

For next week's meeting, we expect Draghi to convey a rather dovish message, pointing to still weak inflationary pressure and also emphasizing the disinflationary impact from a stronger euro. The most important message to watch will be whether Draghi confirms the October statement that there will be no sudden end to QE. We expect him to do so as this would be the only way to – at least – temporarily get the genie back in the bottle. It would also show Draghi's magic of how to guide financial markets with very few words and without any action.

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# ECB Crib Sheet: Your guide to potential market movements

How markets could react to Thursday's ECB meeting. Scenario analysis: Click on the image to enlarge

	Inflation outlook	Growth outlook	Reference to the EUR level	QE taper guidance		EUR/USD	2-year Schatz	10-year Bund
Current stance	"Underlying inflation is expected to rise gradually"	"The risks... to growth outlook are broadly balanced"	"Volatility in exchange rate is source of uncertainty ..."	QE is "not going to stop suddenly"				
Very dovish	Transitory factors keeping inflation low are here to stay	Risks to the growth outlook to the downside	Unwarranted tightening of monetary conditions	GC considering QE extension beyond Sep 2018		1.20	-5 bp	-10bp
ING Base Case	Underlying inflation still expected to rise gradually	Risks still broadly balanced	Exchange rate is a downside risk to growth outlook	GC's majority retains the open-endedness feature of QE		1.22	-5 bp	-5 bp
Hawkish	Even greater confidence of CPI converging to target	Recovery improved, risks still balanced	The EUR level is a reflection of fundamentals	GC members not in agreement on the open-endedness		1.24	+5 bp	+10 bp
Very hawkish	Upside risks to the inflation outlook for both 2018 & 19	Risks to growth outlook are to the upside	The current EUR level not a concern to the Gov Council	QE may end abruptly if econ recovery continues		1.25	+10 bp	+15 bp

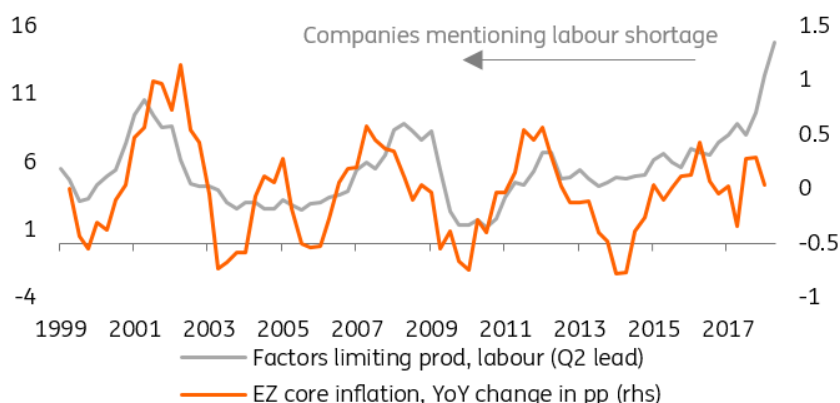
Source: ING

## Taming the hawks

We expect President Draghi to convey a rather dovish message and tame the market's hawkish fantasies (at least for now). The President is likely to point at still weak inflationary pressure, emphasising the disinflationary impact from a stronger euro. Indeed, every time hawkish comments dominate the ECB debate, the euro appreciates and immediately provides ammunition for the ECB doves. **The key thing to watch:** Whether Draghi confirms the October statement that there will be no sudden end to QE.

We expect him to do so as this would be the only way – at least temporarily – to get the genie back in the bottle. It would also show Draghi's magic of how to guide financial markets with very few words and without any action. Interestingly, the ECB has picked up the narrative from Draghi's Sintra speech and is increasingly focusing on growth, considering inflation only as a derivative of growth developments.

## Labour shortages and core inflation



Source: Macrobond

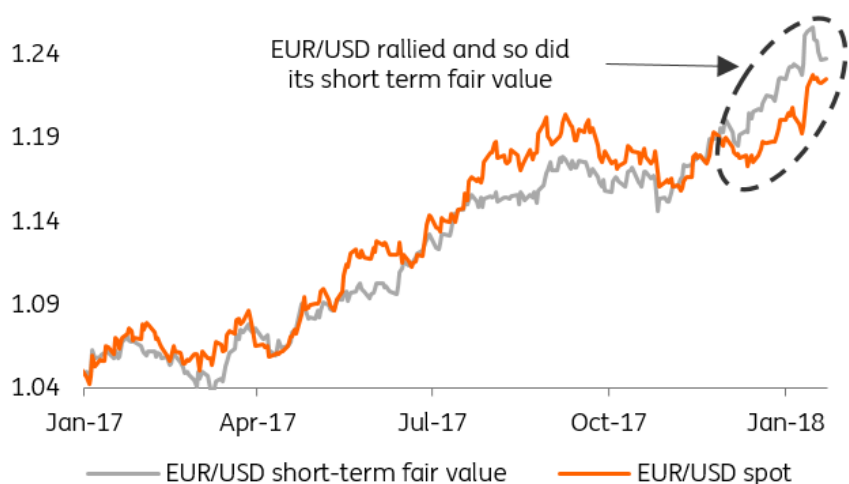
## What this means for FX markets

### High hurdle to send EUR lower

The likely cautious tone of the ECB meeting should put a limit on the scale of EUR upside rather than driving it lower. This is because

- (1) even on the very short term valuation basis, the EUR/USD still remains modestly undervalued;
- (2) market's base case of a cautious ECB tone, following the comments of various ECB board members;
- (3) solid EZ economic outlook and the recent data upside surprises have lowered the credibility of the threat for further and material QE extension.

## Euro vs. fair value



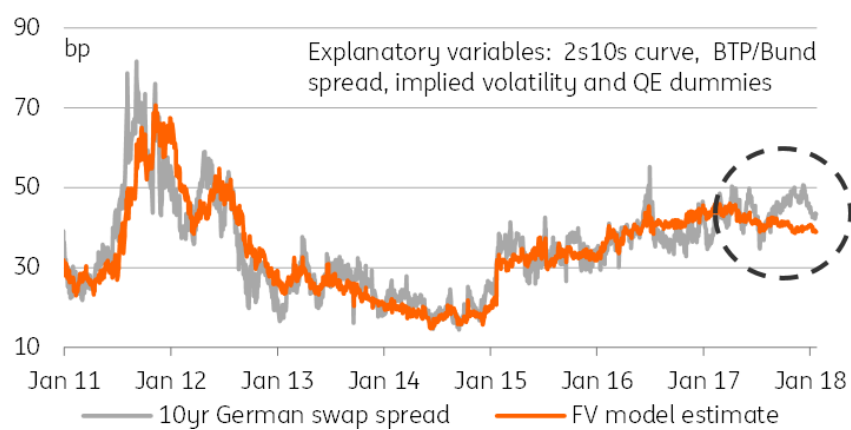
Source: ING

## What this means for bond markets

### Hawkish surprise less likely after recent ECB push back

Despite the recent pushback by ECB officials yields are still significantly higher than before the ECB minutes. We believe markets still await a dovish confirmation, which should prompt moderately lower Bund yields, key being the confirmation that there will be no sudden end to bond purchases. The upside in rates on any disappointment in this regard is moderated by valuation models versus swaps suggesting that Bunds are now trading less rich compared to past months.

### German swap spreads vs. fair value



Source: ING

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## Our guide to central banks in 2018

Everything you need to know about central bank policy around the world this year



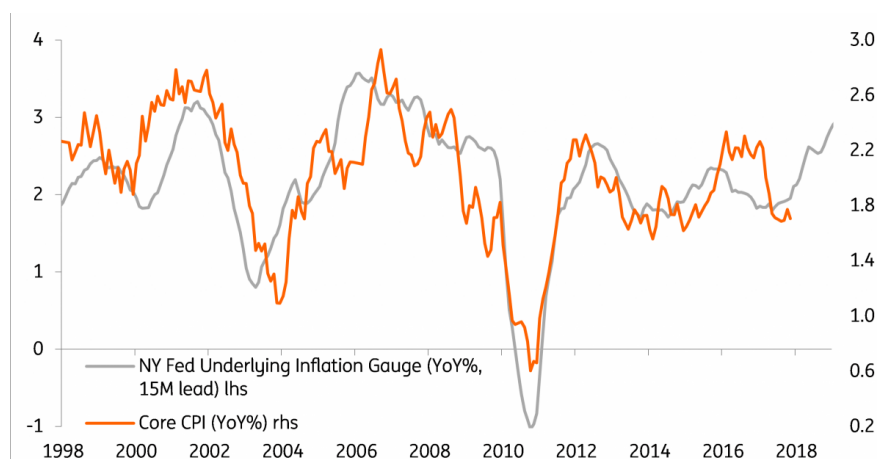
Source: Federal Reserve, Bank of England, Shutterstock

### Federal Reserve: Three hikes this year as inflation makes a comeback

The US economy is going from strength to strength. It looks set to expand by 3% this year given that tax cuts will further fuel domestic demand and the softness of the dollar puts US exporters in a highly competitive position to benefit from the global upturn. Inflation is also likely to rebound as distortions relating to cell phone data plans drop out of the annual comparison while robust economic activity, rising commodity prices and a gradual pick-up in wage growth add to price pressures –we could see 3% headline inflation this summer.

Having said that, we are currently forecasting no rate hike in 1Q18. Near-term activity data may be somewhat soft given bad weather in January and core inflation is likely to remain below 2% through to April. As such, incoming Federal Reserve Chair Jay Powell may choose to wait until the outlook is clearer before triggering consecutive hikes in Q2, Q3 and Q4. Nonetheless, with the Fed citing financial stability risks and loose financial conditions as additional reasons to raise interest rates, our forecast could be revised to insert a fourth hike, most probably for the March FOMC meeting.

## Underlying US inflationary pressures are building



Source: Federal Reserve, Bank of New York, Macrobond

## ECB: Taming the hawks

ECB watchers this year might feel as though they've stepped onto the set of a movie combining the scripts of "Groundhog Day" and "Aladdin". Every time the ECB thinks it has bought some time, either macro developments or statements by ECB members undermine its plans and let the genie of policy changes out of the bottle. While the ECB had actually tried to hush any exit speculation with the October decision of "lower for longer", strong macro data, a general fear in financial markets that inflation could return faster than anticipated and remarks by ECB officials have recently fuelled new speculation about the future of QE.

We don't expect any changes at January's ECB meeting but bank president Mario Draghi will have to address the latest speculation that QE could stop in September. We will be watching closely to see whether Draghi confirms what he said in October, that "it's never been our view that things should stop suddenly". We would expect him to do so, as this would be the only way - at least temporarily - to get the genie back in the bottle.

We stick to our previous view that the ECB will not stop QE in September but will rather decide on another "lower for longer" strategy beyond September, probably until the end of the year. Interestingly, the ECB is increasingly focusing on growth and seems to regard inflation only as a derivative of growth developments.

## Bank of England: The rate hike window is closing

For the Bank of England, there are really two things that will matter most this year. The first is Brexit; the likely agreement-in-principle of a transition period by the end of the first quarter would be positive, averting the tail-risk of a "cliff edge". That still leaves a number of open questions, including whether a two-year transition is long enough, and whether firms will boost investment without having firmer details of the UK's future trading relationship.

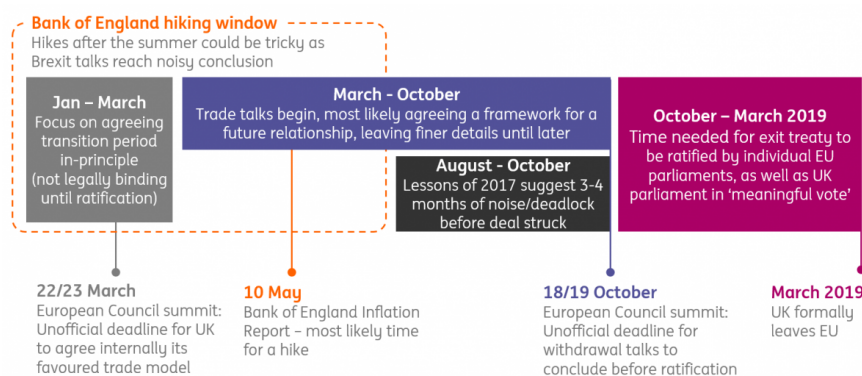
The second is wage growth; policymakers are looking for a sharp pick-up over coming months. There are signs of skill shortages in certain sectors, prompting employers to raise pay in a bid to

retain staff. That said, the economy is still struggling and input prices are still rising, meaning some firms may continue to take a more conservative approach to wage setting.

A rate hike still isn't guaranteed this year - although this is a close call. Whatever policymakers decide, we think they have a fairly narrow window before the summer to squeeze in another rate rise, with Brexit noise likely to ramp up in the autumn. Recent BoE speakers haven't guided markets towards a February rate rise, which leaves May's meeting as the most realistic hiking opportunity.

[Read more about the Brexit challenges looming this year](#)

## 2018 Brexit timeline



Source: ING

## Bank of Japan: Heading for the exit?

There is increased speculation that BoJ governor Haruhiko Kuroda and his Monetary Policy Committee will start hinting at a possible exit strategy from their Qualitative and Quantitative Easing (QQE) Policy, which combines asset purchases with a zero percent target on 10Y Japanese Government Bonds (JGBS) and negative rates (-0.1%) on excess reserves on bank deposits held with the Bank of Japan.

Although there is such merit in this speculation, given the duration and extent of improvements in economic growth, and recent inflation data has been more positive, much of the inflation pick-up is related to energy prices, and as such, almost certainly only a temporary response to crude oil fluctuations. So we don't think the time is yet right for the BoJ to signal an end to the easing.

If we are wrong and they decide to do so, we believe the most sensible course of action would be to simply formalise the undershoot of current asset purchases in a new target. This would send a moderate signal of policy re-alignment, whilst actually changing nothing on the ground. It could therefore be viewed as a dovish normalisation.

The other factor to bear in mind is the approach of the April 2019 consumption tax hike. With data running as well as it has, this tax hike has to remain on the cards. If the BoJ waits too long to start moving on its exit plan, it may find its attempt to extricate itself from unnecessary easing clashing with the fluctuations caused by the tax hike.

In short, the arguments for some normalising BoJ action are growing, but the story is not there yet. That said, the window for moving will not be wide open forever, and a move later this year, perhaps at the start of the next fiscal year, might be a sensible base forecast.

## Riksbank: Waiting for the ECB

The latest Riksbank minutes paint a fairly optimistic picture of the economic outlook in Sweden. Growth remains solid, inflation has returned to target, and the global upswing underway should provide a tailwind for the Swedish economy in 2018. The only cloud on the horizon is the sharp fall in the housing market this autumn, and even that cloud has a silver lining in the Riksbank's view. That means it is natural for the Riksbank to start moving towards a tighter policy stance. The decision in December to end the QE programme was the first step in that direction, although the reinvestment policy adopted means the Riksbank's balance sheet will continue to expand in 2018.

Whilst the [committee is becoming more divided](#), the Riksbank will now most likely wait to make its next move until there is more clarity on the ECB's intentions. That is only likely to come in June. If, as we expect, the ECB extends QE beyond the current end date in September and signals a rate hike only in mid-2019, we think it will be difficult for the Riksbank to stick to its current interest rate forecast. A first full hike is expected in Q4 with a smaller probability for the first hike in Q3.

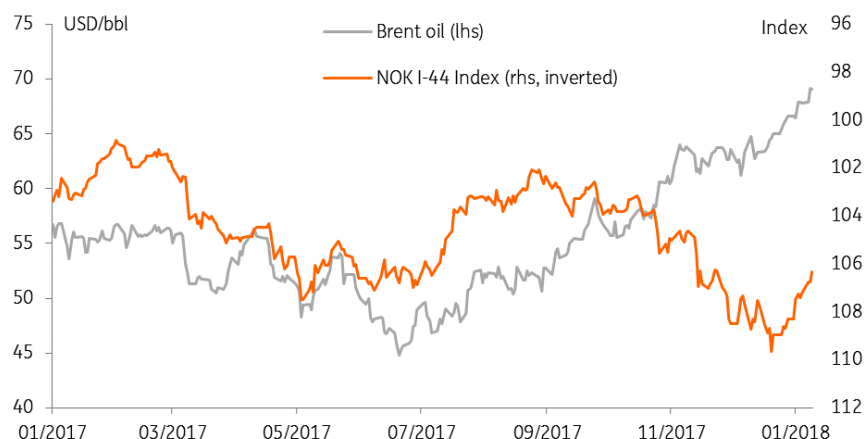
At most, it could dip a toe in the water by increasing the policy rate by 10bps to -0.40%. Should the ECB turn more hawkish by the summer, that may very well open doors for the Riksbank to start hiking sooner as well.

## Norges Bank: Hawkishness may be on the way

In December, Norway's central bank delivered an upbeat assessment of the economy, revising up forecasts for GDP and inflation, and shifting forward the expected date for its first rate hike by two quarters into December 2018. Since then, the data has been largely as the Bank expected: inflation rose to 1.6%, and activity indicators have been consistent with 0.6% Q4 growth. House prices did continue to fall in December, but at a moderate pace that will not overly worry the central bank.

Rising oil prices suggest more hawkishness may be on the way. The Norges Bank will probably be pleased that the positive correlation between the Norwegian krone (NOK) and oil prices have returned in 2018. Since December's meeting, Brent is up another 9% and the Norwegian Petroleum Directorate published a fairly upbeat forecast for hydrocarbon production and exploration in 2018 and beyond (a key driver for Norwegian growth). That means there is a chance of further upward revisions to the Norges Bank's forecast, though that is most likely a story for March or June, should the oil price hold up.

## Oil and NOK reconnect at the end of December



Source: Macrobond

## Reserve Bank of Australia: AUD strength could delay rate hike

After some fairly disappointing data on consumer spending and wages at the end of 2017, the most recent Australian data has shown a marked improvement. What has looked like a faltering household sector came blistering back, with fantastic retail sales growth for November (published January 2018) and strong autos growth, too. Consumer confidence has also shifted higher, and the labour market data firmed more than had been expected.

Yields on shorter-dated Australian government debt have picked up, though this could simply reflect moves in the US 2Y Treasury rather than hint at any imminent RBA tightening. Indeed, recent RBA commentary has made a big deal of unwarranted AUD strength, and with the AUD/USD pushing back up through 0.80, we believe the RBA will be happy to leave the cash rate on hold at 1.5% at their 6 Feb meeting. Even the Australian housing market has shown some signs of calming down, in a measured fashion, which will provide some solace to those who believe the RBA has left rates too low, for too long, and has contributed to a debt-fuelled housing bubble (not our view incidentally).

Our house view is for only one rate hike in 2018 in the second quarter. Though recent AUD strength and RBA comments suggest we ought to push this back at least to 3Q18.

## Bank of Canada: Strong growth vs. NAFTA uncertainty

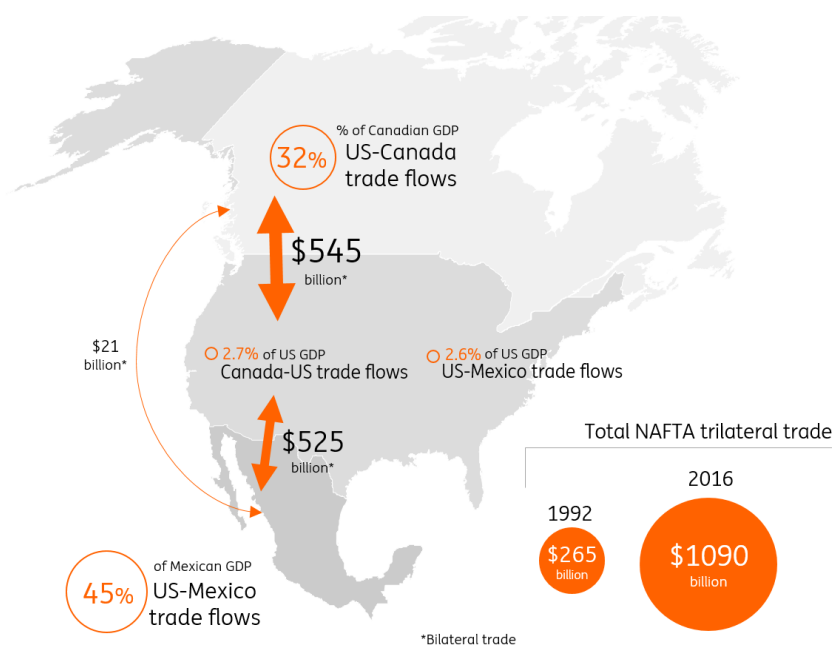
Following a raft of strong activity data and a pick-up in inflation, the Bank of Canada raised the target for its overnight rate to 1.25% at its January meeting. Two bumper jobs reports and stronger inflation readings led policymakers to conclude that the economy is "operating roughly at capacity". And there are few reasons to see that coming to an end. We see further upside to growth given the better global backdrop and higher commodity demand.

NAFTA remains the big unknown. US-Canadian trade flows equate to 32% of Canadian GDP so any disruption would be very bad news should President Trump decide to pull the plug on the agreement. With the next round of talks taking place shortly before the President's State of the

Union address on 30th January, the risk is coming more sharply into focus and the Bank of Canada has said that the associated uncertainty is "clouding the economic outlook".

That said, we are encouraged by Trump's recent comments, hinting at a growing willingness to work with Mexico and Canada on a NAFTA compromise. As such, we are predicting two more 25bp hikes in the second half of 2018.

## NAFTA in numbers



Source: Macrobond, ING

## Reserve Bank of New Zealand: NZD strength means any rate hike thoughts far-fetched

If anything, the strength of the currency plays an even more important role in the decisions of the RBNZ than the RBA, and recent strength in the NZD means that any imminent rate hike views are really very far-fetched even if the ultimate direction later this year is upward.

Recent data shows the New Zealand manufacturing sector at its weakest in five years and service sector PMIs have also eased back. We have a rate hike forecast for 2Q18, but this is beginning to look difficult to sustain, and we are likely to push this back and probably remove the second hike pencilled in for 4Q18.

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## Eurozone: Full speed ahead

The Eurozone economy is set for a fourth consecutive year of above-potential growth in 2018. While the output gap is gradually closing, inflation is only expected to rise very slowly, keeping in place expansionary monetary policy throughout the year



Source: Shutterstock

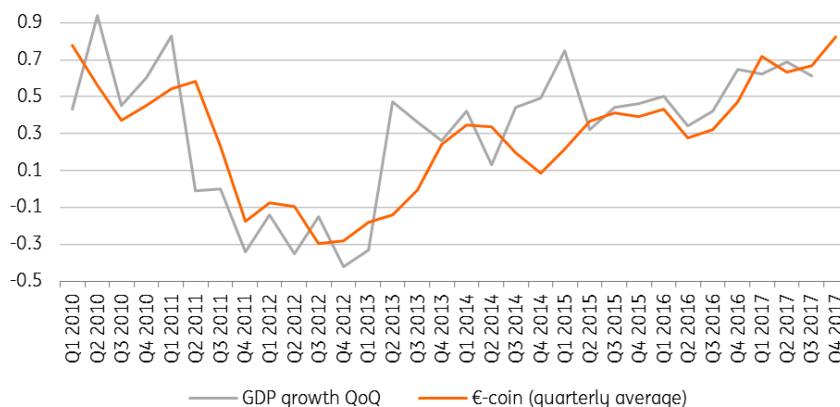
### It's all systems go!

The Eurozone recovery seems to be going into overdrive. As far as confidence indicators are concerned, 2017 ended with a bang. The European Commission's economic sentiment indicator (ESI) surged to 116 in December from 114.2 in November. The Business Climate Indicator rose to 1.66, hitting its highest level since 1985. Since October 2016 the Economic Surprise Index has been continuously in positive territory, reflecting an uninterrupted stream of economic indicators coming out better than expected.

The €-coin indicator, a proxy for the underlying growth momentum, hit 0.91% in December, suggesting an above 3% annualized growth pace. While we doubt that this pace will be maintained throughout the year, we believe that GDP growth in 2018 will be at least as good as in 2017. That would be the fourth consecutive year of above-potential growth. With employment rising 0.4% in the third quarter, December consumer confidence hit its highest level since January 2001, boding well for consumer expenditure.

Rising supply constraints and generous financing conditions are likely to continue to underpin the business investment revival. Notwithstanding the strong euro, export perspectives remain upbeat. The rebound in global investment is particularly helpful for Eurozone exports. The assessment of export orders in the manufacturing sector is now at the highest level in 10 years.

## Growth pace continues to accelerate



Source: Thomson Reuters

## The political angle

True, politics could still cause havoc, but probably not enough to spoil the growth party, we believe. With the pro-independence parties still holding a majority after the regional elections in Catalonia, the problem is not going to be solved rapidly, though we don't think that the Spanish economy will suffer significantly from the current stalemate. That said, some negative impact cannot be avoided. The budget for 2018 has still not been approved, as the Basque National Party is refusing to support the draft budget of Rajoy's minority government, as long as the Catalan issues have not been settled.

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### *Some difficult political problems remain*

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In Germany, there is still no new government, which is quite unusual for the country. It is still unsure whether SPD party members will give the green light to another grand coalition. However, the biggest problem that the current power vacuum creates is rather European, as in the current circumstances Chancellor Merkel doesn't have a mandate to support ambitious reform plans for the Eurozone. A new grand coalition might be more "euro-minded", one of the demands of Martin Schulz, but it remains to be seen to what extent this is true in practice.

Finally, 4 March has been set as the date for the Italian general elections. At this moment no clear winner looks likely, which will make the formation of a workable coalition difficult, but we consider the likelihood to have an anti-European government quite small (about 10%).

## What could spoil the party?

Of course, we cannot exclude sudden shocks on financial markets, which could also temper the growth momentum. As a matter of fact, it would be a surprise if the low volatility and depressed risk premia would remain in place for the whole of the year. In that regard, it still looks wise not to overdo the expectation of continuing above-potential growth.

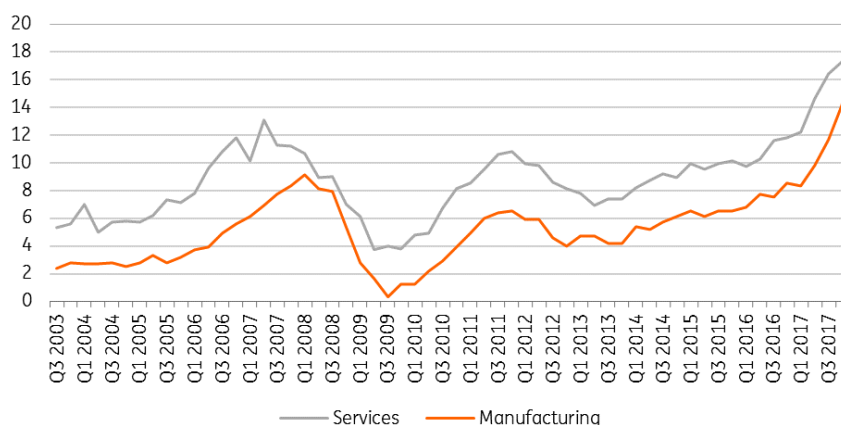
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*Be careful not to get too excited*

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That said, we believe that 2018 GDP growth will come out at 2.4% on the back of a strong base effect and the current growth momentum. From the second half of the year onwards, growth is likely to start converging gradually towards the longer-term growth potential, which for the Eurozone is definitely below 2%. The European Commission now actually expects that the output gap will already become positive in 2018, which limits the potential to continue to expand at above 2% growth rates.

## Limits to production



Source: Thomson Reuters

## The inflation conundrum

The inflation story is puzzling us. Pipeline inflation is definitely rising, while the labour market is tightening.

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*Pipeline inflation is rising rapidly*

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But we still have some doubts about the speed of transmission into higher inflation rates. In the PMI Manufacturing Survey businesses reported elevated rates of inflation in both output prices and

input costs as supply chain pressures increase, with average vendor lead times lengthening to one of the greatest extents on record.

The unemployment rate, standing at 8.7%, has now been declining continuously since May 2013 to reach the lowest level since January 2009. Looking at the hiring intentions published in the European Commission's Economic Sentiment Survey, this decline is bound to continue. Indeed, in December employment plans reached the highest level in 30 years in industry, while they also improved in construction (to a 10-year high) and in services. The unemployment rate is, therefore, most likely to fall below 8% by the end of this year.

## Phillips curve has flattened



Source: ING estimates

## A renewed focus on wages

With the percentage of companies mentioning the scarcity of labour as a factor limiting production now at the highest level since the start of the monetary union, wage growth should start to pick up. Annual growth in compensation per employee rose already from a low of 1.1% in the second quarter of 2016 to 1.7% in the third quarter of 2017 and we believe that this trend will continue in 2018.

In Germany IG Metall (where, admittedly, labour tightness is the most advanced), the trade union for the metal and electrical industries, started nation-wide "warning strikes" to support its demand for a 6% pay-rise and a 28-hour working week. Of course, this is not necessarily going to be the outcome of the wage negotiations, but gradually rising wages look likely in an environment of tightening labour markets. That being said, the amount of slack still present in the European labour market means that the increase will be rather at a snail's pace. Core inflation will probably also grind higher, though from its very low current level of 0.9%. Looking at the relatively flat Phillips curve, a fall of Eurozone unemployment to 8% by the end of the year, will probably push core inflation to around 1.5%. That's a step in the right direction, but far from an inflationary shock.

## The ECB's next moves

Nevertheless, with the growth picture looking very strong, the calls to end the ECB's expansionary monetary policy will grow louder. The president of the Bundesbank, Jens Weidmann repeated in an interview with Spanish daily El Mundo that the ECB should set an end-date for its asset-buying program. That said, a majority within the Government Council will want to avoid the repeated mistake of premature tightening, certainly given the stubbornly subdued inflation dynamics.

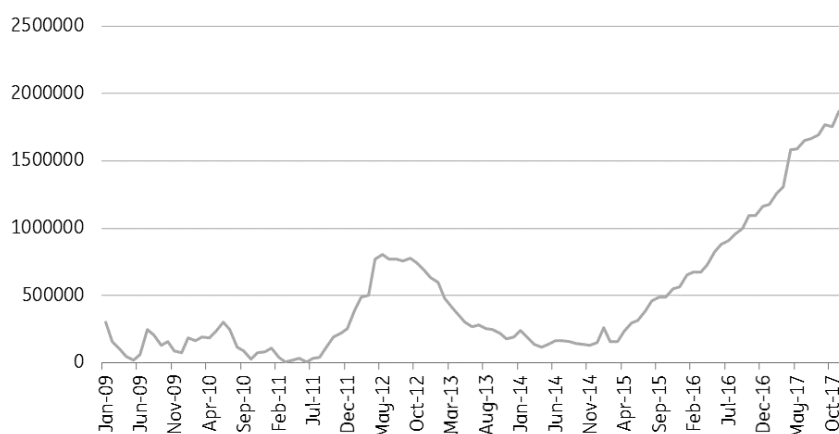
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### *Watch for subtleties in the ECB's communication*

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But even if backpedalling on its announced QE timeframe looks out of the question, a small change in communication is not to be excluded. Indeed, from the minutes of the December meeting, it transpired that *"the view was widely shared among members that the Governing Council's communication would need to evolve gradually, without a change in sequencing, if the economy continued to expand and inflation converged further towards the Governing Council's aim"*. We still expect a short lengthening of the asset purchase program until December 2018, to allow some further tapering. While net asset purchases will definitely have ended at the start of 2019, a first rate hike might have to await the summer of 2019.

## Excess liquidity likely to increase further



Source: Thomson Reuters

## Excess liquidity

On the back of the ECB's QE program excess liquidity is likely to hit €2000 billion in the course of 2018 and start only to decline very slowly in 2019. As the enormous excess liquidity keeps money market rates close to the ECB's deposit rate, they will most probably remain in negative territory until the summer of 2019. As for bond yields, we believe the QE program will limit the upward shock on yields. However, some contagion effect from higher US yields and the expectations that in 2019 net purchases from the ECB will end is likely to result in a gradual upward trend.

## Eurozone economy in a nutshell (%YoY)

	2016	2017F	2018F	2019F
GDP	1.8	2.4	2.4	1.8
Private consumption	2.0	1.9	2.2	1.9
Investment	4.5	4.0	3.9	2.0
Government consumption	1.7	1.1	1.3	1.3
Net trade contribution	-0.5	0.2	0.0	0.0
Headline CPI	0.3	1.5	1.5	1.7
Budget balance (% GDP)	-1.5	-1.3	-1.2	-1.0
Refi rate (eop)	0.0	0.0	0.0	0.25
10yr Bund (eop)	0.30	0.42	0.75	1.10

Source: Thomson Reuters, all forecasts ING estimates

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