Economics

DBS Flash

European Central Bank turns a dovish hue

DBS Group Research | 8 March 2019

Radhika Rao
Economist

Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@dbs.com

- *The European Central Bank's policy has taken a dovish turn*
- *GDP growth and inflation forecasts have been cut to underscore concerns over the outlook*
- *A fresh round of funding, two-year TLTROs, have been rolled out, while QE reinvestments will continue for an extended period*
- *Rates will be on hold for rest of the year, along our expectations*
- *While policymakers prefer to stay ahead-of-the-curve, a severe downturn in second half of the year could require new measures*
- *This dovish turn pushed EUR/USD decisively below the pre-normalisation trading range. We maintain our negative view on the euro.*

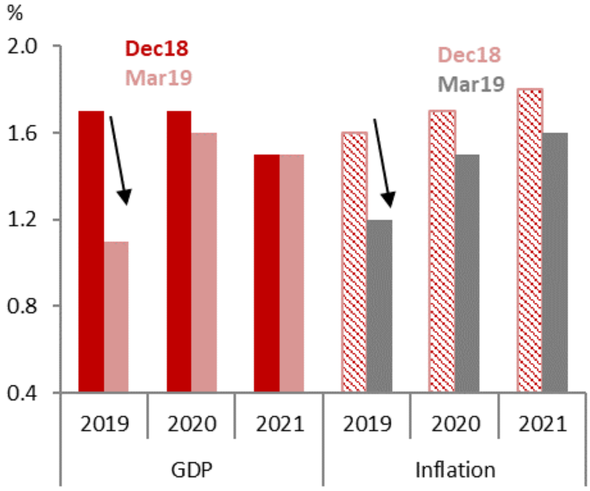
The European Central Bank (ECB) caught up with the economy's evolving reality of slowing growth and easing inflation. With growth falling below the post-quantitative easing quarters and inflation likely to follow suit, the central bank opted to frontload measures. Importantly this contrasts with the decision to cease QE two months back.

The ECB's tone was cautious. They expressed fears that the economy might remain stuck in a "period of continuous weakness and pervasive uncertainty" this year. Staff GDP forecasts were cut sharply – growth is now seen at 1.1% in 2019, 1.6% in 2020 and 1.5% in 2021. This compares to December's outlook for growth at 1.7% in 2019 and 2020. They retained the guidance that risks to the growth outlook are "still tilted to the downside", owing to geopolitical uncertainties (including Brexit), protectionist threats and slowing emerging markets.

Despite this, the ECB holds on to expectations that the slowdown will be temporary and improve in 2H19, pointing to a strong labour market, better loan growth, higher fiscal spending and easing domestic idiosyncratic factors, that particularly hurt German industrial activity last year.

Inflation forecasts were also lowered – now seen at 1.2% in 2019, 1.5% in 2020 and 1.6% in 2021. This compares with 1.6% for 2019 and 1.7% for 2020 in December. Core inflation forecasts were lowered by 20bps across this year and next. A concurrent revision in underlying oil price assumptions also underscored their benign view on cost-push forces. This inflation outlook suggests that the ECB expects inflation to remain below the 2% target even in the medium-term.

ECB staff projections - Growth and inflation lowered



Source: ECB, DBS Group Research

This cautious economic assessment was accompanied by four measures, few new while others reaffirmed their policy bias.

- The forward guidance on rates was changed to "interest rates will remain at their present levels at least through end-2019", from the earlier "through the summer of 2019". Separately, the ECB chief suggested that few of the Council members backed a pause into March 2020

- ECB will continue to reinvest proceeds of bonds maturing under the just-concluded QE program, "in full" and "for an extended period of time".

- **New round of Targeted Longer-term Refinancing Operations (TLTROs-III)** were unveiled, starting in September 2019 and ending in March 2021. These will be rolled out quarterly, based on the main refinance rate (not the deposit facility rate) and with a two-year maturity. Further details will be announced closer to the date. These will help preserve favourable lending conditions and ensure transmission of an accommodative monetary policy. The previous two rounds of TLTROs were announced in 2014 and 2016.

- The existing ECB lending operations will continue as fixed rate tender procedures with full allotment at least until March 2021.

Policy outlook: Yesterday's measures were not a big surprise, but the timing of the announcement was. The decision to be ahead-of-the-curve was likely a step to reverse any unwarranted tightening in financial conditions. Policy normalisation plans are on ice (see here), with no rate hikes likely beyond the ECB President Draghi departure from office in 4Q this year. In fact, this marks the only instance when the head of the central bank ends his tenure without any rate hikes.

While the funding support might cap any increase in funding costs, it does not alleviate the main risks for the Eurozone outlook, i.e. external developments – overhang of US auto tariffs, slowing global growth particularly in China, and Brexit developments. This also suggests that any severe downturn in the second half of the year might necessitate new and unexplored policy responses.

The ECB's dovish turn pushed the EUR/USD decisively below the pre-normalisation trading range of 1.15-1.25, along the expectations of the DBS Currency FX Strategist. The next target at 1.10 beckons.

Group Research

Economics & Strategy

Taimur Baig, Ph.D.
Chief Economist - G3 & Asia
+65 6878-9548 taimurbaig@dbs.com

Nathan Chow
Strategist - China & Hong Kong
+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.
Economist – Indonesia & Philippines
+62 21 2988-4003 masyita@dbs.com

Joanne Goh
Regional equity strategist
+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan
Credit Strategist
+65 6878-2072 neelg@dbs.com

Eugene Leow
Rates Strategist - G3 & Asia
+65 6878-2842 eugeneleow@dbs.com

Chris Leung
Economist - China & Hong Kong
+852 3668-5694 chrisleung@dbs.com

Ma Tieying
Economist - Japan, South Korea, & Taiwan
+65 6878-2408 matieying@dbs.com

Radhika Rao
Economist – Eurozone, India & Thailand
+65 6878-5282 radhikarao@dbs.com

Irvin Seah
Economist - Singapore, Malaysia, & Vietnam
+65 6878-6727 irvinseah@dbs.com

Duncan Tan
FX & Rates Strategist - ASEAN
+65 6878-2140 duncantan@dbs.com

Samuel Tse
Economist - China & Hong Kong
+852 3668-5694 samueltse@dbs.com

Philip Wee
FX Strategist - G3 & Asia
+65 6878-4033 philipwee@dbs.com

Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).