DBS Flash

ECB is dovish but keeping its powder dry

DBS Group Research

April 11, 2019

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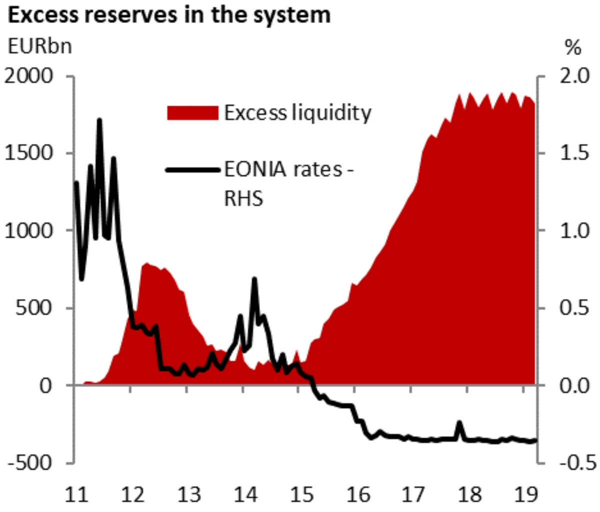
- *The European Central Bank retained its cautious guidance on April 10*
- *Details on the TLTRO III are pending; we expect an announcement in June*
- *The ECB is keeping its powder dry. No fresh measures were announced but there were assurances of its sufficient policy firepower*
- *The ECB is considering supporting the banking sector via a tiered deposit facility. In our view, a decision is not imminent*
- *Sentiment indices in the Eurozone have stabilized but hard data have remained weak*
- *Brexit uncertainties will persist from a second delay in UK's from the EU to October*
- *The risk of fresh US tariffs on EU goods may be around the corner*
- ***Implication for our forecasts:** No change to our forecasts for growth and inflation to slow to 1.2% in 2019*
- ***Implications for investors:** ECB's bias to pause in 2019-20 will not only suppress EU and German bond yields against their higher US peers, but also weigh on EUR*

The European Central Bank (ECB) reiterated that policy will be accommodative "at least through the end of 2019". Markets have priced out rate hikes and any kind of policy changes well past first half of next year, which we reckon may be extended well past end-2020. The ECB's assessment of economic conditions was unchanged from March, when inflation and growth projections were lowered sharply. This week, the IMF joined other multilateral agencies in lowering its growth forecasts for an EU economy facing intra and external challenges.

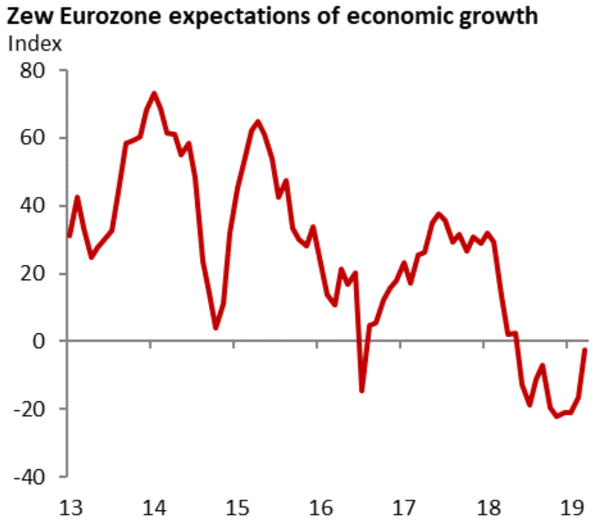
Two interesting issues emerged at the meeting, but clarity was lacking.

Firstly, the ECB will announce details on the Targeted Longer-term Refinancing Operations (TLTROs-III) at a "forthcoming meeting". We believe that the this will take place at the June meeting when it releases the next set of staff projections. TLTROs-III is scheduled to start in September 2019 and end in March 2021. Each TLTRO III will be rolled out quarterly with a two-year maturity based on the main refinance rate (and not the deposit facility rate). Besides helping to preserve favourable lending conditions, this will ensure transmission of an accommodative monetary policy. The ECB's latest bank lending data saw demand for loans from businesses weaken at the start of 2019, just as consumer credit rose by the slowest pace since in over five years, signalling need for some relief.

Secondly, the ECB is studying a proposal to introduce a tiered deposit rate mechanism to address the adverse effects of negative deposit rates (currently at -0.4%) on the banking sector and savers. Excess reserves in the system have risen sharply in past few years owing to QE (see chart), and together with negative rates, have led banks to pay for some of their excess cash parked at the ECB. A tiered system is meant to exempt banks from paying the central bank and result in net savings for banks. This measure, if perceived as a signal for rates to remain low for an extended period, could weigh on European markets.



Source: ECB, Bloomberg, DBS Group Research



Source: CEIC, DBS Group Research

We are unconvinced that the move to a tiered deposit system is imminent. The Governing Council members are divided on the urgency and effectiveness of such a measure to mitigate the impact of negative rates. Concurrently, the authorities might prefer to keep their powder dry and introduce this measure to defend against further deterioration in the outlook later this year, when fresh and unexplored policy responses will be needed.

ECB has turned dovish

Eurozone sentiment indices may have started to stabilize (see chart). Zew expectations for growth came in at -2.5 in March, significantly less worrisome than the -21 to -22 readings in November-January. Sentiment was lifted by a dovish tilt in the Fed's stance, signs of progress towards a US-China trade deal and a stabilisation in regional PMIs.

Hard data, however, have yet to affirm a sustainable revival, particularly for production and retail. The factors that depressed factory activity in 2H18 are temporary and should start to fade from 2Q19. Businesses are, however, likely to remain guarded, especially the threat of fresh US tariffs on the EU goods.

Apart from data, the ECB will also keep an eye on three external risks to the Eurozone's fragile outlook – prolonged Brexit uncertainties, renewed trade tensions with the US, and the risk of a US-China trade deal (if any or delayed) that falls short of expectations.

Brexit remains a risk. Brussels has acceded a second delay in UK's exit from the EU to October from April 12. This by no means provides any assurance for UK Prime Minister May and cross-party factions to agree on any resolution including the withdrawal plan. The EU may attach pre-conditions such as the UK needing to adhere to EU rules in the interim, no change or reopening of talks pertaining to the withdrawal agreement, and no escape clause for the UK to leave early if a deal is approved (currently a low probability outcome). **While the risk of a no-deal Brexit cannot be totally dismissed, the odds of further delays remains high.**

The US has revived threats of fresh tariffs in response to EU's alleged subsidies to its largest aerospace and defence company. The White House is considering levying tariffs on USD11bn worth imports from the EU (vs annual 2018: USD215bn), which includes food products, aeroplanes e.t.c. Trump has until May, 90 days after the review in February, to decide whether to hit up to 25% tariffs on foreign-made autos and car parts. Germany is concerned because the US is the largest export market for its auto industry.

Finally, high-level talks between the US-China delegations have been ongoing but inconclusive. While a deal is tentatively set for late-April, markets have been sceptical on the terms of any bilateral agreement and whether existing tariffs will be rolled back. Resolving contentious areas such as intellectual property rights, markets access, technology/knowledge transfer e.t.c. will also be challenging for both countries seeking economic and political mileage from these discussions.

No monetary policy stabilization before 2020

With hard data still to show signs of a turnaround, challenging global backdrop, threat of fresh tariffs and a tricky political backdrop drop suggest that the ECB is likely to maintain a dovish bent this year and next. Efforts will be underway to reverse any unwarranted tightening in financial conditions while keeping policy normalisation plans on ice. ECB President Draghi is set to leave office in October with a legacy of ending his tenure without any rate hikes.

Implication for our forecasts: We maintain our forecast for growth and inflation to slow to 1.2% in 2019 (see here and here).

Implications for investors: The ECB is expected to stay on pause in 2019-20, suppressing Eurozone and German bond yields. EUR's price action is likely to reflect the negative EZ and US rate differentials. As our FX Strategist noted in the Macro Strategy dated April 8, 2019, "*As the largest component in the DXY Index, the weak euro has been a key reason why the US dollar has held up well against the Fed's extended pause and US President Trump's push for easing.*" The ECB's dovish tilt will keep EUR/USD below the pre-normalisation trading range of 1.15-1.25, along the expectations of the DBS Currency FX Strategist.

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