Daily Note

DRAGHI BADLY BOXED IN

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- **ECB will end QE this month but revises growth forecasts lower again**
- **EA expansion is slowing; Germany and Italy could be in recession**
- **Draghi drops more hints of further (T)LTROs**
- **Enhanced forward guidance on reinvestment adds limited value**
- **But ample reinvestment flexibility may ease pressure on BTPs for now**

A badly timed QE exit. The ECB will end its €2.6trn asset purchase programme (APP) this month, as expected. The central bank reiterated that its policy rates will stay at their present levels at least through the summer of 2019. But the exit from QE comes at a particularly difficult time. The pace of EA euro zone expansion has slowed meaningfully this year. Real GDP contracted in Germany and Italy last quarter. The risk of a technical recession is significant in both economies. The PMIs released this morning deteriorated further. Protectionism worries have eased for now, but a renewed heightening of trade tensions cannot be dismissed. Even without an increase in protectionism, global growth is likely to ease further, led by a slowdown in emerging markets.

Slowing expansion and growing divergences. The euro zone could also come under greater competitive pressure as a result of yuan and EM FX depreciation and some weakness in the dollar. Any rise in the trade-weighted euro is particularly damaging for Italy because of its poor productivity. We have written before that the central bank's growth projections looked optimistic. In the new staff forecasts released yesterday, the ECB revised down real GDP expectations for this year and next by 0.1pp to 1.9% and 1.7% respectively. The staff expects the 1.7% rate to be maintained in 2020, but growth to slow to 1.5% in 2021. We think there could be more downgrades to come.

Capex and exports a big drag on growth. Projections for fixed investment were revised sharply lower – partially due to idiosyncratic factors, but largely because of continued policy uncertainty and weaker foreign demand. The ECB also scaled back its forecast for exports following another downgrade of global growth expectations until 2020. On the positive side, lower oil prices will give real disposable income and private consumption a modest boost.

But the risk is that a maturing growth cycle and slowing world growth may create a profitability squeeze which could force firms to further rein in their capex and hiring plans. The pressure is already evident. For instance, in the new projections, the forecasts for compensation per employee have been cut for 2019-20. Also, during the press conference, ECB President Mario Draghi noted that while a large share of SMEs reported higher turnover, the percentage of firms indicating increasing profits declined.

Risks to growth: broadly balanced or not? The central bank still sees the risks surrounding the EA growth outlook as broadly balanced. But it also warns that the balance 'is moving to the downside' due to uncertainties associated with geopolitical factors, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility.

Separately, the ECB 'enhanced' its forward guidance on reinvestment. The ECB will continue reinvesting the principal payments from maturing securities purchased under the APP for an extended period of time past the date when it starts raising its key interest rate. Francois Villeroy de Galhau, the governor of the Bank of France hinted at the tweak last month. We think this enhanced forward guidance is of limited value if we go by the Fed's timeline for normalising policy. The Fed ended QE in November 2014, but carried on reinvesting until September 2017. The Fed raised its policy rate for the first time in the current cycle in December 2015. Besides, there is a lot of ambiguity about what the ECB means by 'extended period'.

More ambiguity than clarity on reinvestment details. The central bank provided some clarifications on the technical parameters of the reinvestment programme. The reinvestments will be made according to the revised capital key and will apply to the stock of asset purchases. We have highlighted that the new capital key makes the ECB QE even more lop-sided. For instance, it raises the amount of Bunds that the central bank could buy while further reducing BTPs that it is allowed to purchase. As it is, the Eurosystem has bought €16bn worth of Italian assets in excess of what the capital key would indicate, implying constraints on how much Italian debt it could purchase in future, even if it were to adhere to the *old* capital key. Thus, the reinvestment parameters at the outset could imply greater pressure on BTPs.

But in typical ECB fashion, the details it made public seek to ease this concern, at least in the short term. The central bank appears to have given itself ample flexibility on how to reinvest to bring it into 'closer alignment' with the new capital key. Specifically, it notes that 'limited temporary deviations in the overall size and composition of the APP may occur during the reinvestment for operational reasons'. Additionally, 'any adjustment to the portfolio allocation across jurisdictions will be gradual and will be calibrated as appropriate to safeguard orderly market conditions'.

Some form of TLTRO increasingly likely. We have been making the case that the ECB could announce another round of (T)LTROs or at least extend the maturity of outstanding TLTROs. If the ECB does not act, Italian lenders in particular will face significant liquidity constraints from mid-2019 onward. In his press conference after the meeting, Mario Draghi dropped more hints to this effect. He said *some* (versus *two* in the last press conference) Governing Council members had mentioned TLTROs and that the ECB is reflecting on using this tool to maintain accommodative financing conditions.

The Draghi dilemma. Draghi sought to exude confidence in the euro area growth outlook to justify ending QE. At the same time, however, he drew attention to mounting risks that might necessitate recourse to more policy tools (including TLTROs) to smooth the exit. Much of the ECB's problem arises from over-reliance by the EA on monetary stimulus to offset weakness (see today's Europe Watch for more details). In the absence of a meaningful fiscal boost, especially in Germany and Italy and given the (self-imposed) constraints on its bond-buying scheme, the ECB's options are quite limited at this point. Perhaps, Draghi should have declared victory much earlier in the cycle.