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The Aerial View

Morning Briefing

The ECB's Challenge

- **Germany’s neighbours have finally responded to monetary policy extremes**
- **Low inflation will stay the ECB's hand - for the moment**
- **We doubt Italy has been displaced from its prime spot on the list of concerns**

The fact that Germany is keen for the ECB to hasten the pace of policy normalisation requires little elaboration. Suffice to say that the Bundesbank believes Germany’s trend rate will be far outpaced this year. Meanwhile, Germany’s neighbours have finally responded to monetary policy extremes that have seen the ECB’s balance sheet swell to over 40% of GDP (viz the Fed’s 23%).

IHS Markit calculates that Euro-zone GDP growth may have reached 0.8% q/q in Q4, which, it said, “would round off the best year in a decade”. Hence, the fact that the Euro-zone has come along in leaps and bounds this past year may see Germany enjoy a little more support in the hawks’ camp.

Neil Mellor
Senior Currency Strategist,
BNY Mellon

Email >

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> ***An inflation overshoot must be Mr Draghi's preferred risk when growth has been bought at such cost***

For the moment, the fact that aggregate Euro-zone inflation (which fell to 1.4% y/y in December from 1.5%) has yet to respond to this improved performance will stay the ECB's hand: as we have argued, an inflation overshoot must be Mr Draghi's preferred risk when growth has been bought at such cost. Moreover, equanimity would be better served by a stronger consensus than that which made for a somewhat fraught October Council meeting – an important consideration, perhaps, in view of what is at stake.

Indeed, while Mr Draghi has issued not-so-subtle warnings that those countries which have shunned reforms may be found out once normalisation gets underway, we doubt that Italy has been displaced from its prime spot on what is his likely list of concerns. Current polls suggest that the more extreme Eurosceptic parties may well be kept from power come March; but even so, no executive will be in a position to offer a swift remedy to the structural issues blighting the economy.

> ***The Italian government faces the prospect of rolling over bonds at a rather sizable premium***

Certainly, Italy has been on the mend - thirteen consecutive quarters of growth has made serious inroads into the country's bad loans. But falling from record highs, the latter remain high nonetheless, which makes for an inauspicious starting-point for any policy normalisation – particularly in an economy with over a tenth of its workforce unemployed (one third for youth) and with a debt-to-GDP ratio of 130%.

Moreover, given that the ECB has effectively funded the country's budget in recent years (buying EUR 319 Bn of Italian debt), the Italian government faces the prospect of rolling over bonds in a market whose limited contingent might

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On the Radar

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• EZ Jan Sentix index (0930 GMT)

• EZ Nov retail sales (1000 GMT)

• EZ Dec EC economic sentiment (1000 GMT)

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understandably demand a rather sizeable premium.

Suffice to say, this will be a challenge. Indeed, recall that ECB chief economist Peter Praet told Der Spiegel in June that Italy would be on its own if APP tapering led to a rise in its debt spreads. But then, in view of the risks that this would entail, is it reasonable to assume that the ECB would simply stand by? This possible dilemma appears to encapsulate some of the risks facing the ECB amid a steady improvement in fundamental that its loose policy settings are encouraging.

Please direct questions or comments to:

AerialView@BNYMellon.com
