Economics Group

Special Commentary

Making Substantial Changes to Our ECB Views

Executive Summary

- ECB President Draghi made clear in comments today that the ECB is likely to ease policy relatively soon if the economic situation in the Eurozone does not improve.
- In light of these comments, and considering recent economic developments and past policy actions from the ECB, we now expect the ECB to cut its deposit rate and main refinancing rate 10 bps to -0.50% and -0.10%, respectively, in September. We also expect a change in forward guidance on interest rates.
- We do not expect the central bank to restart asset purchases at this time, although a further deterioration in growth and inflation outcomes could change that view.

Draghi Offers Freshly Minted Dovish Comments

The underwhelming performance of the Eurozone economy has been a source of concern for monetary policymakers at the European Central Bank (ECB) for some time. Economic growth has been sluggish, with GDP growth of just 1.2% year-over-year through Q1-2019. On the price front, CPI inflation has struggled to get anywhere close to the central bank’s inflation target of “close to, but below” 2%, and indeed the core CPI inflation rate has dipped below a 1% year-over-year pace on multiple occasions over the past several months. While we—and the ECB—expect economic growth to continue, we believe the downside risks for both growth and inflation have become more prominent. It is against this backdrop that ECB President Draghi delivered some critical comments in a seminal speech at the ECB’s Forum on Central Banking in Sintra, Portugal today, which we believe have significant implications for the path of ECB monetary policy moving forward.

In his recapping of the ECB monetary policy experience of the past twenty years, as well as the current situation, Draghi noted that while there has been a successful transmission of monetary policy to financing conditions and the GDP and employment, “the final legs of the transmission process to wages and inflation have been slower than we expected.” And while noting that wage growth is now strengthening as labor market slack lessens, Draghi also noted that “the pass-through from wages to prices remains weak.” In this context and referring to the economic outlook and economic trends, Draghi stated:

“In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required.”

Mr. Draghi’s comments are particularly important in that, in contrast to the most recent ECB commentary, it now puts the onus on the economic data to improve to avoid further monetary policy easing. What then could represent that type of improvement? Simply looking at the ECB’s growth and inflation forecasts, one measure of improvement might be whether there are upside GDP growth surprises (for reference, the ECB’s staff projections forecast quarterly growth of 0.2% in Q2, 0.3% in Q3 and 0.4% in Q4), along with a sustained firming in underlying inflation trends.

Another perspective, however, is to consider the ECB’s monetary policy easing reaction function over the past several years. Although the ECB has a sole inflation mandate, and thus price trends appear to be most influential in prompting monetary policy moves, Eurozone growth conditions

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are also relevant. To capture both, we examine trends in the Eurozone Composite PMI as well as the Eurozone core CPI through most of this decade (Figure 1).

**Figure 1**

![Eurozone Composite PMI and Core CPI Index, Year-over-Year Percent Change 3-MMA](chart)

**Composite PMI: May @ 51.8 (Left Axis)**

**Core CPI: May @ 0.9% (Right Axis)**

**Source: Datastream and Wells Fargo Securities**

The ECB has in fact spent most of the current decade easing monetary policy through a variety of measures (policy interest rate cuts, negative policy interest rates, quantitative easing, an accelerated pace of quantitative easing and its targeted long-term lending programs), while the periods of monetary policy stability have been somewhat briefer. The key periods when the ECB was easing monetary policy in some form were:

- **Mid-2011 to early 2015**: The ECB implemented multiple rate cuts, eventually taking its deposit rate into negative territory, and initiated its quantitative easing program in early 2015.

- **Early 2016 to Q1 2017**: The ECB cut its deposit rate further, as well as accelerating the pace of its monthly asset purchases to €80 billion from €60 billion.

There have been no decisive easing actions from the ECB since Q2-2017, with the central bank initially trimming its asset purchases through the latter part of 2017, and subsequently tapering and eventually finishing its net asset purchases by the end of 2018.

Looking at the periods when the ECB was easing monetary policy (2011 to early 2015, and 2016), we note that one of two conditions typically prompted and contributed to those easing moves:

- The Eurozone economy was in recession or, alternatively, the composite PMI was substantially below the breakeven 50 level.

- The trend of core CPI inflation (three-month average of year-over-year inflation) was perceptibly below 1%.

Accordingly our rule of thumb for the ECB’s monetary policy easing reaction function over the past several years is:

**ECB monetary policy easing typically occurs when the Eurozone composite PMI is substantially below 50, OR the trend of core CPI inflation is perceptibly below 1%.

In our view, for there to be “improvement” that would dissuade the ECB from easing further, both of the above conditions would need to be avoided. At the current juncture, we see little prospect of any significant firming in the composite PMI or core CPI by the time of the next ECB monetary policy meetings, in July and September. Although the composite PMI may still be in growth territory, the trend of core CPI inflation could still be below 1%, and indeed we think ECB policymakers perceive there to be a real risk of core CPI inflation slowing further from current levels. Accordingly, we now view additional ECB monetary policy easing as the most likely scenario, the timing and method of which we outline in greater detail below.
From the Bottom, Looking...Down?
The ECB has a few options in its policy toolkit, as highlighted by recent speeches from Draghi and other key policymakers, including rate cuts, changes to forward guidance and asset purchases (i.e., quantitative easing). As we will discuss over the course of this section, we think the most likely course of action for the ECB will be to cut interest rates and change forward guidance, but we do not currently expect renewed asset purchases.

Recent media reports have explicitly suggested that ECB officials anticipate using rate cuts as the first-order method of stimulus, but there are quite a few options in terms of the timing and nature of rate cuts. In terms of timing, we think September makes the most sense for a rate cut for a few reasons. First, it gives the central bank a few weeks to digest the market reaction to its recent communications, and also allows it to assess the outcome of potential U.S.-China trade talks at next week’s G20 summit. If the ECB still feels that action is warranted by the time its July meeting comes, it can then signal that a policy move will likely come at the September meeting, which notably features updated ECB economic projections. In recent history, the ECB has tended to make its most significant policy decisions in meetings accompanied by economic projections. As of now, we do not think the economic situation in the Eurozone is dire enough to warrant immediate policy action (i.e., in July), although this week’s Eurozone PMIs and next week’s CPI figures will be especially important to watch for further clues on the potential timing of any ECB policy action.

In terms of the nature of rate cuts, we think the ECB will cut its deposit rate and main refinancing rate (MRO rate) 10 bps to -0.50% and -0.10%, respectively, in September. The deposit rate has for the most part served as the most important ECB policy rate given the substantial amount of excess liquidity in the Eurozone financial system, and thus markets will probably be most focused on what changes, if any, the ECB makes to the deposit rate. However, the MRO rate is also important, particularly now that the new round of targeted long-term refinancing operations (TLTROs) will be offered at a floating rate indexed to the MRO rate over the life of those loans. Thus, any cuts to the MRO rate should reduce the rates offered on TLTROs, effectively making monetary policy more accommodative.

We do not expect the central bank to introduce a tiering system to mitigate the impact of negative interest rates on the commercial banking sector, but admit that it is a relatively close call and we will be closely monitoring any comments on the topic ahead of and during the July policy announcement. Finally, we would also expect the ECB to adjust its forward guidance, which currently states that rates will remain at present levels through H1-2020. In our view, this language could become less time-contingent (“at present levels for an extended period,” for example), and could also be modified to include the possibility of lower interest rates (“at present levels or lower”).

Asset purchases are another means through which the ECB could ease monetary policy. In recent commentary, ECB President Draghi stated that there was “considerable headroom” for renewed asset purchases. However, existing issuer limits prevent the ECB from purchasing more than 33% of any Eurozone sovereign’s total stock of government debt eligible for purchase under the public sector purchase program (PSPP). According to our calculations, the ECB already owns roughly 30% of the eligible stock of German government bonds, suggesting there is limited room to expand purchases with the current issuer limits in place. If the ECB seeks to restart asset purchases, it will likely need to raise this issuer limit—perhaps to 50%—which we suspect will be met with significant political resistance. In any case, we do not expect the ECB to restart its asset purchases at this time. That view could change if we start to see a more significant deterioration in actual core CPI inflation outcomes in the months ahead.
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