S&P Global Ratings

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Economic Research:

ECB: Back To The Future?

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Key Takeaways

- We expect the ECB to switch back to easing mode at its meeting next week and open the door for an easing package in September, as uncertainty remains and the economy continues to muddle through external weakness.
- All options remain on the table for the September meeting: We expect the ECB to cut the deposit rate by 10 basis points and potentially resume net asset purchases by €15 billion a month in October.

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Uncertainty and downside risks to growth continue to undermine convergence to the ECB's policy targets

As uncertainty and downside risks to growth persist and market-based inflation expectations point south, S&P Global Ratings expects the European Central Bank to switch back to an easing bias in July and decide on a new round of monetary policy stimulus in September. The minutes of the ECB's June monetary policy meeting released last week reiterated the dovish tone heard in President Mario Draghi's Sintra speech by saying that in the face of uncertainty, the Governing Council stands "ready and prepared to ease the monetary policy stance further by adjusting all of its instruments."

Since the meeting, the landscape has not cleared. The European economy is still evolving at low gear and two speeds, with robust service activity on the one side but no obvious recovery in manufacturing on the other (for details, see "Eurozone Economic Snapshots: A Two-Speed Economy"). Although the French and Spanish economies are holding up well, while less reliant on subdued Chinese demand and probably boosted by structural improvements, the German and Italian economies continue to hover close to recessionary territory. At this stage, there is more risk that weakness in the manufacturing sector is being transmitted to the service sector than the other way around. The persistence of several external risks (Brexit, U.S.-China trade, Iran, U.S. tariffs on European cars, the Chinese slowdown) is becoming a risk of its own. If anything, this context suggests we could see more downward revisions to growth and inflation forecasts this year.

Meanwhile, even if nonmarket-based inflation expectations look less worrying than market-based inflation, we believe the ECB cannot be complacent about price developments in the eurozone. Energy prices are not the only driver of the current "lowflation." About 50% of the items in the ECB's Harmonised Index of Consumer Prices are increasing at a pace inferior to 1%. The price of non-energy industrial goods is barely increasing (0.2% year on year in June) with the price of durable goods receding once again. At 1.6% growth year on year, the price for services is more in line with the ECB target, but communication services are pulling them down, and rising unit labor costs are not prompting a rise in consumer prices.

Looking at inflation and growth expectations for next year, we find that the "Orphanides rule"—a simple symmetric interest rate rule for monetary policy that the ECB uses--points to a rate cut of around 20 to 30 basis points (see table 1), whether we look at the market's, the ECB's, or our forecasts.

Table 1

The Orphanides Rule Points To A Rate Cut Of 20 To 30 Basis Points

2020 expectations	GDP	CPI	GDP gap	CPI gap	Interest rate change
Consensus forecast	1.30	1.40	-0.15	-0.40	-0.28
ECB forecast	1.40	1.40	-0.05	-0.40	-0.23
S&P Global Ratings forecast	1.30	1.30	-0.15	-0.50	-0.33

Sources: ECB, Bloomberg, S&P Global Ratings.

The current policy rate (the deposit rate) is already in negative territory, and the ECB faces an effective lower bound at zero because of the possibility that households can convert large amounts of deposits into zero interest-bearing cash (see charts 1 and 2). Nonetheless, we think the ECB has room to cut the deposit rate further by at least 10 basis points. Its negative interest rate policy works and is gaining traction via corporate deposits, which cannot be easily converted in cash, as a recent paper shows (see ECB working paper No. 2289: "Is there a zero lower bound? The effects of negative policy rates on banks and firms").

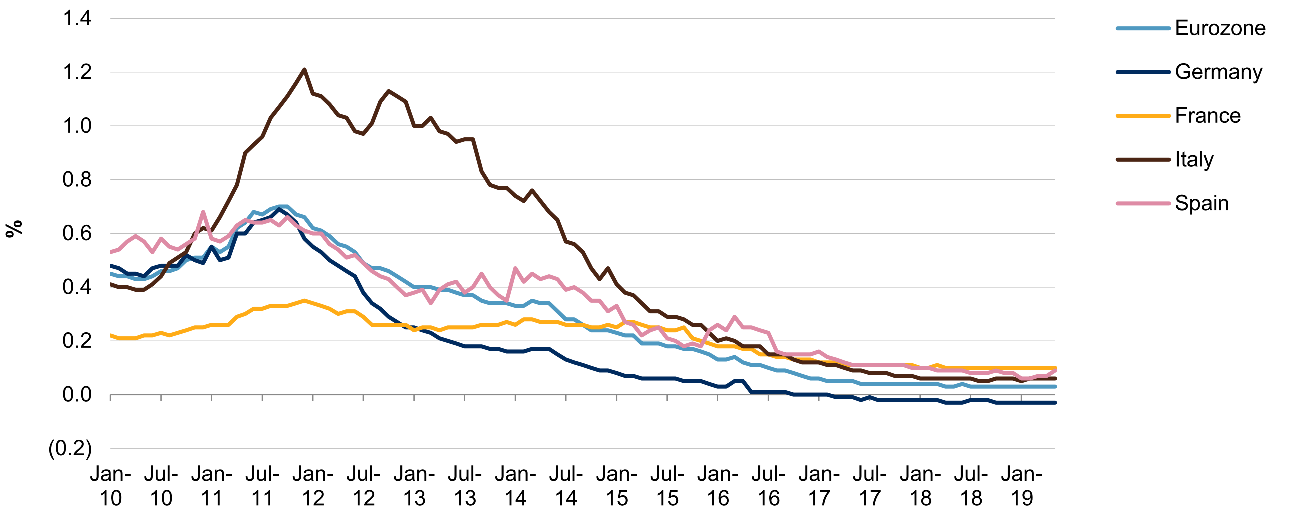
What's more, the past few years have shown that the ECB has other efficient tools at its disposal, and that combining all instruments is the most efficient way to loosen monetary policy. In a recent speech, the ECB's chief economist Philip Lane has shown that the central bank's nonstandard measures (targeted longer-term refinancing operations, quantitative easing, negative rates, and forward guidance) have added 0.8 percentage point to GDP growth and 0.3 percentage point to inflation in 2018.

Mr. Lane's speech even shows that the ECB's net asset purchase program has been more powerful than negative rates in stimulating growth and inflation. Granted, the ECB has set itself a limit of buying no more than 33% of a country's debt issuance so as not to have a veto power in the case of a debt restructuring. The ECB is close to reaching this limit for countries like Germany and the Netherlands, but this is a legal and political issue, not an absolute limit.

The effect of the ECB's asset purchase program on the yield curve also seems to be strong and not vanishing rapidly (see ECB working paper No. 2293: "Tracing the impact of the ECB's asset purchase programme on the yield curve"). According to this paper, the current stock of assets on the ECB's balance sheet was compressing the 10-year term premium by 95 basis points at the end of 2018.

Chart 1

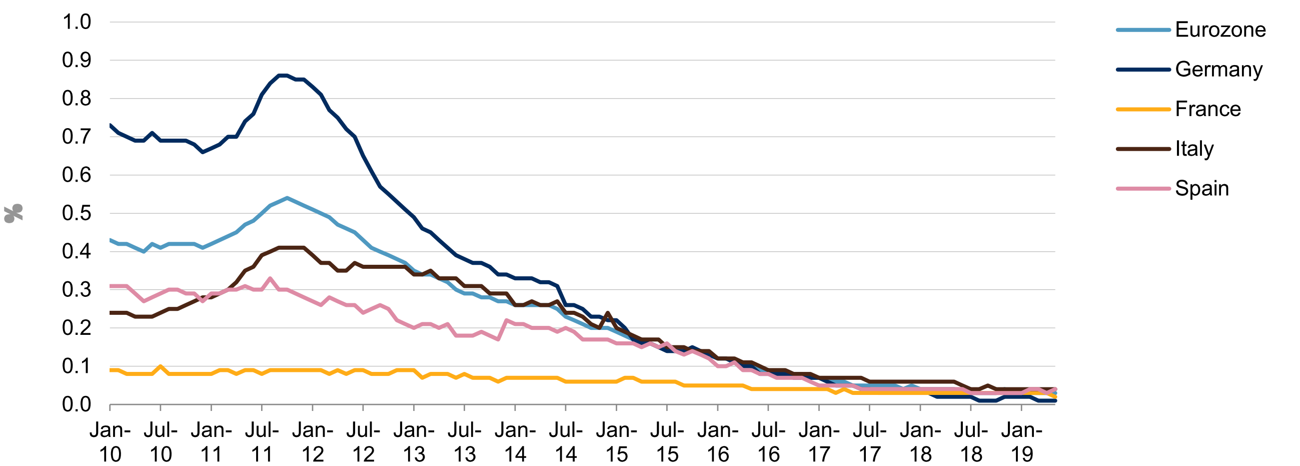
Eurozone Banks Have Lowered Their Interest Rate On Overnight Deposits Close To 0% As Interest Rates Have Turned Negative
Nonfinancial corporates: Bank interest rates on overnight deposits



Sources: ECB, S&P Global Ratings.

Chart 2

Households: Banks Interest Rates On Overnight Deposits



Sources: ECB, S&P Global Ratings.

The ECB is set to prepare another policy package for September

We think all of the options mentioned above remain on the table for the ECB to deliver price stability. We expect the central bank to adjust its forward guidance, reopening the door to a rate cut at the July monetary policy council (next week), even though such a bias was removed from the introductory statement in June 2017. The ECB is likely to say it expects interest rates to remain at the current or lower level until the end of 2020. The ECB will likely have to lengthen the time leg of the forward guidance once again in the future, given the slow development of the eurozone economy. A downward bias would allow the ECB to cut rates as soon as September 2019, if the euro strengthens on looser policy by the U.S. Federal Reserve System, market-based inflation expectations do not increase markedly from their current lows, and the ECB's staff projections for growth and inflation are lower in September. The question of tiering deposit rates for banks' excess reserves is still open.

While a relaunch of quantitative easing in the sense of a resumption of asset purchases seems premature for July, we think the ECB could announce a "reassessment" of the program in July and potentially announce at the September meeting that it will resume asset purchases by €15 billion a month from October. Given subdued price developments and persistent external risks, the ECB cannot be complacent. It probably has to unveil a powerful package in July. The ECB might even surprise us with more unconventional measures. In any case, we do not expect the ECB to be able to raise rates at least until the second quarter of 2021.