December 09, 2016

Economics Group

Special Commentary

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ECB Maintains Accommodative Policy Stance

The main event of the week turned out to be the regularly-scheduled policy meeting that was held at the European Central Bank (ECB) on Thursday. Although there were some mixed moves by the Governing Council of the ECB, the outcome was, on balance, dovish. Moreover, the Governing Council indicated that it is prepared to ease policy further, if necessary.

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Figure 1

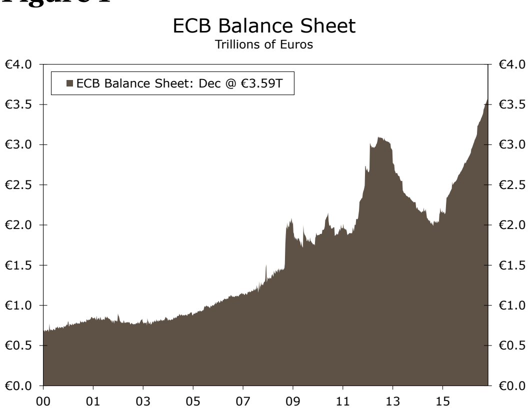
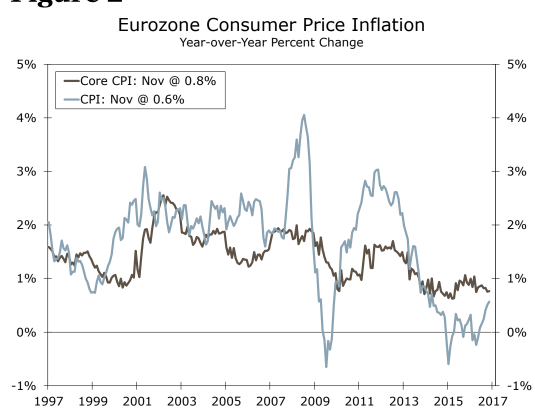


Figure 2



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

The ECB has been buying assets (mostly government bonds) from the private sector for nearly two years with its recent pace of purchases totaling €80 billion per month. This quantitative easing (QE) program has led to a marked increase in the size of the ECB's balance sheet over the past two years (Figure 1). The ECB's QE program was set to expire in March 2017, so most analysts had looked for some sort of decision on Thursday regarding the longevity of the QE program. In the event, the Governing Council announced that it would dial back its purchase rate to €60 billion per month starting in April 2017. This decision surprised most analysts because they had not expected the ECB to announce a "tapering" in its monthly purchase rate just yet.

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However, the Governing Council also said that it would extend its QE program through December 2017, which was longer than most analysts had expected. In addition, the ECB indicated that it was willing to ease policy further in the future if progress toward its inflation goal was not met. The reaction in the currency market, in which the euro depreciated sharply in the immediate aftermath of the announcement, suggests that most investors view the ECB's actions as dovish on balance.

The overall rate of CPI inflation has edged up recently, but remains well below the ECB's target of "close to 2 percent."

As noted previously, most analysts expected the Governing Council to extend its QE program, by at least a few months, because inflation in the overall Eurozone remains well below the ECB's target of "below, but close to 2 percent over the medium term." The overall rate of CPI inflation in the Eurozone has edged up in recent months as energy prices have stabilized (Figure 2). However, the core rate of inflation, which measures underlying inflationary pressures in the economy, remains below 1 percent, let alone 2 percent.

Figure 3

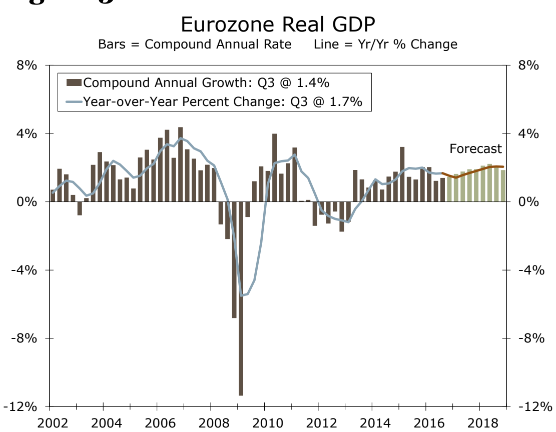
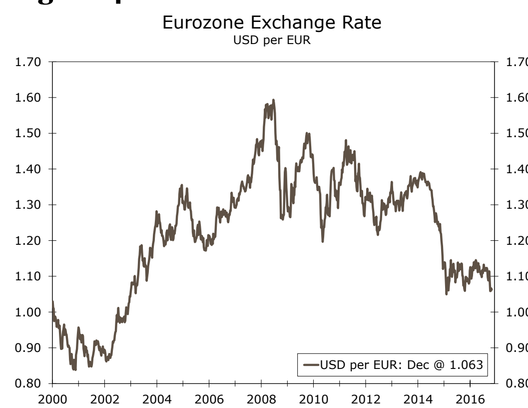


Figure 4



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities

GDP in the overall euro area continues to expand, but the rate of growth generally remains lackluster. Moreover, we expect the rate of economic growth to remain sluggish for the foreseeable future (Figure 3). Consequently, any rise in inflation in the Eurozone that may happen over the next year or so probably will occur at a slow pace. In other words, it seems like it will be awhile before the ECB's target rate of inflation is achieved. In that regard, the ECB forecasts that the annual rate of inflation will slowly rise from 1.3 percent next year to 1.7 percent in 2019.

As noted above, the euro depreciated in the immediate aftermath of the ECB's announcement on Thursday, and it remains near its multi-year low against the U.S. dollar (Figure 4). Looking forward, our currency strategy team forecasts that the euro will depreciate at a modest pace versus the greenback as the Fed hikes rates in coming months while the ECB continues to maintain an accommodative policy stance.

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