



# Flash

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## ECB out of ammunition; over to fiscal policy?

ECB delivers wide-ranging but modest easing package

Change in forward guidance suggests rates may remain low for even longer

Renewed bond buying confuses markets and may cause problems for Ms Lagarde

Draghi suggests fiscal policy must do more. Has the ECB run out of ammunition?

When Mario Draghi became president of the ECB in 2011, he signalled a substantial regime shift at the ECB

by cutting policy rates for the first time since the spring of 2009. In the intervening eight years, the ECB has implemented a range of measures taking monetary policy much, much, further into unknown territory than most would have predicted and many would have liked.

As Mr Draghi prepares to step down next month, **there are signs of another important regime shift and** the easing measures he announced appear to lock his successor, Christine Lagarde, into **a prolonged** and seemingly almost permanent **era of very low interest rates but possibly with little scope to ease policy meaningfully further.**

However, **Mr Draghi may also have left Ms Lagarde with some potentially major problems. The promise to restart government bond-buying and to continue this until inflation moves materially closer to target** can only be adhered to if the ECB's Governing council decides to remove some technical limits on the amount of bonds it can purchase from specific issuers. This **could be a source of significant friction within the ECB.**

### Expected actions vs surprising twists

**While the measures announced by the ECB were along broadly expected lines, there were two major surprises from Mr Draghi. The first is the subtle but important shift in the emphasis in policy guidance from being 'date dependent' (as typified by the ECB's previous commitment not to raise rates 'at least through the first half of 2020') to being 'state dependent' as evident in the change in the opening statement that rates will not rise 'until we have seen the inflation outlook robustly converge to a level close to, but below, 2%'. This approach was further emphasised in the even more surprising commitment to leave the re-started Asset Purchase Programme open-ended.**

**The second surprise from Mr Draghi was the increased emphasis on fiscal policy taking the primary role to support the EMU economy in the future.** The statement acknowledges continuing downside risks to the outlook for and accordingly **the ECB retains a bias to ease further** by noting key ECB interest rates are expected to *remain at their present or lower levels* until inflation picks up towards target. **However,** while monetary policy is set to remain supportive, **much more important in this context was Mr Draghi's indication that 'now it is high time for fiscal policy to take charge'.** He also said that there was unanimity that *'fiscal policy should become the main instrument'*. So, **there is a strong sense that scope for further monetary policy measures is fairly limited.**

## What did the ECB do and why?

The ECB introduced a package of easing measures in line with their view that the impact of a package combining a range of policy measures implemented together is significantly stronger than one focussed on a single policy instrument. As a result, in addition to the notable shift in the nature of its forward guidance on policy, Mr Draghi announced four new measures today;

### 1. The ECB cut its deposit rate from -0.40% to -0.50%.

A cut in the deposit rate had been widely signalled with some commentators suggesting it could be a somewhat larger 20 basis points. **The decision to opt for a relatively small cut may reflect a growing view that the benefits of such action may not significantly outweigh associated costs** (see our earlier analysis 'A small step for the deposit rate, a giant leap (in the dark) for the ECB') and Mr Draghi repeatedly acknowledged damaging side effects of negative rates in his comments today. **This may be one element of several that hint the ECB monetary policy may be reaching its limits** in terms of a capacity to ease further.

### 2. The ECB also announced a two-tier system for bank reserves to limit the adverse effects of the cut in the deposit rate on the banking sector (and hence on the main conduit for monetary policy to the 'real economy').

Again this measure had been hinted at and, on the initial technical guidelines, **this seems to apply to most of the excess reserves presently held by banks in current accounts** (other than at the deposit facility) at the Eurosystem, thereby providing some offset to the drop in the deposit rate. The signalled scope to alter the related metrics is not likely to be either sufficient or suitable to become a significant monetary policy tool but it may develop for other reasons.

### 3. The ECB made its Targeted Long Term Refinancing Operations (TLTRO's) notably more attractive

#### The ECB cut the interest rate on such borrowings

(depending on the increase in lending undertaken by Banks, the cost for them of borrowing under this scheme will range from the prevailing Refinancing rate (currently zero) and the prevailing deposit rate (now at -0.50%).

**Also encouraging is the extension of the maturity of such lending** from two to three years although an even longer duration with some optionality might have been more attractive. While we previously discussed similar or more aggressive actions of this form and **it should have some positive impact on bank lending, changes of this magnitude are unlikely to have a dramatic 'macro' effect.**

### 4. The ECB announced it will restart its Asset Purchase Programme from November 1st at a monthly purchase rate of €20 billion.

**This could prove to be the most notable aspect of the ECB's decisions. There had been significant debate as to whether this form of Quantitative Easing would resume** with several ECB officials appearing to downplay its likelihood. Moreover, unlike previous tranches which were strictly time bounded (albeit repeatedly extended), **the ECB's announcement envisages that the APP will be open-ended and will continue 'to run for as long as necessary to reinforce the accommodative impact of our policy rates'.**

## Market thinking on APP

**The initial market reaction to what appeared to be a potentially indefinite QE was a sharp drop in the exchange rate of the Euro and a similarly sharp fall in Euro area bond yields but these moves quickly reversed** and that reversal developed sufficient momentum to end the European trading session with the Euro exchange rate stronger and bond yields higher than before the ECB measures were announced. **Two developments may go some way to explaining the sharp turnaround** in market thinking in the wake of the ECB announcements.

**First of all, it is questionable whether the ECB can continue to buy Government bonds for very long without breaching its self-imposed limits** on the share of bonds it can own from particular issuers. While it has some limited discretion in relation to the proportion in which it buys the debt of various governments, it appears that unless issuer limits are increased, the APP might be unable to properly function beyond a year.

When questioned about this potentially critical constraint, Mr Draghi noted that *'we have relevant headroom to go on for quite a long time at this rhythm without the need to raise the discussion about limits'*. However, he was probably being both evasive and honest when he prefaced this by saying *'there was no appetite frankly to discuss the limits'*.

This also feeds into **the second development that saw 'sources' quoted as indicating only a narrow majority of the ECB governing council favoured restoring the APP** with several influential voices including those of Jens Weidmann of the Bundesbank, Francois Villeroy De Galhau of the Banque De France and even Benoit Coeuré of the ECB's executive board opposed to the measure.

**The market reaction** entailing the eventual reversal of its initial response to the restart of the APP **seems to reflect a view that ECB bond-buying will be short-lived rather than indefinite.** While technical workarounds to the

current issuer limits should not be too problematic, the sense may be that many high profile ECB officials are opposed to it may be seen as a more binding constraint on future ECB decision-making particularly in a post - Draghi era.

**The significance of this issue is notably heightened by the phrasing in the opening statement that the APP will only 'end shortly before we start raising the key ECB interest rates'.** If the ECB does not address a perceived pressing problems with limits, it might be felt that the technically enforced end of the APP towards the end of 2020 would imply a rise in ECB policy rates could follow soon afterwards-an altogether different outcome than is almost universally expected. On some measures, markets currently don't envisage any material move towards even modestly higher rates until 2024. So, **there appears to be some significant disconnect between the apparent assumption by markets that the APP will be short-lived while the era of ultra-low rates is semi-permanent.**

**Unfortunately for Ms Lagarde** (and the ECB's new chief economist, Philip Lane), **this issue poses a potentially major problem for the credibility of ECB policy in that it points towards an inconsistency between the stated intention to make the APP 'state dependent',** which on the ECB's latest projections would see a sustained and consequently substantial amount of government bond purchases, **and current market thinking that sees technical limits quickly shutting down those purchases** presumably because of a forceful opposition within the ECB's governing council to make any adjustments that would remove those limits.

**If Ms Lagarde is to be a successful ECB president, this may prove to be a battle she cannot lose.** Moreover, if fiscal policy is to become increasingly important to setting a sustainable and healthy growth path for the Euro area, the restraining influence the APP could provide until inflation returns towards the ECB's target might represent a meaningful contribution that accords with the ECB's primary goal of price stability as well as its secondary role in supporting the general economic policies of the EU.

## Where next?

**The outlook for the Euro on FX markets and for Euro area term rates continues to be shaped by a wide range of factors. The new ECB projections envisage a slow and modest improvement** in growth and inflation will take hold after some potentially bumpy periods in the near term. Beyond this broad economic outlook, **market movements may be more significantly driven by surprises** possibly related to trade tensions and/or Brexit. **The ECB actions were intended to remove any expectations of further near term policy changes and put monetary policy on a clear and sustainable path.**

**Whether that policy path encompasses a softish Euro on FX markets and lower bond yields will only become clearer as the scope for sustained government bond purchases is established.** This potentially vexed question may keep the ECB in the spotlight for some time to come. If the ECB acts to remove current market concerns that technical limits on bond-buying will soon bite, the scope for lower bond yields and a weaker currency might increase appreciably. If instead, the prospect of the APP ending soon becomes entrenched, today's linking in the ECB statement of the timing of that end and the start of ECB rate hikes could entail a major shift in market expectations.

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