June 14, 2019

ECB needs to do more to support growth

As does fiscal policy

The ECB sounded dovish last week, acknowledging downside risks to growth and inflation and the uncertainty prevailing at the moment, but there was little new actually announced on the policy front. Overall, the tone lacked a sense of urgency, suggesting that the ECB will once again be reactive rather than proactive. Fiscal policy also needs to do more to lift growth and inflation in the Eurozone.

Source: Istock

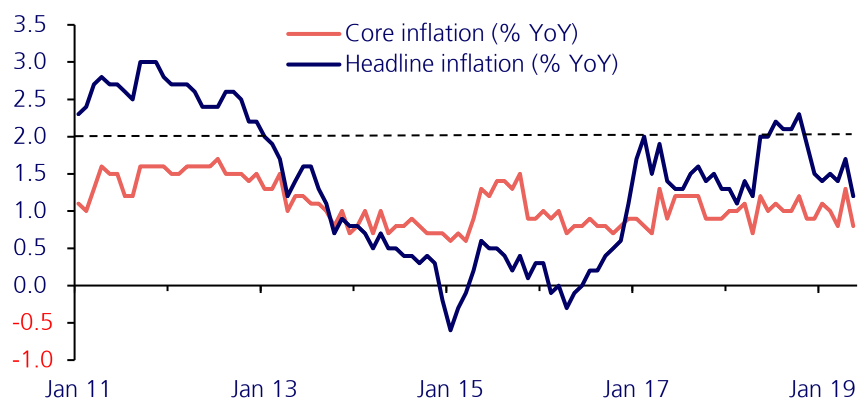
A dovish tone to last week's press conference

At last week's ECB monetary policy meeting and press conference, ECB President Mario Draghi struck a dovish tone, mentioning that the Governing Council had discussed re-starting Quantitative Easing (QE) asset purchases and cutting interest rates.

Draghi also confirmed that risks surrounding the Eurozone outlook remained 'tilted to the downside', and that uncertainties had increased and looked to be more prolonged compared to March because of the rise of protectionism and the ongoing Brexit saga. Indeed, compared to previous press conferences, there was a lot more emphasis on protectionism affecting confidence and activity as well as increasing uncertainty.

The ECB also revised down its forecast for GDP growth next year, by two tenths of a percentage point to 1.4%, and expects inflation of only 1.4% in 2020 and 1.6% in 2021.

Eurozone inflation is far below the ECB's 'close to 2%' objective



Source: Bloomberg, Note: The ECB's inflation objective is a rate 'below, but close to, 2% over the medium-term'

The ECB does not yet seem willing to act forcefully

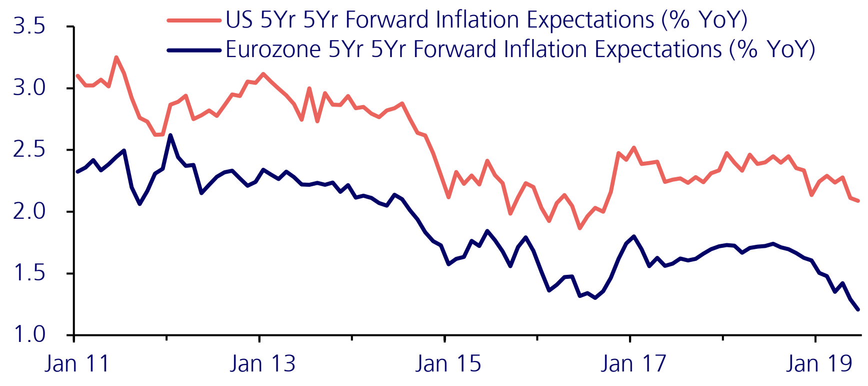
However, there did not seem to be much of a sense of urgency in dealing with downside risks. In particular, Draghi sounded complacent about the risks of deflation, saying that there was 'no probability of deflation', and only a very low risk of recession in the Eurozone. With core inflation averaging just 1% YoY over the past six months, and inflation expectations low and falling, it seems complacent to argue that there is no probability of deflation. Rather, the Eurozone could be just one economic shock away from deflation. In addition, with trade tensions high and the US and Emerging Market economies slowing, to argue that there is a very low risk of recession seems misplaced in our view.

More forward guidance and TLTRO's

Admittedly, the ECB did adjust its forward guidance, saying that interest rates would stay at current levels at least until the first half of 2020, whereas previously it had only made this commitment for the rest of 2019.

However, the commitment to keep interest rates at present levels at least until mid-2020 was not particularly dovish given that financial

Eurozone inflation expectations are declining sharply



Source: Bloomberg

markets were not pricing in an increase in interest rates anytime soon anyway.

The ECB also gave more details on its latest Targeted Longer-Term Refinancing Operations (TLTRO III) for banks. These are scheduled to start in September with an interest rate 10bps above the existing TLTRO II for assets that qualify. Nevertheless, the term of the TLTRO III will only be for two years, which is less generous than the existing TLTRO II, and we do not think the announcement is a game changer for the banking sector.

Action on QE still appears some way off

Although Draghi said the Governing Council had discussed other more aggressive monetary policy measures that could be used to support growth, such as restarting QE or cutting interest rates further, it did not appear that a decision was imminent. Rather, Draghi said in referring to QE that, '… it's a reflection that has just started today in this meeting.'

Draghi did mention that there was 'considerable headroom' for more bond purchases. Given its self-imposed limits of the capital key and not owning more than a third of any particular bond issuance, this suggests that the ECB has either not yet reached its threshold for sovereign bonds purchases, or that it envisages some flexibility with respect to these limits. However, a more explicit indication of willingness to buy more bonds and be flexible with, or abandon, these self-imposed limits would be helpful.

Indeed, given how low inflation currently is, and how inflation expectations have fallen sharply over the past few months as well, the risk of waiting to make a decision is that low inflation expectations become embedded in the economic system and thereby harder to dislodge, similar to the Japanese experience.

A common way to gauge inflation expectations is the so-called 5-year, 5-year forward inflation swap rate, which captures investors' expectation for inflation in the medium-term. At 1.2%, this measure is currently at its lowest level on record, and well below the comparable figure for the US of 2.1%.

Change in ECB leadership may be delaying a decision

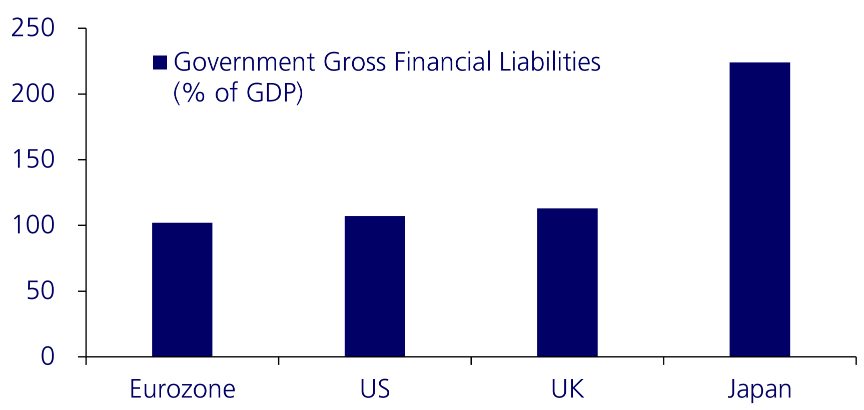
However, Draghi downplayed the fall in inflation expectations that has taken place in recent months. The forthcoming change of leadership at the ECB at the end of October may be complicating matters by delaying any decision on new policies until Draghi's replacement starts. Delaying risks missing an opportunity to act quickly to halt declining inflation expectations and could be a policy mistake.

The ECB is right to emphasise the need for fiscal policy to do more

Where we would agree with the ECB's analysis is that fiscal policy needs to be used more actively, especially in the next downturn. Draghi said 'By the way, let me add that in case these adverse contingencies were to happen, certainly fiscal policy will have to also come into consideration and play a fundamental role.'

The ECB has emphasised the need for fiscal policy to do more previously, but the language used this time was particularly strong. Indeed, there may be diminishing effectiveness in employing further unconventional monetary policy by itself, which is why coordination with fiscal policy could have a bigger impact in terms of stimulating the economy.

Aggregate Eurozone government debt is close to US & UK levels



Source: OECD

At the Eurozone level, there is capacity for more fiscal stimulus, as aggregate Eurozone government debt levels are similar to countries such as the US and UK. What's more, the European Commission (EC) projects the budget deficit for the Eurozone as a whole in 2019 to be only around 1% (with a similar figure for the cyclically adjusted budget deficit).

Conclusions

The ECB appears to be slow in responding to downside risks emerging for the Eurozone economy, suggesting that more action will eventually be needed when it does decide to act.

However, not all of the Eurozone's problems can be put on the ECB. Governments that have the fiscal capacity to spend more should also consider doing so in order to support growth and inflation in the Eurozone, and in particular to stop the slide in inflation expectations.

Until that happens, core Eurozone government bond yields are likely to remain low and downside risks to growth high.

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