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Implications of the ECB's strategy review

Policy rates to stay low and QE to continue well into 2022

Despite a spike in Eurozone inflation in August, the ECB is likely to remain dovish. Indeed, the ECB recently adopted a 2% symmetric inflation target as part of its strategic review of monetary policy and vowed to take a very cautious approach to tightening. This is supportive for risk assets in the region. However, we still view negative policy rates as counter-productive and the review could have been used to address this issue.

Source: IStock

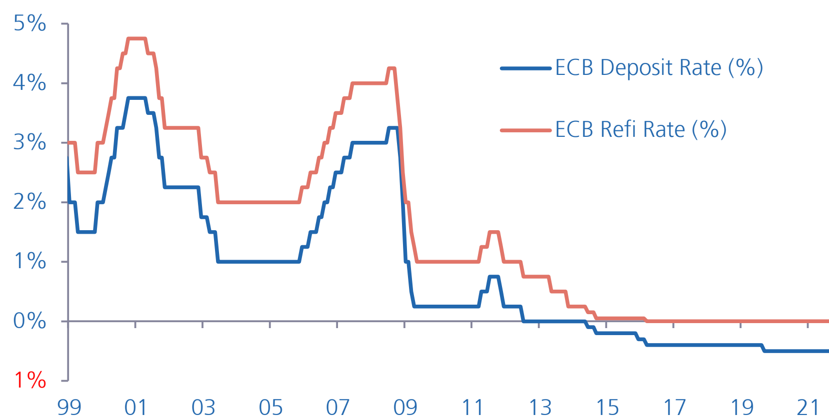
On the 8th July the ECB announced the results of its strategic review of monetary policy, adopting a 2% symmetric inflation target for the first time, amongst other changes. It then gave further details on what this implied for monetary policy going forward at its regular monetary policy meeting on the 22nd of July.

The overall takeaway is that the ECB remains extremely dovish and is likely to keep policy rates at their current low levels (i.e., a negative deposit rate of -0.5% and a refinancing rate set at 0%) for the foreseeable future. The ECB will also likely continue with large-scale asset purchases well into 2022 and ignore a near-term spike in inflation that saw headline Eurozone inflation hit 3% in August.

Led by President Christine Lagarde, the ECB seems determined to learn from and avoid the mistakes of the past. For example, in 2011, when the Eurozone was still recovering from the Global Financial Crisis (GFC), it raised interest rates in what is now widely regarded as a policy mistake as it weakened the fledgling recovery and arguably helped precipitate the Eurozone debt crisis of 2011-15.

The wish not to derail the recovery this time by tightening monetary policy too early is laudable. However, we remain concerned that negative interest rates are distortional to the financial system and counterproductive. Nevertheless, the strategic review did help to clarify the ECB's new monetary policy framework and has implications for financial markets and the real economy that we examine below.

The ECB's policy rates have been stuck at low levels for a long time



Source: Bloomberg

Why was a review needed?

The last monetary policy review was conducted in 2003 and the Eurozone economy and financial markets have seen profound changes since then.

Since the early 2000s, estimates of long-term trend growth have gradually fallen, reducing the neutral interest rate and increasing the chances of conventional monetary policy hitting the zero-lower bound. (The zero-lower bound refers to the fact that when policy rates are close to zero it can be difficult to cut them further to stimulate the economy in a downturn.)

Inflation and long-term interest rates have also been on a downward trend in recent years. Indeed, inflation has fallen well-short of

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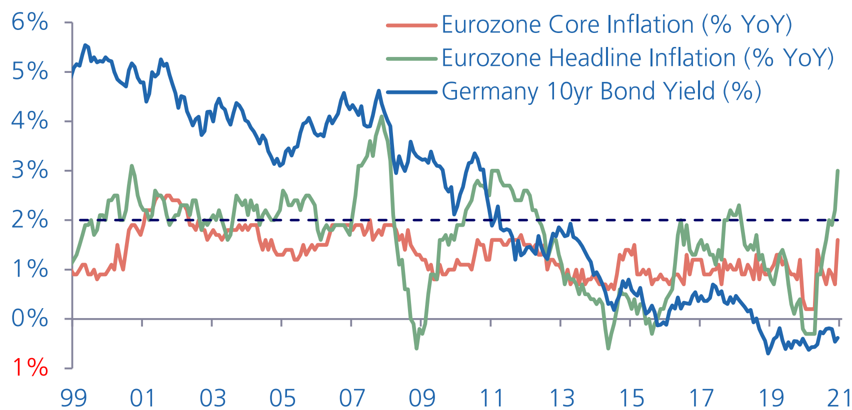
Inflation and long-term interest rates have been trending down



Source: Bloomberg

the ECB's previous inflation target of "below, but close to, 2%", whereas until the 2008/09 GFC it was fluctuating broadly around this level.

Finally, the ECB has also expanded its toolkit into once unthinkable areas, with negative policy rates introduced for the first time in June 2014, and the adoption of Quantitative Easing (QE) in 2015.

What was decided in the review?

The main conclusions of the ECB's strategic review, announced on the 8th July were:

1) A simplified symmetric inflation target of 2% over the medium term.

2) A commitment to be aggressive in responding when inflation falls below 2% and to look through temporary deviations above 2%.

3) The inclusion of owner-occupied housing costs when considering inflation.

4) A commitment to incorporate climate change considerations in monetary policy, for example by incorporating environmental criteria in corporate bond purchases.

5) A simplified communication approach at its regular monetary policy meetings and press conferences.

Auf Wiedersehen Bundesbank

From a standard macro-economic perspective, the most important change was the new formulation of the ECB's inflation target.

The previous formulation, adopted in 2003, stated that the ECB's objective was to target an inflation rate of 'below, but close to, 2% over the medium-term'. This was widely understood to mean that the ECB was targeting an inflation rate of 1.8% or 1.9%, but with a focus on keeping inflation at or below this level, following in the footsteps of the Bundesbank monetary orthodoxy of maintaining central bank credibility and avoiding too high inflation at all costs.

The dropping of this previous formulation and replacement with an explicitly symmetric inflation target of 2% is a recognition that we are now operating in a new financial and economic environment where deflation is as likely, if not more likely, to be a problem than too high inflation and a bigger threat if it becomes entrenched because it is harder to then eliminate. Japan's experience with deflation for more than 20 years demonstrates this.

This shift represents a significant move away from the traditional western central bank focus during the 1990s and early 2000s on reducing inflation, which the Bundesbank epitomised. What's more, the ECB has also reduced the emphasis on the analysis of monetary aggregates in its monetary policy decision statement and press conference, which was also a hallmark of the Bundesbank approach.

However, the shift by the ECB towards a symmetric inflation target of 2% is not as large as the US Federal Reserve`s (Fed) move last year, to Average Inflation Targeting (AIT) of 2% from a previous policy of simply targeting 2% inflation. AIT implies the Fed can tolerate inflation overshooting 2% for quite a while to compensate for previous persistently low inflation.

So far, so good

On the 22nd of July, in its first monetary policy meeting following the strategic review, the ECB gave more detail on what the review means in practice for monetary policy. In particular, it explained the implications for forward guidance. (Forward guidance refers to when central banks explain the likely future course of monetary policy, indicating, for example, what they want to see in terms of developments in growth and inflation before considering raising interest rates or reducing asset purchases.)

The ECB said that it would not raise interest rates until inflation was expected to reach its 2% inflation target 'well ahead of the end of its projection horizon and durably for the rest of the projection horizon, and it judges that realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term.'

The ECB's projection horizon refers to its staff GDP and inflation forecasts, which project out for up to the next three years and the ECB clarified that 'well-ahead' means the mid-point of its projection horizon, so around 18 months.

The ECB has therefore committed not to raise interest rates until: 1) it forecasts inflation to reach 2% within around 18 months, 2) it expects inflation to stay durably at these levels for another 18 months, and 3) it also expects underlying inflation to stabilise around 2% over the medium-term (i.e. beyond three years). Whilst appearing quite specific and technical, these three conditions were again emphasised on 19th August in a blog post by Philip Lane, ECB Chief Economist, and so are important to understand. (see The new monetary policy strategy: implications for rate forward guidance (europa.eu).)

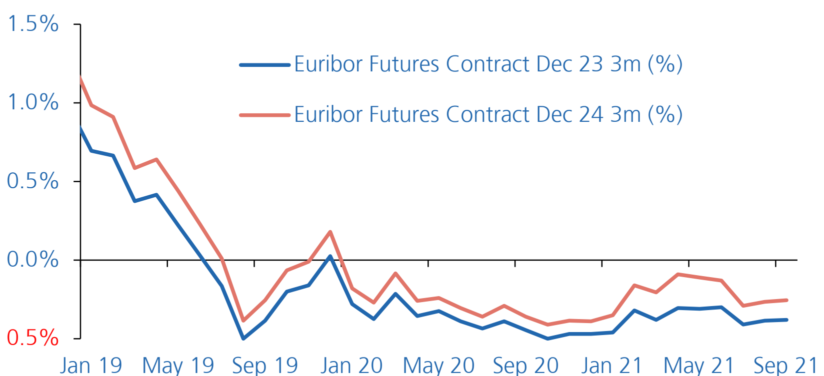
No rate rises anytime soon

This is quite a stringent list of conditions and in our view imply that the ECB is unlikely to raise policy rates from their current low levels for the foreseeable future. Indeed, any near-term spike in inflation, such as the one we are seeing currently, can be dismissed by the ECB in terms of having implications for monetary policy as long as its inflation forecast and view on underlying inflation dynamics further out remain unchanged.

H2 inflation spike unlikely to alter policy

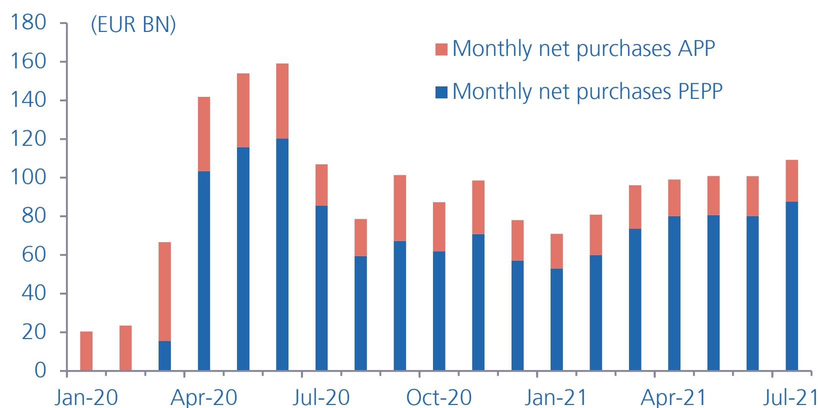
The ECB's staff macro-economic projections as of June this year (the projections are updated every quarter) are that headline inflation will average 1.9% in 2021, peaking at 2.6% in Q4, but decline to an average of 1.5% in

Futures markets are not pricing in ECB rate increases anytime soon



Source: Bloomberg

ECB set to reduce asset purchases in 2022, but still keep buying



Source: ECB

2022 and subsequently 1.4% in 2023. Core inflation is seen even lower. Thus, the conditions for raising policy rates are far from being met according to the ECB's criteria.

Eurozone inflation may spike even higher than the ECB currently forecasts in the second half of 2021, due to various base effects kicking in and as prices recover in some sectors such as leisure and tourism after having been severely depressed last year due to Covid. Indeed, data released recently show headline inflation reached 3.0% in August (a ten-year high) and core inflation 1.6%, in large part because of these effects.

However, even if inflation spikes higher than the ECB expects in the near term, the conditions for raising interest rates that it has laid out are still unlikely to be met. The spike in inflation is likely to be regarded as temporary and its projections for 2022 and 2023 are unlikely to change much. (The next set of ECB staff GDP and inflation projections will be released at the September 9th ECB monetary policy meeting.)

Implications for PEPP and QE

What are the implications for the ECB's various asset purchase programmes, in particular the EUR 1,850bn Pandemic Emergency Purchase Programme (PEPP)?

The PEPP was established by the ECB in March last year at the height of the Covid-19 pandemic to stabilise financial markets and support the economy. The initial total planned envelope of purchases of private and public securities of EUR 750bn was subsequently increased to EUR 1,850bn. (The ECB also increased the monthly pace of purchases in April this year to around EUR 80bn per month from a previous pace of around EUR 60bn per month.)

The programme is currently due to end in March 2022, but the ECB's dovish strategic review and July monetary policy meeting and press conference suggest that asset purchases could continue at a substantial pace well into 2022.

To maintain a significant amount of asset purchases, the ECB could either extend the deadline of the PEPP programme from March 2022 to later in 2022 or increase the size of an existing QE asset purchase programme (the APP), currently running at around EUR 20bn per month alongside PEPP.

We expect to get more clarity on the ECB's preferred option at one of its remaining monetary policy meetings this year. The key point is that given its recent dovish strategic review, the ECB is unlikely to favour a sudden stop to asset purchases. Instead, substantial asset purchases of public and private sector securities, especially government bonds, can be expected to continue well into 2022, despite the current spike in inflation.

Investment implications

A dovish central bank, keeping interest rates lower for longer, and maintaining an asset purchase programme even in the face of a strong economic recovery is likely to be supportive for the region's risk assets, and put downward pressure on the euro, other things being equal.

It is also likely to keep core government bond yields low and spreads between periphery and core government bond yields tight, though we still expect core government bond yields to gradually move higher as we progress through the economic cycle.

However, we are concerned that maintaining negative/zero policy rates for even longer is disruptive to the financial system and counterproductive, and this may take some of the edge off the ECB's otherwise supportive policies.

Conclusions

Overall, the strategy review was somewhat of a missed opportunity in our opinion. It could have been used to prepare investors for an eventual exit from negative policy rates to reduce distortions to the financial system, while still keeping monetary policy extremely supportive.

For example, the ECB could have focused on keeping policy rates close to zero but at positive rather than negative levels, while still maintaining a substantial amount of monthly asset purchases under the PEPP and APP.

Fortunately, despite being somewhat of a missed opportunity, the outlook for the Eurozone economy and risk assets is still positive in our view, as monetary policy will be accompanied by continued supportive fiscal policies.

In particular, the rapid roll-out of the NextGenEU initiative suggests strong fiscal support for the Eurozone in 2022, and as a result we expect to see continued above-trend growth in the region supporting local risk assets, especially equities.

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