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The ECB contemplates further monetary easing

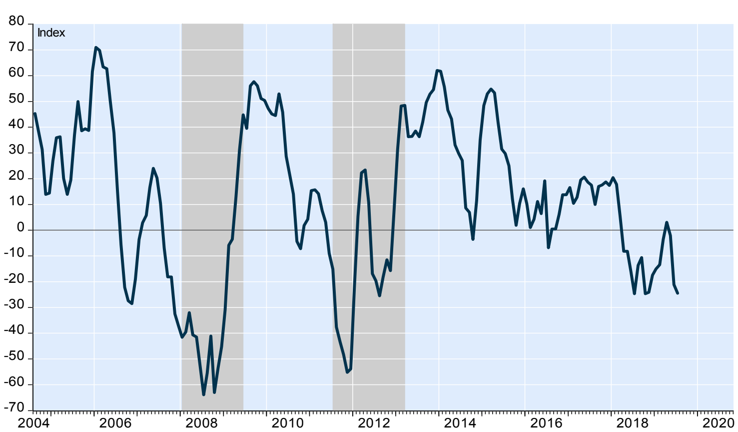
By Jocelyn Paquet

The perennial signs of mid-summer vacations have returned. The weather is gorgeous, the smell of barbecue fills the air and my outlook inbox is filling up fast with out-of-the-office automatic replies. But while some of our readers may be enjoying this piece with their feet resting near the campfire, their economics team keeps toiling hard, for the next few weeks promises to be quite interesting on the monetary policy front.

Looming large is the incoming Fed meeting (July 30-31), at which the United States' central bank is widely expected to cut benchmark rates by 25 basis points. But since every commentator have already given their two cents worth on the topic, we'll spare you five minutes and focus instead on what is shaping up to be a less straightforward affair: this week's ECB meeting.

Back in June, European policymakers were in "broad agreement" that the ECB should stand "ready and prepared" to provide more policy accommodation in the event that the economic "soft patch" failed to dissipate. Since then, economic growth in China continued to decelerate, wiping out hopes of an exports-driven rebound in Europe. The Zew survey then showed analysts downgrading their expectations for the German economy, with some even forecasting a drop in GDP in the second quarter. The European Commission now see GDP expanding just 0.5% in Germany in 2019, hardly the kind of number that would reassure the ECB.

Eurozone: Sentiment deteriorates further in Germany
Zew indicator of economic sentiment. Last observation: July 2019



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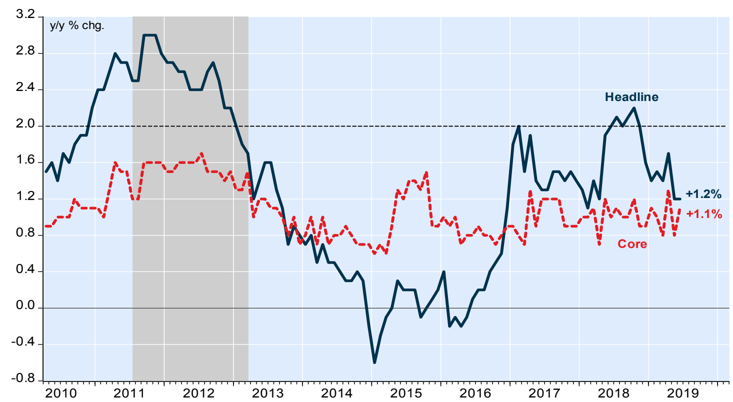
Inflation is another concern. Speaking two weeks after the latest central bank's monetary policy meeting, ECB President Mario Draghi reiterated the Governing Council's "conviction in pursuing our aim of inflation to 2% in a symmetric fashion" and added that policymakers were considering at the moment how their instruments could be adapted "commensurate to the risk to price stability". He went even further, stating that, "[i]n the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required." As of now, there is little sign that inflation is on the verge of a breakthrough. In June, the core CPI, which excludes energy, food, alcohol and tobacco, was up just 1.1% from its level a year ago. That's about half the ECB's target of less but close to 2%. Inflation expectations are also rather weak.

Eurozone: Core inflation still far below ECB target in June
Consumer price index



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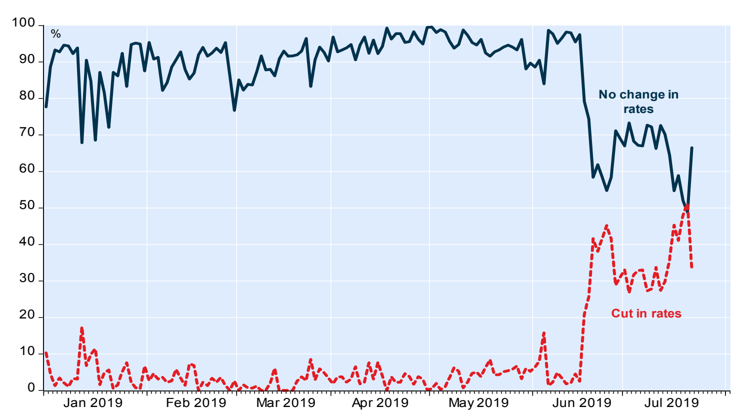
In this context, it now looks certain that the ECB will loosen policy. But how? And when? The central bank has signaled that all options were on the table at this point including lowering interest rates paid by banks on their deposits at the ECB, restarting the quantitative easing program, and altering forward guidance. For much of the month of June, markets seemed to agree that additional stimulus would come in the form of a cut to the ECB's deposit rate from -0.4% to -0.5% at the September meeting, i.e. simultaneously with the publication of the staff's economic projections. But then odds in favour of an earlier intervention started increasing as data continued to disappoint and the Fed started sounding more dovish. What's more, approximately 50% of analysts now expects the ECB to relaunch its asset purchase program in the coming months.

Eurozone: Non-trivial probability of a rate cut this week
Odds implied by overnight indexed swaps



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At this point, the most likely scenario is that the European Central Bank will tweak the language used in its statement to clearly announce an incoming loosening of policy in September. But the ECB has developed a tendency to undercut the Fed's moves lately and there is a non-trivial probability that it may do so again this time, opting to reduce rates ahead of U.S. policymakers this week.

Whatever it chooses to do in the end, the way forward is fraught with obstacles for the ECB. Whatever Mr. Draghi says, the central bank's toolbox looks pretty depleted at the moment and it's unclear what the effects of further monetary stimulus would be at this point. Take a lowering of deposit rates for instance. A fall further into negative territory would perhaps encourage consumption and investment, but it would also hurt banks' profitability since financial institutions cannot pass on negative rates to their depositors. To mitigate that risk, the ECB would probably have to introduce a tiering deposit system, which would shield a portion of the banks' deposit from negative rates. No one quite knows where the effective lower bound is when it comes to deposit rates – i.e. the point where the positive effects starts being outweighed by the associated costs – but it has got to be getting close otherwise a tiering system wouldn't be necessary.

The benefits of a relaunch of the asset purchase program are also unclear. Most research show that quantitative easing has diminishing return and the ECB has already gobbled up €2.6 trillion worth of assets (or 20% of the eurozone's GDP) in the past few years. There's also an argument that buying so much debt could eventually reduce market efficiency. Then there are legal considerations associated with restarting QE. As of now, the ECB can own a maximum of 33% of the sovereign bonds of any single country. In some cases (Germany for instance), the ECB is already getting close to that limit. As such, was the ECB to start buying sovereign bonds again, rules would have to be changed for the program to extend beyond a year, leaving the ECB exposed to legal challenges.

All in all, we think there's no need to cut your cottage vacations early in order to see what the ECB will do. But we'd still suggest keeping an eye at markets on Thursday.

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