Bond Blog

PGIM FIXED INCOME

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THE ECB NEEDS TO FOLLOW THE TALK WITH THE WALK

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After a COVID-related delay, last week's publication of the European Central Bank's (ECB) monetary policy framework review arrived several months earlier than anticipated and to a less-than enthusiastic reception. The revised framework has naturally drawn comparisons to the Fed's recently implemented strategy of flexible average inflation targeting (FAIT), thus the initial critiques have claimed that the ECB's revised framework has not gone far enough to address the weak inflation that has plagued the euro area for more than a decade.

Yet, the resolve of European policymakers since the start of the pandemic should not be underestimated. The following outlines why we believe the revision is the appropriate one for Europe and the rationale behind the policy steps that may follow - possibly as soon as the ECB's late-July policy meeting. Coupled with tailwinds provided by the recent rebound in activity and improving sentiment, such action could return inflation to target more quickly than expected. However, if significant action fails to materialize, the ECB may have opened a new window for participants to question its credibility and policy effectiveness.

When Established Best Practice is Radical

The ECB's framework revision adopted established practice with a traditional 2% target - one that is symmetric and flexible over the medium term - hence underwhelming those calling for a regime similar to FAIT.[1] Yet, the latter approach may be ill-suited for the challenges facing the ECB.

First, such a strategy requires market participants to form different inflation expectations depending on the time horizon - one over the near term and another over the medium term. For the Fed, this is a surmountable challenge as medium-term inflation expectations are well-anchored and rarely drop below 2%.

While euro area inflation expectations traded above 2% before the global and sovereign debt crises, they subsequently fell below 2% and were on a downward trend, reflecting a de-anchoring of inflation expectations in Europe (Figure 1). Furthermore, these expectations are increasingly influencing actual inflation outcomes given that the passthrough from wages to inflation has weakened in recent years.[2]

Rather than a flexible average strategy that seeks to lift inflation expectations that have already de-anchored, the ECB's Governing Council decided on a clear, fixed inflation anchor via a symmetric 2% target.[3]

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FIGURE 1: MEDIUM-TERM INFLATION EXPECTATIONS (5Y5Y SWAPS)

Source: Bloomberg as of July 15, 2021.

Second, given the scale and longevity of the euro area's inflation undershoot, adopting FAIT would have implied inflation outturns of close to 3% over the next decade. Therefore, such a change could be viewed as implicitly raising the inflation target, a prospect that would be unlikely to garner consensus support among the Governing Council.

The new inflation target, alongside an explicit recognition of the asymmetry of monetary policy at the zero-lower bound, suggests a more radical shake up to ECB monetary policy. Given the Governing Council's assessment that medium-term inflation is "well below" its objective, the new framework points to comprehensive and sustained policy easing with a willingness to tolerate - if not target - inflation overshoots.[4] While we're encouraged by the ECB's direction, its talk now needs to be backed by decisive policy action.

Implications for the Policy Outlook

Commitment to the new framework is key to sustainably achieving the inflation target. As signaled by ECB President Lagarde, existing forward guidance will need to be updated to reflect the new framework, which we expect may occur at the policy meeting on July 22. The guidance also needs to be strengthened, perhaps with a link to inflation outturns rather than forecasts. This change would signal a strong commitment to stay the course and avoid a premature monetary tightening in the face of overly optimistic projections.

Based on its policy actions since the start of the pandemic, it is clear that the Governing Council sees asset purchases as the policy tool to do the heavy lifting, particularly as it pertains to long-term rates. This view is reinforced by recent ECB analysis regarding the effectiveness of quantitative easing, which projected that the euro area 2019's GDP growth and inflation would have been 1.1 percentage point and 0.75 percentage points lower, respectively, without a negative policy rate and asset purchases.[5,6]

While the debate about the ultimate effectiveness of QE continues, in addition to the purchasing demand, asset purchases also act as a policy signal that boosts confidence and reduces uncertainty. This sentiment channel can be reinforced by forward guidance that projects an accommodative policy as long as needed to return inflation to target.

Perhaps as early as September, we expect a decision on the scaling up of QE under the existing Asset Purchase Programme (APP) beyond March 2022, which is when the current pandemic emergency asset purchase programme (PEPP) is due to end. The large gap between the ECB's forecast for inflation of 1.4% by the end of 2023 and its new 2% inflation target suggests a significant increase in APP purchases beyond March. Indeed, we project that APP purchases could expand by as much as four fold - from the current open-end run rate of €20 billion to approximately €80 billion per month (Figure 2). That top end estimate would equate to an additional €720 billion over 12 months, similar in magnitude to the asset purchase announcements made at the height of the pandemic in March 2020. Complementary adjustments, such as increased flexibility in APP operations, will also be needed to ensure that the ECB has ample discretion.

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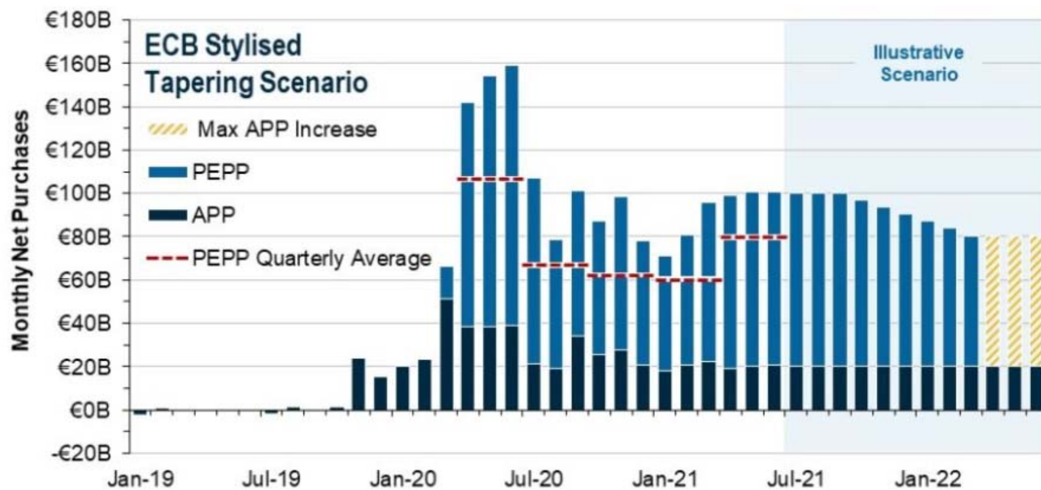
FIGURE 2: THE APP STANDS AT THE READY BEYOND MARCH 2022



Source: PGIM Fixed Income, ECB as of July 15, 2021.

Resetting the Credibility Benchmark

Although the stated details of the ECB's framework revision continue to underwhelm some participants, we see the new regime as a clear delineation from past policy. Granted, the main policy rate may remain stagnant near current levels, but it may do so for the foreseeable future. The rate accommodation, coupled with updated, strengthened forward guidance (possibly as soon as next week), ample capacity to boost open-ended asset purchases, and targeted long-term refinancing operations, places the ECB's framework in a new paradigm that is better suited to address the region's chronically weak inflation.[7]

The announcement of the revised framework also sets another benchmark on which its policy credibility will be judged. Thus, its future effectiveness as an institution relies on backing its talk with the policy walk.

[1] The ECB's prior target was formally described as "below, but close to, 2%."

[2] See Del Negro, Lenza, Primiceri and Tambalotti, (2020), What's up with the Phillips Curve? ECB working paper series no. 2435, July.

[3] Symmetry refers to the view that positive and negative deviations from the target are undesirable, hence confers the ability to correct for above and below target inflation.

[4] See: https://www.ecb.europa.eu/press/accounts/2021/html/ecb.mg210709~8d7a056036.en.html

[5] For reference, real GDP and inflation in the euro area in 2019 came in at 1.3% and 1.2%, respectively.

[6] See Rostagno, Altavilla, Carboni, Lemke, Motto, Guilhem (2021), Combining negative rates, forward guidance and asset purchases: identification and impacts of the ECB's unconventional policies, ECB working paper series no. 2564, June.

[7] The new paradigm may also apply to future steps to address climate change, which we have previously addressed, but did not cover in this post.

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