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PGIM FIXED INCOME

Broad-Based ECB Policy Package Amidst Deep Divisions

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The European Central Bank (ECB) delivered a broad-based easing package in its policy meeting on Thursday. The package included a wide array of measures, most notably a cut in the key policy rate deeper into negative territory and a resumption of asset purchases (APs). At €20 billion per month, the scale of the purchases is relatively small, which is indicative of deep divisions on the matter and vocal opposition by the hawks on the Governing Council (GC). As expected, the ECB cut its inflation and growth forecasts, although its growth expectations remain rather optimistic in our view. Further growth disappointments may trigger another deposit rate cut, possibly in December. The immediate market reaction to the package has been lackluster.

The policy measures are truly broad-based, but the scale of the APs falls short of market expectations.

- The deposit rate was cut by another 10 basis points to negative 50 bps.
- Tiering is being introduced in an attempt to offset the negative impact on the banking system, especially the liquidity-rich banks in northern Europe. Those deposits that are exempted from the negative deposit rate will be remunerated at zero interest.
- At the same time, the terms and conditions of the TLTROIII financing, in large part taken up by the more liquidity-strained banks in southern Europe, were further enhanced. In particular, the maturity of these loans is now extended by one year to three years (just as for the earlier TLTROII loans), and interest charges were effectively lowered by 10 bps.
- APs are beginning in November at a monthly pace of €20 billion and are effectively open-ended; they will be maintained as long as necessary to bolster monetary policy accommodation and are seen ending only shortly before an eventual first rate hike. In any event, the open-endedness of the purchase scheme and its relatively limited size likely emerged as a compromise with the hawks, in principle allowing the program to be small and short lived, if a more vibrant recovery takes hold. In addition, there was little specificity on the nature of the assets to be purchased, but President Draghi indicated in the press conference that, by and large, the ECB would buy the same asset classes as during its earlier QE operations (i.e., no bank debt).
- Importantly, forward guidance is no longer calendar-dependent, but is open-ended and state dependent, with policy rates remaining at their present level or lower until the inflation outlook "robustly converges" towards the ECB's inflation target of just below 2%. This change anchors rate expectations and also ensures prolonged APs, if necessary, to achieve the ECB's objectives.

The vote in the GC was not unanimous, but there was still a broad majority in favor of APs. President Draghi indicated that support was stronger for measures other than APs. Nevertheless, the support level for APs was strong enough that a formal vote was not needed. That said, the hawks were not only a vocal majority, but also reportedly represented about half of the euro area in terms of output and population. Press reports suggest that France joined Germany, Holland, and Estonia in opposing APs and that, besides the French and German central bank governors in the GC, the French and German members of the Executive Board also voted against APs. This would make the AP decision one of the most contested in the ECB's history.

Forecast revisions were considerable as far as inflation is concerned, but growth forecasts still strike us as overly optimistic. Headline inflation is now seen averaging 1.2% this year (down from 1.3%) and only 1.0% in 2020, substantially below the earlier 1.4% forecast. By 2021, inflation is seen rising to 1.5%, still well below the ECB's de facto target. On the other hand, real growth forecasts were only marginally cut to 1.1% this year and 1.2% next year, just 0.2 percentage points below the ECB's earlier forecast. President Draghi made it clear, however, that the baseline does not assume a hard Brexit scenario or a substantial worsening of the trade conflict—both are significant risks, however. Thus, in this context, the ECB maintains its downward bias to its growth outlook. By contrast, we expect the economy to remain sluggish and real growth at 0.8% next year.

Just as in previous press conferences, President Draghi shrugged off allegations by President Trump that the ECB is seeking an unfair advantage and targeting the exchange rate. The euro fell immediately after the announcement of the ECB package, but fully reversed course later on, seemingly in response to a tweet by President Trump. Overall, the immediate market reactions were lackluster.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of September 2019.

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