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Broad-Based ECB Easing Package in the Works

By Jürgen Odenius, PhD, Principal and Economic Counsellor, Macroeconomics Team

Those who were looking for reassurance that a broad-based policy easing by the European Central Bank (ECB) is in the works were not disappointed by Thursday's meeting of the Governing Council (GC). The ECB took several critical steps towards a package of easing measures, likely to be initiated in September 2019. Besides adopting a formal easing bias, the GC tasked committees to examine broad-based policy options, including the design of a tiering system and options of the size and composition of possibly renewed asset purchases. In sum, a first rate cut in September combined with tiering is all but a foregone conclusion. A decision on asset purchases is now highly likely, but it may come only in December, depending on the degree of the economic slowdown and how quickly a consensus in the GC can be forged.

The ECB is highly likely to revise down its inflation forecasts in September. The persistent lingering of trade war and geopolitical uncertainties, in and of itself, is seen as a "materialization of risks" with considerable impact on the outlook. The statement reflects these concerns and refers to inflation rates, both realized and projected, as having been "persistently below levels that are in line with its aim."

Relatedly, the growth outlook is seen near a tipping point and is likely to be revised down sharply as well. President Draghi repeatedly pointed to dichotomous economic performance: the service and construction sectors as well as the labor market have remained resilient, but are slowing; the manufacturing sector is experiencing an idiosyncratic shock that is heavily weighing on Germany and Italy, in particular. He acknowledged that the ECB's June macro forecasts were predicated on a recovery in the second half of the year and that the prospects for such a recovery are now dimming significantly. Against this background, we expect the ECB to substantially revise down its current 2020 growth forecast from 1.4% closer to 1%.

Our own, out-of-market consensus, forecast sees growth decelerating to 0.8% next year. It is predicated on the view that additional monetary policy easing is likely to see decreasing returns to scale in terms of its impact on the real economy.

Once more, the Governing Council went out of its way to flag its determination to take additional easing measures. The statement adopted new language stressing the ECB's "commitment to symmetry in the inflation aim." In other words, the ECB is determined to fight low (below target) inflation with the same vigor as it would fight above target inflation.

As so many times before, in almost customary fashion, President Draghi elegantly went beyond market expectations. As expected, the ECB adopted a formal easing bias and, therefore, all but pre-announced a cut in its deposit rate (-40 bps) in September. We expect a cut of 10 bps, possibly followed by a further cut in December.

Those who expected strong signals of broad-based easing were not disappointed, to the contrary. The GC tasked committees to draw up broad based policy options. These include ways to reinforce forward guidance, measures designed to mitigate the negative impact of rate cuts on banking sector profitability in the form of a tiered system for reserve remuneration, and "options for the size and composition of potential new net asset purchases." Although the composition of any policy package remains to be determined, we expect tiering to be introduced alongside a first rate cut in September. More importantly, the probability of renewed asset purchases has risen substantially.

The timing of a decision on renewed asset purchases critically depends on the degree of the economic slowdown and whether President Draghi can build quickly enough a broad-based consensus in the GC. The body language in the press conference suggests that consensus has not yet been reached. Questions about unanimity of the GC's decisions were sidestepped somewhat, suggesting that more work needs to be done. However, once the macro forecasts are revised down in September, consensus is likely to follow, provided the economy continues to underperform.

Questions about President Trump's renewed allegations about currency manipulation by the ECB were masterfully shrugged off. When asked about the latest allegations earlier this week, President Draghi seemed surprised and claimed ignorance, just to follow up with a reminder about the ECB's inflation target, also reminding the audience (and by extension President Trump) that there is an international consensus among policy makers to refrain from currency manipulation.

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

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