# BTMU Economic Brief

# *Euro area – The ECB in 2018: forced to end asset purchases, but no rate hike on the cards*

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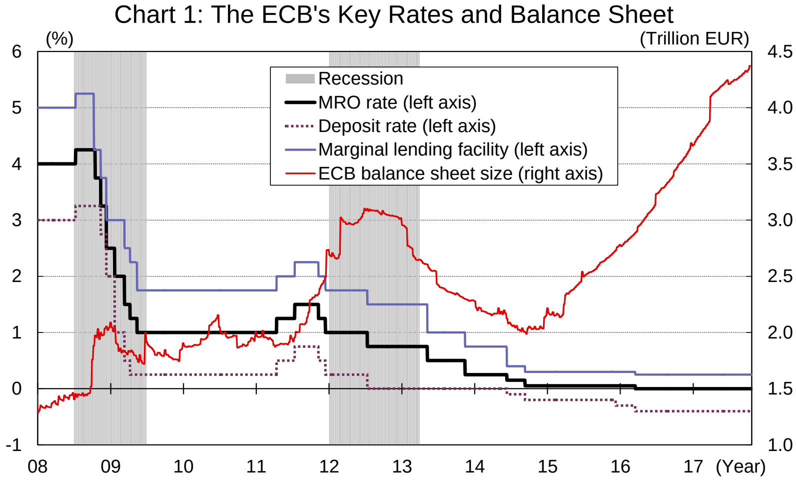
## 1. Introduction

Euro zone interest rates have been slashed to record lows since 2012 and an expanded QE programme has led to the ECB's nominal balance sheet swiftly doubling in size. But we have now reached the beginning of the end of QE. Monthly asset purchases will be reduced from €60bn to €30bn for nine months from January 2018. We expect that this will be followed by further purchases, at a slower pace, until the end of the year. Recent economic data have been buoyant but the ECB's decision largely reflects technical limits reached after hoovering up government bonds (from countries with different public finances) rather than a firm belief in a sustainable euro zone recovery. The overall monetary policy mix remains extremely loose, yet inflation, held back by a strong euro and disappointing wage growth, is stubbornly low. This makes it tricky for the ECB to normalise rates as any hint would lead to further euro appreciation and a weaker inflation outlook. The ECB has provided strong guidance of its intended sequencing; interest rate rises will only take place after the end of (net) asset purchases. The result is that the 'slower for longer' taper provides a strong anchor for expectations and we do not forecast any change in the main refinancing operations (MRO) rate in 2018 (the forecast horizon of this report). Nor is it likely that the ECB will risk an early deposit rate hike and a stronger euro. In short, highly accommodative monetary policy is likely to remain in place for some time.

Chart 1: The ECB's Key Rates and Balance Sheet

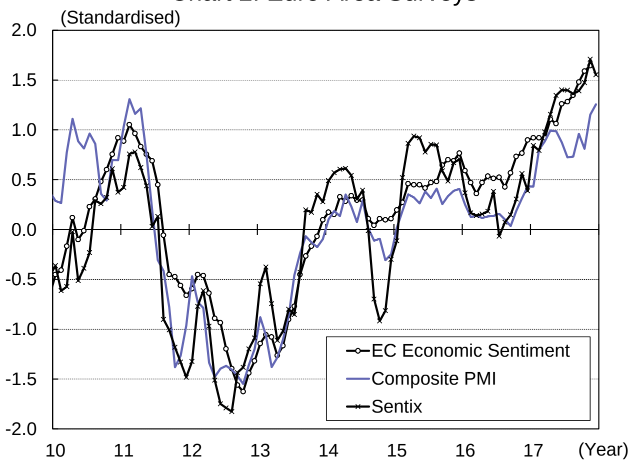



Source: Macrobond, BTMU Economic Research Office

## 2. Is the euro zone ready for tighter monetary policy?

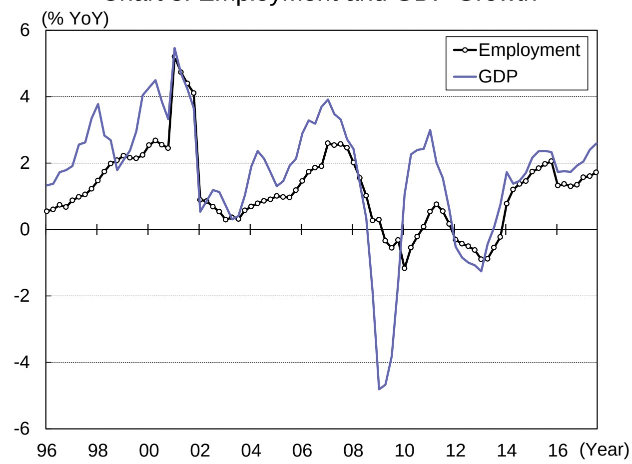
The euro zone recovery continues apace, helped by very accommodative monetary policy. Seasonally adjusted GDP growth was revised up to 0.7% QoQ in Q2 2017(2.3% YoY), and followed by a firm 0.6% QoQ in Q3 (2.5% YoY). There are very few signs of this momentum slowing in the final quarter of the year. Chart 2 shows how business surveys are at long-term highs (the European Commission's economic sentiment indicator has not been this strong since 2000). Activity is largely driven by personal consumption. Employment and GDP are rising in unison (chart 3). Unemployment, at 8.8% in October, is at its lowest since January 2009. The expansion is broad-based geographically. Chart 4 shows that growth rates are trending up in most euro zone countries. With the unweighted average national growth rate above the euro zone average it shows that smaller economies are currently leading the way. The external backdrop has also been supportive. There has been a continued global upswing since mid-2016 and a pick-up in world trade.

Chart 2: Euro Area Surveys



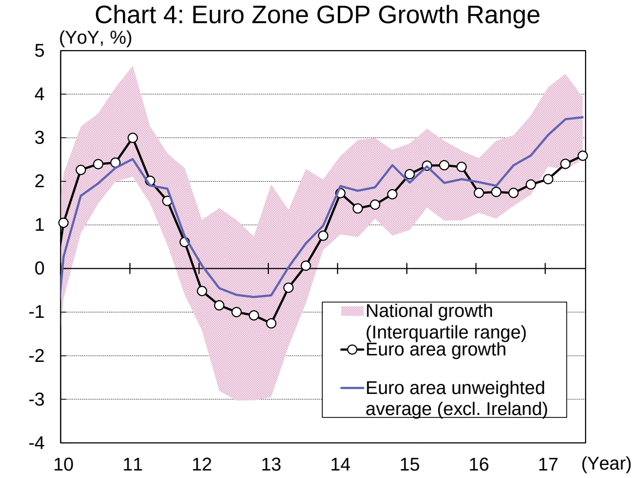

Source: Macrobond, BTMU Economic Research Office

Chart 3: Employment and GDP Growth



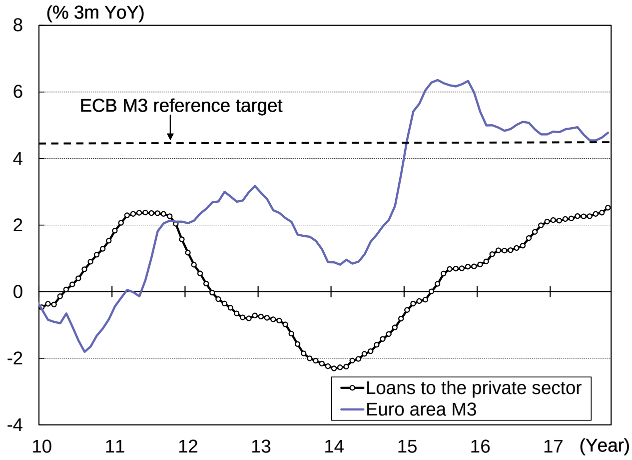

Source: ECB, BTMU Economic Research Office

Chart 4: Euro Zone GDP Growth Range




Source: Eurostat, BTMU Economic Research Office

Chart 5: M3 and Credit Growth



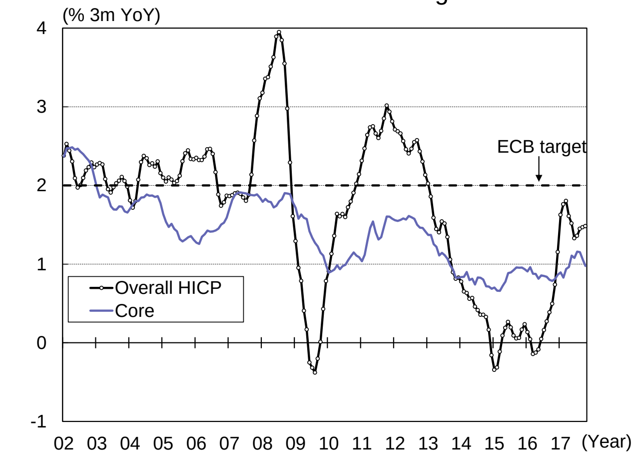

Source: ECB, BTMU Economic Research Office

The ECB's accommodative stance is affecting financing conditions. Interest rates on lending to non-financial corporations (NFCs) and households are at long-term lows, and the spread on these between core and peripheral countries has narrowed considerably. The result is that credit growth to the private sector, at over 2% YoY, is finally picking up (see chart 5). The

ECB's Bank Lending Survey continues to show both broad-based demand and easing credit standards for loans across member states. M3 money supply growth, bolstered further by QE, is hovering slightly above the ECB's reference target of 4.5%.

However, despite the supportive financing conditions and firm economic activity, we seem far from reaching sustainable inflation at the ECB's target of just below 2% YoY. The final numbers for October showed the Harmonised Index of Consumer Prices (HICP) at 1.4% YoY while core inflation, which has been on a very gradual uptrend, slipped back from 1.1% to 0.9% YoY (see charts 6 and 8) – and the preliminary estimate for November suggests core remained at this rate. The market expectations are also muted. 5Y5Y inflation swaps (a measure of the average expected inflation over a five-year period starting in five years' time) have been close to 1.6% since June (chart 7). We do not expect HICP inflation to reach the ECB's target next year, even with the output gap likely to turn positive in 2018 (this is not unique to the euro zone – inflation growth has been below target in both the US and Japan despite above-potential growth).

Chart 6: Inflation vs. Target

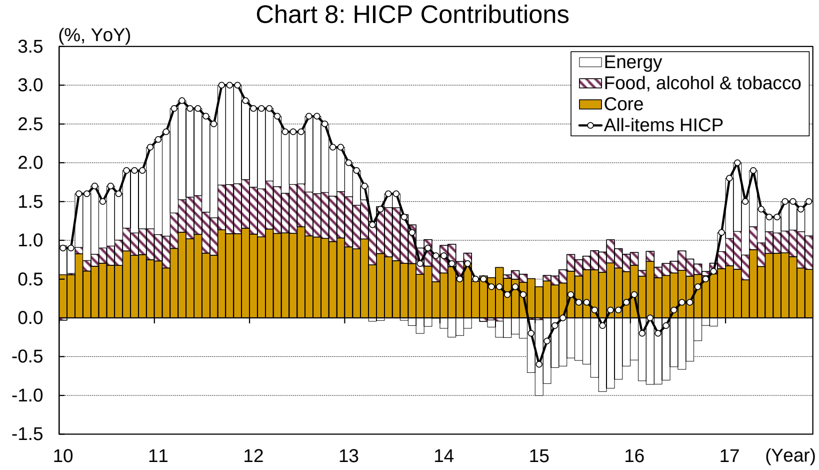



Source: Eurostat, ECB, Macrobond, BTMU Economic Research Office

Chart 7: 5Y5Y Inflation Expectations


Source: Bloomberg, BTMU Economic Research Office

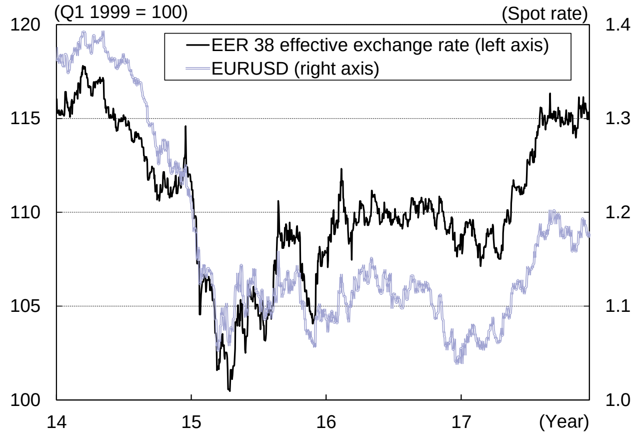
Chart 8: HICP Contributions




Source: Eurostat, BTMU Economic Research Office

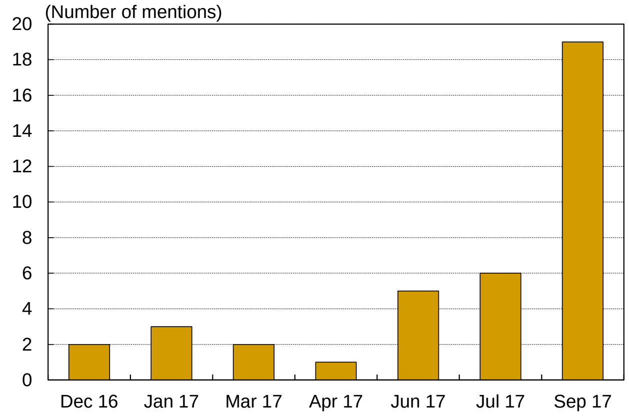
High on the list of worries for the ECB is the exchange rate, which has exerted downward pressure on inflation through lower import prices. As chart 9 shows, the euro has appreciated considerably in 2017, driven by strong fundamentals. While we have seen some softening over the last few months, the real effective exchange rate has strengthened by around 5% since January. Recent strong GDP figures (from Germany in particular) have added renewed impetus. As well as affecting inflation, a stronger euro may also dampen export demand and hinder the economic recovery, adding to the ECB's headache. It is therefore no surprise to see the exchange rate was mentioned almost 20 times in the ECB account from September, many times more than at other meetings in the recent past (see chart 10).

Chart 9: Euro Effective Exchange Rate, EURUSD




Source: ECB, Macrobond, BTMU Economic Research Office

Chart 10: Number of Mentions of Euro Exchange Rate in ECB Accounts

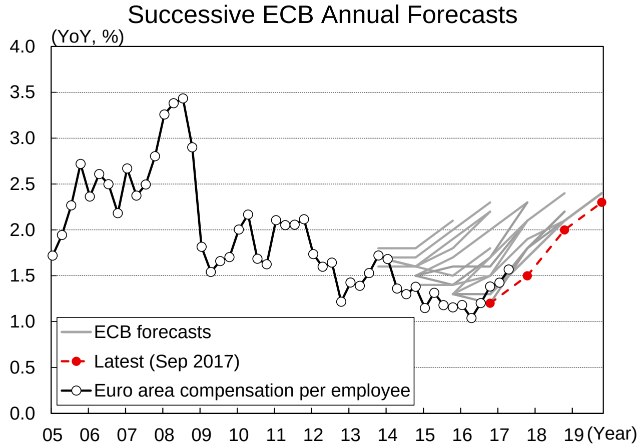



Source: ECB, BTMU Economic Research Office

The inflation outlook is compounded by stubbornly low wage growth – chart 11 shows how consecutive ECB compensation forecasts have not been reached. We do note some signs that wage growth could finally be taking off, though, as economic growth improves and the labour market tightens. Compensation per employee grew by 1.7% YoY in both Q2 and Q3 2017, and more recent data have suggested further improvement. However, these are still only mild gains by historical standards.

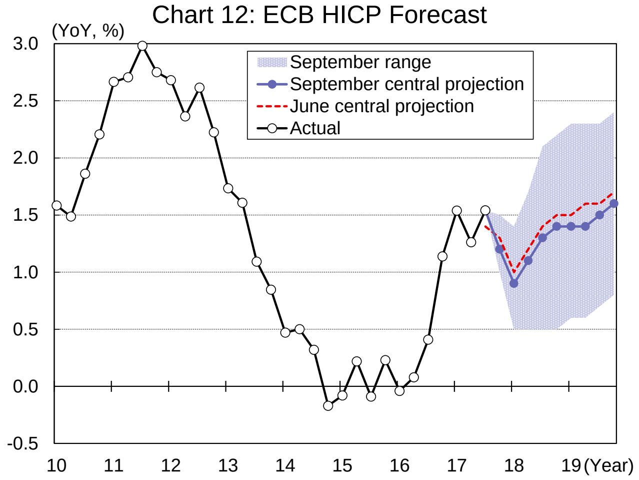
Given these headwinds, the ECB downgraded its inflation forecast in September. As chart 12 shows, risks are roughly balanced, yet the central projection is headline inflation at just 1.6% in Q4 2019.

Chart 11: Euro Area Compensation Per Employee and Successive ECB Annual Forecasts




Source: ECB, BTMU Economic Research Office

Chart 12: ECB HICP Forecast

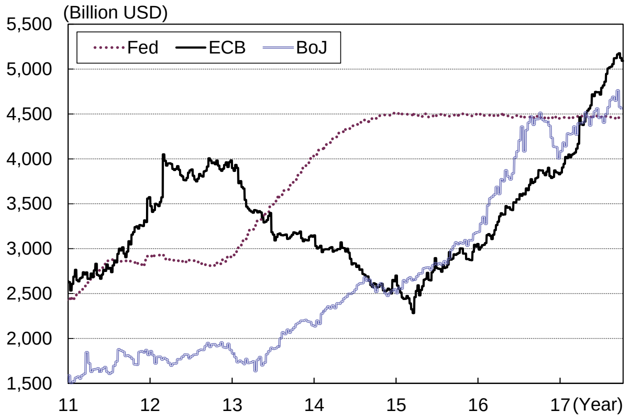



Source: ECB, BTMU Economic Research Office

# 3. The APP is close to its limits

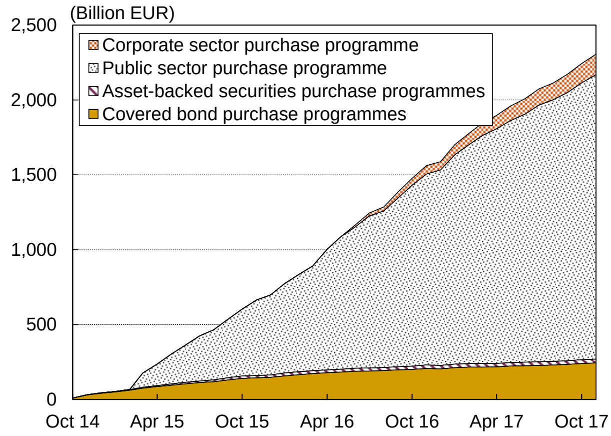
There are several reasons to scale back stimulus despite the weak inflation outlook. Primarily, it is hard to continue the Asset Purchase Programme (APP) in its current form. As shown in charts 13 and 14, the ECB has hoovered up assets since 2015. This has led to increased concerns about market distortion, and technical issues around self-imposed restrictions have surfaced.

Chart 13: Central Bank Balance Sheets



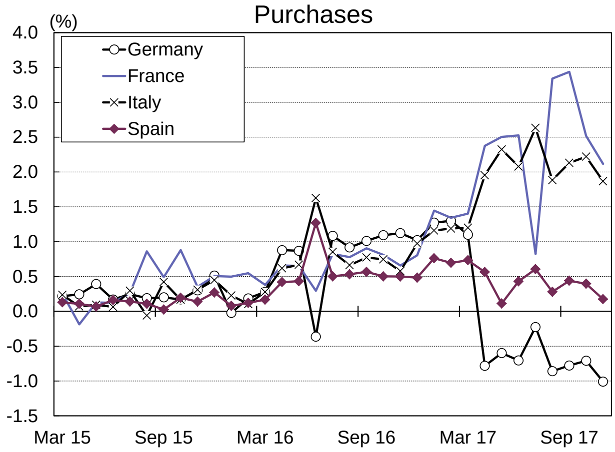

Source: Federal Reserve, BoJ, ECB, Macrobond, BTMU Economic Research Office

Chart 14: Cumulative Purchases Under the APP



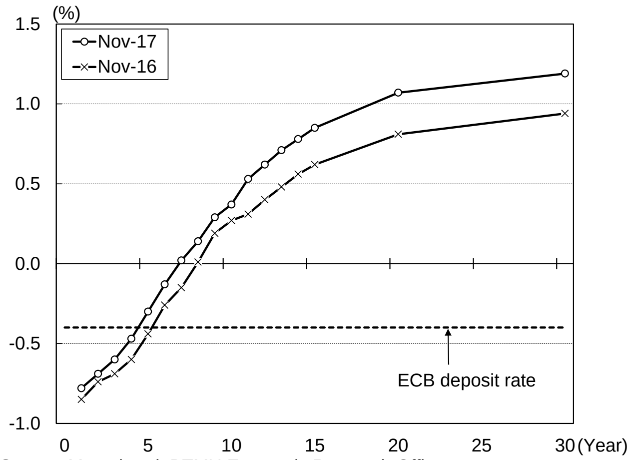

Source: ECB, BTMU Economic Research Office

Chart 15: Deviation from Capital Key in Monthly PSPP Purchases




Source: ECB, BTMU Economic Research Office

Chart 16: 10Y German Yield




Source: Macrobond, BTMU Economic Research Office

Asset purchases are supposed to be carried out in proportion to the capital key (which is based on the size of euro zone members' economies), but the ECB is approaching limits. Most troublesome is a lack of eligible German debt to buy, as Public Sector Purchase Programme (PSPP) purchases vastly outstrip net issuance of sovereign debt. The ECB allows some wriggle room, saying "some flexibility on a monthly basis will support the smooth implementation of the programme" and, as shown in chart 15, the Eurosystem has been buying proportionally more Italian and fewer German bonds since April. Some of this may be due to reinvesting previously purchased bonds which have matured – the September accounts note that there has been some deviation from the capital key "to spread over several months the reinvestment of proceeds from French bonds maturing in July 2017." But it also shows greater tolerance in general from the ECB toward their self-imposed limits.

There are other constraints as well as the capital key. The ECB states that "priority will be given to purchases of assets with yields above the deposit rate" which is currently -0.4%. As chart 16 shows, this may not always be possible. The German yield curve has steepened over the past year, but the short end is still yielding below the deposit rate.

The issue limit of 33% presents a further problem. It refers to "the maximum share of a single PSPP-eligible security that the Eurosystem is prepared to hold". The ECB is approaching this limit for Germany and other member states.[1] The ECB has raised the issue limit for supranational bonds from 33% to 50%, but this seems unlikely to be applied to national bonds given legal pressure from Germany. Looser rules could be subject to challenges as the ECB is prohibited from funding member states under the Maastricht treaty.

[1] We note that the ECB was actually buying more German bonds than implied by the capital key in 2016, which seems odd given this lack of eligible German debt. However, it is probably the case that the ECB was even more constrained by the issue limit in other sovereign markets as a result of the Securities Market Programme (SMP). The SMP (now discontinued) was initiated in 2010 to buy mainly sovereign bonds on secondary markets from Greece, Portugal and Ireland (and later Italy and Spain as well) to ease market pressure on borrowing costs. These SMP holdings still count toward current issue limit totals. Assets that were purchased under the SMP are held until maturity (there are around €80bn outstanding as of November 2017, down from a peak of €210bn). As these bonds drop out it frees more space for the ECB's PSPP purchases, but it seems that a higher pace of bond purchases from other countries, including Germany, was necessary in 2016. From April 2017 the ECB seems to have increased its tolerance for large deviations from the capital key, and has offset a shift to smaller German purchases by buying a disproportionately high amount of French and Italian debt. The legacy of the SMP is still being felt; the ECB is buying noticeably few bonds (relative to the capital key) from Ireland and Portugal in particular.

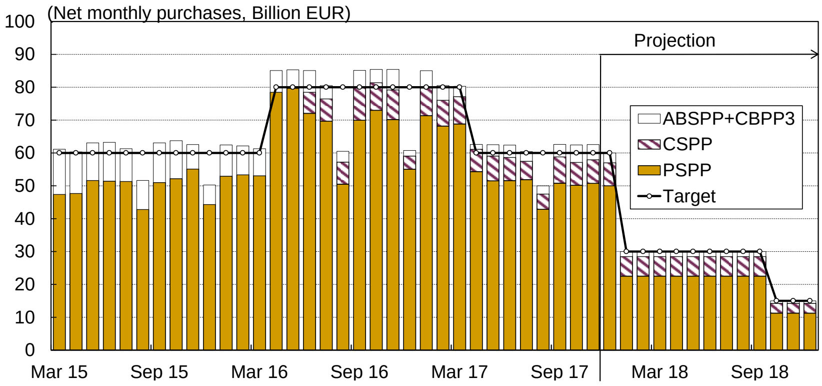
## 4. Asset purchases to be scaled back – but on open-ended terms

Forced into action by the constraints detailed above, the ECB announced that it will reduce the pace of its €60bn monthly asset purchases by half starting in January 2018. This is set to continue "until September 2018, or beyond, if necessary" and until there is a "sustained adjustment in the path of inflation" consistent with the target. In a dovish withdrawal of stimulus, the ECB stressed that they stand "ready to increase the APP in terms of size and/or duration" and reinvestment of principal payments will continue "for an extend period of term" after the end of net monthly purchases. The open-ended nature (it's not quite 'tapering' as there is no firm commitment to end) is important. It seems doubtful that there will be an immediate end to net purchases at €30bn in September given the ECB's desire to ease out of QE without spooking the markets. (This has worked well so far with effective communication from the ECB before the October 2017 meeting meaning that the headline of €30bn for 9 months was more or less the consensus expectation).

So, given this desire to avoid a 'taper tantrum', a hard stop to monthly purchases from €30bn in September 2018 to zero in the next month seems unlikely – even if inflation were to be supportive. **We see a continuation of 'slower for longer' at €15bn until the end of 2018**, but cannot rule out the ECB tapering to zero in instalments. The ECB's approach of 'average' monthly targets suggests the former is more likely, though. This is a baseline scenario and assumes that current economic conditions will prevail.

Chart 17 shows the possible path for tapering with a continuation at €15bn for three months. In this, we have suggested that **there may be a higher proportion of corporate bond purchases** in the monthly net total. This would be because of the limits to the available universe of government bonds (examined in the previous section). Any details on this would likely come at the 14 December meeting. Draghi stated in the October press conference that the governing council did not discuss composition of purchases but stressed that the ECB will "continue buying sizeable quantities of corporate bonds". A higher share of corporates in the overall net purchases makes sense to our minds as it would ease the pressure on eligible government bonds (which is hardly a secret). Nonetheless, the ECB may still want to avoid making such a tacit admission that it is at, or is approaching, the limits of the available universe for some national bonds.

Chart 17: Possible Path for Reduction in Monthly Purchases




Note: ABSPP = Asset-backed Securities Purchase Programme, CBPP3 = Third Covered Bond Purchase Programme, CSPP = Corporate Sector Purchase Programme, PSPP = Public Sector Purchase Programme

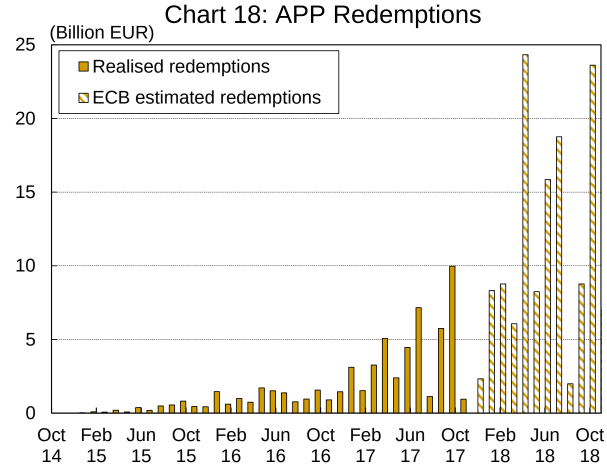
Source: ECB, BTMU Economic Research Office

## 5. Keep an eye on redemptions

As well as net monthly purchases, it is increasingly important to consider maturing bonds and the ECB's reinvestment policy. As shown in chart 18, redemptions are starting to take off after over three years of the APP. These are mostly in the Public Sector Purchase Programme (PSPP). The expected path is not smooth. Redemptions over the next 12 months will average almost €11 billion but range from over €24 billion (April 2018) to less than €2 billion (August 2018).

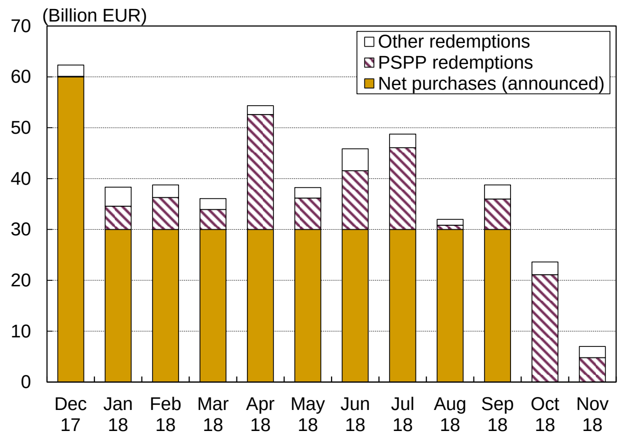
The ECB acknowledge this lumpy profile and explain "principal redemptions on securities purchased under the PSPP are reinvested by the Eurosystem in a flexible and timely manner in the month they fall due, on a best effort basis, or in the subsequent two months, if warranted by market liquidity conditions". This should have a smoothing effect, but we note that redemptions become significant from April 2018 onwards meaning the drop in net purchases as of January next year will not be cushioned that much by parallel repurchases (see chart 19). The ECB may wish to alter its approach and could pre-emptively 'reinvest' ahead of maturity to mitigate this problem (again, this could be discussed at the December meeting). Looking further ahead, though, reinvestment of principal payments could support the ECB. Almost €24bn redemptions are due in October 2018. This, with the current option to smooth over the following two months (and our expectation of further net monthly purchases at €15bn until the end of the year), should help the ECB ease out its net new purchases under the APP.

Chart 18: APP Redemptions




Source: ECB, BTMU Economic Research Office

Chart 19: Future Purchases and Expected Redemptions

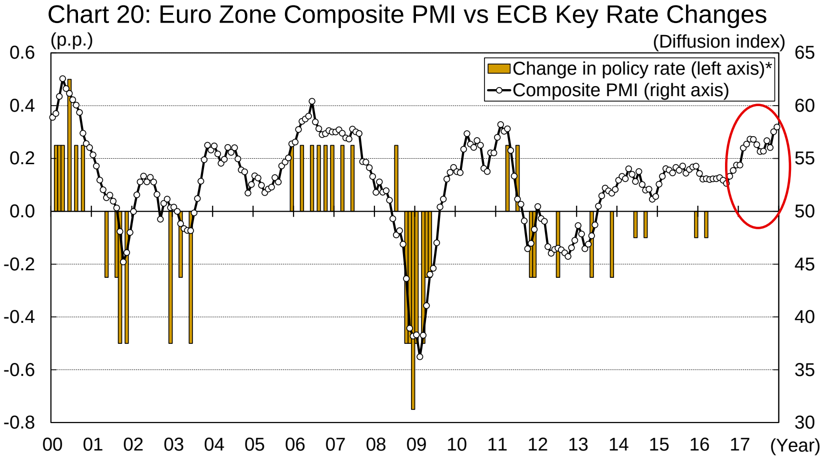



Source: ECB, BTMU Economic Research Office

## 6. Are there arguments for higher interest rates?

As the ECB withdraws one part of its economic stimulus, attention also turns to the outlook for interest rates. Chart 20, below, compares the composite PMI with changes to the ECB key rates. The recent survey strength (the December flash number was 58.0, an 82-month high) could have been consistent with rate hikes in the past. Other indicators, such as the European Commission's economic sentiment gauge, are painting an even stronger picture on a standardised basis.

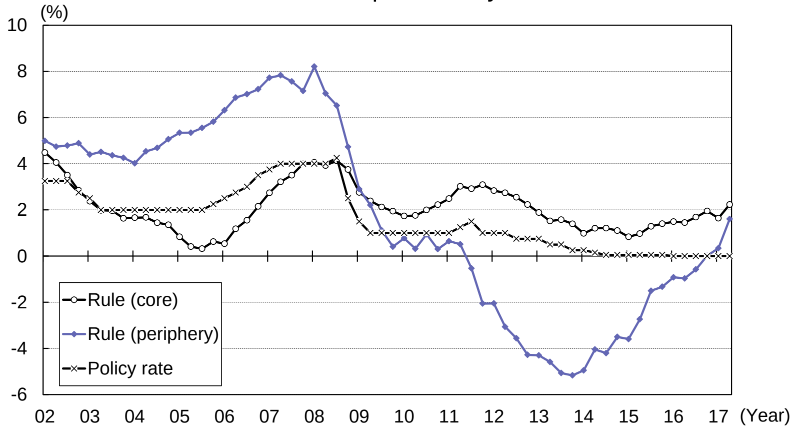
Chart 20: Euro Zone Composite PMI vs ECB Key Rate Changes




Note: MRO rate until Q4 2015 when deposit rate is used.
Source: IHS Markit, ECB, BTMU Economic Research Office

We also note the recovery in peripheral countries where weaker economic activity is often cited as a reason to keep monetary policy loose. Chart 21 shows the implied policy rates from a simple Taylor-type rule. Under this rule, the periphery and core part of the single currency area are finally converging after half a decade of weakness in peripheral countries.

Chart 21: Rule Implied Policy Rates*

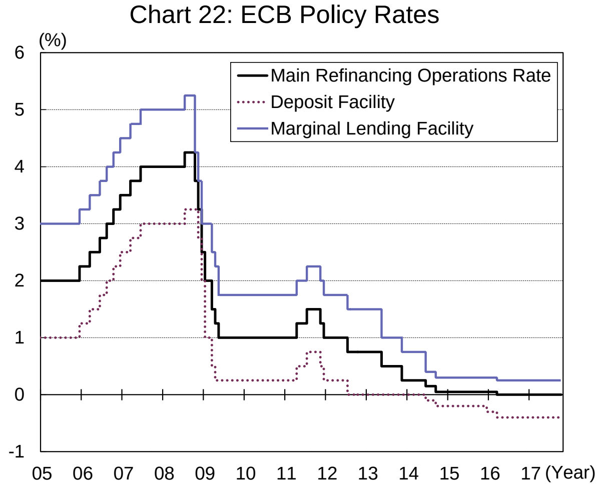



Note: 1 + (1.5 x Core Inflation) - (1 x Unemployment gap)
Source: Eurostat, ECB, Macrobond, BTMU Economic Research Office

However, while economic activity and the recovery in peripheral countries is encouraging, the exchange rate is causing the ECB a headache amid low inflation, as mentioned in Section 2. Technical constraints are one reason for the ECB wanting a slow and low extension of asset purchases, but the effect on the exchange rate is almost certainly also part of the medium-term strategy. There has been firm forward guidance of the ECB's intended sequencing. In the minutes of the meeting in September it was noted that "the Governing Council expected the key ECB interest rates to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases". We interpret this to mean around one year. The FOMC's approach in the US offers a benchmark from the recent past. QE3 purchases were halted on 29 October 2014. The subsequent rate hike – the first since 2006 – took place almost 14 months later on 16 December 2015.

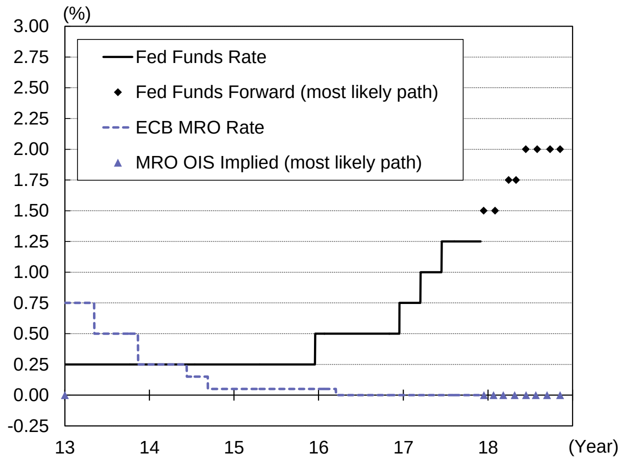
One of the main effects of the ECB's 'slower for longer' taper, combined with its guidance, is that market expectations for any hikes to the current record low interest rates (chart 23) will be pushed back until 2019 at the earliest. In turn, this should keep a lid on the euro. With the US rate hike cycle underway (the market expectation is two hikes in 2018, and the longer term median dot is 2.75) we are likely to see a softer single currency and a boost to prices, all things equal.

Chart 22: ECB Policy Rates




Source: ECB, Macrobond, BTMU Economic Research Office

Chart 23: Fed Funds vs ECB MRO Futures



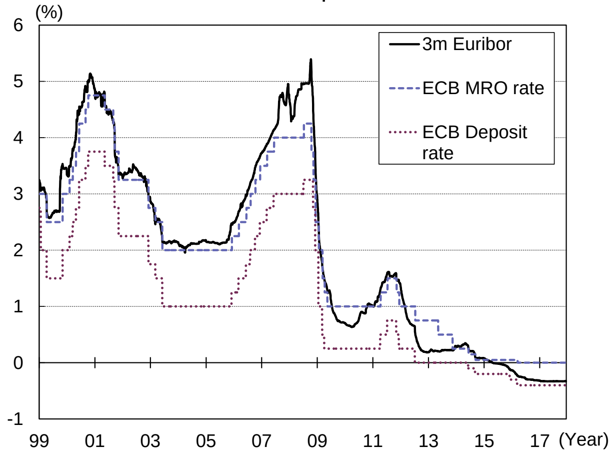

Source: Bloomberg, Macrobond, BTMU Economic Research Office

## 7. Rate increase very unlikely next year

Mindful of the strong forward guidance that the key interest rates will not be increased until sometime after net asset purchases have finished, and our expectation for a continuation of purchases after September next year, **we do not see any change to the MRO rate in 2018.**

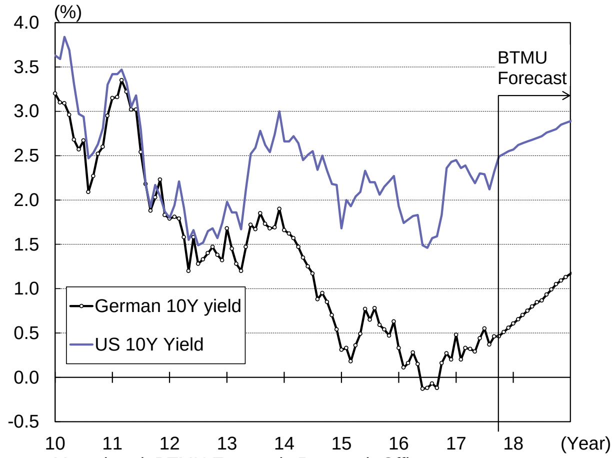
Meanwhile, the deposit rate currently stands at -0.4%, meaning that banks are effectively charged to deposit money at the ECB. There is opposition to this from German press in particular, and concern that low rates are hurting lenders' profits. Some are expecting the deposit rate will be raised before the MRO. It seems plausible. Back in March 2017, Nowotny, the Austrian ECB council member, said in an interview that the ECB could indeed raise the deposit rate before the MRO. Such a move would provide an opportunity to test the water in terms of market response ahead of raising the MRO rate. However, Draghi recently put a dampener on this by saying there is "little evidence that negative rates are undermining bank profitability". Moreover, **it seems unlikely that the ECB would risk strengthening the euro and weakening the inflation outlook by raising the deposit rate**. An earlier change to the deposit rate would therefore only take place if the euro was sufficiently weak. **Our base case remains a concurrent increase in both rates**. We expect the 3-month Euribor rate (chart 24) to stay in negative territory in line with the deposit rate. We also expect a steady increase in bund yields (chart 25) with a fairly smooth path given the ECB's desire to anchor expectations. The weak inflation outlook is likely to keep a lid on 10Y yields. The spread with US 10Y may narrow, but only slightly as the ECB is likely to persevere with reinvestment for some time.

Chart 24: ECB MRO and Deposit Rates, 3M Euribor




Source: Macrobond, BTMU Economic Research Office

Chart 25: German and US 10Y Yield Forecasts




Source: Macrobond, BTMU Economic Research Office

## 8. Conclusion

The ECB has announced it will reduce the pace of its asset purchases from €60bn to €30bn from January to September 2018. This is largely borne out of necessity (there are numerous technical limits to the PSPP programme) rather than a reaction to economic conditions. Inflation remains doggedly below target and the strong euro is not welcome in this regard. However, the 'slow and low' taper pushes back market expectations of a rate hike after the ECB provided strong guidance that it will not raise rates until sometime after the end of net asset purchases. This leads us to expect no change to either the MRO rate or the deposit rate in 2018. With the Fed's tightening cycle well under way this should keep a lid on further euro appreciation and help inflation approach the target.

Taking a wider view, the limits to QE will remain in place as the ECB continues to reinvest maturing assets. This leaves very little room for monetary policy manoeuvre in the event of future shocks. Given this, we expect Draghi will renew calls for looser fiscal policy and continued structural reform to cement the euro zone recovery.

## Box 1: What if economic activity slows?

Despite the current healthy outlook, the euro zone will probably face a cyclical slowdown at some point over the coming years. In this event, the ECB's ammunition would be very limited. The current overall policy mix is still extremely loose despite the slower pace of asset purchases. Interest rates are at, or very close to, the zero lower bound. Tightening will be slow; clear forward guidance means that we do not expect a rate hike in 2018. Asset purchases are being scaled back, but after nine more months at €30bn the ECB will be extremely close to the limits of the QE programme. Assets will remain on the balance sheet even after purchases have stopped, and reinvestment will continue "for an extended period after the end of net asset purchases". This means that it would be very hard for the ECB to restart QE within the current constraints, and the ECB's options would be very limited in the event of a future slump. Monetary policy would have to delve deeper into 'unconventional territory' and ideas such as helicopter money (a 'very interesting concept' according to Draghi in 2016) would gain greater prominence. But monetary policy could no longer be the only game in town. National governments would have to inject meaningful fiscal stimulus, and any structural reforms passed now, while the sun is shining, can only be a good thing further down the road.