Despite decision to end asset purchases, the ECB remains cautious on policy rate normalisation

REIKO SHINOHARA
ECONOMIC RESEARCH OFFICE

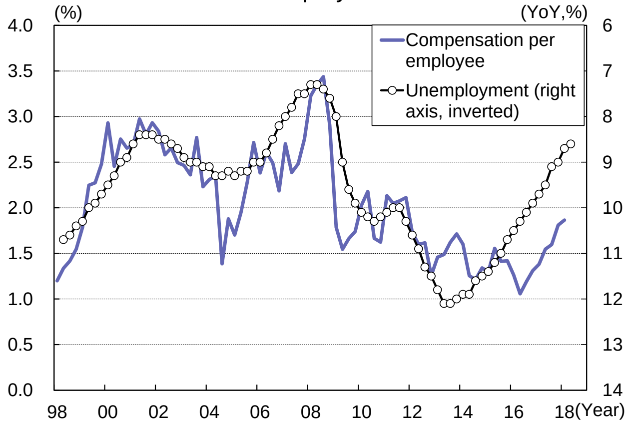
MUFG Bank, Ltd.
A member of MUFG, a global financial group

9 JULY 2018
(ORIGINAL JAPANESE VERSION RELEASED ON 27 JUNE 2018)

At the Governing Council meeting on 14 June the ECB decided 1) that it would reduce asset purchases (currently 30 million euros per month) to 15 million euro per month from October, and end them by the end of the year, 2) that it would continue to reinvest maturing assets even after the end of net asset purchases, and that net asset purchases could be extended if the need arises. Asset purchases are ending in the context of inflation making progress towards reaching its medium-term target of "just below 2%". The ECB's confidence in meeting this target seems to have risen based on continued moderate improvement in wage growth (Chart 1). Another likely factor behind the decision is a desire to avoid any loosening of fiscal discipline in member countries. If the ECB were to continue purchasing the sovereign bonds of euro area countries, this could be seen as encouraging public debt monetisation in countries like Italy, where fears are mounting over the potential for fiscal deterioration under the expansionist fiscal policies of the new government.

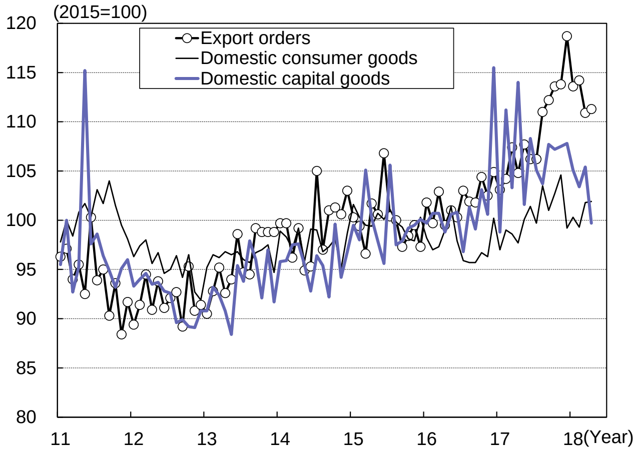
Through this decision has moved the ECB a step further along in its exit strategy, it is indicating at same time that interest rates will remain at the current level until at least next summer. The schedule of rate rises that has been hinted at by the Governing Council, from autumn 2019, is considerably behind the majority of market expectations (of June 2019), demonstrating the ECB's cautious position towards interest rate normalisation. Though the ECB acknowledges that the fundamental strength of Eurozone economies remains unchanged, it points to uncertainty resulting from the rise of protectionism and growing market volatility as source of risk. Whilst this could certainly be attributed to a reaction from the strong growth experienced in the Eurozone economy until last year, exports and capital expenditure in particular were already slowing. Looking at the manufacturing sector in Germany, the largest economy in the region, manufacturing export orders have stagnant in the months to April affected by an earlier appreciation of the euro (Chart 2). Turning to sentiment, the manufacturing purchasing managers index (PMI) declined for a sixth consecutive months in June, and rising trade tensions with the US seem to be a contributing factor. Private consumption-led robust growth is likely to continue. However, the ECB is poised to keep monitoring the potential for worsening corporate sentiment to weigh down the economy by limiting investment and new hires.

Chart 1: Eurozone Compensation per Employee, Unemployment



Source: Eurostat, ECB, MUFG Bank Economic Research Office

Chart 2: German Manufacturing Orders



Source: Bundesbank, MUFG Bank Economic Research Office

For further details, please contact the Economic Research Office, MUFG Bank

Managing Director, Yasuhiro Ishimaru Tel: +81-(0)3-3240-3204

Written by Reiko Shinohara <reiko_shinohara@mufg.jp>