Euro area – Rate hikes on the horizon as ECB winds down QE

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1. Introduction

The ECB is taking steps towards monetary policy normalisation. First, monthly net purchases under the expanded asset purchase programme (APP) were reduced from January. It then dropped the commitment to "increase the APP in terms of size and/or duration" if economic conditions deteriorate. Now, it could be argued that conditions have indeed worsened. After consecutive quarters of 0.7% QoQ GDP growth, the figures for Q1 and Q2 were underwhelming at 0.4% and 0.3% respectively.

But the ECB has looked past weaker data on account of evidence that underlying inflation is drifting higher. On 14 June it was announced that net asset purchases will be reduced in size again after September and are then likely to cease altogether at the end of the year. Forward guidance on interest rates meant that the overall tone of the June announcement was dovish, though. We already knew that key rates would remain at their current levels until "well past" the horizon of net asset purchases. The ECB has now clarified that rates will be unchanged "at least through the summer of 2019" which is later than many had expected.

A low-key July meeting did very little to change the outlook and **we expect the first hike – to the deposit rate only – in late Q3 2019**. This will prime the ECB for an increase in the main refinancing operations (MRO) rate in Q1 2020 in order to restore the 25bp corridor between the key rates.

2. The economy loses momentum

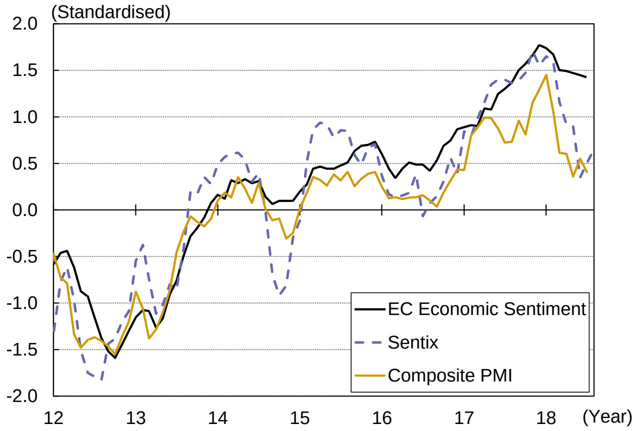
Euro area data have been disappointing in H1 2018. GDP growth fell to 0.4% QoQ in the first quarter, down from 0.7% at the end of 2017. Domestic demand, led by private consumption, was the main engine of growth, although the contribution from gross fixed capital formation was smaller. Changes in inventories also made a positive contribution. Net trade was a drag, however, amid worries about protectionism.

In Q1, reports of flu in Germany, inclement weather and workdays lost to strike action suggest that some one-off factors dragged down overall economic activity. But there was no rebound in the second quarter – the preliminary estimate shows QoQ growth at just 0.3% QoQ (2.1% YoY).

Some form of slowdown is no surprise. There was a sense that sentiment indicators were looking unsustainably strong at the end of 2017, as shown by the standardised figures in Chart 1. This led us to write in March that softer confidence figures over the coming months seemed likely[1] (although we did not expect the numbers to be quite so weak – global trade tensions and the risk of US tariffs on imports of EU cars in particular are probably weighing on the latest figures). In fact, some recent numbers have been a bit more encouraging. The composite PMI for July, assuming a constant profile through the rest of the quarter, is consistent with around 0.5% QoQ GDP growth in the Q3 (Chart 2).

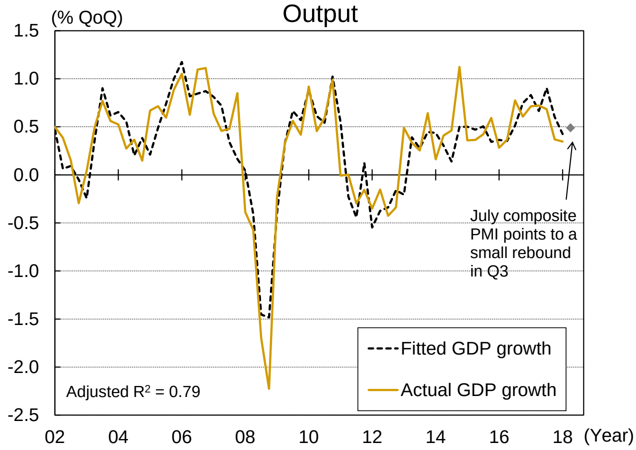
[1] See here: www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-Euro20180305.pdf

Chart 1: Euro Area Sentiment Indicators



Source: European Commission, IHS Markit, Sentix, MUFG Bank Economic Research Office

Chart 2: Euro Zone Actual GDP Growth and PMI Model Output



Source: IHS Markit, Eurostat, MUFG Bank Economic Research Office

Taking a wider view, we note that most forecasters, us included, have expected euro area economic activity to moderate towards potential for some time. This is now happening. The economy had expanded for five years in a row but it looks like buoyant growth in 2017 was probably an exception rather than a new norm. This year, supply-side constraints are expected to become increasingly binding with capacity utilisation at a post-global financial crisis (GFC) high. The strong euro is weighing on exporters who may have hoped to benefit more from the global upswing. In terms of consumer spending, headwinds are likely from higher precautionary saving and slowing employment growth.

Nonetheless, the fundamentals of the euro area economy remain strong against a background of very accommodative monetary policy. With lending conditions still favourable, firms are likely to respond to capacity constraints and improved profits by increasing investment. Consumer spending will continue to be supported by a tight labour market, even if employment growth slows and higher fuel prices become a drag. The recently softer euro should cheer exporters which have been hampered by the strength of the single currency.

As Peter Praet, the ECB's chief economist, said in May "the latest euro area data point towards some moderation, but remain consistent with a solid and broad-based economic expansion". We agree. Underlying conditions are still supportive and the economy remains robust overall.

Our forecast is for 2.2% annual average GDP growth in 2018 (an upwardly revised Q4 2017 figure helpfully boosts the carryover).

3. The inflation outlook

The ECB can look past weaker growth if there are signs of a sustained adjustment in the path of inflation towards its target of just below 2%. As Executive Board members have repeatedly stressed in speeches, this requires the following three conditions to be met:

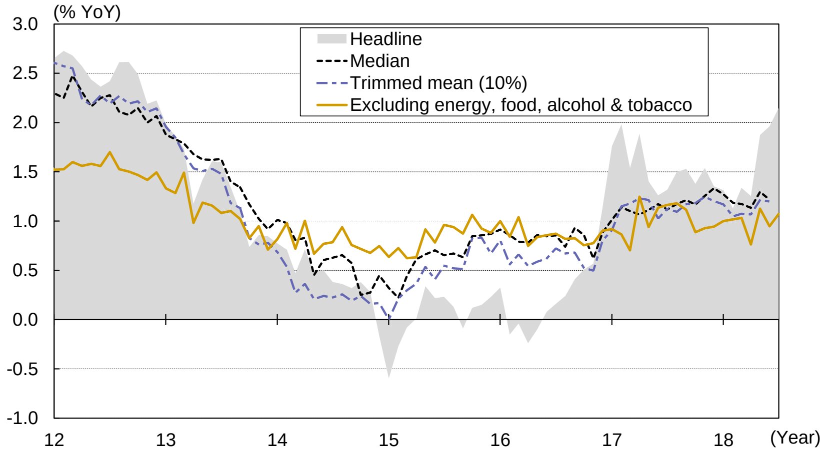
(1) **Convergence:** headline inflation has to be on course to reach the aim over a meaningful definition of the medium term (monetary policy cannot control inflation over the near term).

(2) **Confidence:** the ECB has to be sure that this upward adjustment in inflation has a sufficiently high probability of being realised.

(3) **Resilience:** the adjustment in inflation has to be self-sustained.

On the same day as the disappointing Q2 GDP growth data was released, Eurostat announced that headline inflation reached 2.1% YoY in June. This above-target figure was boosted by higher energy prices, but the nature of the above conditions means that the ECB examines underlying price pressures to assess whether any adjustment is sustainable. Chart 3 shows various measures of core inflation, which generally remain subdued. HICP inflation excluding energy, food, alcohol and tobacco was just 1.1% YoY in July.

Chart 3: Euro Area Inflation Measures

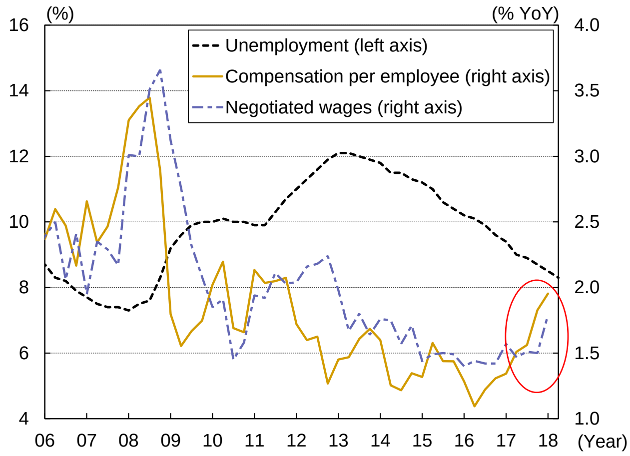


Source: Eurostat, MUFG Bank Economic Research Office

While core inflation remains a long way from the ECB's target of below, but close to, 2% over the medium term, there are some encouraging signs. Firstly there has been a very gradual upward shift above rates of 2014-15 when HICP inflation excluding energy, food, alcohol and tobacco fell to a low of just 0.6% (the weaker figure in April this year can be attributed to the early timing of Easter). Inflation is less responsive to slack since the GFC but there are suggestions that the traditional Phillips curve relationship may be beginning to reassert itself (and there may have been more evidence if not for high migration flows into Germany).

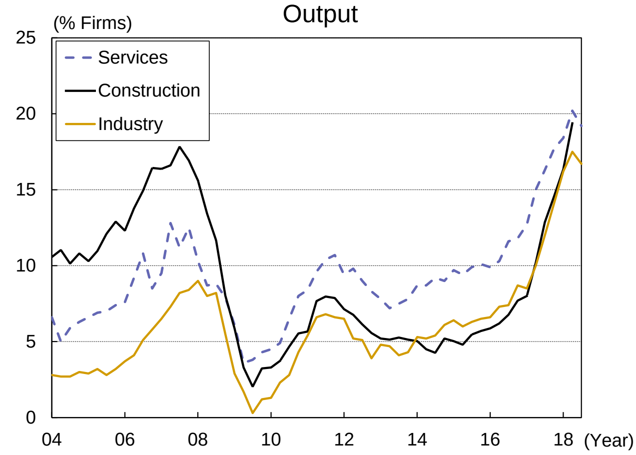
The euro zone unemployment rate is the lowest since December 2008 and employment has risen by over 9 million since 2013. Against this background, Chart 4 shows how wage growth is improving steadily toward 2% YoY and it is notable that negotiated wages have been rising sharply. With an increase in the numbers of firms – whether in services, industry or construction – reporting labour as a factor limiting output (Chart 5), it is unlikely that this upward pressure on pay will end.

Chart 4: Wage Growth and Unemployment



Source: Eurostat, ECB, MUFG Bank Economic Research Office

Chart 5: Firms Reporting Labour as a Factor Limiting Output



Source: European Commission, MUFG Bank Economic Research Office

We expect core inflation will drift upward under this moderate wage pressure. Strong base effects are likely to then lend support to YoY rates through Q3 2018. Overall HICP should be pushed up further by higher oil prices. Further ahead, we expect that inflation will be sustainably close to 2% by mid-2019.

4. Monetary policy outlook

Against this background we turn to the outlook for monetary policy. The ECB had provided clear guidance about its intended sequencing: it will stop net asset purchases first before raising interest rates sometime later.

1. APP

The ECB already started to take tentative steps away from its APP by dropping the so-called easing bias in March. This was a phrase in the introductory statements after monetary policy meetings which stated that the ECB was ready to increase the APP "in terms of size and/or duration" if conditions deteriorate. Omitting this was a small but symbolic change as the ECB edges away from its €2.4 trillion quantitative easing (QE) programme.

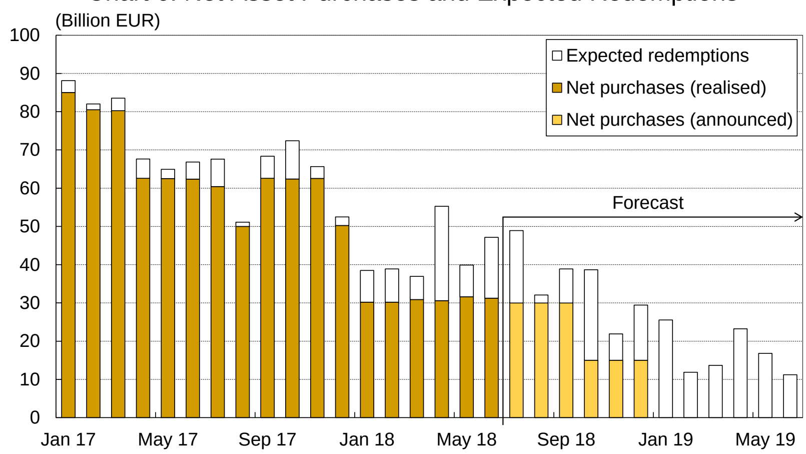
Since then data flow has continued to surprise on the downside, but it was not enough to derail the ECB's departure from net asset purchases. It was announced at the 14 June monetary policy meeting that the ECB "will continue to make net purchases under the APP at the current monthly pace of €30 billion until the end of September 2018". After that, it is "anticipated" that the pace of net asset purchases will be reduced to €15 billion each month until December 2018 when net purchases are set to stop. This change was in line with our expectations.[2]

[2] See here: www.bk.mufg.jp/report/ecoeu2017e/BTMU-Economic-Brief-Euro20171213.pdf

It is worth highlighting that the ECB uses the soft word "anticipate" rather than a stronger commitment, and also states that the move is "subject to incoming data" on the medium-term inflation outlook. However, a U-turn would be embarrassing and risk credibility. Any change to the announced path seems very unlikely. We also note that the announcement came both before it was necessary and earlier than expected (most observers expected the change at the July meeting, which, it turns out, was very low-key as the ECB eased into summer with very little to trouble the markets). There may have been pressure from the more hawkish members of the Governing Council. Besides, the ECB would have found it hard to continue net asset purchases under its own rules, even if it wanted to, because of a lack of eligible public sector debt.

Chart 6 shows how the APP is likely to develop over the next 12 months. It is important to note that the ECB will remain active in markets even when net asset purchases end in order to reinvest maturing assets. The profile of these redemptions is quite bumpy but some flattening is to be expected. Public sector purchase programme (PSPP) redemptions, which form the bulk of total purchases, 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". Smoothed reinvestment will help ease the effect on markets after more than three years of net purchases. The ECB may announce further flexibility in forthcoming meetings. For example, reinvestment could be smoothed over more than the current two months, or perhaps pre-emptively. Also, maturing PSPP securities could be reinvested in the corporate sector to help ease availability constraints.

Chart 6: Net Asset Purchases and Expected Redemptions



Source: ECB, MUFG Bank Economic Research Office

Looking ahead, it may be around three years before the ECB ceases to reinvest principal redemptions. The Fed's approach (and possibly the BoE by then) will be a useful guide for future policy. In the US, the announcement of an end to reinvestment came after four hikes from the post-GFC low rate. As we discuss below, we do not expect lift-off any time soon in the euro area, and any subsequent moves higher are likely to be very gradual.

2. Key rates

The ECB has been clear about its sequencing. Interest rates will remain at their current levels "for an extended period of time" and "well past" the end of net asset purchases. Draghi has also consistently stressed that monetary policy will remain "patient, persistent and prudent".

This emphasis on gradualism meant that June’s enhanced forward guidance on rates was not surprising, although the move to an explicit (or “Odyssean”) approach was not anticipated. The ECB announced that it expects key interest rates to “remain at their present levels at least through the summer of 2019 and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectations of a sustained adjustment path.”

The key phrase is “through the summer of 2019”. This is perhaps purposefully vague and raises an issue of semantics (those in northern euro zone countries may feel that their summer is lot shorter than it is in the south!). Our own interpretation is that a move after August 2019 would fit with the forward guidance.

Trying to underline the overall dovish message, Draghi reiterated that the ECB will be patient and gradual in his Sintra speech a few days after the policy meeting. His caution is understandable. It is impossible to know how the economy will react after such a large dose of unconventional monetary stimulus, especially with some uncertainty about the global outlook amid trade tensions. As discussed above, though, our base scenario is that core inflation will be sustainably closer to 2% by mid- to late 2019. If so, the ECB will be under increased pressure to tighten policy.

This guides us to expect the initial hike in late Q3 2019. The move could well come at the 12 September monetary policy meeting which will be Draghi’s penultimate before his term expires on 31 October 2019. After eight years at the helm without any rate hikes he may well want to start the ball rolling towards normalisation for his successor.[3]

[3] See here for discussion on his replacement: www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-Euro20180220.pdf

An initial move in the deposit rate before adjusting the MRO rate was mooted back in April by Austrian central bank governor and Governing Council member Ewald Nowotny. After the euro appreciated on this remark, the ECB distanced itself from the comments saying “they do not represent the view of the Governing Council”. But such a move makes sense to our minds. It would set the wheels in motion and move the ECB closer to reinstating its preferred corridor of 25bp between each key rate (a reluctance to push the MRO rate into negative territory has meant the current 40bp gap to the deposit rate).

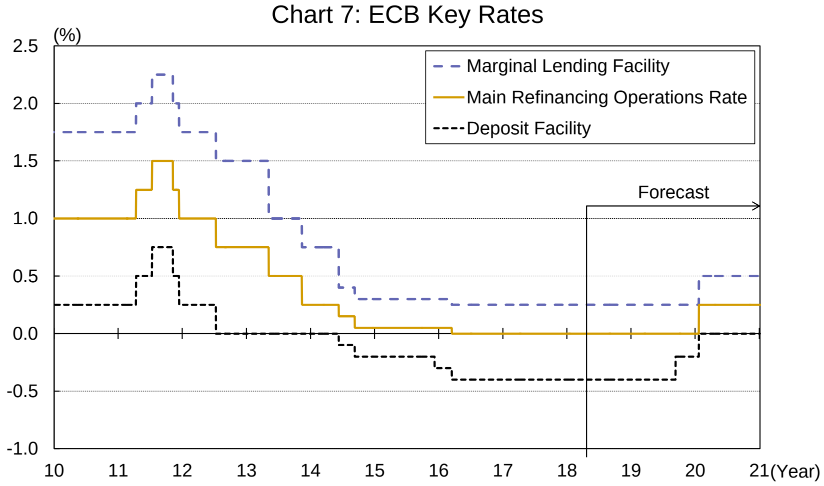
We think lift-off could be broken down into two steps. First, we expect a 20bp increase in the deposit rate in Q3 2019. This would be followed relatively swiftly by another 20bp hike, to 0%, and a 25bp MRO rate hike, to 0.25%, in Q1 2020 (Chart 7).

The 25bp channel between the deposit rate and the MRO rate would be restored, teeing up the ECB for further moves later. In order to return to its preferred corridor an alternative would be to increase the MRO (and lending rate) by just 5bp alongside the first 20bp move in the deposit rate. To our minds, the single move in the deposit rate in Q3 2019 would be more straightforward, and arguably more dovish, as only one key rate is increased initially.

After this we expect a pause before hiking resumes at regular intervals. Again, the example of the US is a useful guide: the Fed waited a year after the initial lift-off before raising rates again

– although market volatility, political uncertainty and the Brexit shock in 2016 may have delayed further moves.

Chart 7: ECB Key Rates



Source: ECB, MUFG Bank Economic Research Office

5. Conclusion

It has been announced that net asset purchases under the APP have been extended until December 2018 at a further reduced monthly pace. This is very likely to be the end of the ECB's net purchases, but reinvestments are set to continue for some time.

Key interest rates, and forward guidance on their expected evolution, are then the main policy tool. The ECB has stated that rates will be unchanged "at least through the summer of 2019". There is unlikely to be much of a wait into autumn. We forecast that the deposit rate will be increased in late Q3 2019, just before the end of Draghi's term.

While it is very clear that the ECB will not rush things, slightly weaker economic activity is unlikely to be much of a speed bump. The ECB's primary objective is to maintain price stability and it will continue to look for evidence of a sustained adjustment in the path of inflation. Core inflation is now showing signs of moderate upward pressure and we expect it will approach the target by mid-2019. Besides, even with some slowdown, GDP growth (2.1% YoY in Q2) is likely to remain above potential (around 1.5%).

Overall, our judgement is that the risk of deflation has passed and the euro zone is no longer in crisis so unconventional measures are no longer warranted. However, while not quite at the lower bound (equities could be added to the APP for example), the ECB cannot afford to make mistakes as it eases away from the current ultra-loose policy stance.