Economics

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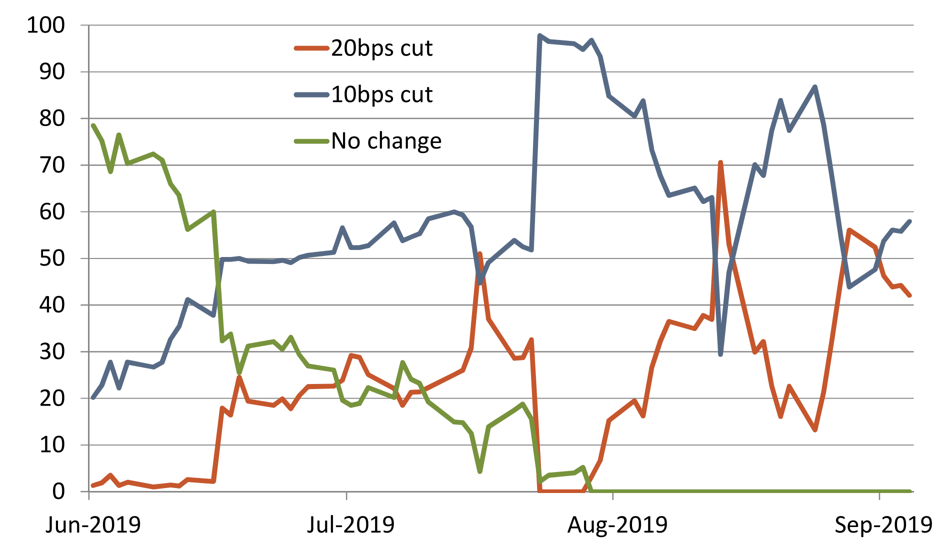
ECB preview: a compromise package

- **All members of the ECB Governing Council look ready to ease monetary policy further on 12 September.** However, the members seem to disagree more than usual about the nature and size of the additional stimulus measures.
- When the ECB decided to keep monetary policy on hold in July, it left the door wide open for a new comprehensive policy package to emerge this month. Comments by Governing Council members shortly thereafter nurtured such expectations. But the pendulum has swung the other way recently. Even some usually dovish members have cautioned against doing too much, arguing in particular against an immediate resumption of net asset purchases.
- This week's discussions could be lively. We expect a broad majority – not necessarily all – of the Governing Council members to support a policy package in the end. In our view, the ECB will probably:
  - **cut the deposit rate by 20bp from -0.4% to -0.6%;**
  - **re-launch monthly net asset purchases worth €30bn euros for at least 12 months** – an alternative could be €20bn euros for at least 18 months;
  - **strengthen its forward guidance** by extending the horizon to keep rates at present or lower levels beyond H1 2020; the ECB may also link the outlook for asset purchases to the path of inflation, or even to a specific rate;
  - **introduce a tiering system for bank deposits** so that only reserves in excess of at least 10 times the minimum reserves will be charged the penalty rate; and
  - **raise the self-imposed issuer limit for purchases of government bonds** from 33% to 40% or even 50%.
- **The outlook is fraught with more uncertainty than usual.** After a heated debate this week, the Governing Council may postpone a decision to resume net asset purchases and/or settle on a 10bp cut in the deposit rate (see Chart 1 on how the market is split about the size of a rate cut).
- **The ECB is reviewing its monetary policy strategy, including whether to make its "below, but close to 2%" inflation target (more) symmetrical. The review will not be finalised before 2020.** Incoming ECB president Christine Lagarde, rather than its incumbent head Mario Draghi, will eventually present the results.
- To bring the arguments for or against specific ECB actions into focus, we present how a conversation might go between two hypothetical Governing Council members – a dove and a hawk – just ahead of this week's meeting (see overleaf).

Chart 1: The market is pricing in a rate cut, but is split about its size



Implied probability for a change in the ECB's deposit rate (currently at -0.4%) at the 12 September ECB meeting, in %. Source: Bloomberg

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Dove and hawk: a hypothetical conversation

Dove: It is clear that the time has come to act decisively – no ifs or buts. Otherwise we may have to ease policy more later on.

> **Hawk:** Yes, growth is soft and core inflation refuses to go up. But why not take it easy and go step by step? We can afford to do less now.

Dove: I do not think so. We have to come up with a package now that is both significant and impactful: rates, asset purchases, long-term loans and forward guidance reinforce each other.

> **Hawk:** Our stance is already highly accommodative. And why should we go for a big package if we can separately use different tools for different contingencies – for example, rate cuts against an unwarranted tightening of financial conditions, asset purchases to fight low inflation and liquidity injections such as TLTROs (targeted long-term refinancing operations) to boost bank lending.

Dove: But we are not delivering on our goal to keep inflation below, but close to, 2%. We need to do whatever we can within our mandate to get there.

> **Hawk:** How confident are you that monetary policy can do much about trade tensions or Brexit? It has become less effective and has notable side-effects.

Dove: Sure, fiscal policy is more effective than monetary policy. But waiting for fiscal policy to act would be like waiting for Godot. As a side-effect, our policy helps to provide fiscal space.

> **Hawk:** The more monetary policy acts like the only game in town, the less fiscal policy may do its job.

Growth outlook

Dove: Pervasive uncertainty will be with us for the rest of this year – just look at trade tensions, the hard Brexit risk and the weakness of the Chinese economy. Our growth forecasts have come down again (see Chart 2).

> **Hawk:** The Eurozone's domestic economy is still doing fine (see Chart 3), and the fear factor may fade as everybody gets used to the mess.

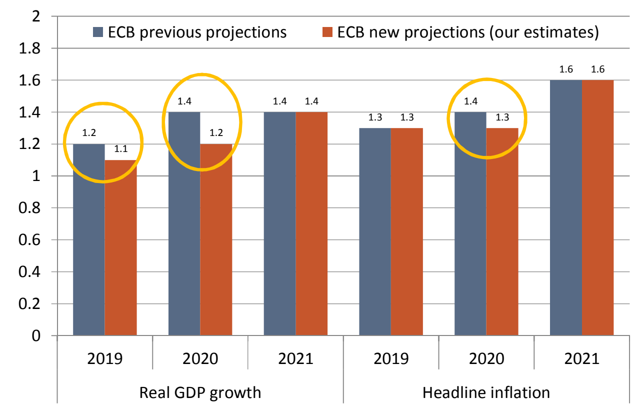
Dove: I'm not sure about that. The industrial downturn is spreading more and more to other parts of the Eurozone economy. Services close to manufacturing are suffering and employment growth is slowing.

> **Hawk:** Incomes continue to rise solidly and consumers remain confident about their financial situation.

Dove: But the risk that we could be heading for a recession is rising.

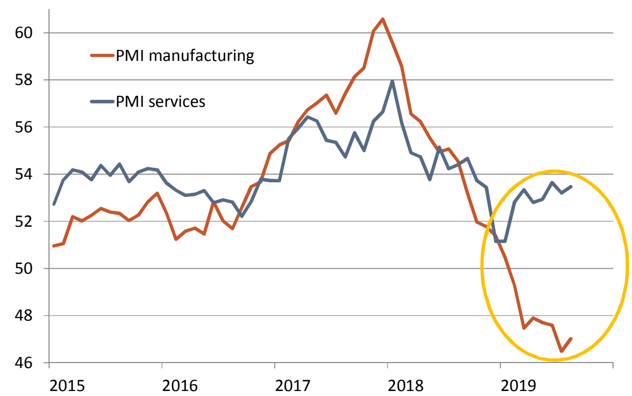
> **Hawk:** While there is a significant recession risk, that applies only to Germany and Italy, and maybe even there only to the industrial sector.

Chart 2: ECB projections: previous versus new (our estimates)



Yoy, in %. The "new projections" are Berenberg estimates for the new staff projections which the ECB will publish on 12 September. Sources: ECB, Berenberg

Chart 3: Mind the gap: Eurozone PMI manufacturing versus services



A value above/below 50 signals expansion/contraction. Monthly data. Source: Markit

Deposit rate

Dove: I think we agree that rates have to go lower, but how low should we go? If you ask me, it has got to be a rate cut of 20bp.

> **Hawk:** 10bp will do. A bigger rate cut could signal that we are panicking. Plus, we should leave some headroom to be able to do more later on if necessary.

Dove: We are not at the effective lower bound for interest rates yet, so we still have enough headroom. The natural interest rate has most likely fallen by 20bps or more.

> **Hawk:** The natural interest rate has fallen, but by less than that. We also should keep in mind that our policy stance itself can affect the natural rate, so we may be chasing our own tail.

Dove: A Taylor-style reaction function justifies a bigger rate cut, regardless of your estimate of the output gap or your inflation target.

> **Hawk:** We all know how difficult it is to tell the size of the output gap, or the level of the natural rate.

Dove: Markets are pricing in a cut by 15bp (see Chart 1). Financial conditions could tighten at the short end of the yield curve if we cut by less. Of course, we should not be led by markets. But we do have to take financial conditions into account.

> **Hawk:** We need to cut rates, but markets have got ahead of themselves.

Dove: Look to the US. We could pre-empt further Fed rate cuts with a bigger cut now and avoid unwarranted tightening later via the exchange rate.

> **Hawk:** The Fed's dovish turn has not boosted the euro too much this year. The euro remains competitively valued. Anyway, let's focus on us.

Tiering of the negative deposit rate

Dove: If we settle on a rate cut – and possibly net asset purchases – we have to introduce deposit tiering.

> **Hawk:** Really?

Dove: If we go lower, the costs of more negative rates will otherwise offset their benefits.

> **Hawk:** Bank profitability is not our mandate – it is price stability.

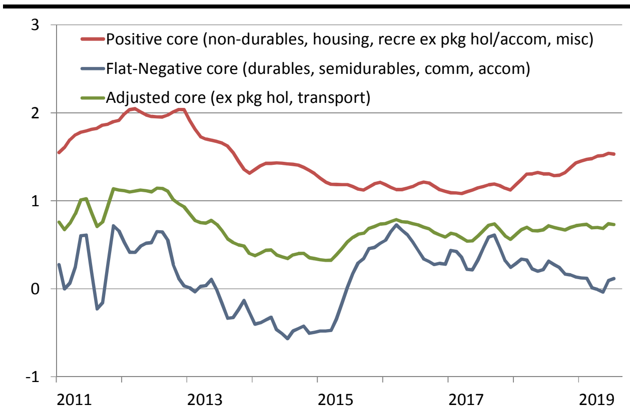
Dove: But low bank profitability can further impair the transmission of our monetary policy stance to the real economy and inflation.

> **Hawk:** The data show that bank lending is doing fine.

Dove: It may not stay this way. Banks are weak. We should exclude all reserves up to at least 10 times from current minimum reserves. Tiering creates space for further rate cuts.

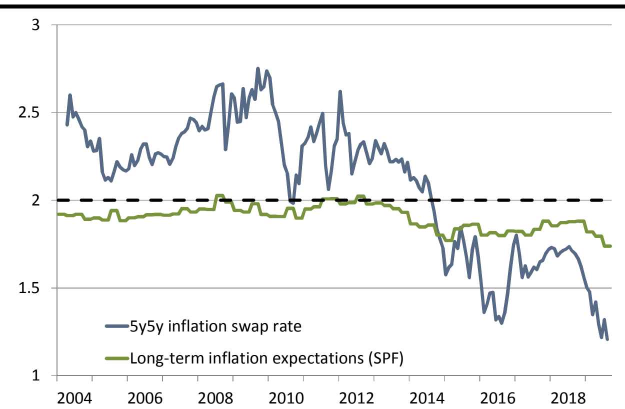
> **Hawk:** Yes, but at the price of distorting markets more.

Chart 4: Inflation – softer versus stronger basket



Yoy change in %. Adjusted core: core consumer price index ex package holidays and transport services. Stronger basket: non-durables, housing services, recreation and personal care (ex package holidays and accommodation); and miscellaneous services. Softer basket: durables and semi-durables, communication and accommodation services. Source: Eurostat, Berenberg

Chart 5: Market- and survey-based inflation expectations



Monthly data for swap rate. It is an indicator of inflation 5-10 years in the future. Quarterly data for Survey of Professional Forecasters (SPF), in %. Source: Bloomberg, ECB, Berenberg

Inflation outlook

Dove: Let's move on to inflation. I don't like what I see: price pressures remain weak. Even for 2021, we forecast inflation to be far below our target (see Chart 2).

Hawk: Underlying price pressures are building. Look at those items of the price basket that are closely linked to domestic demand and the labour market (see Chart 4).

Dove: But core inflation is still at around 1% – and has been for more than five years now. Weaker growth prospects point to a worsening of the medium-term outlook.

Hawk: Yes, but the medium-term over which the ECB should reach its inflation target should be interpreted flexibly amid long-term disinflationary headwinds such as demographics, global competition and technological change.

Asset purchases

Dove: Still, inflation expectations are at ever greater risk of becoming de-anchored (see Chart 5). We should thus re-launch net asset purchases.

Hawk: I see no need to do that now. Survey-based inflation expectations are at 1.7-1.8% for the long term. They are still below, but close to, 2%.

Dove: Even survey-based inflation expectations have fallen to their lowest level ever. Indicators across the board – market or survey-based, short- or long-term – point to even lower inflation.

Hawk: We are still far away from the 2014/2015 trough and deflation risks, though.

Dove: I do not want to wait until that. We need to announce quantitative easing now.

Hawk: If necessary, we will announce it in December – it is still too early now to know whether we really need to do it.

Dove: Let us talk about the sum. I would go for at least €60bn, for 24 months and as long as necessary.

Hawk: Again, if necessary, at most €15bn, for six months, which would allow us to stay within our issuer limit. Do not forget our ongoing re-investments (see Chart 6).

Universe of eligible assets

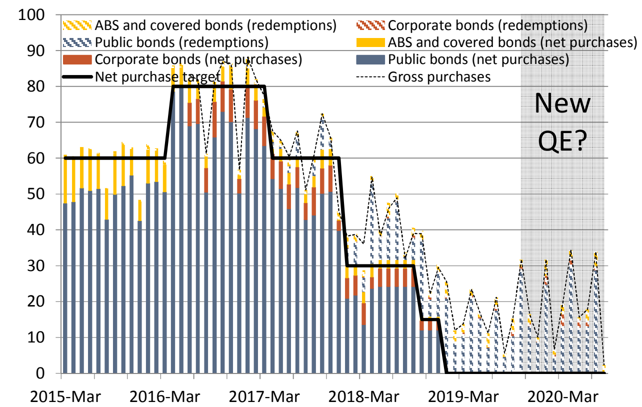
Dove: To have more flexibility, we need to expand the universe of eligible assets.

Hawk: Again, not yet, one step after another.

Dove: We need to raise the issuer limit from 33% to 50% to give us more headroom for a sizeable purchase programme of government bonds (see Chart 7).

Hawk: But doing so would bring us closer to the monetary financing of fiscal policy.

Chart 6: Past ECB asset purchases



In bn euros. Source:

Chart 7: Firepower if issuer limit raised from 33% to 50%

monthly purchases (in bn euros)

duration (in months)	15	25	35	45	55	65	75
12	180	300	420	540	660	780	900
18	270	450	630	810	990	1170	1350
24	360	600	840	1080	1320	1560	1800
30	450	750	1050	1350	1650	1950	2250
36	540	900	1260	1620	1980	2340	2700
42	630	1050	1470	1890	2310	2730	3150
48	720	1200	1680	2160	2640	3120	3600

Raising the issuer limit from 33% to 50% would open up c€1.1trn euros of government bonds for a new ECB purchase programme. Green (red) shaded combinations are (not) possible in that case. Numbers show total amount of a new purchase programme in €bn. Sources: Bloomberg, ECB, Berenberg

Dove: Would you prefer to open the universe of eligible assets to (unsecured) bank debt and equity?

Hawk: No, that creates even more distortions. Banks already have access to cheap funding via our TLTROs.

Dove: What about a review of the capital key rule?

Hawk: That is a no go. We have to stick to the capital key allocation of purchases. Otherwise we would violate the rule that we implement the same monetary policy for all member states.

Forward guidance

Dove: Forward guidance is another tool we should work on. Why not link our guidance on rates or net asset purchases to a specific rate of core inflation?

Hawk: That is too strong for me: we would corner ourselves and lose options.

Dove: What about extending the guidance beyond the first half of 2020?

Hawk: We may have to do that at some point. But as we are data-dependent, we can easily wait until 2020 before changing it.

Liquidity injections (TLTROs)

Dove: Anything else? The new targeted long-term liquidity operations which we call TLTROs are starting this month. I want to make them cheaper.

Hawk: Even cheaper?

Dove: Let's go lower and get rid of the 10bp mark-up on top of the deposit rate we agreed on earlier this year.

Hawk: No. The terms are sufficiently generous. The loans will turn cheaper with a rate cut anyway.

Review of strategy

Dove: One last thing: regarding the review of our strategy, we should really make our target symmetrical, either by setting it at 2% straight or by moving to a range of 1-3% or...

Hawk: ...wait, wait. I see your point, but we should take our time. We have to be careful not to lose our credibility by being unduly hasty now.

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