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# ECB: GOING ALMOST TO THE LIMIT

## Berenberg Macro Flash

Wow. In almost every respect, the ECB went beyond expectations today. That holds for the scope and breadth of its monetary policy measures (see our earlier message) as well as for the generous details of its LTRO liquidity injections and its forward guidance on interest rates. According to ECB president Draghi, the Governing Council adopted the comprehensive package with "an overwhelming majority".

The package can help to return the Eurozone economy back to its trend rate of growth by mid-2016 unless a new shock such as Brexit were to intervene. The very fact that it is so broad enhances the probability that it will work. Some of the measures, notably the generous liquidity injections into the banking system and the purchases of corporate bonds, are designed to widen bottlenecks in the transmission of the monetary stimulus to the real economy. Which of these measures will have what precise impact is hard to say. We are in uncharted territory, after all. But chances are that enough elements of the package will have enough of an impact on confidence and credit creation to make a difference over time.

A look at the ECB's new macroeconomic projections helps to explain why the Governing Council delivered such a significant stimulus today. In December, the ECB had surprised us by adjusting its forecasts for growth and inflation by very little. This time, the ECB staffers in Frankfurt went much further than the Eurosystem forecasters had last time. By slashing the inflation projection for this year from 1.0% to 0.1% and cutting the growth forecast from 1.7% to 1.4%, the ECB de facto lowered its call for nominal GDP by 1.2 percentage points. That is a lot. The ECB also became more cautious for 2017. Even for 2016, the ECB expects inflation of just 1.6%, a still somewhat subdued rate.

| Macroeconomic projections | | | | | | |
|---|---|---|---|---|---|---|
| | | GDP | | | Inflation | |
| | 2016 | 2017 | 2018 | 2016 | 2017 | 2018 |
| ECB Mar 2016 | 1.4 | 1.7 | 1.8 | 0.1 | 1.3 | 1.6 |
| ECB Dec 2015 | 1.7 | 1.9 | | 1.0 | 1.6 | |
| Berenberg | 1.3 | 1.7 | | 0.4 | 1.6 | |

Yoy changes in %. Source: ECB, Berenberg

In a way, the very fact that the ECB has today slashed its projections for inflation so much makes it even less likely that the ECB will ease policy further later on. Following the modest rebound in oil prices over the last few weeks, headline inflation is more likely to come in above rather than below the new ECB projections over the course of this year. Our own calls for inflation of 0.4% in 2016 and 1.6% in 2017 are now modestly above those of the ECB. Short of another dramatic plunge in oil prices or a serious economic crisis, headline inflation is unlikely to undershoot the ECB's new projections by an amount that could justify additional easing. In this sense, the ECB has probably gone close to the limit today.

**OBJECTIONS AGAINST THE ECB STIMULUS**

Naturally, the package will meet some heavy criticism. Below, we take another look at the standard arguments that are often advanced against a further ECB stimulus. We do not find these arguments convincing.

**Objection 1: Monetary policy is no longer effective**
This argument contains a kernel of truth. In the wake the post-Lehman financial crisis, caution reigns supreme. Banks extend less credit and households and companies are more reluctant to borrow. As a result, the credit channel to transmit a monetary policy stimulus to the real economy is somewhat constrained. But monetary policy still works, relying more on the confidence channel than before. For example, the Fed decision to start serious quantitative easing in March 2009 and the ECB's OMT programme of summer 2012 boosted confidence to such an extent that the economies left recession shortly afterwards. On a somewhat smaller scale, the series of ECB decisions from June 2014 onwards that culminated in the start of sovereign bond purchases in early 2015 has helped to revive credit demand in the Eurozone. While credit growth remains very moderate and in need of an additional stimulus such as the one Draghi delivered today, the situation is much less dire than it was when credit volumes were still contracting in 2012 and 2013.

**Objection 2: The ECB has now run out of ammunition**
Wrong. Of course, with the main refi rate now at 0.0% and the deposit rate at -0.4%, the room for further rate cuts is limited. As Draghi explained, the emphasis is shifting from rates to non-conventional policy measures. But the room for such measures is far from exhausted. We do not believe that the ECB will have to go beyond the current measures. But if it had to, it could still scale up its open market policy by buying more assets. In a highly unlikely extreme case, that could even include equities and senior bank bonds. In summary: if required, the lender of last resort could do a lot. Fortunately, thanks partly to the measures taken today, the risk that such extreme measures may become necessary seems minuscule.

**Objection 3: The ECB takes pressure off governments to deliver pro-growth structural reforms**
This argument is misguided. First, remember that Italy's prime minister Renzi delivered his big major labour market reform right after the ECB had announced major sovereign bond purchases in early 2015. That definitely does not show any moral hazard. More importantly, it is not the task of a central bank to push an economy into recession or to keep it well below trend growth until a supply-side revolution - or a very different kind of revolution - breaks out. A central bank that would pursue such a policy would be abusing its independence and breach its mandate badly. The central bank has to safeguard price stability. To do that, it has to keep aggregate demand close to the growth trend of the economy that is shaped by supply side factors. The central bank has to meet its mandate if trend growth is slow or fast. The central bank can, within limits, urge other policy makers to enhance supply. But that's it. In the end, central bankers have to take the decisions of parliaments and voters on taxes, regulations and other factors that determine supply as given.

**Objection 4: The aggressive monetary policy expropriates savers**
Wrong. Bond yields and other financing costs in the economy reflect the supply of and demand for investible funds much more than the refinancing costs of banks. The persistently low bond yields in the Eurozone are a consequence of heightened risk aversion in the wake of the post-Lehman and the euro crisis.

US yields today are higher than those in the Eurozone because the US Fed had acted much more aggressively much earlier than the ECB. Because of that, the US recovery has been more robust than that of the Eurozone. As a result, the US Fed can now delight savers by raising rates whereas the ECB, having being well behind the Fed until recently, still needs to ease policy. If the ECB now manages to get demand growth back to trend, the concurrent increase in confidence and the resulting rise in credit demand will push yields up. The ECB package today is good news for German savers. It lays the basis for the economic recovery that, in due course, will lead to higher yields.

Remember that, since the start of the euro in 1999, the ECB has delivered a much greater degree of price stability than even the Bundesbank had ever managed while holding the monetary reins in the decades before. Seen from this angle, the ECB has managed to preserve the purchasing power of German pensions and savings rather well.

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