High probability of ECB easing as downside risks to growth and inflation increase

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EXECUTIVE SUMMARY

European Central Bank (ECB) policy manoeuvrings are taking centre stage once more. The ECB left monetary policy unchanged at its May meeting, in line with the market's expectations. However, it was Draghi's post-meeting comments that took investors by surprise. Below, Ken Orchard, T. Rowe Price's Portfolio Manager of European Fixed Income, provides his latest thoughts on the likely policy path pursued by the ECB.

The probability of ECB monetary easing action at the next meeting on 5th June is high. Draghi clearly indicated that the ECB Governing Council (GC) was prepared to take action, unless there were upside surprises to growth or inflation. Several other members of the GC have made supportive comments over the past week. A deferred decision is perhaps indicative of the lack of unanimity between members of the Governing Council on what form any monetary easing action should take.

President Draghi stated that the Governing Council (GC) was "comfortable" about acting at the June meeting. The reasons cited were concerns about a prolonged period of low inflation and an economic recovery that is proceeding at a slow pace. Draghi explicitly mentioned that the strength of the euro and geopolitical risks presented downside risks to growth and inflation, adding there was "consensus about being dissatisfied about the projected path of inflation."

These risks are bearing out with the release of first quarter 2014 GDP data for euro-area countries. Germany and Austria were relatively strong, but negative growth was reported in Italy, Netherlands and Portugal. France was at zero. The GC stated that it wanted to see new staff projections for inflation and growth in 2014-16, released in early June, before taking action. The likelihood is that there will be downside revisions from the March projections. Last week a survey of ECB professional forecasters showed a modest decline in inflation expectations over the next few years.

Another important focus for the ECB is bank loan data. Credit conditions continue to remain tight for small- and medium-sized enterprises (SMEs), especially in the periphery countries. In Q1 2014, Eurozone banks' net lending to the private sector was zero, while they increased holdings of government bonds and sold corporate bonds. The data for April lending will be released at the end of May.

What are the ECB's options in June?

In line with the market's view, we expect the ECB to announce a series of policy easing measures in June. The most likely policy outcome is threefold:

1. A cut in the repo rate to 10-15 basis points from the current level of 25 basis points.
2. A reduction in the deposit rate to -10 or -15 basis points from zero.
3. Targeted liquidity injections through a VLTRO – very long-term refinancing operations[1] - that is structured to incentivise banks to lend to SMEs.

We expect a negative deposit rate to be applied only to excess reserves held on deposit at the ECB or national central banks (i.e. bank reserves in excess of the reserve requirement set by the ECB). Excess reserves in the euro-area are currently around €91.6 billion[2] (as of 13 May, 2014) concentrated in four countries (Germany, Austria, Finland and Holland). These reserves are declining quickly as banks repay money borrowed through the LTRO programme. It is also possible that the ECB would allow banks to keep a certain amount of excess reserves on deposit at their national central banks at a zero interest rate, and only charge the negative rate on amounts above a threshold. This would reduce the number of banks affected by the negative rate.

Real economy and market impacts

The headline impact of a negative deposit rate, a departure from conventional policy for the ECB, should weaken the euro in the short term. A lower euro will help France, Italy and Spain with a 6 to 12 month time lag. However, the currency effect is likely to wane over time.

A negative deposit rate on excess reserves may also be beneficial for the front end of sovereign yield curves, as some banks may invest part of their excess reserves in bonds rather than be charged a negative rate. This impact has largely been priced-into the financial markets already, however.

Gains to the real economy of a negative deposit rate are likely to be modest in the euro-area, with only a marginal impact on lending from the core to the periphery. It is unclear, for example, whether it would help to restart the unsecured inter-bank lending market, which has been largely shut over the past two years.

A new VLTRO would be specifically designed to boost SME lending, as opposed to increasing financial market liquidity. This extra-targeted liquidity should help SMEs over the long term. However, as we have seen with the UK's funding for lending scheme (FLS), stimulating SME lending is difficult and requires a wide base of resources, not just funding.

What about quantitative easing?

There is increasing speculation that the ECB will follow other central banks, including the Federal Reserve, and implement a quantitative easing (QE) programme. It is still unclear as to whether the ECB will embark on QE given the political and practical difficulties of implementation across the euro-area. The ECB's statutes do not permit it to buy bonds directly from governments, which some politicians and central bankers interpret as a de facto ban on QE. The ECB will need to show that it has tried everything else before it can embark on QE. With that said, the market is likely to price a higher probability of QE later this year.

[1] Long term Refinancing Operation (LTRO) provides low cost financing to Eurozone banks, including loans of 6-month, 12-month and 36-month maturities. The aim is to maintain liquidity for banks holding illiquid assets. VLTROs are extended maturities and are likely to have a term of 3-5 years.
[2] ECB Monthly Bulletin, May 2014

That trend has already been apparent over the last two weeks. Sovereign spreads in “soft core” countries, including France and Belgium, as well as Spain and Italy have narrowed slightly on the increasing speculation surrounding QE. This positive effect could continue for a few more weeks or longer. Experience of the US treasury market suggests that bonds rally into a Federal Reserve announcement and then stabilise or sell off in the aftermath.

We could see a similar response in Europe. Bond yield valuations are trading at expensive levels based on recent history and, with the probability of higher US treasury rates, are likely to drift higher over the medium term.

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