TS Lombard

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Daily Note

QE-II TO SET SAIL IN SEPTEMBER

Shweta Singh / Davide Oneglia

- **Draghi takes another big step towards renewed ECB stimulus**
- **Expect more rate cuts, deposit tiering and QE-II in September**
- **With a few tweaks to the ECB's self-imposed constraints on asset purchases, the size of QE-II could be meaningful**
- **But how effective will it be?**

ECB President, Mario Draghi is preparing for his farewell voyage at the next meeting in September. The central bank kept its key policy rates unchanged at this week's policy meeting but set the stage for rate cuts and a package of easing measures, likely to be announced in September.

This is not a surprise, as ECB officials had been signalling additional stimulus in their recent communications. Draghi's speech in Sintra was forceful, highlighting the potential for rate cuts and QE-II. Philip Lane, the new chief economist, heightened expectations in his maiden speech by emphasising that a stimulus package would be forthcoming.

Four things stood out for us in Thursday's Governing Council (GC) decision and in Draghi's subsequent press conference:

(1) **The ECB paved the way for interest rate cuts by adding 'lower' to its forward guidance on interest rates**. The GC now expects the ECB's key rates "to remain at their present or lower levels at least through the first half of 2020". Markets had already been pricing in 20bps of rate cuts by the end of next year, so the statement was no reason to get excited.

(2) **The GC underlined the need for a highly accommodative monetary stance for a prolonged period**, as inflation rates, both realised and projected, have been persistently below target.

(3) **The GC emphasised that its inflation target is symmetric**. Specifically, if the medium-term inflation outlook continues to undershoot, the GC said it is determined to act, in line with its commitment to symmetry. Our concern is not with symmetry, but with the tools the ECB has to meet even the current, relatively asymmetric, target of inflation below but close to 2% over the medium term.

(4) **The GC has tasked Eurosystem committees to examine various policy options.** These include ways to reinforce forward guidance on policy rates; steps to mitigate the cost to banks of negative rates on reserves held at the ECB, such as a tiered deposit system; and options for the size and composition of potential net new asset purchases.

We continue to expect a package of measures to be announced in September, when the new set of staff macroeconomic projections are released. The steps are likely to include a rate cut, the introduction of a multi-tiered deposit rate and the restart of QE. The GC may also drop the practice of saying how long it expects policy rates to stay where they are or fall further.

The marginal benefits of cutting rates deeper into negative territory are limited at best, even if they are accompanied by cheap long-term refinancing operations (TLTRO-III) and a tiering of deposit rates.

On the other hand, QE-II could give a more significant boost to monetary and financing conditions. Even so, a second round of asset purchases will have a milder impact than QE-I, when borrowing costs were higher, fragmentation across the EA was severe, the euro was stronger and domestic risks were far greater.

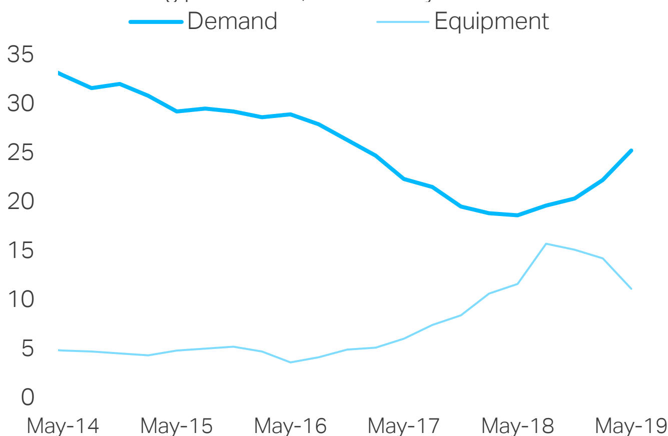
The first round of ECB QE unfolded largely against the backdrop of the Fed normalising its ultra-loose policy, which boosted the euro area's competitiveness by weakening the single currency. External assets became more attractive for EA residents, leading to large net portfolio outflows and pushing EUR lower. But a lot has changed since then. The Fed is likely to relax policy as early as July 31. Most global central banks are also easing. There are concerns that trade wars will morph into a global FX war. The bar for the euro to edge lower and boost inflation expectations may be much higher this time, while the pool of eligible assets that the ECB can buy has shrunk.

How many assets can the ECB buy? Our estimates suggest that if the ECB were to stick to its 33% issuer limit, it could buy up to EUR50bn of public assets a month for 12 months. If the limit were raised to 50%, the universe of eligible assets could expand to EUR90bn a month. In addition, the bank can still purchase up to EUR340bn of non-bank private sector assets. In comparison, ECB QE-I was nearly twice as large, totalling EUR2.6trn. Of course, the ECB could always relax its self-imposed eligibility criteria further, giving it more assets to buy.

The key issue, however, is whether the ECB can loosen the all-important constraint of its capital key. In the absence of such a change and/or a meaningful fiscal boost across the EA, the ECB will be easing monetary policy with one hand – perhaps two - tied behind its back.

Weak demand a growing concern

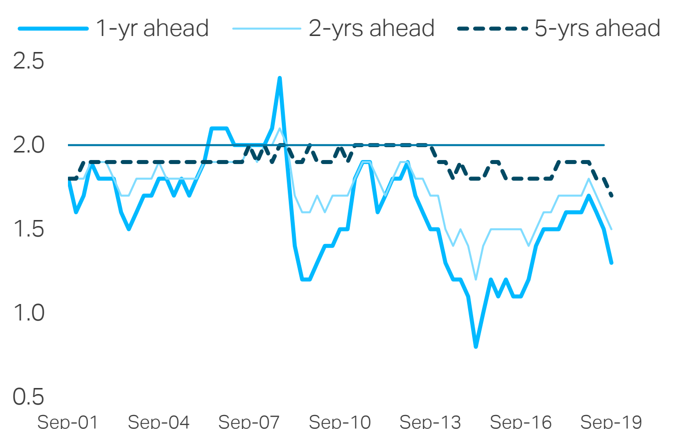
Factors limiting production, % of surveyed firms



Source: EC, Datastream, TS Lombard

Inflation expectations fall

Inflation forecasts, %y/y



Source: ECB SPF survey, Datastream, TS Lombard