European Central Bank: all options on the table

European Central Bank (ECB) President Mario Draghi opened the door to further easing of monetary policy when, following the bank's 22 October meeting, he announced that "the degree of monetary policy accommodation will need to be re-examined at our December monetary policy meeting". Two important questions for the next few months are: what form will further ECB easing take and what are the implications for the US Federal Reserve (Fed)?

Draghi has dropped the clearest hint he can that further monetary policy easing by the ECB is coming, and soon. Citing downside risks to the outlook for Eurozone economic growth and inflation, he said at the bank's October press conference that officials had engaged in "a very rich discussion about all monetary policy instruments that might be used if warranted". A sharp rally in European bond markets in the wake of these comments certainly suggests that market participants are expecting the ECB to deliver on these hints at its 3 December meeting.

By ruling nothing out in terms of what form further easing might take, Draghi has left the ECB room to get creative in how it stimulates the economy. We think the options on the table are:

1. An extension of the current asset purchase programme beyond its September 2016 end date;

2. A step up in the pace of monthly asset purchases from €60 billion per month at present;

3. A change in the composition of assets purchased under the programme, perhaps to include corporate and high yield bonds;

4. A cut in key ECB interest rates: the deposit rate (already at -0.2%) and the lending rate (currently at 0.05%);

5. "Blue-sky" measures such as re-defining the ECB's inflation target; including equities, bank loans or overseas bonds in the purchase programme; or engaging in 'helicopter money' (giving newly created money to households).

Some combination of measures 1-4 would seem to be the most likely outcome of the December meeting. The first three measures would increase the total size and scope of the ECB's asset purchase programme, which is currently fairly small compared to those of the US and UK relative to the size of the economy.

The fourth measure – an interest rate cut further into negative territory – looks more appropriate than it did even very recently because the problems facing the Eurozone are now of a more 'conventional' macroeconomic nature. That is, the economy is suffering from a lack of demand and a loose labour market which is creating very little in the way of inflationary pressure, rather than the earlier problem of a total lack of functioning of the banking sector.

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What's more, the experience of Sweden's Riksbank, the Swiss National Bank and Denmark's Nationalbank all suggest that the current ECB deposit interest rate of -0.2% may not be the 'zero lower bound' for interest rates. Put another way, Draghi may be able to pull a little bit more stimulus out of the conventional interest rate lever by taking it further into negative territory, without pushing households into holding excessive amounts of cash. A deposit rate cut would also have the virtue of expanding the universe of assets eligible for purchase under the ECB's programme – which, at present, is limited to bonds with yields that are above the deposit rate.

Implications for the Fed

So some form of ECB policy easing appears to be on the agenda for December. Does this have implications for the monetary policy path that the US Federal Reserve (the Fed) will pursue? The Fed's December policy meeting will be held on the 15-16 December, two weeks after a potential easing move by the ECB.

The statement released after the Fed's October meeting made explicit reference to "determining whether it will be appropriate to raise the target range at its next meeting", which has been taken by the markets as a strong hint that the December meeting is 'live'. The federal funds futures market* has moved to price in a 50% chance of a hike in December, up from 30% previously.

However, were the ECB to ease in early December, and depending on what combination of policy levers the ECB pulls, we would expect it to reduce the chances of an interest rate hike by the Fed. After all, the economic impact of ECB easing will be primarily felt through a weaker euro – and therefore a stronger US dollar. That would see US financial conditions tighten and imported goods disinflation increase. This is not a backdrop against which the Fed would like to hike.

Alternatively, if the Fed is clear in its communications going into December that an interest rate hike is coming, the ECB may take a more cautious view on policy easing, perhaps by undertaking only a modest expansion of the asset purchase programme and leaving interest rates unchanged at current levels.

Either way, what is clear is the central banks cannot act in isolation – the policies of one are transmitted to others via exchange rate movements. The upshot is that we are cautious about the degree to which monetary policy in the US and the Eurozone can diverge over the coming year. For now, we maintain our calls for the ECB to ease modestly and for the Fed to hike in December – but this is an uneasy combination and, if something has to give, it is more likely to be the Fed than the ECB.

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