Go big or go home

The European Central Bank (ECB) eased policy at the end of last year in response to disappointments in its inflation forecasts and building risks in the global economy. While this loosening disappointed market expectations for more aggressive steps, Mario Draghi struck a bullish tone, noting that the central bank had taken “significant” and “adequate” steps. **Fast forward three months and the ECB looks set to loosen policy again. What has triggered such a sharp reversal over such a short period of time?** Three factors have probably swayed the Governing Council. First, it will need to revise its inflation forecasts lower again. The decline in oil prices means that HICP will this year significantly undershoot December forecasts (see Chart 6). While this is likely a temporary effect, the ECB cannot afford to be complacent over second round effects on inflation expectations. Second, the growth outlook has deteriorated and risks to the downside have increased. This has been evident across the global economy and local survey data have signalled a clear moderation in momentum. Finally, the increase in financial stress, particularly around the financial sector, threatens to undermine the transmission of the ECB’s policy to the real economy if sustained.

What might the ECB’s response look like? **Certainly, there are a number of levers that the central bank can pull to try and cushion the effect of recent shocks**. We would expect to see at least a 10bps deposit rate cut, although a larger move is possible. Negative interest rates have come under increased scrutiny over recent weeks. The concern is that this policy generates a tax on the banking sector, which seems unwilling to pass negative rates on to retail deposit holders. Further squeezes in margins pose a clear challenge for a sector already struggling to grow balance sheets and build capital buffers. So, the ECB may announce a shift to a tiered deposit rate structure to partially shield the banking sector from negative rates on excess reserves and facilitate further cuts into negative territory. However, while negative rates grab headlines, additional stimulus through this channel is clearly limited. **The more powerful loosening is likely to come through the Asset Purchase Programme (APP). In December, the ECB extended this programme until at least February 2017**. This time it is expected to increase the pace of monthly purchases by at least EUR 10bn (to EUR 70bn). This front-loaded increase in the central bank’s balance sheet should provide a stronger stimulus to the real economy through portfolio rebalancing, a weaker currency and enhanced inflation expectations.

Any increase to the APP will raise familiar questions around the scarcity of assets to buy; particularly German government bonds which are yielding negative out to eight years (see Chart 7). The ECB could relax some of its restrictions on purchases of individual issuances, but this will only buy time. **It is becoming increasingly likely that the Bank will need to break some of the key restrictions on its QE programme in order to achieve the balance sheet expansion required to support growth and inflation**. It could move away from the capital key weightings for purchases – i.e. buy disproportionate amounts of Italian compared to German sovereign debt. Alternatively, it could buy bonds below the deposit rate, implying larger losses on some purchases. Either step would be controversial, but not as bad as the ECB conceding the fight against deflation.