QNB Economics
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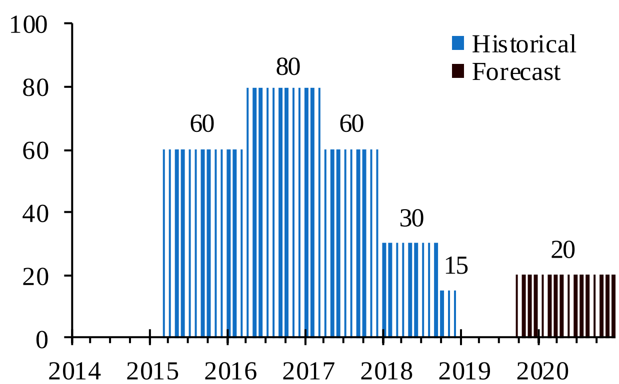
ECB must do more in September to stave off weak economic growth

Last week we highlighted divergent economic performance across the Euro area. Our conclusion was that "This divergence in performance across the Euro area is a serious problem for policy makers and the ECB in particular. … For example, there is not enough German government debt for the ECB to buy and too much Italian debt."

We believe that the ECB is putting together a comprehensive package of monetary stimulus to be announced at its meeting on 12 September. Here we review the likely components of the ECB's stimulus.

European Central Bank Asset Purchases
(EUR Bn)



Sources: ECB, Haver, QNB Analysis

A constellation of factors mean that the ECB has little choice but to provide monetary stimulus to the Euro area economy at its September meeting. The first factor is the economic weakness that we highlighted last week. The second factor is persistently below-target inflation. The third is the continued escalation of the trade war between the US and China, which will further weaken external demand for Euro area exports. The fourth factor is the Fed's dovish pivot and recent interest rate cut that puts upward pressure on the Euro by reducing the interest rate differential.

Our view is that the ECB will need to engage in a combination of four main measures to stimulate the economy due to the constraints limiting the effectiveness of each measure alone.

First, the ECB will begin with a cut to its headline interest rate, the 'deposit rate'. However, we expect only a 10bp reduction to -0.50% because of the hit to bank profitability from a contraction in their net interest margins as they struggle to pass negative interest rates on to their customers.

Second, we expect the ECB to reactivate its asset purchase program, buying EUR 20 Bn of assets per month (see chart). This is a relatively modest rate of quantitative easing because the ECB is not allowed to buy more than 50% of any single bond or more than 50% of the bonds issued by any single government. Indeed, it is difficult for the ECB to buy more than 33% of any single bond as that would allow it to block decisions in debt restructuring negotiations. The ECB has also committed to try to purchase assets according to the share that each country has in the ECB's capital.

Third, we expect the ECB to launch a new round of Targeted Longer-Term Refinancing Operations (TLTROs), providing subsidised funding to banks that are willing and able to increase their lending to the real economy. TLTROs have been an important support to the Eurozone economy in the past, by boosting the supply of credit. However the effectiveness also depends on credit demand, in other words the ability and willingness of consumers and companies to borrow. With economic uncertainty relatively high, it is likely that weak demand for credit is more of a constraint than weak supply.

Finally, we expect the ECB to also update its "forward guidance" with a further extension of its commitment not to raise interest rates, by six-months, to before the end of 2020. The ECB could strengthen the stimulus from forward guidance by making a commitment to continue quantitative easing over a similar or shorter time horizon.

Although positive for Euro area growth over the next few years, we fear that such an extensive package of monetary stimulus from the ECB will upset President Trump. So, we expect the ECB's actions to fuel a continuation in Trump's barrage of tweets complaining that the Fed is not doing enough, by cutting interest rates, to support the US economy. We also fear that this may provide Trump with a convenient excuse to start attacking European imports with tariffs.

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