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New ECB Stimulus Package Is Likely To Keep Interest Rates Low Through 2023

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Key Takeaways

- The message behind the European Central Bank's new easing package is that low rates are here to stay over the near to medium term.
- Although we think that fiscal policy would be a better way to stimulate growth and inflation, the ECB easing package can still keep the European economy from declining even faster.
- We expect another rate cut of 10 basis points in December, as lower economic growth in Europe appears inevitable.
- As a result, the ECB is unlikely to exit negative interest rate territory before the end of 2023.

The European Central Bank (ECB) has once more embarked on another round of monetary policy easing. It has gone all-in to avoid disappointing markets and to maximize the effects of its easing package, and used every tool at its disposal to stimulate the economy, including:

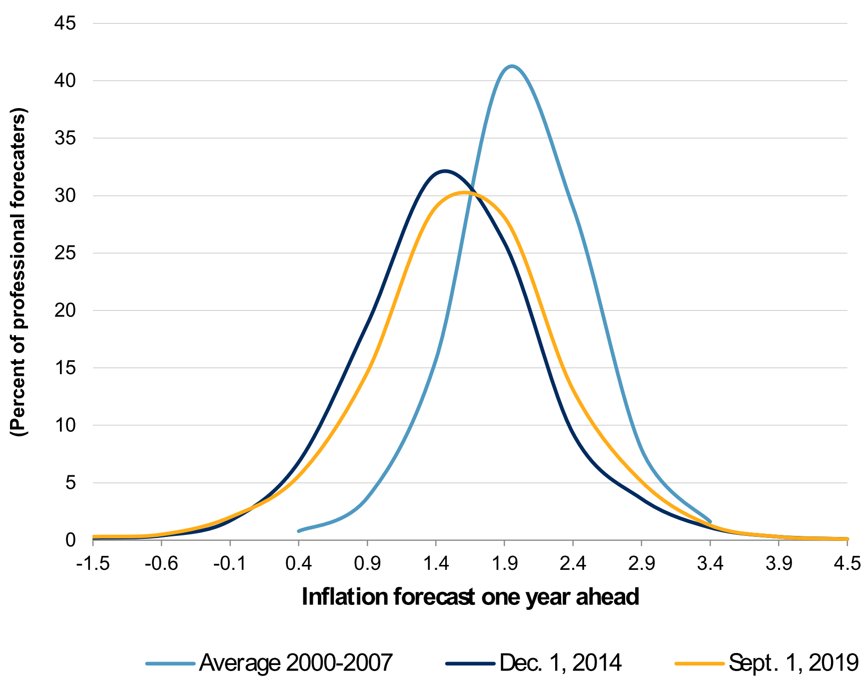
- A reduction of 10 basis points (bps) in the deposit rate from -0.4% to -0.5%;
- More open-ended quantitative easing (QE)—i.e. the resumption of €20 billion per month in net asset purchases starting in November and continuing for as long as necessary;
- Linking lower rates to the underlying inflation outlook. The ECB's forward guidance is now that interest rates are expected "to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics";
- A two-tier system for bank deposits that will mitigate the impact of lower rates for longer on banks' profitability. Similar to what we have seen in Switzerland, only reserves in excess of six times the reserve requirements will be charged at the deposit rate; and
- More favorable conditions for targeted longer-term refinancing operations (TLTROs). Those were extended to three years from two previously, and banks exceeding a net lending benchmark will now be able to earn the deposit rate.

As we argued in the past, this additional stimulus is unlikely to boost growth or inflation by much. Risks to growth stem from weak external demand and geopolitical uncertainty, which is not something the ECB package will change. What's more, interest rates on new business loans currently average 1.6% while German 30-year sovereign bonds are trading in negative territory. This makes it difficult to argue that financing costs are a hurdle to investment.

We think that fiscal stimulus would be a more effective medicine to boost growth, as monetary policy is coming ever closer to the limit of the effective lower bound. This is something the ECB President Mario Draghi has also acknowledged and has strongly called for. Nevertheless, even if monetary policy stimulus has diminishing returns, it can still ease the pain. Moreover, in the face of slowing growth, low inflationary pressures (since 2015 core inflation has been stuck around 1%), and low inflation expectations (chart 1), the ECB has to do "whatever it takes" to fulfill its mandate to remain credible. We can see that professional forecasters' inflation expectations are returning to where they were in 2014, before the onset of the first asset purchase programs.

Chart 1

Professional Forecasters Inflation Expectations



Source: S&P Global Ratings, ECB

Lower Borrowing Costs Ahead

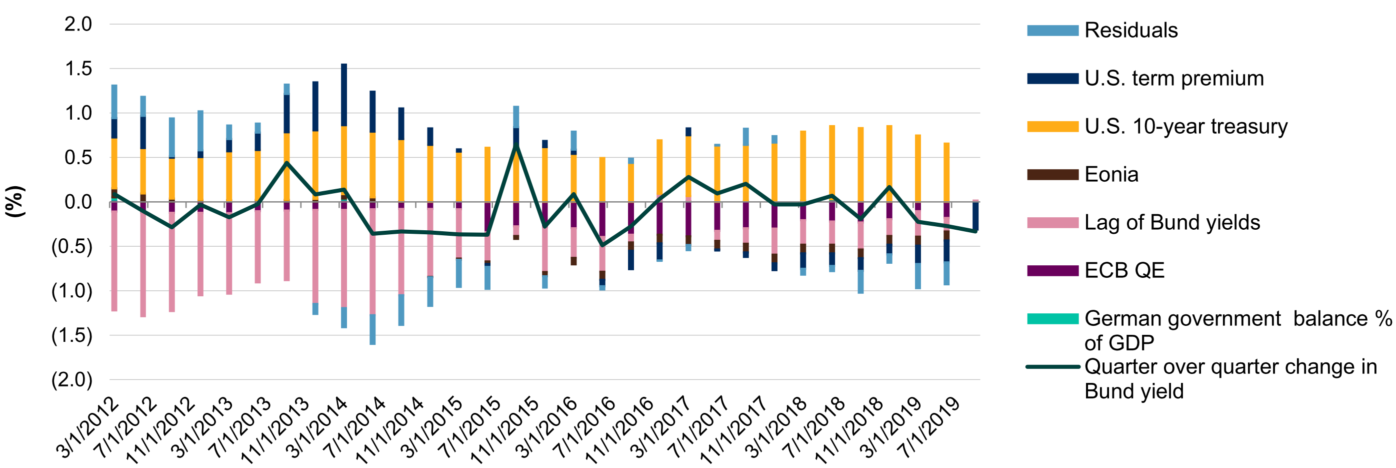
The new ECB package will ensure borrowing costs stay lower for longer at least until 2023 thanks to a lower deposit rate, terms that are more favorable for TLTROs, and forward guidance that pushes the time for rate hikes further out. Given market pressures, banks are likely to continue to lower the interest rates they offer to firms and households. This will continue to ease firms' deleveraging task in countries like Spain, and ensure that credit creation remains positive even though the demand outlook is worsening. This should support growth.

On the other hand, the tiering of deposits for banks might reduce the pressure for banks to pass on negative interest rates to retail depositors. As a stand-alone measure, it should also ensure that their profits suffer less from negative rates. Looking at the current level of excess reserves and taking into account the fact that banks will have to pay 10 bps more on the nonexempted excess reserves, this would be around €2 billion net benefit to the banking system.

Additional asset purchases will also translate into lower borrowing costs for those financing themselves on the market. Expectations of more QE have already helped push bond yields further into negative territory this summer. By increasing the stock of government bonds on its balance sheet, the ECB will make safe asset scarcity more acute and thus force investors to look for yields elsewhere, pushing yields down across all asset classes. Decomposing Bund yield changes since 2015, we find that the ECB's asset purchases have been weighing on yields more so than risk aversion (see chart 2). We use an error correction model to decompose the factors driving the Bund.

Chart 2

ECB QE Has Been The Main Drag On German Bund Yields Since 2015
(Contribution to the quarterly change in the German 10 -year yield)



Sources: S&P Global Ratings, ECB, ACM, Bundesbank, Datastream.

Lower yields will also continue to create more fiscal space for Eurozone sovereigns. This is especially relevant for heavily indebted countries, like Italy, that need to reduce debt, but also might need some fiscal stimulus as their economy slows. For example, thanks to lower yields, the Italian government has seen its interest expenditures go down to an estimated 3.6% of GDP this year, compared with 4.5% in 2014. While these gains have already been spent, current Italian 10-year yields are just below 1%, suggesting there is more fiscal space to gain.

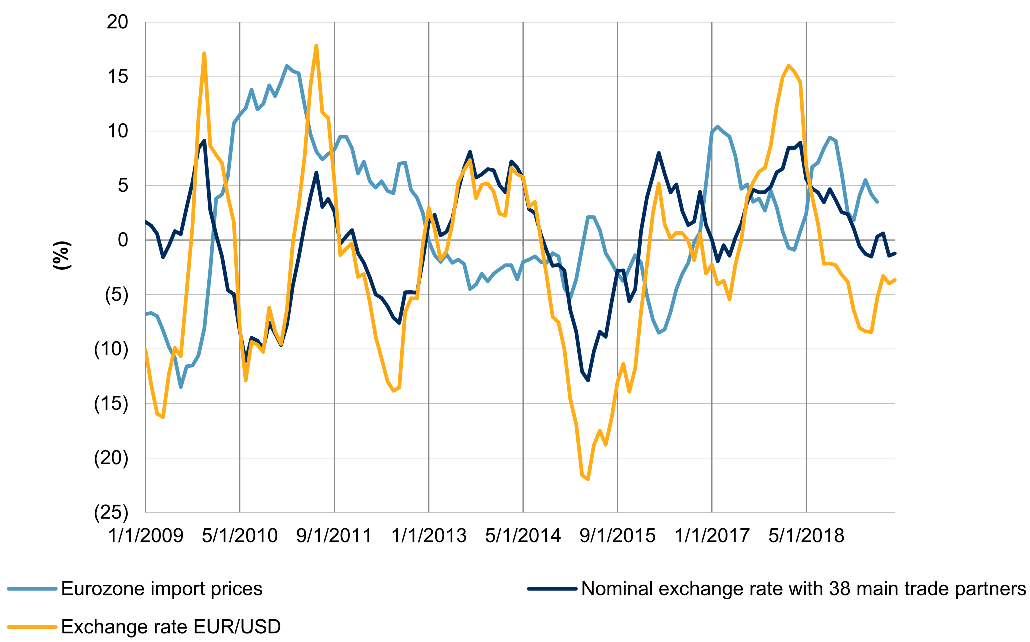
This environment of low rates will extend at least to 2023 in our view. In our view, the ECB's downward revisions to growth and inflation for 2020 and 2021 even point to another 10 bps rate cut in December. The ECB might even have to do more if downside risks to growth (e.g. escalation of trade tensions or a hard Brexit) materialize. Thus, we think the ECB is unlikely to raise rates before 2022 and to get out of the negative territory before the end of 2023. This means it is unlikely to stop QE before 2021 and to start reducing the size of its balance sheet before at least the end of 2024. We think that the ECB's asset purchases will continue to compress the term premium on government bond yields in a more potent manner for the next five years.

A Policy To Boost Prices

Monetary policy easing will lift inflation mainly by influencing the exchange rate. A lower exchange rate will be the main channel through which the ECB package boosts price levels. The depreciation of the exchange rate since the end of 2018 has already lifted import inflation to an average of 4% in the first half of this year (see chart 3). However, the impact might be limited, as other central banks (e.g. the Fed) are also loosening monetary policy, the Euro is already low (1.11 against the U.S. dollar), and global capacity pressures are decreasing against a backdrop of slower growth.

Chart 3

A Weaker Euro Will Help Lift Eurozone Prices



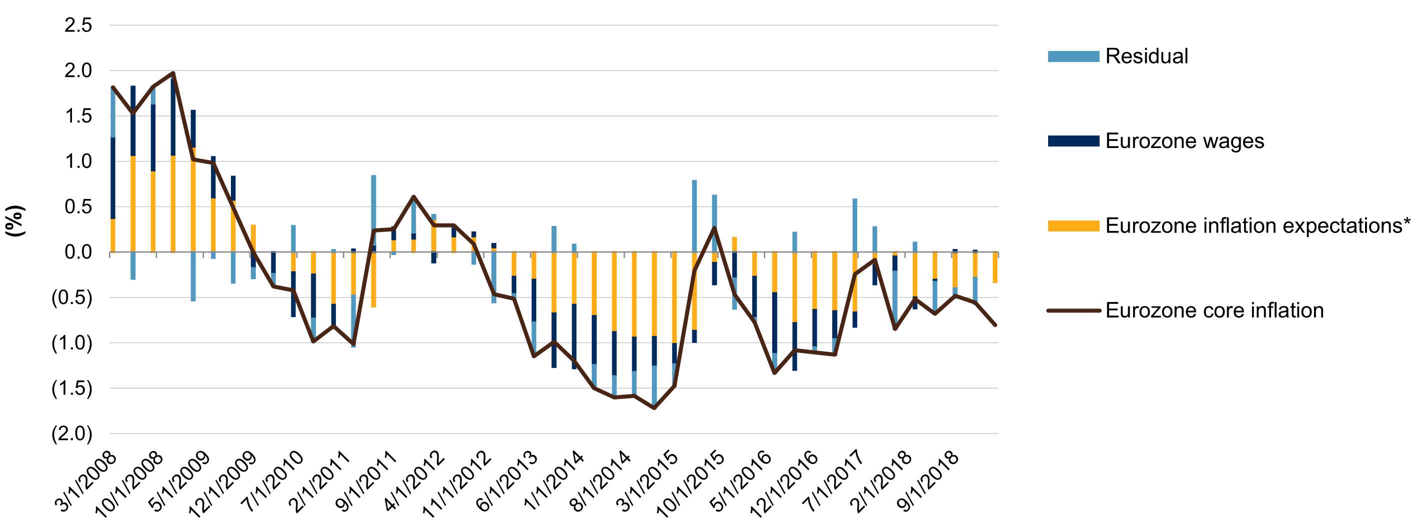
Sources: S&P Global Ratings ECB ,Eurostat. NOTE: All price changes are year over year.

Supply-side (and thus inflationary) pressures are also decreasing in the eurozone domestic economy. The ECB package will support the economy, and work to prevent too many job losses. In this way, firms will operate in a slightly less tight labor market, meaning that upward pressures on wages are more likely to decrease in the short term. What's more, if inflation has been stuck at 1%

in the past two years in spite of robust job creation and higher salaries, it is because firms have opted for lower margins rather than increase their prices (see chart 4). In an environment of slowing demand growth, they are likely to continue to keep their prices unchanged to retain their market share.

Chart 4

Eurozone Inflation, Wage, And Residual Changes



Sources: Eurostat, S&P Global Ratings estimates. All changes are year over year. *Proxied by core inflation (-1)

When we look at the pass-through of wage growth to inflation, the residual can be interpreted as the change in corporate margins. We can see that higher wages have put upward pressure on inflation since 2017. Most firms, however, have chosen since then to keep their prices low.

Related Research

- ECB Stimulus Signal Is Good For Growth, Bad For Bank Profits, July 26, 2019

This report does not constitute a rating action.