Europe's economic slowdown makes the proposed normalisation of ECB monetary policy harder

by Franck Dixmier | 23/01/2019

Summary

The European Central Bank's gradual normalisation of its monetary policy should continue, but the economic slowdown in the euro-zone will likely delay any rate increases, and the window of opportunity is becoming increasingly narrow.

Key takeaways

- At its meeting on 24 January, the ECB should consider the economic slowdown seen in the euro-zone's four largest economies during the fourth quarter of 2018
- To avoid a sharp slowdown in financial conditions, the ECB should discuss the possibility of new liquidity programmes targeted to meet the needs of banks
- In the context of economic slowdown and a possible pause in rate hikes by the Fed, the normalisation of the ECB's monetary policy is becoming more complex

The latest economic developments in the euro-zone make it harder for the European Central Bank (ECB) to continue the gradual normalisation of its monetary policy.

The slowdown has impacted each of the region's four main economies: Germany, France, Italy and Spain. Each is facing specific difficulties, but all four have seen a synchronised fall in activity indicators, including purchasing managers' index (PMI) data.

In addition, core inflation, a key indicator for the ECB, is stagnating at around 1% – far from the central bank's target of below, but close to, 2%.

The ECB will have to take note of these developments. Admittedly, there is no economic forecast due at the 24 January meeting, as the next update is scheduled for March. However, ECB president Mario Draghi should recognise that the slowdown in euro-zone growth, which was seen as temporary in December, will likely last longer than expected. This should be acknowledged even if he remains confident that a recession should be avoided, as he asserted in his speech to the European Parliament in December.

No one doubts the ECB will continue to act to avoid a sharper slowdown in financial conditions. Beyond the horizon of reinvestments announced in December – which could continue after the first rate hike – the central bank could also announce the possibility of new liquidity programmes in 2020. This would calm fears of markets drying up, especially in view of the targeted long-term refinancing operations (TLTROs) repayments.

By maintaining its very large balance sheet (42% of the euro-zone's GDP), the ECB retains the ability to adopt an accommodative policy despite stopping its asset purchases.

But will the ECB be able to raise rates in the near future? Investors are doubtful, and have pushed their expectations of a first hike in the deposit rate to the second half of 2020. The window of opportunity is becoming increasingly narrow: the ECB can hardly act in a context of economic slowdown, but by waiting too long, it could face other headwinds – the Fed may well lower its rates in 2020, as anticipated by the markets a few days ago.

We are not expecting any significant impact on the market as a result of this ECB meeting, which should only confirm the expectations investors already largely hold.

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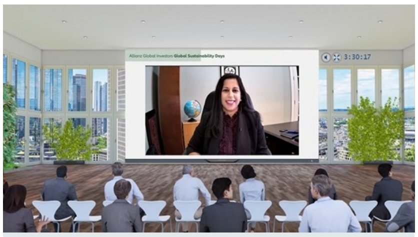

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Caution and flexibility: a new "behind the curve" strategy for the Fed

by Franck Dixmier | 24/01/2019

Summary

In hitting pause on monetary tightening, the Fed is clearly planning to remain cautious and flexible while staying behind the curve. This offers a favourable context for risk assets in the short term.

Key takeaways

- Fed Chair Powell's recent statements confirm a change of tone and strategy: the Fed will adopt a cautious and flexible approach to stay "behind the curve"
- The Fed clearly wants to hit pause on monetary tightening and not increase rates in March – but it is unclear whether this is just temporary or an announced end to rate hikes
- For investors, this pause from the Fed is an opportunity that offers a favourable context for risk assets in the short term
- In the medium term, rate hikes cannot be ruled out if inflation overshoots the Fed's 2% target

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