Flash by EIC

SCB Economic Intelligence Center

15 June 2018

ECB set to end APP at year-end, EIC anticipates a rate hike in latter half of 2019

Event

- The European Central Bank (ECB) announced to reduce its quantitative easing and signaled to terminate its Asset Purchase Programme (APP). In line with market expectations on the meeting on 14 June, 2018, the announcement includes the following

  1. Extend quantitative easing for 3 months from the initial exit in September 2018 to December 2018. The ECB anticipates that net purchases will then end because headline inflation will likely reach the 2% target in the medium term.

  2. Reduce the APP to a monthly injection of EUR 30 billion in government bonds until September 2018. The ECB also expects the monthly purchase to fall to EUR 15 billion between October and December 2018.

- The ECB agreed to keep the policy rate on hold. The rate refers to the interest rate on the main refinancing operations at 0.00%. Also, interest rates on the deposit facility between commercial banks and the ECB were kept at -0.40% and the interest rates on the marginal lending facility at 0.25%. The ECB also stated their intention to maintain such rates at least until summer of 2019 (June-September).

Analysis

- **The ECB cited stronger Eurozone economies as it plans an exit from the APP and an interest rate hike in the future.** At the latest meeting, the ECB upgraded the forecast headline inflation to 1.7%, 1.7% and 1.7% from 1.4%, 1.4% and 1.7% in 2018, 2019 and 2020, respectively. Upward-trending inflation will follow higher global crude oil prices, weaker euros against the USD and tightening labor market. The latter was seen through the steady decline in unemployment rate which stood at a 9-year-low of 8.5% in April. Rising toward the 2% target, headline inflation will boost confidence of the inflation-targeting ECB on ending the APP and normalizing its monetary policy. Moreover, the ECB also revised its GDP forecasts to 2.1%, 1.9% and 1.7% from 2.4%, 19% and 1.7% in 2018, 2019 and 2020, respectively. The downward revision of the 2018 growth forecast was contributed to the growth slowdown in the previous quarter and intensifying anti-trade policies by the U.S. Such policies are anticipated to undermine global trade trends. However, the ECB expects overall Eurozone economies to be solid and enjoy broad-based economic growth.

- **The euro fell following monetary policy announcement as the ECB remained cautious about a rate hike.** Following the announcement by the ECB President, Mr. Mario Draghi, to relax the APP and hold policy rates, the euro weakened 1.0% to reach 1.173 USD/EUR from 1.185 USD/EUR prior to the news. Germany's 10-year government bond yields dropped 3.7 bps to stand at 0.439%. While the APP reduction was broadly in line with market anticipations. However, the ECB's intention to hold policy rates until at least mid-2019 reflects its dovish stance. Some analysts viewed that the ECB should begin raising policy rates soon. In that case, the ECB would be better equipped with tools to cope with potential economic crisis in the future.

Implication

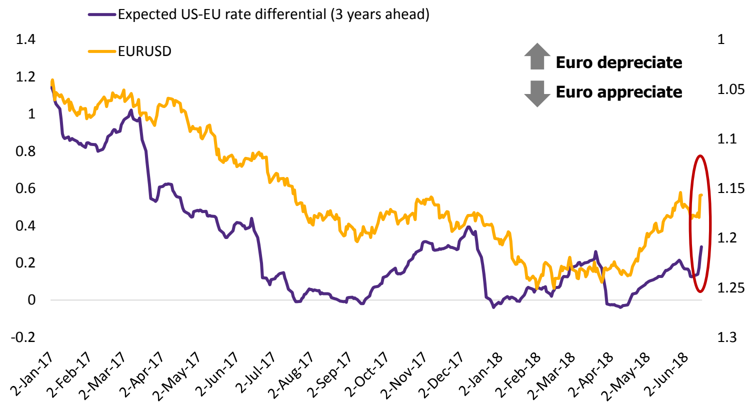
- **The EUR/USD will briefly experience volatility, but tend to strengthen toward the end of the year.** Despite the ECB's announcement to end its bond purchase at the end of this year, its plan to hold policy rates at least until mid-2019 and the Fed's dot plots revealing more rate hikes, totaling 4 times, in 2018 prompted the market to price in the ECB's continued accommodative monetary policy. In particular, the degree of accommodation would be more than that of the Fed, as reflected by the widening gap between the Fed and ECB forward rates (Figure 1). Such factor led the euro to fluctuate and weaken against the dollar in recent periods. However, looking forward, ECB views that the Eurozone economies and inflation will unfold as expected by the ECB. This will the end the APP and provide a clearer timeline of rate hikes. The Fed, on the other hand, will slow down their rate increases as it moves closer toward the neutral rate. Then, the difference between forward rates will narrow and the euro will appreciate from the present 1.16 USD/EUR to 1.20 USD/EUR at the end of 2018.

- **Key factors to watch are inflation developments, anti-trade policy and political uncertainty which can significantly impact the ECB's policy in the future.** While the ECB pointed to improvements in the economies through both higher and more broad-based growth, EIC sees risks that the ECB might not tighten its monetary policy stance as planned. First, inflation could turn out to be lower than expected due to global crude oil prices that fluctuate according to geopolitical factors. Second, anti-trade policy by the U.S., particularly threats to impose import duty on automobile and parts, would largely impact a number of major European carmakers. Third, political uncertainty and Italy's fiscal deficit would adversely impact investor confidence and Italy's government bond yields. And fourth, the UK's separation from the EU (Brexit) would impact trade and investment of both parties. Nonetheless, the ECB's policy could be flexible and with room for adjustments, as reflected in the ECB's statement, subject to incoming data in devising the plan to exit the APP and raise interest rates appropriately and sustainably.

Figure 1: Difference between forward rates of the Fed and the ECB further widened this year

US – EU rate expectation differential (3 years ahead) compared with EURUSD

Unit: % Unit: USD/EUR



Source: EIC analysis based on data from Bloomberg

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