Central Bank Watch

ECB restarts QE but not enough to revive economy

European Central Bank (ECB) launched fresh stimulus package and cut its key interest rate on 12 Sep, aiming to fight against subdued inflation and revive the ailing economy in Europe. The magnitude of rate cut is relatively modest and the size of QE is small, insufficient to revive its sagging economy but able to pile pressure on US Fed and other central banks to ease policies.

- **Magnitude of rate cut missed expectations.** ECB decided to cut rates deeper into negative territory by lowering its interest rate on deposit facility by 10bp to -0.5%, missing market expectation of 15bp. ECB signaled more rate cuts to come until inflation outlook improves. We expect another 10bp cut in Dec 2019 as economic slowdown is very likely to continue in 2H19. ECB's move may infuriate Trump, who repeatedly attacks ECB for currency manipulation and calls on US Fed to adopt negative-rate policy.

- **QE is open-ended with no time limit, a dovish surprise.** ECB will restart its quantitative easing (asset purchase) program from Nov 2019. Although the pace was only €20bn per month (lower than market expectation of €40bn), the overall QE plan was a dovish surprise because ECB pledged to run it for as long as necessary to reinforce accommodative impact and to end shortly before it starts raising the key ECB interest rates. About the need for the new QE, ECB is divided as central bank chiefs of Germany and France expressed skepticism, who believe the most important weapon of ECB should be reserved for the real crisis. The previous QE was launched in Mar 2015 and ECB had spent over €2.6tn over the following four years, lifting economic growth successfully but failing to raise muted inflation. Under the previous QE, balance sheet of ECB ballooned to about €4.65tn, double the size of 2015. Now ECB pulls out QE just nine months after the end of previous QE, indicating that ECB is heading for "Japanisation" by keeping policy rates ultra-low for decades.

- **Eurozone gets fresh help but monetary policy alone is far from enough.** Eurozone economy has weakened sharply since 2Q19 and Germany is at risk of falling into recession. ECB reduced its growth forecasts by 0.1ppt in 2019 to 1.1% and 0.2ppt in 2020 to 1.2% against the backdrop. To shore up the economy, ECB has delved deep into its toolbox and asserted that "all instruments are on the table, ready to be used." In addition to the rate cut and the restart of QE, ECB also made TLTRO-III more generous to provide longer and cheaper loans. However, all these latest measures were not enough to revive the vulnerable economy amid internal and external risks and threats, including US-China trade disputes and Brexit chaos. And even worse, because rates are at record low and ECB's balance sheet is the second largest among global central banks, monetary stimulus is close to its limits, leaving limited room for more monetary easing actions. That's why ECB is calling for more fiscal stimulus to complement.

ECB macroeconomic projections (Sep 2019 and Jun 2019)

	2019		2020		2021	
	Jun19	Sep19	Jun19	Sep19	Jun19	Sep19
Economic growth rate	1.2	1.1↓	1.4	1.2↓	1.4	1.4→
Inflation rate	1.3	1.2↓	1.4	1.0↓	1.6	1.5↓

Source: ECB, CMBIS

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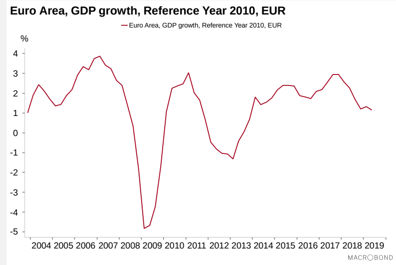
Euro Area GDP growth rate



Source: Macrobond, CMBIS

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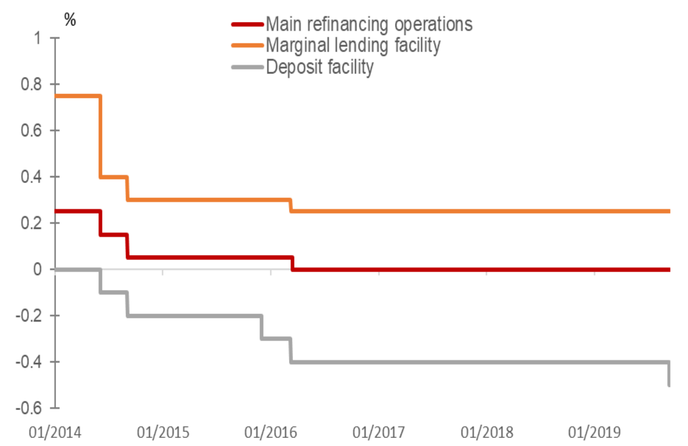
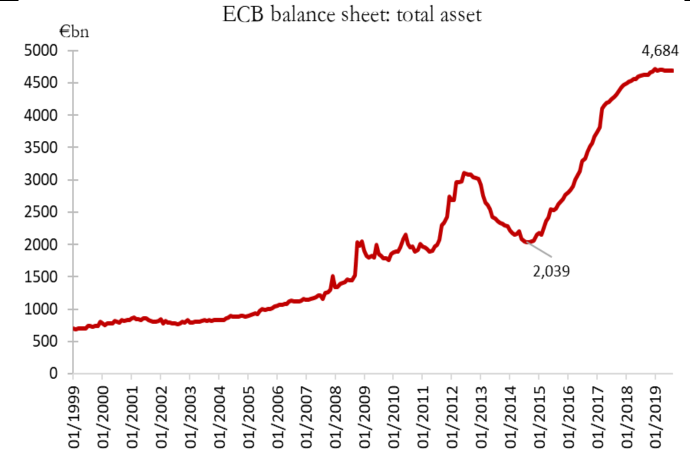
- **ECB gave banks pain relief to soften the impact of rate cuts.** To "protect the transmission of monetary policy through lending channels" and allow ECB to pull rate even lower if needed, ECB introduced a two-tier system in which part of banks' holdings of excess liquidity can be exempt from the deposit charge. Two-tier is expected to relieve some of the pressure on banking profits by offsetting the damage caused by negative interest rates, but it may not be enough to restore European banks' confidence as the monetary policy is on the road to "Japanisation".
- **Policy impacts and our forecasts: ECB's sweeping stimulus package will increase pressure on other central banks to ease policy soon.** Markets seesawed and European bank stocks slid after the QE announcement. ECB's stimulus package provides the latest reason for Trump to criticize US Fed. In general, ECB's decision will broadly be positive to market risk appetite and we believe ECB is going to deliver more easing. After ECB, market is now switching focus to US Fed. We now expect Fed to cut 25bps in Sep and also see a growing prospect of another 25bps rate cut in Oct 2019 or Dec 2019. ECB stimulus plan and Fed's rate cut are creating room for Asian banks to follow and act. But again, monetary ease alone may not be enough to boost economy as major downside risks linger.

Figure 1: Key ECB interest rates



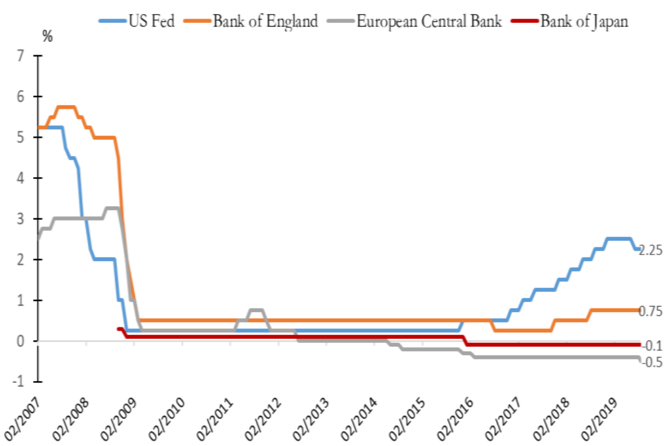
Source: Bloomberg, CMBIS

Figure 2: Size of ECB balance sheet has doubled after previous QE



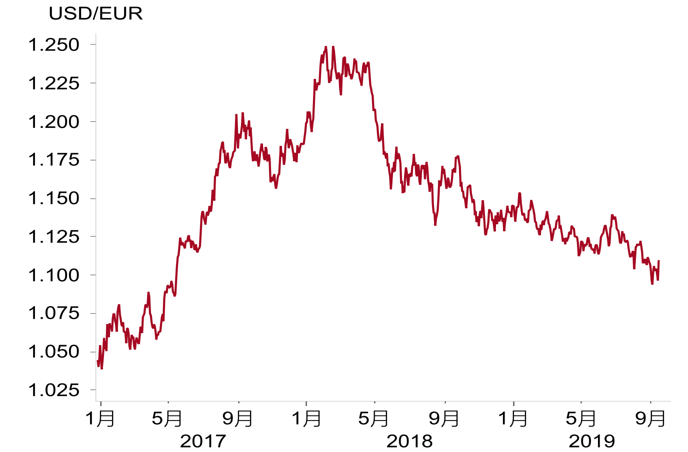
Source: Bloomberg, CMBIS

Figure 3: Key policy rates of major central banks



Source: Bloomberg, CMBIS

Figure 4: USD/EUR exchange rate



Source: Macrobond, CMBIS

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