

## ECB: Draghi Leaves Lagarde an Open-Ended, More Qualitative Bazooka

- Although the size of the ECB's moves toward more accommodative policy under-shot market expectations, forward guidance was more dovish than expected and, most importantly, the asset-purchasing programme left the return to QE open-ended, which together made for a total package that was at least as ambitious markets had anticipated.
- Today's decisions mark a good working compromise between the Governing Council's hawks and doves, and leaves some flexibility for Lagarde when she assumes the Presidency of the ECB—but today's moves also likely hand her the difficult task of raising limits on asset purchases and clarifying the ECB's stance on the symmetry of its inflation target.

### MORE DOVISH THAN INITIAL DETAILS IMPLIED

In his penultimate meeting as ECB President, President Mario Draghi brought in a fresh package of stimulus measures than were smaller than markets expected in terms of interest-rate cuts and the pace of new quantitative easing (QE), but delivered an overall dovish package by

- putting the resumption of the asset purchase programme (APP) on an open-ended horizon;
- replacing date limits in the Bank's forward guidance with an expectation that inflation would need to "robustly converge" to the ECB's inflation target before rates are raised; and
- announcing terms that are better than markets expected for the third set of targeted longer-term refinancing operations (TLTRO III).

The impact of the less-generous-than-anticipated, Swiss-style tiered exemption to shield banks' excess reserves from the -0.50% deposit rate may be a wash: on the one hand, it helps shore up bank profitability (particularly for core Eurozone banks), mitigates the impact of the rate cut on the stability of the financial system, and helps keep banks in a position to lend; but, on the other hand, it likely puts distortionary upward pressure on short-term rates.

**Revisions to the ECB's macroeconomic forecasts imply that, based on the wording of today's decisions, a reversal in rates isn't expected before 2022 and the new round of QE should last at least until end-2021.** The ECB brought down its real GDP growth forecast for 2019 by a tenth to 1.1% y/y (chart 1), but kept 2020 at 1.4%. The Bank's inflation projections got shaved more substantially: 2019 fell only from 1.3% to 1.2% y/y (chart 2), but the 2020 inflation outlook came down from 1.4% to 1.0% y/y and even 2021 got pulled down a tenth to 1.5% y/y. Core inflation projections also got pulled down: from 1.2% to 1.1% y/y in 2019; from 1.4% to 1.2% y/y in 2020; and from 1.6% to 1.5% y/y in 2021. On these forecasts and in view of the wording of today's decisions, the ECB would not expect to raise rates any time before 2022 and would end QE only "shortly before it starts raising the key ECB interest rates."

### CONTACTS

**Brett House, VP & Deputy Chief Economist**  
416.863.7463  
Scotiabank Economics  
[brett.house@scotiabank.com](mailto:brett.house@scotiabank.com)  
[@BrettEHouse](https://twitter.com/BrettEHouse)

Chart 1

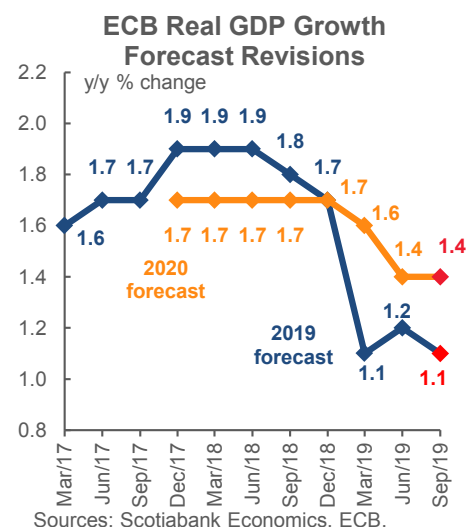
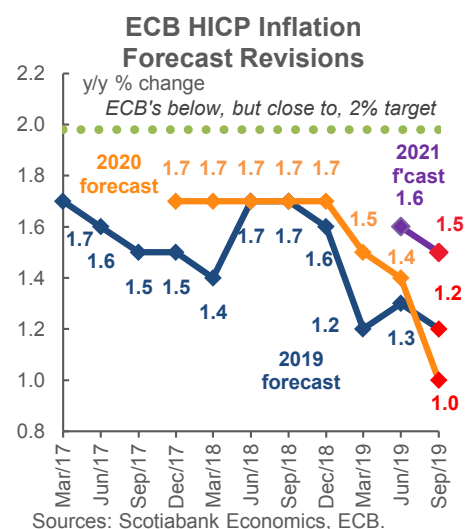


Chart 2



## HARD DISCUSSIONS REMAIN FOR LAGARDE

The total package represents a constructive compromise between the Governing Council's hawks and doves, and bequeaths some flexibility and some hard discussions to Christine Lagarde when she assumes the ECB Presidency on November 1 and begins a strategic review of the ECB's policy framework and operations. Today's decisions also keep some powder dry to deal with a possible no-deal Brexit or a further worsening in economic conditions.

At a EUR 20 bn monthly pace and under the APP's existing proportionate composition, QE could bump into its existing issuer limits by end-2020 unless there is an imminent move toward more fiscal stimulus by major Eurozone governments that would be financed by increased sovereign bond supply. Pres. Draghi urged Eurozone governments that have fiscal space to use it, with evident frustration that they haven't been more proactive in doing so. On the one hand, today's actions by the ECB open up more breathing space for European governments to drag their feet further on action to increase spending. But in substantive terms, the open-ended nature of this new round of asset purchases also raises the prospect of it becoming *de facto* fiscal QE if governments don't act.

Alternatively, to deal with the APP's limits, the ECB could decide to make qualitative shifts to the proportionate composition of its purchases between Eurozone sovereign issuers, increase the share of corporate bonds in the APP, or include additional financial instruments in its purchase programme. All three options could enhance moral hazard for the respective issuers, with the first option potentially further exposing the ECB to charges that it is violating rules against monetizing fiscal deficits. On its current limits, the APP is expected to run out of space to purchase German debt by end-2020, but would still have scope to keep buying Italian bonds for around seven years.

Lagarde could also initiate a contentious discussion on raising the APP's limits that could result in open disagreement with the Governing Council's hawks. As it is, comments from German and Dutch policymakers, among others, imply that the Governing Council's consensus around today's decisions was likely less iron-clad than Draghi described it in the press conference: Governors from all three countries disagreed with the restart of QE. This opposition would likely be even stronger in a conversation on raising the APP's purchase limits, which Draghi said was not discussed today since the nature of the talks and the extent of agreement were both too "broad". Such a discussion would also run counter to Lagarde's oft-expressed view while IMF Managing Director that monetary accommodation is reaching its limits, both in Europe and elsewhere, and needs to be supplemented by more expansionary fiscal policy. Still, if it's already clear that the APP is going to begin hitting its limits by late-2020, it would make sense for her to initiate this discussion earlier rather than later in her term.

Today's statement and press conference also left unresolved uncertainty about the symmetry of the ECB's inflation target. In line with July's ECB communications, the statement was clear that the target remains asymmetric, "at a level sufficiently close to, but below, 2%." In contrast, Draghi again spoke of the ECB's "commitment to symmetry" in its inflation targeting, thereby leaving it to Lagarde to clear up this issue as he's unlikely to go further in his final meeting. Later in the press conference, Draghi dismissed talk of changing the inflation target's level since it would not, in his view, enhance credibility.

## DETAILS ON TODAY'S KEY DECISIONS

- The deposit rate was lowered by 10 bps from -0.40% to -0.50%, which was less than market expectations that sat between 10 and 20 bps. The refinancing and marginal lending facility rates were left at their current levels of 0.00% and 0.25%, respectively.
- Forward guidance shifted dovishly, with the removal of date-delimitations as the statement moved from July's advisory that "The Governing Council expects the key ECB interest rates to remain at their present or lower levels through the first half of 2020" and instead linked rates to seeing "the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon," and where "such convergence has been consistently reflected in underlying inflation dynamics."
- QE under the APP will be restarted from November 1 at a monthly pace of EUR 20 bn per month (nearly EUR 35 bn with repurchases), lower than consensus expectations of EUR 30 bn per month. However, this new round of QE is open-ended and the Governing Council expects it to run "as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates." This exceeds the 12-month span anticipated by markets.

- The TLTRO III will be delivered on better than expected terms. The previously announced 10 bps spread over the average rate applied in the Eurozone's main refinancing operations (MROs) over the life of the respective TLTRO will no longer be applied. Similarly, banks whose lending exceeds a benchmark would qualify for a rate as low as the average deposit rate over the life of the TLTRO with no additional spread. This should increase the extent to which the TLTRO will allow banks to lend on favourable terms. The maturity of the TLTRO was extended from two to three years to better align it with term of bank loans used to finance investment projects. Finally, early repayment will now be possible on a quarterly basis from the two-year mark.
- A two-tier system for reserve remuneration was introduced that exempts a share of banks' excess liquidity from the -0.50% deposit rate and instead provides remuneration at 0% for exempt reserves. The exempt share is defined as a proportion of minimum excess reserves, following the Swiss tiering model. The exemption threshold will be set initially at six times a bank's minimum reserve requirements, which is less generous than markets had anticipated. The remuneration rate of the exempt tier and the multiplier to set the exemption threshold shall be adjusted over time as excess liquidity holdings evolve.

**Monetary policy decision:**

<https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.mp190725~52d3766c9e.en.html>

**QE details:**

[https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912\\_1~b17f699a88.en.html](https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912_1~b17f699a88.en.html)

**TLTRO III terms:**

<https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912~19ac2682ff.en.html>

**Tiering details:**

[https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912\\_2~a0b47cd62a.en.html](https://www.ecb.europa.eu/press/pr/date/2019/html/ecb.pr190912_2~a0b47cd62a.en.html)

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