European Central Bank signals return to monetary stimulus

Nick Beams
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The European Central Bank left its present monetary policies on hold at the meeting of its governing council yesterday, but gave a clear indication it will cut interest rates and possibly resume its asset-purchasing program when it next meets in September.

The reasons for the move lie in the growing signs of a slowdown in the euro zone economy, the persistence of low inflation and the impact of geopolitical factors, including the rising trade conflicts.

In his introductory remarks, ECB President Mario Draghi pointed to employment gains and higher wages as promoting consumption. During the question-and-answer period, he said the risk of recession was "pretty low overall."

But there was a marked change of tone when it came to an assessment of manufacturing, which is the driving force of the region's largest economy, Germany. In response to a question, he said the outlook for manufacturing was "getting worse and worse."

This assessment was underscored by a report from Germany's Ifo Institute issued as the meeting was taking place. Its manufacturing business climate index fell to minus 4.3 in July, down from a positive 1.3 in June.

The reading, the lowest in nine years, was preceded by the results of the IHS Markit euro zone purchasing managers' index for manufacturing, which dropped to 46.4—well below the level of 50 that marks the boundary between expansion and contraction. The downturn was most severe in Germany, where the index dropped to 43.1 from 45 the previous month.

Commenting on his organisation's figures, Ifo Institute President Clemens Fuest said: "In manufacturing the business climate indicator is in free-fall. No improvement is expected in the short term, as businesses are looking ahead to the next six months with more pessimism."

The chief economist at Germany's Commerzbank, Jörg Krämer, said that "there is far and wide nothing to be seen" of the second half recovery that had been hoped for, and Germany was in a "grey area between a marked growth slowdown and recession."

In his opening statement, Draghi pointed to the underlying international processes at work. He said "softening global growth dynamics and weak international trade" continue to weigh on the euro area.

"Moreover, the prolonged presence of uncertainties related to geopolitical factors, the rising threat of protectionism, and vulnerabilities in emerging markets is dampening economic sentiment, notably in the manufacturing sector."

While assessing the prospect of recession as low, noting that euro area real gross domestic product growth had risen by 0.4 percent in the first quarter, compared to 0.2 percent in the last quarter of 2018, he said "incoming data and survey information continue to point to somewhat lower growth in the second and third quarters of this year."

The opening statement made clear the ECB is set to take significant action to loosen monetary policy at its September meeting, including a resumption of its asset-purchasing program, so-called quantitative easing (QE), which it announced was ending last December.

It said the ECB expected interest rates to remain "at their present or lower rates at least through the first half of 2020," and that the governing council had "underlined the need for a highly accommodative stance of monetary policy for a prolonged period of time." The council had also tasked the relevant ECB committees with an examination of "options for the size and composition of potential new asset purchases."

The commitment to examine increased asset purchases will further fuel speculation in financial markets. Under its QE program, the ECB went from purchasing government bonds to buying up corporate bonds as well, and there have been suggestions it might follow the lead of the Bank of Japan and start buying the shares of companies.

According to an article in the *Financial Times* previewing the ECB meeting: “The ECB’s last major unconventional policy move—buying the bonds of companies rather than just governments—certainly seemed to do more for asset prices than the underlying economy. The main legacy of this corporate buying is arguably the creation of record demand for European leveraged loans—riskier lending to heavily indebted companies, that has sparked concern among policymakers.”

The leveraged loan market, in which debt resting on shaky foundations is repackaged and then sold off, has similarities to the US sub-prime mortgage market that sparked the financial crash of 2008.

There had been speculation before the governing council meeting that the ECB would announce an immediate interest rate cut together with other measures. When asked why this was not done, Draghi said it was because the issues were complex and needed further examination. While this may be the case, another factor in the delay is likely to have been the meeting of the US Federal Reserve next week, at which an interest rate cut of at least 0.25 percentage points is expected.

Had the ECB decided to move at yesterday’s meeting, the Fed may have decided to go further and cut rates by 0.5 percentage points, the effect of which would have been to lower the value of the dollar against the euro, worsening the position of the euro zone in export markets.

The official policy of both the Fed and the ECB is that they do not shape monetary policy with an eye to its effect on currency values. But the breakout of a currency war, on top of the existing trade conflicts, is very much present.

Following a speech by Draghi in June foreshadowing monetary easing, US President Trump attacked him for seeking to lower the value of the euro to the disadvantage of the US. Draghi issued a rebuttal, but the issue was again raised during question time at his press conference.

Draghi repeated the official line that the ECB’s policies are determined solely by its mandate to secure inflation at around 2 percent and not by currency issues.

But the fact that the issue has even been raised, and the remarks by Trump, point to the breakdown in international economic relations. In the 1980s and 1990s, the major powers made agreements on currency levels in order to try to stabilise the world economy. But such collaboration has now well and truly gone by the board, along with commitments not to engage in trade and tariff wars.