Economist's Weekly Market View

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ECB sticking with its negative interest rate policy

Last week's December meeting of the ECB Governing Council concluded in line with expectations, with no changes to interest rates from their present levels of 0% for the refi rate and –0.4% for the deposit rate. Meanwhile, as previously announced, the ECB is ceasing net asset purchases under its QE programme this month.

The ECB post-meeting statement acknowledged the recent softer tone to Eurozone macro data, noting that incoming figures have been weaker than expected. The Eurozone economy grew by just 0.2% in the third quarter, down from 0.4% in the first two quarters of the year, and the quarterly growth rate of 0.7% recorded right through 2017.

The slower growth in the third quarter is partly attributable to delays in car production associated with new EU emission standards. The underlying data show that government expenditure, personal consumption and investment made only a modest contribution to growth. Meanwhile, net trade acted as a significant drag, while there was an increase in inventories. Survey data suggest that economic activity has failed to regain momentum in the fourth quarter of the year.

The more challenging economic backdrop is reflected in the ECB's updated macro forecasts. It marginally downgraded its GDP growth forecasts for 2018 and 2019 to 1.9% and 1.7%, respectively. Meanwhile, the 2020 GDP forecast was left unchanged at 1.7%, whilst the ECB sees growth slowing to 1.5% in 2021. It also commented that the balance of risks to the growth outlook is "moving to the downside".

The update of its inflation forecasts highlight why the ECB is taking such a cautious approach to tightening monetary policy. They show that it continues to expect inflation to remain below its 2% target over the next 3 years. HICP inflation is forecast to average 1.6% in 2019, 1.7% in 2020 and 1.8% in 2021.

Given this very subdued inflationary outlook, the ECB continues to emphasise that interest rates are expected to remain at their current very low levels "at least through the summer of 2019". In terms of market expectations, futures contracts show that 3–month Eurozone rates, which currently stand at -0.3%, are not expected to turn positive until 2 years' time, at the end of 2020.

Looking out to the medium term, futures contracts suggest that the market is expecting rates to remain low for an extended period. Three month rates are not expected to get to 1% for another five years, by around the second half of 2023.

The ECB introduced its negative interest rate policy back in 2014 when the economy was on the cusp of deflation and still struggling to recover from the great recession of 2008-2010. It was seen as a temporary measure. Since then, the economy has registered solid growth, with the unemployment rate declining from 12% to 8%, while inflation has picked up. Negative interest rates, though, remain in place.

Markets had expected that with QE finishing at the end of 2018, the ECB would move away from its negative interest rate policy in early 2019. However, they have had to change their mind on the back of the guidance from the ECB that it is in no rush the end negative interest rates anytime soon. It is little wonder, then, that the euro remains at low levels against the US dollar.

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