

# ECOWEEK

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## ECB: Mario Draghi passes the baton

■ Market expectations were elevated but the Governing Council did not disappoint. The comprehensive nature of the package, with the introduction of state-dependent forward guidance, take away the need to envisage additional measures in the foreseeable future ■ ECB watching has been narrowed to monitoring the gap between inflation and the ECB target ■ Given certain negative side effects of the current monetary mix, which are acknowledged by the Governing Council, fiscal policy, where leeway is available, is now requested to step up to the plate, so as to foster growth and speed up convergence of inflation to target ■ The policy baton has been passed

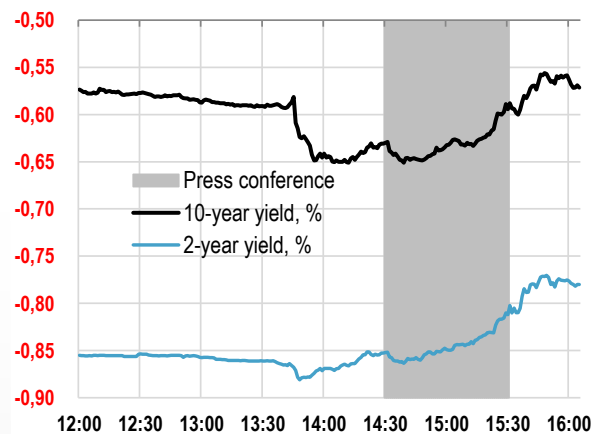
The next couple of years risk being boring for ECB watchers. The package of measures decided by the Governing Council on Thursday was very comprehensive and, hopefully, takes away the need to do more anytime soon. In addition, the forward guidance was particularly strong, both in terms of interest rate policy and as far as the asset purchase program is concerned. The latter will be resumed without an end date.

Whether this degree of monetary accommodation is maintained for some or a very long time depends on how inflation evolves. The hurdle is high: the inflation outlook needs to robustly converge to the ECB's target and this must be consistently reflected in the underlying inflation dynamics. Spikes, which are by definition short-lived don't pass the test. Given the sluggishness of the inflation process, meeting these requirements will take time, which makes it very likely that the current policy will remain in place for a long time. The fact that bond yields, after a dip following the press release, moved higher shouldn't be interpreted as an anticipation of monetary tightening, but is a reflection of a less negative term premium<sup>1</sup>. This in turn would reflect that investors give some credence to the effectiveness of the package. This is indeed the key question in the coming months for markets, households, companies and indeed the ECB, because it will determine whether inflation expectations can re-anchor at a higher level. As emphasised by Mario Draghi during the press conference, these expectations didn't become unanchored, they re-anchored at too low a level compared to the ECB's inflation aim.

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<sup>1</sup> The term premium is the risk premium which the investor receives when buying a bond of a given maturity rather than investing in short-dated government paper over the same period by constantly reinvesting as this paper matures. This premium is a reward for taking duration risk. However, this premium can be negative, as has been the case in the eurozone and the US for quite some time. The term premium should not be confused with the term spread, which corresponds to the difference between the yield on a long-term bond and a shorter-term bond (or the rate on short-dated government paper).

GERMAN BOND YIELDS, INTRADAY, 12 SEPTEMBER 2019



Source: Bloomberg, BNP Paribas

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Theoretically, and given the current environment, some scepticism is warranted and this was discussed in earlier contributions<sup>2</sup>. In addition, although the current policy should have positive effects in the aggregate, concern about the negative side effects is on the rise: overheated property markets in certain countries; negative rates impact pension funds and insurance companies; certain households may decide to save more and spend less considering that, when bond yields are low to negative, wealth accumulation depends on the amount of saving, rather than on the reinvestment of, what has become in yield terms, a meagre financial income.

The repeated insistence by the ECB President on side effects was one of the surprises of the press conference and shows monetary policy is approaching the end of the road. The other surprise was that he and his colleagues of the Governing Council are basically passing the baton to fiscal policy: *“There was unanimity that fiscal policy should become the main instrument to support growth”, “It’s high time for fiscal policy to take charge”, “If fiscal policy is appropriate the monetary package will be effective more quickly”*.

In a way there is something tragic about it: as explained by the ECB president, monetary policy has played a crucial role in creating an environment leading to 11 million new jobs. It has also led to a solid increase in wage growth as the unemployment rate declined. The final step however hasn’t really materialised: the transmission of faster wage growth into higher inflation has been interrupted because of the negative demand shock coming from China and international trade; tariff uncertainty; Brexit uncertainty. Fiscal policy is then requested to step in, at least in these countries which have leeway, that is fiscal space. We now have to see whether the call will be heard.

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<sup>2</sup> Exogenous versus endogenous uncertainty and monetary policy (BNP Paribas, Ecoweek, 5 July 2019), Monetary easing at full employment: how effective? (BNP Paribas, Ecoweek, 12 July 2019)

