ECB Preview: Draghi to Disappoint?

- *The ECB is expected to announce a set of measures at its policy meeting on Thursday to kick-start the bloc's economy: a policy rate cut, the restart of quantitative easing, and a new 'tiering' system for banks' deposits at the central bank.*

- *With President Draghi recently facing opposition from key policymakers in the Eurozone, it is likely that the ECB's announcement will under-deliver on expectations for an aggressive easing package and boost the EUR ahead of, and following, the Bank's meeting.*

FOLLOW US ON TWITTER @SCOTIABANKFX

Shaun Osborne
Chief FX Strategist
416.945.4538
shaun.osborne@scotiabank.com

Juan Manuel Herrera
FX Strategist
416.866.6781
juanmanuel.herrera@scotiabank.com

Thursday's European Central Bank's meeting will outline the course for monetary policy in the Eurozone over the medium term with the Bank expected to deliver a widely anticipated interest rate cut and an announcement that it will relaunch quantitative easing. While analysts' consensus is generally leaning toward a 10 bps reduction in the ECB's deposit facility rate to -0.50% from -0.40% currently, expectations around the volume of monthly purchases under the Bank's new asset buying programme are much more divided (chart 1). In addition to a rate cut and details into QE, there is a strong chance that the Bank unveils a 'tiering' system wherein a specific share of banks' excess reserves would be exempt from negative interest rates at the central bank.

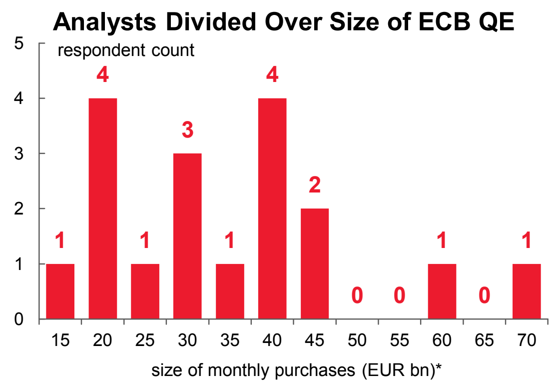
The ECB is facing subdued inflation levels in the Eurozone—with prices growth currently running at around half of its target—and prevailing recessionary risks in some of the Eurozone's key economies, like Italy and Germany (charts 2 and 3). The bloc's economy has been impacted by a full suite of headwinds: the possibility of a no-deal Brexit, political uncertainty in Italy, the China-US trade war, and the threat of tariffs on auto exports to the US. The confluence of these headwinds has led to depressed business sentiment and thus a reduction in demand for capital goods, not just from the Eurozone but also from the UK and beyond the continent. It is this slump in demand for industrial manufactures that has, in part, pushed Germany to the brink of recession. While decent Eurozone-wide job gains and solid wage growth have supported household spending growth against muted consumer confidence—with a positive pass-through to prices—declining business optimism may devolve into flat job and salary gains, pushing inflation further away from the ECB'S target.

In what is to be his second to last ECB meeting, we expect that President Draghi will under-deliver in relation to what is currently reflected in market-weighted interest rate expectations and government debt yields. Over the last two weeks, key policymakers from France, Germany, and the Netherlands, among others, have expressed their opposition to an overtly-aggressive monetary policy stance by the ECB. While these objections should not dissuade Draghi from launching a new round of QE, there is a chance that he unveils a comparatively small asset purchase programme, possibly starting later than October as is currently expected. Such a move would also prove less limiting to his successor, Christine Lagarde.

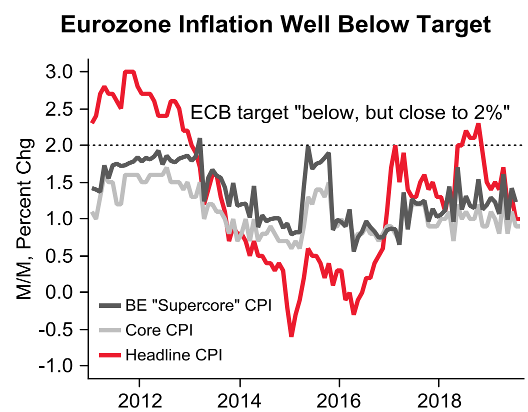
We anticipate the EUR to make some minor gains ahead of the ECB's meeting on Thursday as markets begin to adjust their expectations toward the risk of a less dovish announcement, followed by an additional jump upon the ECB's press release on Thursday morning.

What to expect:

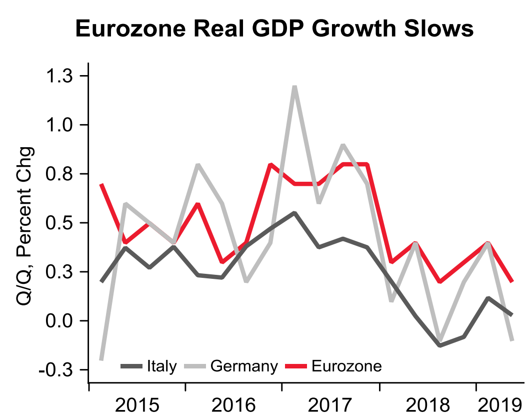
- 10 bps cut in the ECB's deposit facility rate to -0.50%; EUR positive as market pricing still reflects a chance of a 20 bps cut.



Source: Bloomberg ECB Survey, Scotiabank FICC Strategy. *note that some respondents expect the programme to last less/more than the 12-mth median.



Source: Macrobond, Scotiabank FICC Strategy



Source: Macrobond, Scotiabank FICC Strategy

- New round of sovereign and corporate debt purchases totaling EUR 30-50 bn per month for 12 months or longer beginning in October; monthly level over EUR 40 bn likely to be EUR and yields negative with consensus calling for EUR 30 bn per month.
- Introduction of a tiering system which exempts 30% of banks' excess reserves from deposit rate charges; greater/lower share EUR positive/negative.
- Forward guidance changed from "rates to remain at their present or lower levels at least through the first half of 2020" to "rates to remain at their present or lower levels at least through the end of 2020" (perhaps beyond 2020), possibly teeing up an additional rate cut in 2019; EUR neutral as an additional rate cut would be in line with market pricing of 20 bps in cuts by December.
- Possible change to a symmetric inflation target around the 2% mark from the current target of "below, but close to, 2%"; EUR negative as it would suggest that ECB is ready to keep lower rates for longer and allow inflation to run above target before tightening.
- ECB will publish updated macroeconomic forecasts for 2019-2021, likely revise growth and inflation lower for 2019 and 2020; EUR neutral, widely expected.

CONTACTS - GLOBAL FX STRATEGY

Shaun Osborne
Chief FX Strategist
T +1 416 945 4538
shaun.osborne@scotiabank.com

Qi Gao
FX Strategist (Asia)
T +852 2861 4770
qi.gao@scotiabank.com

Juan Manuel Herrera
FX Strategist (G10)
T +1 416.866.6781
juanmanuel.herrera@scotiabank.com