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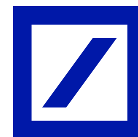

Europe

Economics

Focus Europe

Date
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ECB: Dark clouds, silver linings and balanced risks

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- The ECB continues to exert control over financial conditions with its slow, transparent and balanced exit from QE. Confirmation that net purchases will cease in December will wait a little longer but is still anticipated – the hurdle to an extension of QE feels high. Exiting net purchases remains balanced by the target of ample monetary accommodation through reinvestments, low policy rates and the open-ended guidance on both.
- 'Balance' was the key word at the press conference. The downside risks were dialled up, but these were balanced by the Council's confidence in the resilience of the euro area economy. If the downside risks do not materialise in any substantive way, the resilience of the economy — not least demonstrated by the health of the labour market and the emergence of rising wage inflation — suggests the path to the first rate hike later in 2019 will be clear. Our call remains September 2019 for the first policy rate hike.
- In recent years, the market was likely underestimating the potential for wage growth to pick up in the euro-area. A careful analysis of labour market developments in the EMU would support Draghi's confidence. We include links to our analytical work on this topic.

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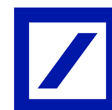

‘Balance’ was the key word

There was little to surprise the markets in the latest ECB press conference. As expected, the ECB confirmed the slowing of net asset purchases from EUR30bn to EUR15bn per month for the final quarter of the year. As hinted in the press last week, the decision to cease net asset purchases in December will be made later and will be conditional on confirmation of the medium-term inflation outlook. However, the ECB continues to “anticipate” that net purchases will end.

Also as expected, the slow, conditional exit from net purchases is balanced by the objective of maintaining “ample” monetary stimulus. The accommodation comes through the same three commitments as previously: (1) reinvestments for an extended period after net asset purchases, (2) unchanged policy rates at least through summer 2019 and longer if necessary, and (3) the availability of “all instruments” (including net asset purchases) if necessary.

The prepared press statement was virtually unchanged. The most significant alteration appeared to be the inclusion of “EM vulnerabilities” in the list of risks and the view that the risks were “gaining prominence”. However, it was not a clear case of dialling up the risks. While Draghi went into detail about how difficult it is to assess the risks from trade war – in terms of assessing the risks of escalation, the impact on general confidence or the impact on international supply chains – if anything, he played down some of the fears. For example, he mentioned the lack of spillover from EM and Italy stresses.

The press statement said the ‘balance of risks’ can still be assessed as broadly balanced, despite the downside risks “gaining prominence”. Draghi nuanced this in the Q&A. He said the view was shared by all on the Governing Council that the balance of risks has not changed. He mentioned two counterbalancing upside risks.

First, the fiscal stance. The ECB views this as slightly easier than previously. According to the staff forecasts, the change in the structural budget balance (fiscal stance) next year is 0.2pp of GDP versus 0.1pp previously and unchanged in 2020 versus an expectation of a one tenth tightening previously.

Second, the “underlying strength of the economy”. The staff GDP forecasts for 2018 and 2019 were revised down by 0.1pp as were the core inflation forecasts for 2019 and 2020, but as we mentioned in our preview, risks were skewed in this direction and the quantum of downgrade is not enough to alter the tone of the policy outlook. If anything, the resilience of growth in the face of the accumulation of risks was the key message from Draghi in the Q&A.

A key part of the resilience argument appears to be the labour market, which Draghi described as “ever improving”. There are two parts to this. One is employment. The job content of growth remains impressive. The employment/GDP ratio is expected to be 0.7 this year, up from 0.6 on average over the last four years and a pre-crisis average of about 0.55.

The other is wage growth. Not only is the strength of the labour market adding to the resilience of the economic recovery, it is also increasingly translating into a wage impulse. The turning point in the euro area wage cycle was in the first half of 2017, with all three of the euro area’s main labour cost indicators now clearly moving upwards – negotiated wages, hourly labour costs and compensation per

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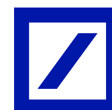
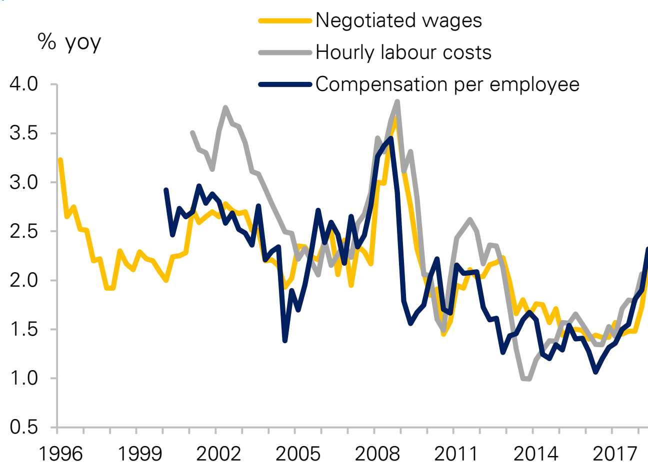


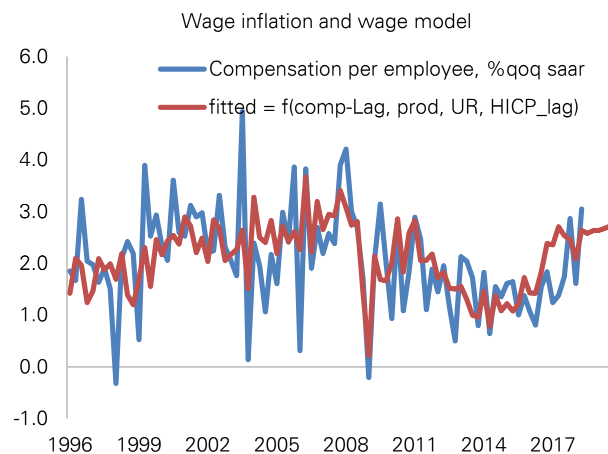
employee (see Fig 1). This coincides with the closure of the unemployment gap – the ECB staff recently argued that on a traditional basis using the unemployment rate and on a broader basis capturing slack outside the standard unemployment rate, the gap is now closed.

Figure 1: The euro area's main labour cost indicators are clearly rising



Source: Deutsche Bank, ECB, Haver Analytics LP

Figure 2: Following some undershooting in H2-2016/ H1-2017, comp per employee is back in line with our model – and the gains should be sustainable



Source: Deutsche Bank, ECB, Eurostat, Haver Analytics LP

No more labouring over why wages are not rising

In recent years, the market was likely underestimating the potential for wage growth to pick up in the euro-area. A careful analysis of labour market developments in the EMU would support Draghi's confidence:

- A simple wage equation model accounting for past inflation, productivity growth and unemployment has explained very well wage developments in the euro-area throughout the crisis years and recently (see Fig 2 and our May 2017 article here). Across countries, similar relations hold also well (see our Feb 2018 wage outlook here).
- Broader labour market slack (constrained part-time workers, people willing to work outside the labour force) in the euro-area appears to move in line with headline unemployment and captures little additional information on the degree of cyclical tightness of the labour market (see our Sep 2017 report here).
- The euro-area Phillips curve is non-linear, flat in periods of high unemployment and steep once unemployment approaches its structural rate (see Fig 3)
  - Hence a prolonged economic trough would bias down short-term Phillips curve estimates. (see our Sep 2017 report here for more details).
  - This short-term estimate bias argument would be reinforced if the Phillips curve had shifted down due to a fall in structural unemployment amid supply-side reforms or inflation expectations amid deflation risks.

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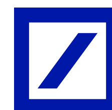
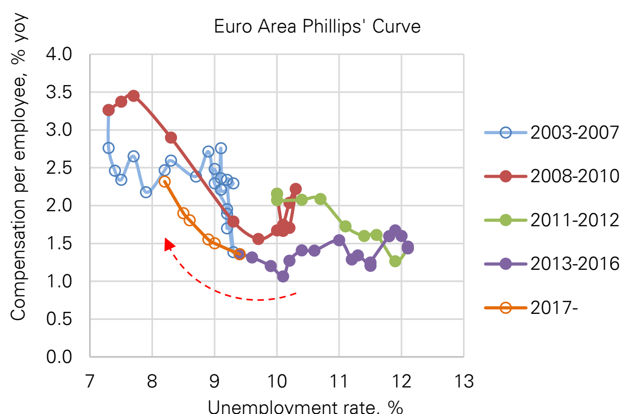


- Once all these potential headwinds pass, a tighter labour market should result in higher wage growth as the workers most likely to quit put pressure on labour costs (see our June 2018 report here for evidence of such mechanisms).

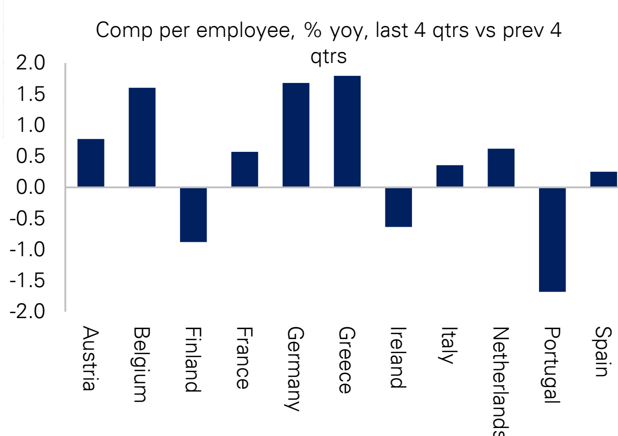
- Finally, the labour share over the last 20 years has remained broadly constant in the euro-area, unlike in the US or Japan (see our Nov 2017 report here). This is true despite the varying cyclical position or supply side reform timings of its member states. This implies that rising nominal wages are relatively more likely to be absorbed by higher consumer prices rather than falling corporate margins.

Figure 3: Increasing evidence of a typical non-linear Phillips curve



Source: Deutsche Bank, ECB, Eurostat, Haver Analytics LP

Figure 4: Evidence of a broad-based acceleration in compensation momentum



Source: Deutsche Bank, Eurostat, Haver Analytics LP

Policy Outlook

First, all else unchanged it will require a non-negligible materialisation of risk – enough to affect the medium-term outlook for inflation – for the ECB to extend the net asset purchases beyond December. However, just because net purchases are close to a conclusion does not mean the monetary policy stance is shifting. An "ample" degree of monetary accommodation remains the ECB's current policy objective. It is achieving this through reinvestments, low policy rates and the open-ended guidance on both.

Second, the ECB is determined to move policy slowly. (1) The end of net asset purchases is still anticipated for year-end. The decision is conditional and there is no reason for the ECB to rush the decision – hence the deferral until later. (2) There is still no discussion on the details of reinvestments – apart from the statement that the capital key will remain the guiding principle. (3) The Council is not talking about the practicalities of how to raise policy rates – the size of hikes, the role of the standing facilities corridor, etc. There is a lot of time yet before this becomes necessary.

Third, the key to the outlook for the economy and monetary policy are the downside risk factors. If the downside risks factors do not materialise in any substantive way, the resilience of the economy — not least demonstrated by the health of the labour market and the emergence of rising wage inflation —

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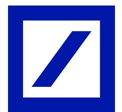

suggests the path to the first rate hike later in 2019 will be clear. We maintain our call that the first policy rate hike will be in September 2019 (+20bp depo, +25bp refi). This is conditional on moderately above-trend growth continuing and core inflation rising to 1.5% next year.

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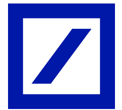

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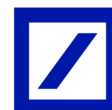

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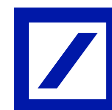

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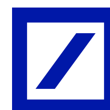

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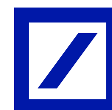

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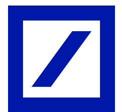

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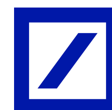

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