The ECB: maintains its course

Summary:

- The ECB maintained status quo on all fronts—policy rate, QE, reinvestment and its forward guidance.
- The main change was the addition that the ECB made to its framework by introducing a fresh guidance on ‘negative rates’ in its policy statement that would seem to suggest that it could resort to a ‘two-tiered’ policy rate framework in the future.
- The ECB’s assessment on the economy remained unchanged with risks to the growth outlook described as being to the ‘downside’.
- We expect the ECB to continue to provide dovish signals and ensure that monetary policy is accommodative to support the real economy.
- We continue to remain bearish on the EUR/USD pair especially with the US President’s decision on whether to increase tariffs on auto imports from the Euro-zone looming in the background.

Strong hints of a possible introduction of a two tiered system

While the ECB maintained status quo on all fronts, it provided an addition to its framework by introducing a fresh guidance on ‘negative rates’. The renewed guidance was the ECB stating that ‘it would also consider whether the preservation of the favourable implications of negative interest rates for the economy requires the mitigation of their possible side effects, if any, on bank intermediation’. In other words, the ECB stated that it is examining the impact that negative interest rates are having on the profitability of the banking sector and if warranted it could introduce measures to counter any adverse effects. Based on media reports and recent communication provided by ECB policymakers, it would suggest that the ECB is paving the way for introducing a two-tiered interest rate system.

As we understand from the minutes of the ECB policy meeting in March-2016 that was the last time such a framework was discussed, a two tiered system is one in which the European banking sector will be exempted from paying interest on their excess reserve holdings but will continue to do so on their required holdings. This will in turn work as a positive interest rate shock to the banking sector given that the ECB President in the press conference stressed that ‘the impact of the negative rates is different when they were initially introduced and that impact has changed now that they have been in operation for a long-period of time.’

ECB’s assessment on the economy unchanged

The ECB did not make any changes to its assessment and outlook on the economy.

- The risks to the growth outlook were described to being on the downside driven primarily by external factors such as: (a) prospective US-Euro-zone trade battle, (b) pending risks from ‘Brexit’ and (c) geo-political uncertainties.
- However, the ECB President Draghi was quick to stress that the risks of a recession remained low given that domestic drivers of growth such as a robust labour market remains intact that is also visible in continued strength in the service sector.
• Inflation was expected to trend lower in the near-term reflecting energy price movements but bottom out in September-2019. The guidance of inflation moving towards the 2% mark in the medium-term was left unchanged.

• On the possibility of renewing quantitative easing, the President said that the situation this time is different than in 2016, when the tool was initially introduced. Although the economic outlook has worsened, this has not translated into a weaker labor market that underpins growth in the economy. His guidance seemed to indicate that the central bank views the current slow-down more as a soft-patch rather than a full-blown recession.

An uncertain road ahead is likely to warrant an accommodative stance

We expect the ECB to maintain an accommodative stance and keep providing a dovish guidance to the market given that the risks to the growth outlook remain firmly to the downside. The main source of risk pertains to a possible intensification of a US and Euro-zone trade battle especially with the US President’s decision on whether to increase tariffs on auto imports from the Euro-zone looming in the background. There has already been some intensification of this with US threatening to impose counter tariff measures of up to USD 11.2 bn on several European products in retaliation for the subsides that European Airbus receives locally. This was followed by the EU threatening retaliation tariffs. However, the main source of risk stems from the prospect of the US President increasing auto tariffs on European imports. Such a move and given the structure of the Euro-zone economy will further hit exports that could pull the region into a recession.

Other risks such as a ‘No-Deal Brexit’ still remain in place. Hence, the ECB is unlikely to deviate from its current accommodative framework in 2019 with a next possible move likely to be in the form of an introduction of a ‘two-tiered’ system. The ECB could also provide more details of the TLTRO III program in subsequent meetings possibly in the June meeting.

Market implications

The ECB maintaining status quo and providing some tentative indications that it could resort to a two tiered rate system was expected. Both the EUR/USD pair and the yield on the German 10-year bund moved lower in response to the tone of the press conference and the post policy statement. We continue to remain bearish on the EUR/USD pair with the US Protectionist stance emerging as the primary driver. Were the US administration to increase the pressure on the Euro-zone, the EUR/USD pair could break below the 1.11 level in the near-term.
Chart 1: Weakness in manufacturing…

![Eurozone PMI chart](source: Bloomberg, ICICI Bank Research)

Chart 2: …has dragged overall Eurozone growth lower

![Eurozone Composite PMI chart](source: Bloomberg, ICICI Bank Research)
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