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Macro and market perspectives
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ECB relaxes constraints on policy easing

Framework change marks another step in the global shift by central banks to adopt new strategies that carve out more policy space – now and in the future.

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Summary

- **The European Central Bank (ECB) has made a significant change to its monetary policy framework by adopting a symmetric objective around its 2% annual inflation target. While this might look like a technocratic tweak, the new policy framework permanently loosens the previous constraints to deliver easier policy, in our view.** This brings the ECB framework in line with most other major central banks. But importantly, we believe this is part of a global trend to relax the constraints preventing looser policy relative to former frameworks.
- **Since the global financial crisis (GFC), the ECB has struggled to restore price stability by keeping inflation and inflation expectations anchored "below but close to 2%" – its previous target.** Now the ECB has opted for a symmetric target around 2% – and also indicated it will deliberately tolerate moderate and temporary overshoots when needing to act strongly in view of the effective lower bound (ELB), below which interest rates cannot be reduced further. The Federal Reserve is going one step further by explicitly aiming for overshoots to make up for past shortfalls.
- **When adjusting our economic projections for the new framework and ECB reaction function, we find it could lead to a roughly 20-30 basis point rise in inflation and a 30-40 basis point increase in GDP growth. Policy rates would be lower than in the previous framework: we no longer see the ECB lifting rates from their current -0.5% level on a five-year horizon versus our previous expectation for lift-off in 2024.** Currently, asset purchases are set to continue until shortly before interest rate lift-off, so regular asset purchases will need to be stepped up beyond the pandemic-emergency purchases that are due to expire in March 2022.
- **For the new ECB strategy to gain credibility, its inflation projections would need to move above 2% at least temporarily, in our view.** Eventually, for the ECB to sustainably center inflation expectations around the new symmetric target, additional fiscal policy support might still be needed. Germany's federal election this year and European Union fiscal reforms in 2022 will be key in determining how much fiscal policy support can contribute to the ECB's price stability objective.
- **Governing Council politics will determine how much of the new flexibility ends up being used in practice.** On balance, we expect doves to have the votes for an easier policy stance, but it is not clear yet if the new policy space will be fully used.
- **We assess how different ECB policy would have been had this framework been in place in the past. Not only do we think the ECB would not have hiked rates in 2011, it would have been more forceful in easing in 2014-2016 via an earlier launch of large-scale purchases of public debt.** At the time, a stronger ECB response would have likely partially countered deflationary pressures that ensued from the euro area crisis due to debt restructuring, under capitalized banks and fiscal austerity.
- **Bottom line: Based on the ECB's forward guidance, implementation of the new ECB strategy should lead to additional asset purchases for several more years.** It should also foster higher inflation expectations in the euro area, underpinning our new nominal investment theme. This reinforces our tactical preference for European equities and strategic view on euro assets: we prefer equities over credit and inflation-linked bonds over nominal government bonds. On its own, the shift in the strategy might not be enough to fully restore price stability –and a further erosion of ECB monetary policy space still remains a risk. Hence all eyes are on upcoming fiscal policy reforms.

Authors

Elga Bartsch
Head of Macro Research — BlackRock Investment Institute

Jean Boivin
Head of BlackRock Investment Institute

Contributors

Nicholas Fawcett– Macro research, BlackRock Investment Institute

Filip Nikolic – Macro research, BlackRock Investment Institute

Elusive price stability

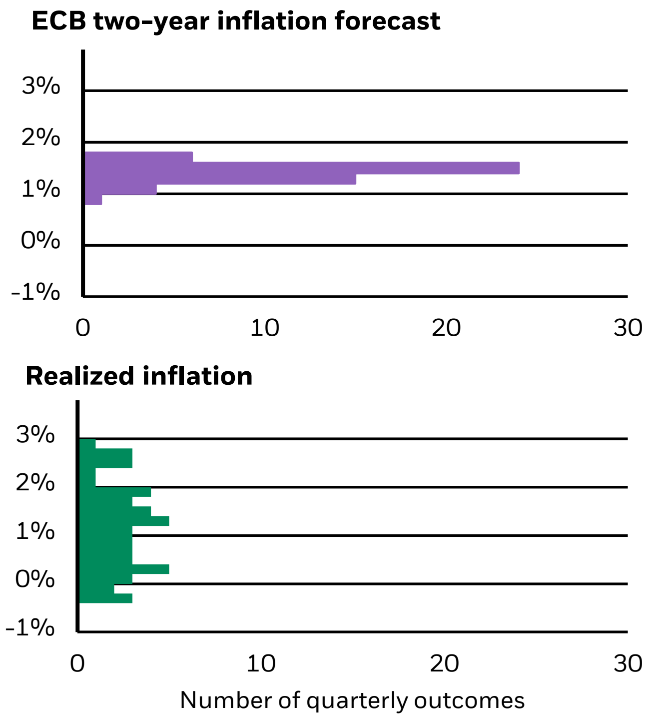
The ECB has struggled even more than other major central banks to restore price stability in the aftermath of the global financial crisis (GFC), even with its previous less ambitious definition of "below but close to 2%." When comparing key inflation statistics before and after the GFC there is a notable shift in the case of the euro area. The distribution of realized inflation between 2009 and mid-2021 shows an average inflation rate of just over 1%, a significant undershoot of the ECB's previous below but close to 2% objective. The ECB's own two-year inflation forecasts have also fallen short of the target since the GFC, though to a smaller degree than realized inflation – implying that the ECB staff – like many other forecasters – have systematically overestimated future inflation. See the charts on the left below. These continued misses of the ECB's primary objective have left policy rates near the effective lower bound (ELB) and pushed government bond yields consistently into negative territory, even at very long maturities.

As well as eroding monetary policy space and central bank credibility over time, the persistent undershooting of its inflation target over the last decade has also led to inflation expectations becoming unanchored and falling below the ECB's inflation objective. Against this backdrop, it is unsurprising that thus far markets have been pessimistic about the ECB's ability to deliver on its revised mandate. This should change as the markets get to better understand the different elements of the ECB's revised inflation strategy and see it operate in practice. Medium-term inflation expectations, based on market pricing, currently stand at 1.7% even taking into account this year's jump in actual inflation – well below the new symmetric 2% target. See the chart on the right below. Even though euro area inflation expectations have increased as much as their U.S. counterparts over the last year, they are still noticeably lower than the medium-term expectations for U.S. CPI inflation. We believe this reflects greater market confidence in the Federal Reserve delivering on its new framework over time, which aims for temporary overshoots of its 2% target, even after taking into account the inflation measurement gap between the CPI and the Fed's PCE target.

More effective monetary policy support is clearly needed if the ECB is to get back on track in anchoring inflation expectations at its target – and the new strategy certainly gives it more room to manoeuvre. When the policy rate is close to the ELB - below which interest rates cannot be reduced further - the ECB has explicitly committed to tolerate a temporary overshoot of its inflation target, reflecting that policy support can be stronger than it otherwise would be. At the July meeting, the ECB Governing Council amended its forward guidance on policy rates by saying that it will not raise rates until inflation is projected to be back at 2%. For now, the ECB has also implicitly committed to ongoing quantitative easing until they see inflation back at 2% and just before it intends to raise interest rates, though the timing will likely be reviewed in the future. We believe the ECB will have to step up purchase volumes after the end of the Pandemic Emergency Purchase Programme (PEPP), due to expire in March. As the new forward guidance on policy rates shows, the new strategy averts the prospect of premature policy tightening, as happened in 2011, even in the face of rising inflation.

Missing the target…

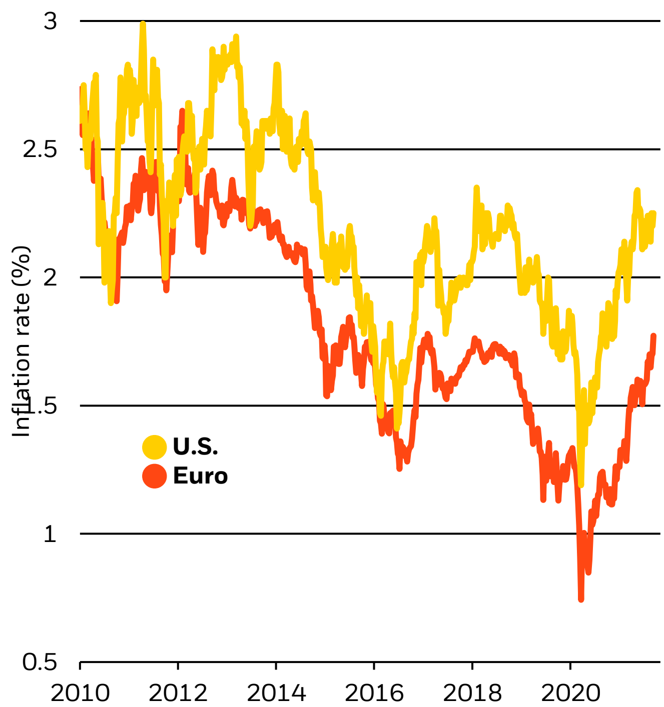
Distribution of forecasts and actual inflation, 2009-2021



Sources: BlackRock Investment Institute, Eurostat and ECB, with data from Haver Analytics, September 2021. Notes: The chart shows the ECB's forecasts for two-year forward inflation from Q1 2009 to Q2 2021, as well as the distribution of quarterly euro area headline inflation (Harmonised Index of Consumer Prices) over the same period.

….leads to unanchored expectations

Forward pricing of U.S. and euro area inflation, 2010-2021



Sources: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2021. Notes: The chart shows the market pricing of five-year inflation in five years' time. Forward-looking estimates may not come to pass.

It could have been different

The persistent undershooting of the inflation objective over the past decade has already forced the ECB to evolve its monetary policy response to events over time. First, the effective lower bound (ELB) – initially perceived to be zero – was redefined to move deeper into negative territory, paving the way for the policy rate to reach its current -0.5% level. Its institutional framework has also undergone changes. Key steps in evolving the market perception of the euro area's institutional framework include Mario Draghi's "whatever it takes" speech in 2012 to stem the European sovereign debt crisis, the Governing Council's unanimous agreement on public debt purchases being an ECB monetary policy instrument and – most recently – the European Union's NextGenEU fiscal program involving jointly issued debt for post-pandemic rebuilding. This evolution has been about learning lessons from some of the episodes discussed below, culminating in the historic response to the pandemic.

This evolution has still proven insufficient to get inflation back to target. Would implementing the new framework earlier have made a difference? In our view, there is little doubt that a more persistent and more forceful monetary response, due to an explicit tolerance of temporary inflation overshoots and a higher price stability norm, would have led to different monetary policy outcomes in the past. A couple of key episodes illustrate this thesis.

First, in April and July 2011, with the deposit rate at 0.25% and close to what was then considered the ELB, the ECB made the policy misstep of raising rates on the back of perceived upside risks to inflation. Intensifying financial market stresses then forced the ECB to adopt several unconventional measures, including the reactivation of the Securities Markets Program (paused in March 2011), the launch of a second covered bond purchase program and three-year longer-term repurchase operations (LTROs). The rate hikes were swiftly reversed in late 2011. But by that time the damage to market expectations had been done.

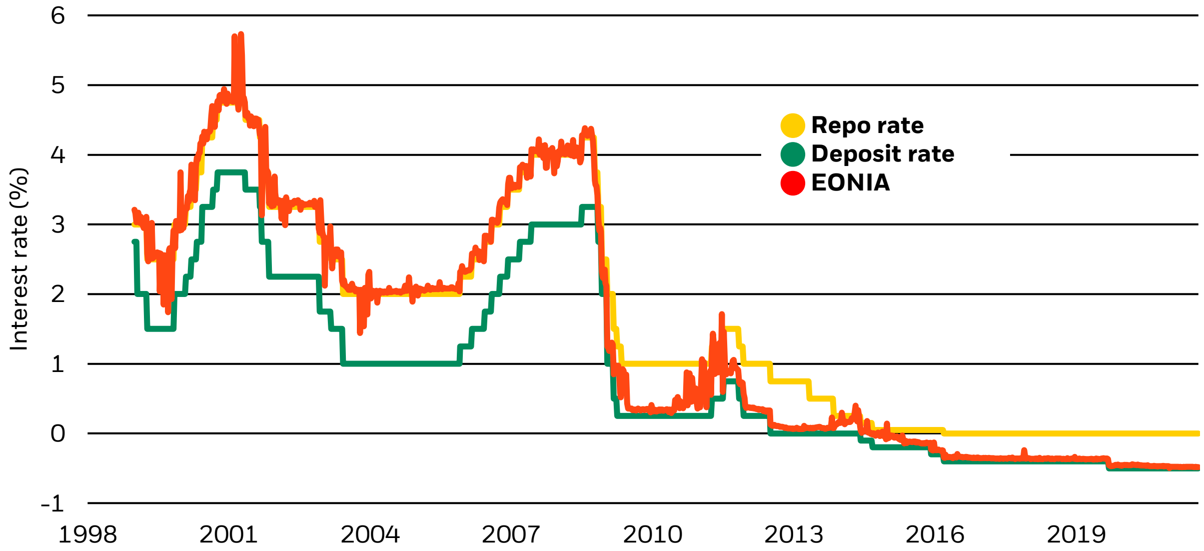
At the same time, the ECB shied away from large-scale asset purchases for monetary policy purposes and instead only supported the covered bond market. An explicit commitment to a more forceful and persistent policy response when nearing the ELB would have allowed the ECB to deliver faster policy expansion to large-scale purchases of public debt. This would have helped it better fend off financial market stresses in peripheral government bond markets that escalated in the summer of 2012. It would have also prevented some of the deflationary pressures from building during the turbulences that ultimately pushed policy rates into negative territory and toward the ELB. See the chart.

A second episode was the period from mid-2014 to early 2016. Responding to downside risks to price stability – including outright deflation – the ECB cut interest rates into negative territory in four separate steps of 10 basis points each. And it only gradually increased the size of its asset purchase programs: first in covered bonds, then in asset-backed securities and only finally moving into government debt – the latter occurring much later than other central banks – as well as introducing targeted longer-term refinancing operations (TLTROs) in the interim.

By shying away from purchases of public debt for monetary policy purposes for so long, the ECB limited the size and effectiveness of its asset purchases – and thus the degree of monetary expansion provided to the euro area. We believe the new ex-ante commitment to a more forceful policy response near the ELB would have almost certainly accelerated the process – especially the adoption of sizable asset purchases – and might have prevented the euro area from becoming stuck in a '"lowflation" trap. The slow policy response between 2014-2016 contributed to the need for another rate cut in September 2019 and the resumption of asset purchases after a pause from January to November 2019.

Hitting the lower bound

Key ECB interest rates and interbank rates over its history, 1998-2021



Source: BlackRock Investment Institute, ECB and European Banking Federation, with data from Refinitiv Datastream, September 2021. Notes: The chart shows the ECB's main target interest rates – the deposit and repurchase (repo) rates – that are used in setting monetary policy via short-term rates. EONIA is the benchmark interest rate for overnight interbank lending.

New strategy already taking effect

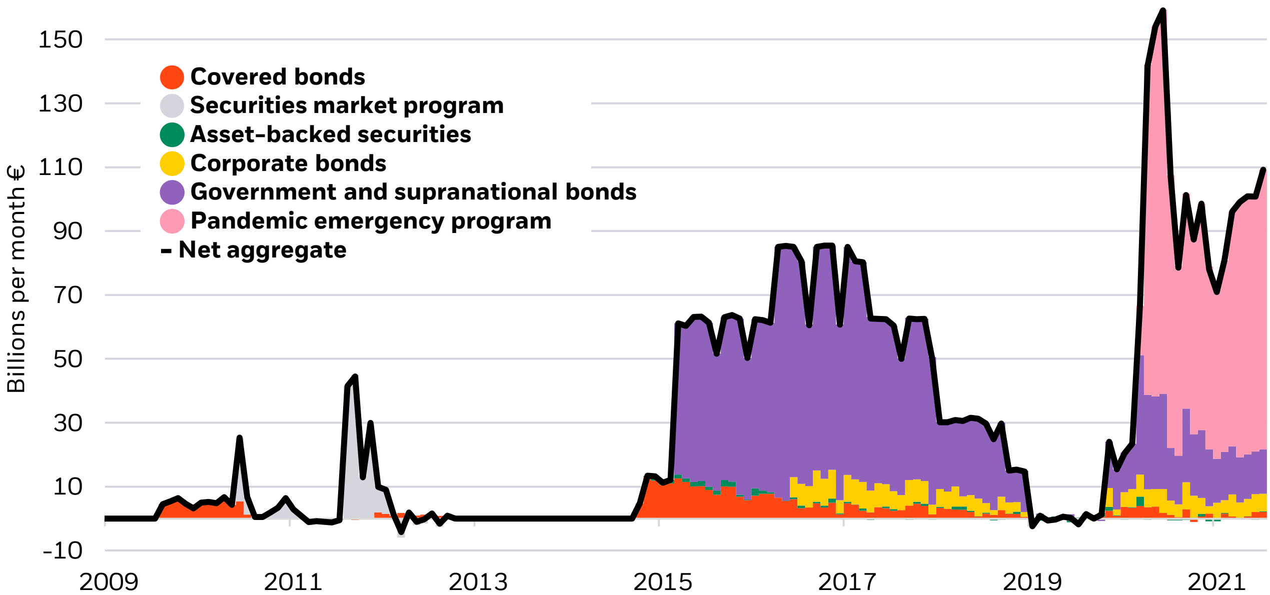
Analytically, the new ECB policy framework can be broken down into three main components. First, a higher and now explicitly symmetric inflation target of 2% instead of the confusing "below but close to 2%." Second, an explicit tolerance for moderate inflation overshoots for a limited period of time that – in contrast to the Fed framework – will not be seen as contributing to the ECB's inflation objective. Third, an explicit tolerance for overshoots near the ELB allowing for a more persistent and more forceful monetary policy response

While the new framework cannot undo past policy outcomes, it is already having an impact on the current policy stance, with potentially more material implications for future policy on interest rates and asset purchases. In late July, the ECB updated its forward guidance to reflect that policy rates will remain at present or lower levels until: 1) inflation durably reaches 2% well before the end of its projections (currently to December 2023); and 2) it judges that the realized progress in underlying inflation is sufficiently advanced to meet its commitment to greater persistence. When the policy rate is close to the ELB, the ECB will explicitly tolerate a temporary overshoot of its inflation target, implying that policy support can be stronger than it otherwise would have been under the previous 2003 strategy framework. In our view, this meaningfully reduces the risk of premature policy rate hikes by the ECB: as a result, we have pushed out our projection for a first rate increase and no longer expect a hike on a five-year horizon.

While the focus of the September meeting was on the quarterly decision on the pace of PEPP, we think the new inflation projections – still well below target – and the implications for the regular APP matter more. The APP is poised to take over as the main asset purchase vehicle once the PEPP concludes. The PEPP is supposed to run until March 2022 – the duration being determined by the assessment on the presence of a pandemic emergency and the pace determined by what the Governing Council deems necessary to ensure appropriate financing conditions in view of the inflation outlook.

Now that the ECB is explicitly tolerating inflation overshoots, particularly near the ELB, we think it is unlikely that a short-term increase in inflation this year will affect the calibration of the future monetary policy stance. More importantly, once the PEPP expires the Governing Council will be in a position to sufficiently step up the APP from the current €20 billion per month pace of bond buying – having made it clear that net asset purchases will be conducted over a materially longer period when it changed its forward guidance on interest rates at the July meeting. Isabel Schnabel, a member of the ECB's executive board, said in an interview in August that the risk is still of inflation being too low even with this year's run-up.

Leaning on the balance sheet
ECB asset purchase programs and monthly buying amounts, 2009-2021



Sources: BlackRock Investment Institute and ECB, with data from Haver Analytics, September 2021. Notes: The chart shows the evolution of the ECB's different asset purchase programs since the GFC. The ECB's purchases started with covered bonds (CBPP) and during the sovereign debt crisis briefly included government bond purchases under the Securities Markets Programme (SMP). In 2015, the ECB expanded purchases to government and supranational bonds (PSPP) and asset-backed securities (ABSPP), then in 2016 corporate bonds (CSPP). These all make up the overall Asset Purchase Programme (APP).

Reinforcing the new nominal

We believe these framework changes should, all else equal, result in higher inflation and stronger GDP growth – but also in lower interest rates in coming years. This reinforces our *new nominal* investment theme: central bank policy will be less responsive to higher inflation than in the past, keeping nominal bond yields and real yields lower. See the chart below.

The ECB's new forward guidance says it will not raise rates until inflation is projected to reach 2% on a sustained basis. Currently, ECB staff projections show inflation well below that level through 2023. For the new policy framework to be credible, future rounds of projections would need to show inflation at and above 2% at some point over the forecast horizon. Prior to the announcement of the new strategy framework, we did not see the ECB lifting rates from the current -0.5% until late 2024. Now the likely lift-off date has moved further into the future beyond our five-year horizon – and we might only see the ECB raising rates later this decade.

Expectations will also play a key role in the future path of inflation. If the new target is viewed as more credible than the previous target in the light of the new framework and the broader macro backdrop, this will likely have the most powerful impact on future inflation. Simulations by ECB researchers from July 2021 suggest that the increase in realized inflation is likely to be larger than the increase in the objective itself because a higher target also eases the constraints caused by the ELB. When adjusting our economic projections for a different ECB reaction, we find that the new framework could result in a roughly 20-30 basis point rise in inflation and 30-40 basis point increase in GDP growth.

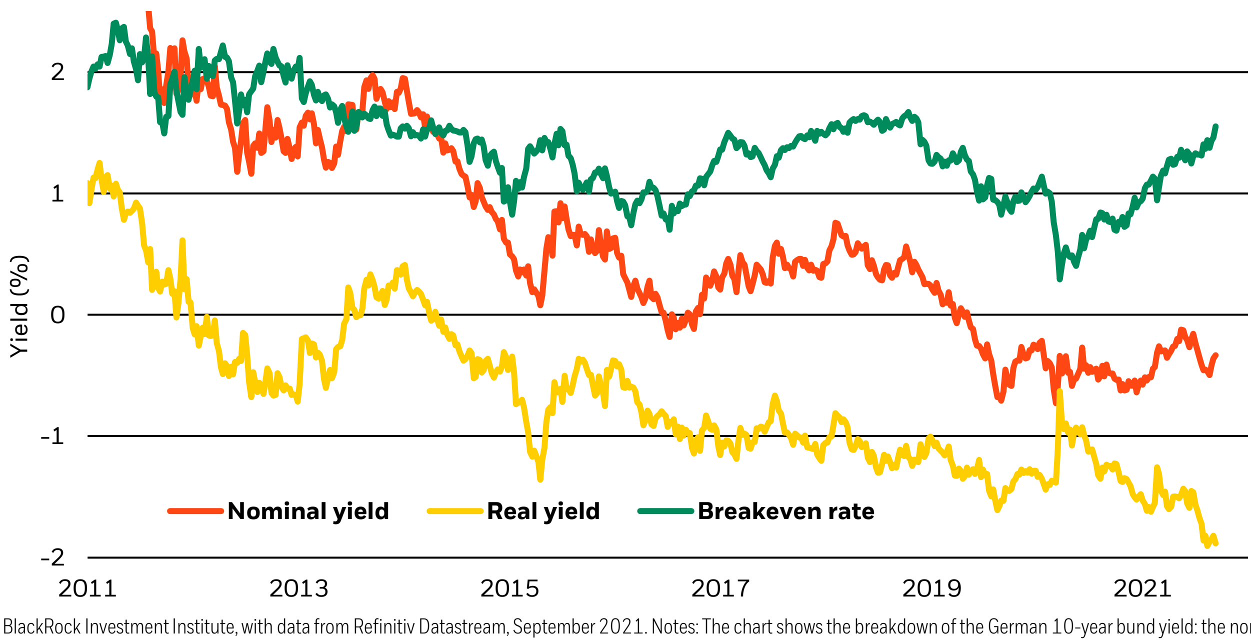
Yet it should be kept in mind that realized inflation stands at just 1.6% on average since inception of the ECB in June 1998, according to Eurostat data. That makes the ECB's re-underwriting of an inflation target of 2% look somewhat ambitious despite the current post-pandemic inflation spurt – and in our view implies that it is probably not achievable through more persistent and more forceful monetary policy alone. Fiscal policy will likely need to provide additional limited support. We believe next year's reform of EU fiscal rules – the Stability and Growth Pact, now suspended until 2023 – will be important to show whether fiscal policy can play a more constructive role in supporting the new ECB framework beyond the deployment of NextGenEU funds. Our focus will, in particular, be on any exemptions from the deficit rules of the Stability and Growth Pact and what could be a slower reduction in debt-to-GDP levels toward the mandated 60% mark. The German election in September will be key for shaping any changes.

The latest euro area inflation spurt is driven by several factors: supply bottlenecks during the uneven economic restart, changes in indirect taxes and carbon pricing, as well as global supply chain disruptions. Contrary to the Fed, which is now actively aiming for inflation overshoots to make up for past undershoots within its new flexible average-inflation targeting framework, the ECB's framework is less ambitious in making up for past misses. Instead it would likely treat transitory inflation overshoots as "bygones" – that is, they won't matter for achieving the inflation objective.

What matters now is how the new framework is implemented – and we expect noisy debates within the ECB's Governing Council that may affect implementation. While we expect doves to have the votes for an easier policy stance, it is not clear yet if the new policy space will be fully used.

New nominal in action

German 10-year government nominal bond yield, inflation breakeven rate and real yield, 2011-2021



Source: BlackRock Investment Institute, with data from Refinitiv Datastream, September 2021. Notes: The chart shows the breakdown of the German 10-year bund yield: the nominal yield is the difference between the inflation breakeven rate and the real yield. Past performance is not a reliable indicator of current or future results.

Positioning for the new framework

In sum, we believe the changes to the policy framework should result in lower real interest rates, further cementing our *new nominal* theme in the euro area by keeping nominal bond yields and real yields lower than they would have been in the past. At the same time, long-term bond yields will likely be marginally higher once the euro area reaches a new steady state due to the higher inflation objective. Even higher real yields would remain well in negative territory and thus be supportive of risk assets. This reinforces our view of long-term bonds being less effective as ballast in multi-asset portfolios – and their potential to increase risk in portfolios given the poorer return profile with their effective duration.

In *A new playbook for higher inflation* from December 2020, our portfolio construction research team showed that positioning portfolios for a regime shift to moderately higher inflation in the U.S. over the medium term can help reduce the impact of higher inflation on multi-asset portfolios by increasing allocations to equities and inflation-linked bonds and decreasing allocations to nominal government bonds. This also applies to Europe, supporting equity valuations and keeping real rates – key for risk assets – firmly in negative territory. The implications of the new playbook are further enhanced by the ECB's new policy framework. The new framework therefore underpins our tactical overweight to European equities and strategic overweight to developed market equities. On both tactical and strategic horizons, we are overweight inflation-linked bonds. And we prefer taking risk in equities over credit, especially at such historically tight spreads.

For the euro/U.S. dollar exchange rate, the overall impact of the ECB's new policy framework on the interest rates differential – often seen as a key driver of exchange rate dynamics – will likely be modest, in our view. Any higher inflation in the euro area should reduce the upward bias in the euro/dollar exchange rate stemming from lower euro area inflation relative to the U.S. based on standard foreign exchange valuation methods (purchasing power parity considerations). Looking at the ECB's new policy framework in conjunction with the Federal Reserve's more substantial monetary policy shift announced last August, we could see potential upward pressure on the euro due to a more timid shift in the ECB policy framework compared with the Fed. Yet any such pressure is likely contained at the current juncture due to the fact that the Fed is getting ready to take first steps towards gradual policy normalization, first by tapering its asset purchases in coming months and then with a first policy rate increase in 2023, possibly earlier.

The ECB is following the Fed in changing its policy framework to allow for looser policy going forward, keeping with the monetary-fiscal policy revolution we laid out last year. The policy revolution marks the most important change in the macro policy landscape since central banks embraced inflation targeting in the early 1990s. These framework changes will lead to important shifts in how central banks respond to rising inflation at a time when debt levels have soared to new record levels as a result of providing a bridge across the Covid-19 disruptions. The main consequence: the low interest rate regime is set to stay the dominant narrative. But the interplay between low long-term yields, wider budget deficits and elevated debt levels constitutes a fragile equilibrium. This fragile equilibrium points to clear risks in the role of government bonds in multi-asset portfolios – which is why we are underweight on both tactical and strategic horizons.

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