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The European economy: topic of the month

Considering the ECB's exit strategy

Kenichiro Yoshida, Senior Economist, Research Department-Europe and the Americas

This article considers the exit strategy of the European Central Bank (ECB). **Chart 1** is created based on the ECB's forward guidance and information ECB President Mario Draghi provided in his statements to show an overall image of the exit strategy, which the author envisages. First, the asset purchases, being conducted at a monthly pace of €60 billion, will be gradually reduced while taking into account an economic recovery and price trends ((2) in **Chart 1**). After the reduction, when underlying inflation is judged to be heading upward, the asset purchases will ultimately be halted ((3) in **Chart 1**). However, reinvestments of the principal payments from maturing securities purchased will likely continue in order to keep the balance of assets on its balance sheet constant at a certain level. After a lapse of a "sufficient" period of time following the halt to the asset purchases, the policy interest rates will be increased ((4) in **Chart 1**).

What is important is the size of asset purchases ((2) in **Chart 1)** may be reduced not only by inflation trends but also by a narrowing of the negative supply-demand gap (i.e.an economic recovery). At the ECB Forum in Sintra, Portugal, on June 27, ECB President Draghi stated, "As the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments – not in order to tighten the policy stance, but to keep it broadly unchanged." This statement of Draghi suggests that not only inflation but also the supply-demand gap may have been incorporated in the ECB's policy reaction functions concerning the asset purchases.

In the ECB's forward guidance on the asset purchase program, the central bank declares that it will continue the asset purchases "until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim." It may be surmised that the ECB's policy package is premised on its inflation outlook that the inflation rate will pick up steam over time along with a narrowing of the negative supply-demand gap in tandem with an economic recovery.

As seen above, the ECB's path to the exit strategy is built upon the assumption that the narrowing of the negative supply-demand gap will eventually feed through to higher inflation. However, what is agonizing to the ECB is that underlying inflation rate is not rising so far despite the narrowing of the negative supply-demand gap. When the current underlying inflation rate is showing no sign of picking up, it is difficult to determine an overall picture leading to the halt to the asset purchases by the end of 2017.

In an overall assessment of prices, trends of the core inflation rate, which excludes such items as energy and food that tend to show big swings among price measures, are particularly important. It is difficult to judge to what level the core inflation rate should rise before giving the green light to an exit from quantitative easing. Looking at the past changes in the core inflation rate and the ECB’s policy interest rates, the core inflation rate has rarely exceeded the year-on-year increase of 1.5% since 2008. If the ECB waits until the core inflation rate rises around the year-on-year increase of 2.0%, the ECB may reach the quantitative limit of the asset purchase.

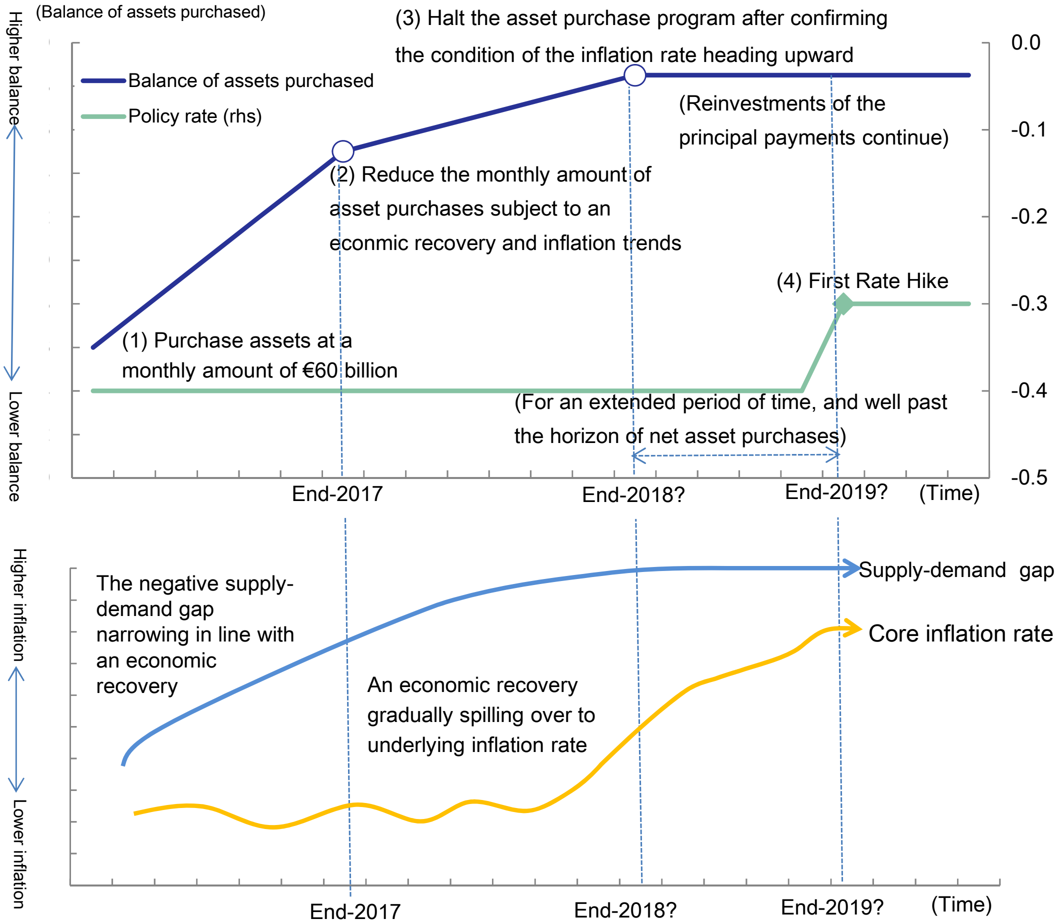
Roughly speaking, if the core inflation rate, which now stands around 1.0% above the year-before level, rises to 1.3%-1.4% year on year and remains stable there, the halt to the asset purchases and interest rate increases by way of normalizing monetary conditions may be justified. Currently, the Mizuho Research Institute Ltd. expects that the year-on-year rise in the core inflation rate will reach 1.3% by around the end of 2018.

As a leading indicator of the core inflation rate in the euro zone, the ECB is said to be closely monitoring developments in wages in Germany. While the relationship between wages and prices is somewhat similar to that between the chicken and the egg, if the increase in wages exceeds the increase in corporate productivity, labor cost would rise, and over time the pass-through of higher labor cost would conceivably result in higher inflation. The unemployment rate in Germany has declined to 3.9%, the lowest level since the unification of Germany, suggesting a tightening of labor market.

However, wage negotiations in Germany tend to be settled in consideration of the headline inflation rate in the past years and wage negotiations have a strong biennial backward-looking tinge. Thus, it is forecasted that increases in the headline inflation rate since the middle of 2016 will be reflected in wages only after 2018.

At present, the prospects for a reduction in the asset purchases and an interest rate hike are as follows. First, regarding the asset purchases, the ECB at a meeting of the Governing Council in September or in October is expected to decide on the extension of the purchases by six months and on a reduction in the monthly purchase amount from €60 billion to €40 billion. Next, if the rate of wage growth in Germany keeps rising, the ECB is likely to reduce the purchase amount to €20 billion in June 2018 and extend the asset purchases by another six months to the end of 2018, and finally take a decisive step to halt the asset purchases at a Governing Council meeting towards the end of 2018. The ECB is expected to raise the policy interest rates in or after 2019, with the prerequisite being the core inflation rate continuously showing the year-on-year rise of around 1.3%-1.4%.

[Chart 1: The Path to the Exit Strategy Assumed by the ECB (Conceptual Diagram)]



Note: (1) to (4) in the Chart show the squence of steps under the exit strategy.

Source: Made by MHRI