Mario Draghi – Deflation Fighter

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The arguments supporting a further rise in share prices have become stronger. The important central banks have been sending expansive signals in recent weeks, i.e. signals that support the economy and the markets. The latest measure was the statement made by the president of the European Central Bank (ECB), Mario Draghi, at the ECB press conference on 22 October.

Deflationary forces

In the Eurozone the downside risks for economic growth and inflation have increased. This is due to the weakness of the emerging markets and the jitters on the financial and commodity markets. The main question is to what extent and for how long the resulting deflationary forces, i.e. forces causing the general price and wage level to fall, will prevent the rate of inflation, which is currently too low, from rising towards the inflation target of slightly below 2%.

Forward guidance

Deflation causes company sales and profits to decrease. As a result, investments and wage increases are reduced. This is the risk that the ECB is fighting to contain. If the result of a thorough analysis of the economic environment by the ECB suggests that the current monetary policies are not sufficient to achieve the inflation target, further expansive steps will be announced at the next ECB meeting on 3 December. The forward guidance, i.e. the preparation of the market for future monetary decisions, is an important instrument of the central bank. It rarely makes a commitment to any specific future action, as a result of which the statement alone can be interpreted as dovish, i.e. supporting inflation and the markets.

Tool box

The toolbox of the ECB contains the already used forward guidance as well as the setting of the price of money (i.e. the key-lending rates) and the setting of the money supply. At the press conference, explicit reference was made to a possible cut in the interest rate on the deposit facilities (of the commercial banks with the central bank) and to the expansion of the extensive bond purchase programme (quantitative easing; QE). The current interest rate is minus 0.2%. The QE programme amounts to EUR 60bn per month and will last at least until September 2016. The purchases can be adjusted with regard to the monthly volume (i.e. more than EUR 60bn), to the composition (i.e. more corporate bonds), and to the duration (i.e. possible extension beyond September 2016).

The Big Five

The other big central banks have been busy as well. In the USA the market expectations with regard to the increase of the Fed funds rate have fallen significantly. The chief economist of the Bank of England has used the term “trilogy” (Great Recession 2008/2009, euro crisis 2011/2012, emerging market 2015). In China the ratio of the money supply M2 to GDP has increased in Q3 after an earlier stagnation phase. Now the ECB has also announced its intention to take further steps. The Japanese central bank may announce the expansion of its security purchase programme as soon as next week, on 30 October.

Positive environment in the short run

The measures taken by the central banks do not form the basis of a structural rally in risky assets. A cyclical rally takes place when the central banks are successful in overcoming the deflation pressure. The change in attitude displayed by the ECB now suggests that the short-term recovery might last while the leading economic indicators are not refuting the ECB’s point of view. Also, the ECB policy supports Eurozone bonds. This means that the environment of the financial markets is positive in the short run, but remains unclear in the medium term.

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