ECB fights deflations risks

Gerhard Winzer

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On 3 December the European Central Bank loosened its monetary policy further. The reaction from the markets was that of disappointment, as assets had had more extensive measures priced in.

Interest rate cut

In more detail: the ECB cut the interest rate of the deposit facility, at which commercial banks can park excess liquidity with the central bank, from -0.2% to -0.3%. However, the yield of the 2Y German government bond was already at -0.45%. Since it is not clear whether further rate cuts will follow, yields have increased. This led to minor losses in outstanding bonds, given that new issues would now command a higher yield.

Extended purchase programme

The duration of the securities purchase programme was extended from (at least until) September 2016 to at least March 2017. At an unchanged monthly purchase volume of EUR 60bn this is equal to an increase of the central bank balance sheet total of EUR 360bn. Some market participants had also discussed the expansion of the monthly purchase volume. But the comprehensive bond purchase programme of the central bank means that the bond volume available for purchases from the private sector will fall and thus keep bond yields at low levels.

The rationale behind the move of the ECB is the excessively low inflation and the overly slow return of the rate of inflation towards the target rate of the central bank of slightly below 2%. In simple terms, the ECB is fighting deflations risks. They have been generated by excess capacities, both in the Eurozone and on a global scale, especially in the emerging countries.

Weaknesses in the emerging economies

The extent and duration of the weakness in the emerging economies and the resulting negative spill-over effects to developed economies are among the most important factors influencing the economy, the financial markets, and the economic policies. The weakness in the emerging economies means that investment growth and the investment ratio (investments in relation to economic output) are declining. The increasing pressure to save in the emerging markets causes both inflation pressure and yields to remain globally low.

Disappointed expectations

In reaction to the announcement the euro and government yields spiked, and share prices declined. The simultaneous fall in share and bond prices suggests that the price movement has nothing to do with future economic data, but with the technical environment of the market. The market prices had accounted for a more significant liquidity injection by the central bank, both for now and the future. The chain of reasoning "less substantial interest rate cut = higher yields = appreciating euro = weaker equities" is naive. However, if it is implemented by computer software, it becomes reality.

Gerhard Winzer

Gerhard Winzer has worked at Erste Asset Management since March 2008. Up until March 2009, he was Senior Fund Manager in Fixed Income Asset Allocation; he has been Head Economist since April 2009.

He holds a degree from a polytechnical college and studied economics and business at Vienna University with a special focus on financial markets. He holds a CFA charter and participated from 2001 to 2003 in the doctoral programme for finance at the Center for Central European Financial Markets in Vienna.

From July 1997 to June 2007, he worked in research at CAIB, Bank Austria Creditanstalt, and UniCredit Markets & Investment Banking. His last position was as Executive Director for Fixed Income / FX Research and Strategy. He was responsible for research on asset allocation at Raiffeisen Zentralbank (RZB) in Vienna from July 2007 to February 2008.