ECONOMIC RESEARCH

# The NewsLine

November 19, 2015

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EUROZONE

# No major impact on yields or exchange rate from new ECB measures

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Additional ECB loosening in December is already factored into current yield and exchange rate levels, potential surprises are likely to be limited. Temporarily at most, the yield on 10yr German government bonds could revisit its low close to zero and the euro-dollar exchange rate dip below parity.

Ahead of the meeting of the ECB Governing Council on 03 December, the question arises as to what can be expected from an extension of QE and/or a further lowering of the deposit rate after the effects of ECB unconventional measures to date. In retrospect, the influence of the ECB bond purchasing program (PSPP) can be summarized as follows: Starting around August 2014, anticipation effects set in, the yield on 10yr German government bonds fell – not only but largely due to QE – from well over 1% to 0.5% at year-end. In January 2015 the ECB officially announced its bond purchasing program, with implementation starting in March of this year. In April the yield on 10yr German government bonds reached its low at marginally above 0%. Market overshooting played a role here, along with, in retrospect, overblown worries that the bonds available for the ECB to buy might be thin on the ground.

The lowering of the deposit rate into negative territory ensued in June 2014, together with the announcement of targeted longer-term refinancing operations (TLTROs). Having brushed USD 1.40 in the first half of 2014, the euro-dollar exchange rate stood at 1.20 USD per EUR at the end of the year. In March 2015 it briefly fell as low as 1.05.

Currently the yield on 10yr German government bonds stands at around 0.5% and the exchange rate is close to 1.06 USD/EUR. These levels already reflect anticipation effects, with the ECB having further fueled expectations of an additional expansion of its unconventional measures, particularly at its last meeting. We now think it will match its words with action in early December. The options include an extension of the monthly bond purchases beyond September 2016 and/or an increase in the current monthly volume of EUR 60bn (e.g. by buying sub-sovereign bonds) and/or a lowering of the deposit rate, which currently stands at -0.2%.

Although we would not welcome such moves, we need to gauge their impact. Any notable positive effect on the economy is not likely. The economy is already receiving a substantial fillip from the existing ECB measures, the weaker euro, the drop in the oil price and less restrictive fiscal policy. The eurozone economy does not need any additional support from monetary policy. With the economy improving, inflation will start picking up again in 2016. Although it is likely to remain below the ECB's benchmark, deflationary trends are not in sight.

The impact on yields will be smaller than outlined above under QE1. Firstly, the starting point is lower, secondly, the scale of the additional unconventional measures will be smaller and, thirdly, there is a risk that current market expectations will be disappointed to some extent. Given that ECB president Draghi has tended to top market expectations to date, current expectations are relatively high. The brief return of 10yr German government bond yields to lows of marginally above 0% cannot be ruled out, but does not look very likely.

Early next year eurozone inflation will climb from close to zero now to around 1% (where current core inflation already stands). Although this is practically inevitable due to a base effect, it could nonetheless influence market-based inflation expectations which generally show a degree of correlation with prevailing headline inflation. Upward pressure on European yields will also come from the other side of the Atlantic. The ECB's QE1 and expanded QE will act as an anchor, should the Fed start moving in the opposite monetary policy direction, as is likely in December. All told, we see long-term interest rates in the eurozone tending up slightly in the course of 2016; the yield on 10yr German government bonds at the end of next year is likely to be in a range of 1 to 1.5%.

With regard to the euro-dollar exchange rate, a drifting apart of Fed and ECB monetary policy is already factored in. However, surprises are possible, such as for instance the size of the key rate gap/the speed of Fed tightening. To this extent, we might see EUR-USD parity. However, the euro depreciation to date was massive and it is buoying the economic recovery. This argues against sustained euro weakness, as do the substantial eurozone current account surpluses. We are penciling in an average exchange rate both this year and next in the region of a good 1.10 USD per EUR (compared with 1.33 in 2013 and 2014, this corresponds to a euro depreciation of over 15%).

These assessments are, as always, subject to the disclaimer provided below.