

July 11, 2019

Are the ECB's cupboards bare?



This topic calls to mind the renowned English nursery rhyme about an old lady - Mother Hubbard - who goes to her cupboard, but when she gets there, the cupboard is bare. So ubiquitous is the rhyme, that 'Old Mother Hubbard' has become a standard turn of phrase, to indicate that you are all out of something. With the European Central Bank (ECB) looking poised to embark on a fresh round of monetary stimulus, Mario Draghi has been busy trying to reassure markets that its not a case of Old Mother Hubbard when it comes to the ECB's toolbox.

With

inflation expectations at all-time lows and with declining global trade volumes taking their toll on the eurozone, the ECB looks poised to re-assert itself in order to support the economy. But with its policy jar looking a little bare, commentators are asking, what shape a fresh round of monetary stimulus could take.

We believe

that a new **asset purchase program (APP)**

is becoming increasingly probable before year-end. The outgoing President, Mario Draghi, said in June that the ECB had 'considerable headroom' with regard to an APP, but, it faces quite a few dilemmas in designing this. The first is that before long, it will likely run out of bonds to buy. This is largely due to its self-imposed 33% issuer limit, put in place to avoid the ECB having the power to block a vote on the restructuring of ECB-held debt of a euro-area country (not blocking such a restructuring could be interpreted as financing of a member state). Of course, the ECB could lift this constraint, but that would require some soul searching as to whether this essentially equates to bailing out governments. If the limits were kept, it is estimated that the ECB would hit the 33% share limit on Germany within one year.

Changing

the 33% would let them buy more German bunds but that's probably not the most effective stimulus, given that investors are already piling into this asset class. Alas, it may also wish to change capital key rules to avoid this, but this would result in more purchases of Italian, French, and Spanish debt, inciting moral hazard.

Increasing

the importance of corporate bond purchases in a new program may be an idea, but again this carries its own problems, mainly in that bank bonds would probably have to be excluded in order to avoid a conflict of interest whereby the ECB is simultaneously the regulator and an investor.

Another

possibility that Draghi has hinted at is **rate cuts**, leading the market to price a 10 basis point cut to the deposit facility rate (to -0.5%) by September. However, negative yields are deeply problematic for banks and insurers. ECB board members, Coeuré and Praet, have indicated that further cuts would need an assessment of deposit-tiering to alleviate pressure on banks.

So, the ECB's cupboard doesn't seem to be bare just yet, but selecting the appropriate tool is not going to be straightforward. Whatever it decides, the market is hoping for decision to be taken at its July 25th meeting, even if the implementation comes later, potentially under the leadership of Christine Lagarde, who is expected to bring 'more of the same' dovishness. In the meantime, Draghi has encouraged Governments to reach into their own cupboards and pull out some fiscal policy saying: *"monetary policy can always achieve its objective alone, but especially in Europe where public sectors are large, it can do so faster and with less side effects if fiscal policies are aligned with it"*.

Disclaimer

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeliness of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned into it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained herein this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent,- subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of- date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

As economic conditions are subject to change, the information and opinions presented in this outlook are current only as of the date indicated in the matrix or the publication date. This publication is based on data available to the public and upon information that is considered as reliable. Even if particular attention has been paid to its content, no guarantee, warranty or representation is given to the accuracy or completeness thereof. Banque Internationale à Luxembourg cannot be held liable or responsible with respect to the information expressed herein. This document has been prepared only for information purposes and does not constitute an offer or invitation to make investments. It is up to investors themselves to consider whether the information contained herein is appropriate to their needs and objectives or to seek advice before making an investment decision based upon this information. Banque Internationale à Luxembourg accepts no liability whatsoever for any investment decisions of whatever nature by the user of this publication, which are in any way based on this publication, nor for any loss or damage arising from any use of this publication or its content. This publication, prepared by Banque Internationale à Luxembourg (BIL), may not be copied or duplicated in any form whatsoever or redistributed without the prior written consent of BIL 69, route d'Esch | L-2953 Luxembourg | RCS Luxembourg B-6307 | Tel. +352 4590 6699 | www.bil.com.