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Quick Takes

About this Newsletter

GR–NEAM's *Quick Takes* covers timely topics relevant to the insurance industry and is written by our Client Strategy and Investment teams. Each edition is designed to keep insurance professionals informed on relevant topics in the industry by providing information on time sensitive issues.

For More Information

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Cracks in the ECB

In recent years, the euro area has displayed tremendous resiliency. It has withstood lacklustre growth, 2 major recessions, major banking crises, near sovereign collapses and a crisis of confidence in the currency itself. As the world's largest economic bloc, the euro area's monetary policy has meaningful influence beyond the euro area and beyond Europe. The policy actions of the European Central Bank (ECB) are therefore of great importance to all that are involved in financial markets and financial services.

Backdrop

In January 2015, against the backdrop of weakening inflation expectations and in the aftermath of the Greek crisis, the Governor of the ECB, Mario Draghi, finally managed to convince a majority of the ECB's Governing Council members of the merits of his planned quantitative easing (QE) program. For almost 12 months previously, hawkish factions within the council, most notably the German Bundesbank members, had vigorously opposed Draghi's plan. A little over a year later, as Draghi now seeks to increase the size of the QE program, it appears that tensions and an absence of unanimity have re-emerged at the ECB.

The hawkish German, Dutch and Finnish central banks are understood to be uncomfortable with any changes to the ECB's existing QE program. In particular, they most certainly do not want its scale (€60 billion per month) to be increased. Combined, the 3 central banks, from time to time also supported by others, form an important and powerful axis within the ECB. The central banks of the euro area countries with less robust GDP and employment growth are keen that the QE program be enlarged. It is understandable that establishing a consensus is a formidable challenge.

The ECB is a complicated organisation. Its price stability mandate is rules based and enshrined in European law. Execution of that mandate is entrusted to the ECB's 25 member Governing Council. It includes 6 Executive Board members (the Governor, Vice Governor and 4 appointed members) and the governors of the national central banks of the 19 euro area countries that use the euro. The Governing Council meets fortnightly and votes, in a very complicated manner, on monetary policy every 6 to 7 weeks, approximately 8 times per year.

Financial markets had expected that at the ECB's December meeting, the scale of the €60 billion per month euro area QE program would be increased. While an extension to its term and composition were announced, no increase to the scale of the program was introduced. The financial markets were disappointed. Commentators believed that disunity had once again returned to Frankfurt and that Draghi's plans to increase the size of the program were being stalled and frustrated by a strong hawkish minority working from within the Governing Council.

Next Steps

At the January ECB meeting this year, Draghi announced an upcoming review of the effectiveness of the QE program, now almost a year old. Findings and recommendations are to be presented at the next meeting (March 10th). The review is considering all aspects of euro area monetary policy. The QE program cannot be viewed in isolation as it buttresses an already impressive array of more traditional monetary policy measures. For example, the ECB has dramatically reduced its interest rates (the deposit rate is now negative) and increased bank lending (through a series of accommodative refinancing operations).

At the March ECB meeting the scale of the QE program (€60 billion monthly) will likely be increased and the already negative deposit rate (-0.30%) reduced further. By adjusting per issuer/issue purchase limits, the breadth of eligible assets will possibly be increased. Also, it is likely that the ECB may change how it forecasts inflation. Some within the ECB have questioned the perceived transiency of the decline in energy prices and their impact on inflation expectations. Inflation and growth forecasts will probably be reduced downwards.

The March ECB meeting will be very important. Arguably, it is the most important meeting since QE was first announced over a year ago. Interestingly, the measures that are to be introduced or changed are arguably less important than how the ECB publicly shows its disposition with respect to its inflation targeting mandate – has it a hawkish or dovish leaning and has unanimity been restored? We know that, within the ECB's Governing Council, unanimity is a principle dear to Draghi's heart – clearly it has been lacking recently.

Finally, expect strong rhetoric from Draghi at his press conference following the March 10th meeting. Draghi's tenure as ECB Governor began during the midst of the euro crisis in 2011. Expected to retire in 2019, he is now more than half way through his 8 year term and policies he oversees now will have influence until and perhaps beyond then. Draghi's legacy will likely be defined by how he returns the ECB Governing Council to a state of unanimity and the bootstrapping of his QE program. He will do all that it takes.

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