2 ECB: monetary easing is here to stay

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At the meeting of the ECB's Governing Council on 15 April, journalists asked Mario Draghi if the ECB would interrupt its QE programme (officially known as the Expanded Asset Purchase Programme) if the inflation outlook were to improve more quickly than anticipated. In response, Mario Draghi repeated his introductory statement, explaining that the ECB intended to complete all of the announced purchases up to September 2016. Since then, several members of the Governing Council have also stated that:

1. the ECB would carry out the full programme as announced and
2. the ECB would extend its QE policy if inflation prospects did not improve sufficiently.

Therefore, the concern that the ECB will prematurely cut short QE is completely unfounded. We will briefly go over why the ECB's policy will remain highly accommodating for years to come.

Last month, we explained that the Fed appeared to be returning to the prescriptions of the Taylor rule, namely:

$$\text{Target key interest rate} = RR + INF + 0.5 *(INF – 2) + (U^* - U)$$

where RR is the equilibrium real interest rate, INF is the inflation rate, U is the unemployment rate and U* is the equilibrium rate of unemployment. Parameters RR and U* are not observable, but the Fed estimates them to be 0% and 5%, respectively. The ECB does not make explicit use of this monetary policy rule, but we will nonetheless attempt to examine what it would indicate for the eurozone.

In the eurozone, the NAIRU (non-accelerating inflation rate of unemployment), the unemployment rate below which inflation rises, would be approximately 9.5%, versus the current figure of 11.3%. According to the IMF, the eurozone's unemployment rate will not reach this level before 2019. On the top of that, the IMF forecasts that inflation will rise only gradually in the coming years, to reach only 1.7% in 2020.

Meanwhile, the equilibrium real interest rate, which Janet Yellen estimates at 0% for the United States, is likely deep in negative territory in the eurozone. Central bankers agree that the equilibrium real interest rate, which is not observable, fluctuates based on the economy's fundamentals. Peter Praet recently addressed this topic ("*Lifting Potential Growth in the Euro Area*", April 2015), suggesting that the equilibrium real interest rate was negative. In July 2014, the ECB's monthly bulletin emphasised that the widening of the private savings / investment gap was exerting strong downward pressure on the equilibrium real interest rate ("*Real Interest Rates in the Euro Area: A Longer-Term Perspective*"). According to IMF forecasts, this gap should remain very wide until at least 2020 (see Chart n°1). Currently, the eurozone's equilibrium real interest rate appears to be in the vicinity of -2%.

Having mentioned the different parameters used in a traditional Taylor rule as applied to the eurozone, we can now study what this analysis can reveal for future years. For future inflation and unemployment values, we use the IMF's projections up to 2020. As for the equilibrium real interest rate, given its non-observable nature, its variation over time and the lack of consensus on how it should be estimated, we use a series of Taylor rule calculations employing different values for the equilibrium real interest rate, as shown in the graph n°2, namely: 0% ; -1%; -2% and -3%. With the economic recovery taking hold, this equilibrium rate is very likely to be less negative in the coming years.

The least that can be said based on these simulations is that the ECB should keep rates close to zero for several years to come. Even if the equilibrium real interest rate returns to 0%, the ECB's refi rate will increase no sooner than 2018, according to this Taylor rule. With an equilibrium real interest rate of -1%,

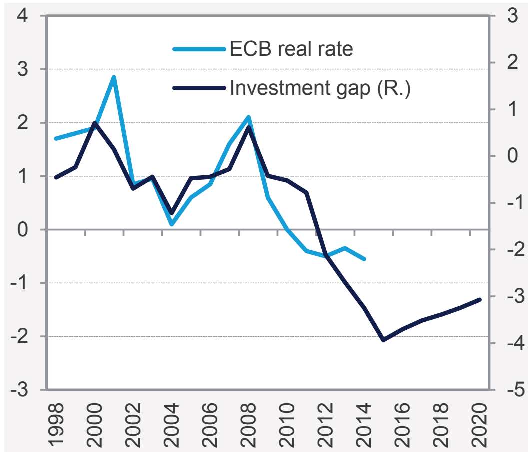
The essential

With the relative improvement of the economic outlook in the eurozone, some commentators are already speculating that the ECB's QE programme—which is only in its beginning stages—may be abruptly halted. However, these is no substantial basis for this speculation.

Using a traditional Taylor rule, we applied simulations to predict the ECB's refinancing rate up to the end of 2020. While these are only estimates (due to the difficulty of determining the equilibrium real interest rate), it can be reasonably concluded that the ECB will maintain a highly accommodating policy for a long time to come.

> "The IMF forecasts that inflation will recover only gradually in the coming years, reaching just 1.7% in 2020"

1 ECB real rate vs investment gap as % of GDP (difference between investment and private savings)

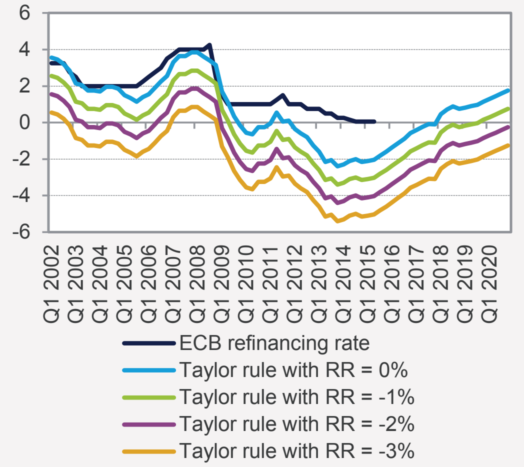


Source: Datastream, Amundi Research

the simulations point to an initial rate increase in 2020. And if we assumed an equilibrium real interest rate of -2% or lower, there would be no point in anticipating a rise in the ECB's rate within the next five years. After all, it has been nearly seven years since the Fed adopted its zero interest rate policy, while the ECB has had a refi rate at or below 0.25% only since November 2013. Regardless of the assumption used for the equilibrium real interest rate, the Taylor rule points to a negative refi rate at the end of Q3 2016, when the ECB's QE programme is scheduled to conclude. Assuming an equilibrium real interest rate of -1%, the rate would be very negative, at close to -2%! The economic recovery would have to be very robust for the ECB to abruptly end QE in September 2016, and this is not the likeliest scenario.

In any event, and discounting the fact that the ECB does not explicitly use a Taylor rule, the ECB should maintain zero interest rates at least until 2018, and the short end of Germany's rate curve should therefore remain flat. Furthermore, the "terminal rate" under a hypothetical future monetary tightening cycle (which would stretch over a considerable amount of time) would itself be very low, and the long end of Germany's rate curve is thus bound to remain very low for a prolonged period.

2 **Classical Taylor rule for the ECB**



Source: Datastream, Amundi Research

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