Missing out on monetary normalisation

Pressure on ECB after tightening delay

by David Marsh in Boston

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It wasn't supposed to turn out like this. Thursday's European Central Bank announcement of more stimulus for euro area bank lending and postponement until at least 2020 of its first post-financial crisis interest rate increase could mean the ECB will miss out a cycle of monetary normalisation.

Mario Draghi, the ECB president, will bow out at the end of October, after eight years, as the first head of a German-based central bank for 20 years to leave office without raising interest rates. His earlier plan, looking decreasingly likely in the past two years, had been to depart after launching a gradual rise in interest rates to help his successor weather what will be a difficult transition.

Draghi is following, to many observers, what is a surprising precedent. Hans Tietmeyer, the Bundesbank president otherwise known for monetary orthodoxy, in charge in 1993-99, never raised interest rates, reflecting a steady alleviation of monetary pressures in Europe on the path to monetary union in 1999.

The governing council's unanimous decision exposes the ECB to three sets of pressures which will further weigh on the man (it is highly unlikely to be a woman) taking over from Draghi. The one helpful factor for ECB continuity is that the governors who agreed on Thursday another round of long-term refinancing operations, as well as the delayed tightening, included the four heads of the German, French, Dutch and Finnish central banks, who are all contenders for Draghi's job.

The biggest risk is that the ECB will be bereft of monetary ammunition when and if the US Federal Reserve starts to ease interest rates in response to a further slowing of the US economy – or even a recession – later in 2019 or next year.

ECB watchers have long worried that, unless the central bank can raise interest rates before the next downturn, Europe will have no more conventional monetary instruments to fight a recession. This will raise pressure for further quantitative easing in Europe, despite heavy opposition in Germany – all the more intense because massive government bond purchases since 2015 have failed to raise inflation back towards the ECB's medium-tern target of close to 2%.

The second source of problems is that Draghi, in comments on Thursday, may end up being blamed for making a bad situation worse. The apparent reversal from the ECB's avowed intent to shrink its balance sheet after ending QE in December may be a sensible adjustment. Yet Draghi's reference to the 'persistence of uncertainties' over geopolitics, protectionism and emerging markets may heighten gloom. The downbeat December statement about 'angst' by Jay Powell, Fed chairman, had a similar effect.

The third issue is political. The International Monetary Fund, the French government and the ECB have been joining forces – so far to little avail – to persuade Germany to adopt more Europe-orientated economic measures to help longer-term euro area stabilisation.

Benoît Coeuré, an ECB board member, warned last year that Germany would have to increase efforts for risk-sharing to prevent the bank having to take more extraordinary action when the next crisis strikes. Euro area reform, including setting up a European Monetary Fund, adopting a significant pro-growth euro area budget and pooling instruments for bank deposit insurance, has lost nearly all traction in the past 12 months.

However, particularly if the German economic picture worsens and Italian tensions intensify, the German government will face further calls for affirmative European action in the next few months.

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