Macro Weekly

Group Economics

11 March 2016

Is this going to work, Mr Draghi?

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- **The ECB delivered another set of measures to stimulate growth and push up inflation**
- **The debate about whether the ECB is on the right track is getting increasingly polarised**
- **We must bear in mind that this is an experiment never seen before. The outcome is uncertain**
- **Nevertheless, a lot of the criticism of ECB policy cannot be supported by evidence**
- **We think the latest set of measures will have a positive impact on the eurozone economy**

The ECB lowered its growth forecasts and in particular its inflation forecasts. In response, it took another set of measures to push up inflation and support economic growth in the eurozone. Discussions about whether the ECB (and other central banks, for that matter) are doing the right thing are becoming more polarised. Sceptics are getting louder and louder. Are they right?

A huge experiment, indeed
The short answer to this question is that nobody knows for sure. We are in uncharted territory. And have been for a long time. Without a shadow of a doubt, it is fair to say that we are witnessing the biggest experiment in monetary policy mankind has ever see. Perhaps I should rephrase that statement just a little bit. We are not only witnessing it, we are experiencing it, or perhaps even better, we are subject to it. And to be fair, the outcome is uncertain.

Lessons from the 1930s
This policy direction was chosen in 2008 when central banks feared that doing nothing might risk a repeat of the depression of the 1930s. One of the key lessons economic historians have drawn about the 1930s is that the US Federal Reserve made things worse by allowing too many banks to fail and allowing the money supply to shrink. Central banks were keen not to make the same mistake this time so they engaged in and encouraged support and rescue operations for banks and they tried to increase the money supply. At that time, most economists and commentators agreed with such action.

Fast forward eight years. A depression has been prevented, and many, though certainly not all vulnerabilities have been eased. I think one has to credit policymakers, in particular central banks.

The healing process is far from complete

Nevertheless, growth remains weak, emerging economies have taken on a lot of debt, often denominated in US dollars and China's growth is sliding. Productivity growth in advanced economies disappoints, potential growth is low and excess capacity is wide-spread. This makes the situation vulnerable and focusses attention on deflation risks.

Hard to substantiate criticism of the ECB

Critics of current monetary policy and the most recent ECB actions in particular argue along a couple of different lines. One of these is that low interest rates do not encourage spending, but may do the opposite as people feel increasingly uncomfortable with low and even negative interest rates. I think it is very difficult to find evidence to support that assertion. Lower borrowing costs may not encourage a lot of new borrowing, but they do "exactly what it says on the tin": they lower borrowing costs, leaving borrowers with more spending power. I cannot understand why we would expect lower oil prices to lead to higher consumer spending through an improvement in spending power, while we would not expect the same from lower borrowing costs.

Another line of argument critics follow is that the policies pursued create bubbles and will or may lead to financial instability. I think the assertion that bubbles have been created across a range of assets is not supported by the evidence. Yes, bond yields are very low, but economic circumstances do not suggest that yields are too low. An assessment of equity valuations is complicated, but simple PE ratios do not suggest the market is excessively expensive, in my view. I do think, however, that the involvement of the ECB in various segments of the bond market is creating distortions, the effects of which are hard to assess.

Pension funds under pressure

Some critics argue that interest rates should not be cut, but raised. That is a line of thinking I cannot follow at all. In the Netherlands in particular, people point out that low interest rates are detrimental to pension funds. I would argue that this is only so because the net present value of the liabilities of pension funds is based on market interest rates. People worry about the funding ratios of pension funds but forget that total assets are at record levels. The 20 year swap rate is currently just over 1%. A funding rate of a pension fund of, say, 90% means that a fund will be able to honour 90% of its nominal promises if it achieves an investment return on its assets of merely that 1% over the longer term. It is hard, if not impossible to find periods when investment returns on a diversified portfolio were lower than 1% annually over a 20 year period. That does not mean, of course, it cannot happen and short-term volatility may compound problems. However, I think people are too pessimistic about pension funds.

Another observation about pension funds is that we must bear in mind what these monetary policies are trying to achieve. We had large credit bubbles in 2008. They popped and policy has been aimed at making the adjustment less painful by lowering the burden on borrowers. Naturally, that is at the expense of savers. These policies must work through a redistribution of wealth and income from savers to debtors.

Too much reliance on central banks

As can be concluded from the above, I think the ECB is following policies that can be justified, though there is uncertainty and negative side effects that are hard to quantify. That does not mean, however, that I think this sort of policy is the best we can think of. Potential growth in advanced economies and the eurozone in particular is disappointingly low. That is not something monetary policy can do much about. It is up to other policymakers to strengthen growth dynamics. While some progress has been made regarding structural policies in a number of eurozone countries, the overall record is still very disappointing. Support for economic growth in the shorter term should not only come from monetary policy, but could also come from fiscal policy. Unfortunately, government debts are already high and, more to the point, the budget rules in the eurozone are aimed at preventing excessive deficits. While that is not an unreasonable ambition, there are circumstances in which more flexibility to take coordinated stimulus would be helpful. Germany is a case in point here. The country is running a small budget surplus and a huge surplus on the current account of the balance of payments. Yet, it intends to stick to a balanced budget despite the additional spending necessary because of the refugee crisis.

If budgetary policy does nothing to support economic growth when it is needed and structural policies fail to raise the dynamism of our economies we become too reliant on our central bank and they are forced to take more unconventional measures.

A leap into the dark or falling into a black hole?

Yesterday, the previous president of the Dutch central bank said that the ECB is taking a leap into the darkness. I think that is right. But I also think that a considered leap into the darkness is better than falling into the black hole that is a deflationary depression.

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Main economic/financial forecasts

GDP growth (%)	2014	2015	2016e	2017e
United States	2.4	2.4	1.7	2.1
Eurozone	0.9	1.5	1.2	1.6
Japan	-0.1	0.5	0.8	0.6
United Kingdom	2.9	2.2	1.6	2.5
China	7.3	6.9	6.5	6.0
World	3.4	3.1	3.0	3.5
Inflation (%)	**2014**	**2015**	**2016e**	**2017e**
United States	1.6	0.1	1.4	1.6
Eurozone	0.4	0.0	0.1	1.5
Japan	2.8	0.8	0.5	1.8
United Kingdom	1.5	0.0	0.5	1.8
China	2.0	1.4	2.0	2.5
World	3.8	3.6	3.8	3.6
Key policy rate	**10/03/2016**	**+3M**	**2016e**	**2017e**
Federal Reserve	0.50	0.50	0.50	1.25
European Central Bank	-0.30	-0.70	-0.70	-0.70
Bank of Japan	-0.10	-0.30	-0.30	-0.30
Bank of England	0.50	0.50	0.50	1.50
People's Bank of China	4.35	4.10	3.85	3.85

3M interbank rate	03/03/2016	10/03/2016	+3M	+12M	2016e	2017e
United States	0.64	0.63	0.6	0.6	0.6	1.4
Eurozone	-0.21	-0.22	-0.55	-0.55	-0.55	-0.55
Japan	0.10	0.10	-0.1	-0.1	-0.1	-0.1
United Kingdom	0.59	0.59	0.6	0.9	0.6	1.6
10Y interest rate	**03/03/2016**	**10/03/2016**	**+3M**	**+12M**	**2016e**	**2017e**
US Treasury	1.83	1.93	1.9	2.2	2.2	2.5
German Bund	0.17	0.30	0.2	0.5	0.5	0.8
Euro swap rate	0.54	0.66	0.5	0.7	0.7	1.0
Japanese gov. bonds	-0.03	-0.03	0.2	0.3	0.2	0.3
UK gilts	1.43	1.54	1.5	1.8	1.7	2.3
Currencies	**03/03/2016**	**10/03/2016**	**+3M**	**+12M**	**2016e**	**2017e**
EUR/USD	1.09	1.11	1.05	1.05	1.05	1.05
USD/JPY	113.7	113.2	117	122	120	120
GBP/USD	1.42	1.43	1.35	1.5	1.48	1.50
EUR/GBP	0.77	0.78	0.78	0.7	0.71	0.70
USD/CNY	6.54	6.52	6.55	6.75	6.70	6.80

Source: Thomson Reuters Datastream, ABN AMRO Group Economics.

Key Global Macro Events

Day	Date	Time	Country	Key Economic Indicators and Events	Period	Latest outcome	Consensus	ABN AMRO
Saturday	12/03/2016	15/03/2016	CN	M2 money growth - % yoy	Feb	14.0	13.7	
Saturday	12/03/2016	15/03/2016	CN	New loans - CNY bn	Feb	2510	1200	
Saturday	12/03/2016	15/03/2016	CN	Aggregate financing - CNY bn	Feb	3417	1841	
Saturday	12/03/2016	06:30:00	CN	Retail sales - ytd yoy	Feb	10.7	10.7	
Saturday	12/03/2016	06:30:00	CN	Industrial production - ytd yoy	Feb	6.1	5.6	
Saturday	12/03/2016	06:30:00	CN	Fixed asset investment - ytd yoy	Feb	10.0	9.3	
Monday	14/03/2016	07:30:00	IN	Wholesale price index - % yoy	Feb	-0.9	-0.2	
Monday	14/03/2016	11:00:00	EC	Industrial production SA mom	Jan	1.4	-1.0	**1.2**
Monday	14/03/2016	13:00:00	IN	CPI - % yoy	Feb	5.7	5.5	
Tuesday	15/03/2016	13:30:00	US	Retail sales - % mom	Feb	0.2	0.0	**0.0**
Tuesday	15/03/2016	13:30:00	US	Prod. prices index excl food and energy - % mom	Feb	0.4	0.1	
Tuesday	15/03/2016		US	NAHB home builders' confidence index	Mar	58	59	**59**
Tuesday	15/03/2016		JP	Policy rate - %	Mar 15	80.0	81.5	
Wednesday	16/03/2016	13:30:00	US	CPI Inflation - % mom	Feb	0.0	-0.2	**-0.2**
Wednesday	16/03/2016	13:30:00	US	CPI Inflation - % yoy	Feb	1.4	0.9	**0.9**
Wednesday	16/03/2016	13:30:00	US	CPI excl food and energy - % mom	Feb	0.3	0.1	**0.2**
Wednesday	16/03/2016	13:30:00	US	CPI excl food and energy - % yoy	Feb	2.2	2.2	**2.2**
Wednesday	16/03/2016	13:30:00	US	Housing starts - % mom	Feb	-3.8	3.2	**3.0**
Wednesday	16/03/2016	14:15:00	US	Industrial production - % mom	Feb	0.9	-0.1	
Wednesday	16/03/2016	19:00:00	US	FOMC rate decision lower bound	Mar 16	0.25	0.25	**0.25**
Wednesday	16/03/2016	19:00:00	US	FOMC rate decision upper bound	Mar 16	0.50	0.51	**0.50**
Thursday	17/03/2016	00:50:00	JP	Merchandise trade exports - % yoy	Feb	-12.9	-3.8	
Thursday	17/03/2016	07:30:00	NL	Unemployment rate	Feb	6.5		**6.5**
Thursday	17/03/2016	09:30:00	CH	SNB 3-month Libor Upper Target	Mar 17	-0.25	-0.25	**-0.25**
Thursday	17/03/2016	09:30:00	CH	SNB 3-month Libor Lower Target	Mar 17	-1.25	-1.25	**-1.25**
Thursday	17/03/2016	09:30:00	CH	SNB Sight Deposit Interest Rate	Mar 17	-0.75	-0.75	**-0.75**
Thursday	17/03/2016	10:00:00	NO	Policy rate - %	Mar 17	0.75	0.50	**0.50**
Thursday	17/03/2016	11:00:00	EC	CPI Core yoy	Feb F	0.7	0.7	**0.7**
Thursday	17/03/2016	13:00:00	GB	Policy rate - %	Mar 17	0.5	0.5	**0.5**
Thursday	17/03/2016	13:00:00	GB	BoE size of asset purchase programme - GBP bn	Mar	375.0	375.0	**375.0**
Friday	18/03/2016	06:30:00	NL	Consumer confidence - index	Mar	-1		**1**
Friday	18/03/2016	11:30:00	RU	Key rate %	Mar 18	11.0	11.0	**11.0**
Friday	18/03/2016		US	Univ. of Michigan cons. confidence - index	Mar P	91.7	92.3	**91.0**
Friday	18/03/2016	20:00:00	MX	Policy rate - %	Mar 18	3.75		

Source: Bloomberg, Reuters, ABN AMRO Group Economics (we provide own forecasts only for selected key variables and events)