EUROZONE UPDATE

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ECB SIGNALS A PLAN TO CUT POLICY RATES BY THE END OF 2016 AND TAPER ITS QUANTITATIVE EASING PROGRAM IN 2017

The ECB opens a door to a very gradual taper of its quantitative easing program in 2017

The ECB is also signaling another rate cut by early 2017 that would push short term interest rates deeper into negative territory

Matching PNC's forecast and consensus, the ECB left key interest rates unchanged at its September 8 Governing Council meeting. The deposit rate, which serves as the benchmark for short-term euro interest rates, is negative 0.40 percent, and the main refinancing operation rate and the marginal lending facility rate are 0.00 percent and 0.25 percent, respectively.

The ECB also refrained from changing the minimum end-date of its quantitative easing (QE) program in September, a surprise to us. The ECB continues to commit to buying €80 billion euros per month in euro assets through at least March 2017, "or beyond if necessary" – a newly added phrase that emphasizes that the ECB might continue to buy assets after March. But of course, "might" is a much weaker commitment than "will." The ECB could still make a firm extension of the end date of its asset purchase program at the December Governing Council meeting, but in the base case, they are more likely to taper QE in 2017. If so, they would reduce asset purchases very gradually to limit the risk that Eurozone interest rates spike higher.

Furthermore, the ECB signaled that they could also cut the deposit facility rate 0.10 percentage points to negative 0.50 percent by early 2017. In their opening statement to their September press conference, the ECB pledged that "We will preserve the very substantial amount of monetary support that is embedded in our staff projections." The September staff projections cut their forecast for Eurozone short-term interest rates in 2017 and 2018 by 0.1 percentage points from the ECB's June forecast, and call for them to be lower than they were in August 2016 – and also predict that ten-year government bond yields will be unchanged in 2017 from 2016, and then rise 0.2 percentage points in 2018. If so, a steeper euro yield curve could lessen some of the profitability pressures on the Eurozone's financial sector, especially if the ECB begins

CHART 1: AFTER MORE STABLE ENERGY PRICES IN 2016, EUROZONE INFLATION SHOULD RISE IN 2017

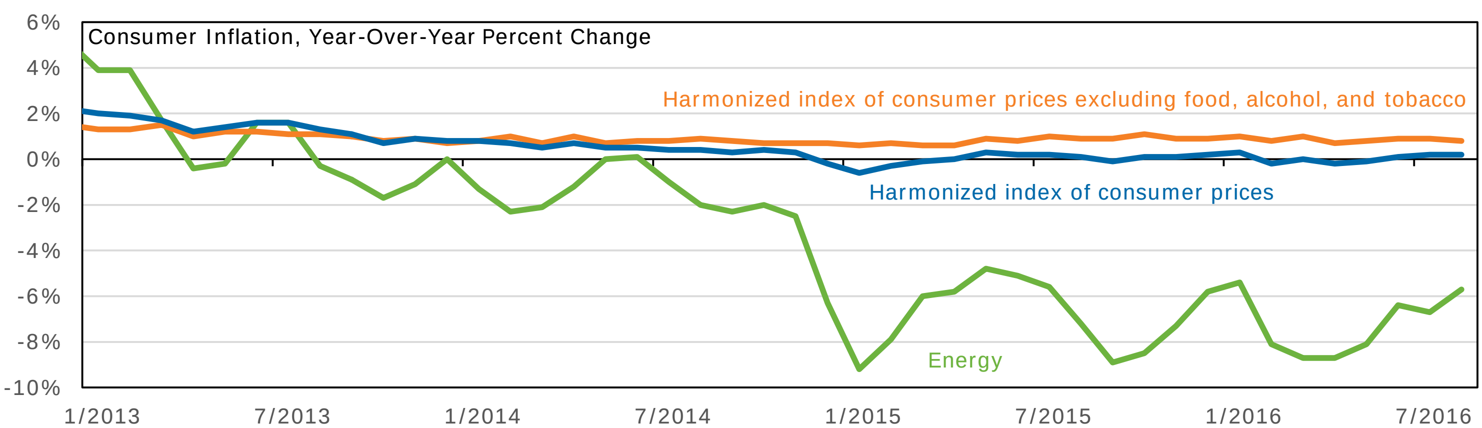

Chart sources: Eurostat, CEIC, The PNC Financial Services Group

The ECB optimistically projects trend-like economic growth in 2017 and 2018, and higher inflation as more stable oil prices reach the consumer basket

emulating the Bank of Japan in exempting some of financial institutions' excess cash deposits from negative interest rates. Even if the ECB does not cut rates in the next few months, its commitment that policy interest rates "remain at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases" means that euro short-term interest rates can be expected to stay negative for at least a year after the end of an ECB taper – that is, likely until the second half of 2018 if not later.

The ECB's projections for real GDP growth and inflation in September changed little from the June forecast vintage. The ECB forecasts real GDP growth of 1.7 percent in 2016, 1.6 percent in 2017, and 1.6 percent in 2018 – an optimistic projection for trend growth affected little by spillover from the UK's Brexit referendum. PNC Economics conservatively forecasts real GDP growth of 1.3 percent in quarterly annualized terms in the second half of 2016, 1.4 percent in 2017, and 1.3 percent in 2018, anticipating some headwinds to growth from Brexit-related spillovers and potential political tensions around the future of the Eurozone and the migrant crisis.

The ECB also forecasts consumer inflation measured by the average annual change of the HICP index of 0.2 percent in 2016, 1.2 percent in 2017, and 1.6 percent in 2018. While the ECB has been serially overoptimistic about inflation rising in the past, this time looks like it will be different – famous last words, we know! Stable global oil prices in 2016 should in 2017 lift Eurozone headline inflation closer to core inflation, which has held steady near 1.0 percent in annual terms since mid-2014 (See Chart 1). Stronger headline inflation would provide a justification for the ECB to taper asset purchases.

Euro initially depreciates in our baseline forecast, then appreciates in 2017-2018 as the ECB follows through on a taper of quantitative easing

If the ECB follows through on cutting short-term interest rates and the Federal Reserve raises the federal funds target range as PNC forecasts at the December 14-15 Federal Open Market Committee meeting, the euro could depreciate to near $1.08 per euro by year-end 2016 (Chart 2).

However, if the ECB then signals in 2017 that a taper of its quantitative easing program is approaching, the euro could subsequently appreciate against the dollar. PNC Economics forecasts that the euro may end 2017 at $1.10 per euro and 2018 at $1.12, slightly weaker than it was after the September 2016 ECB Governing Council meeting. In any case, the euro seems unlikely to depreciate dramatically in 2017 and 2018 the way it did in 2014 and 2015. Risks to the exchange rate's outlook from economic fundamentals and interest rate differentials seem more balanced than in the last few years.

CHART 2: EURO MAY WEAKEN NEAR TERM ON AN ECB RATE CUT, THEN STRENGTHEN ON A TAPER OF THE QE PROGRAM

Chart sources: European Central Bank, CEIC, The PNC Financial Services Group

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