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Recent ECB Policy and Inflation Expectations

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On May 8, European Central Bank (ECB) President Mario Draghi stated the ECB would be "comfortable" taking measures to boost inflation.[1] On June 5, the ECB formally announced its policy. One headline declared "Draghi Unveils Historic Measures Against Deflation Threats."[2] The ECB reduced its benchmark rate to 0.15 percent, reduced its deposit rate to –0.1 percent, and announced a bank lending facility of roughly 400 billion euros. The ECB also announced a potential plan to conduct outright asset purchases and conveyed a strong willingness to "act swiftly" to "further address risks of too prolonged a period of low inflation."[3]

Market participants may not expect recent ECB policy to boost inflation.

At least temporarily, the policy spurred several typical financial-market effects generally attributed to a successful monetary expansion: Some bond yields fell, the euro depreciated against the U.S. dollar, and stock prices rose in Germany. However, breakeven inflation expectations seemed unaffected, which can be interpreted as a signal that market participants do not expect the policy to successfully boost inflation.

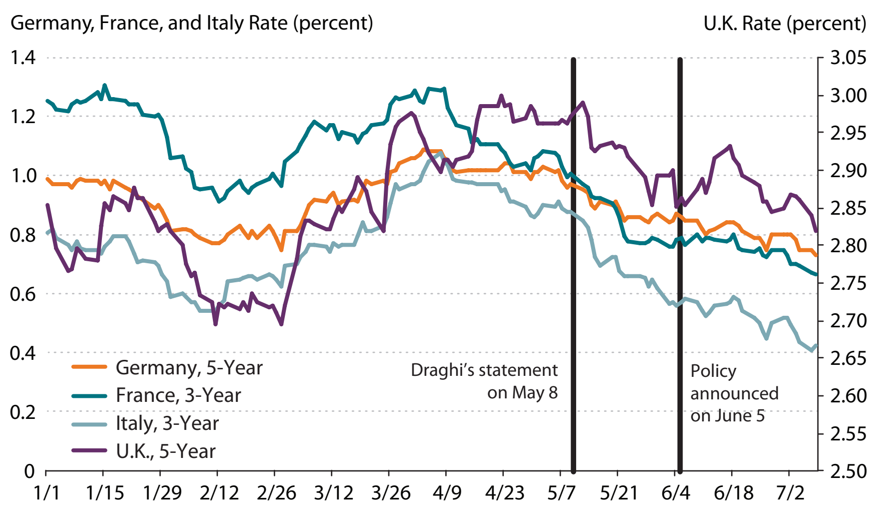
Breakeven inflation expectations are defined as the additional yield provided by nominal debt with respect to the yield on inflation-indexed debt. Many analysts prefer breakeven inflation expectations over self-reported inflation expectations provided by surveys because the former reflect the actual behavior of market participants.

The first figure shows breakeven inflation expectations implied by sovereign bonds from the euro zone and the United Kingdom that mature in three or five years. After the May 8 statement and June 5 policy announcement, these inflation expectations continued a gradual decline. In fact, they moved in tandem with U.K. securities (which are not directly affected by ECB policy). This reduction can be interpreted as the market expecting a decrease in inflation over the next three or five years.

Breakeven inflation expectations implied by bonds of other maturities suggest a similar interpretation: For example, breakeven expectations implied by 10-year bonds were flat for Germany, France, Italy, and the United Kingdom. Moreover, those implied by Italian debt maturing in 1 year fell swiftly after the statement and announcement, entering negative territory on May 28.

For comparison, consider recent U.S. policy. The second round of quantitative easing (QE2), a $600 billion program of outright asset purchases, seems to have boosted inflation expectations. The second figure shows breakeven inflation expectations implied by U.S. Treasuries. These inflation expectations reversed their downward trend around the time then-Fed Chair Ben Bernanke discussed the possibility

Sovereign Bond Three- and Five-Year Breakeven Inflation Expectations, 2014

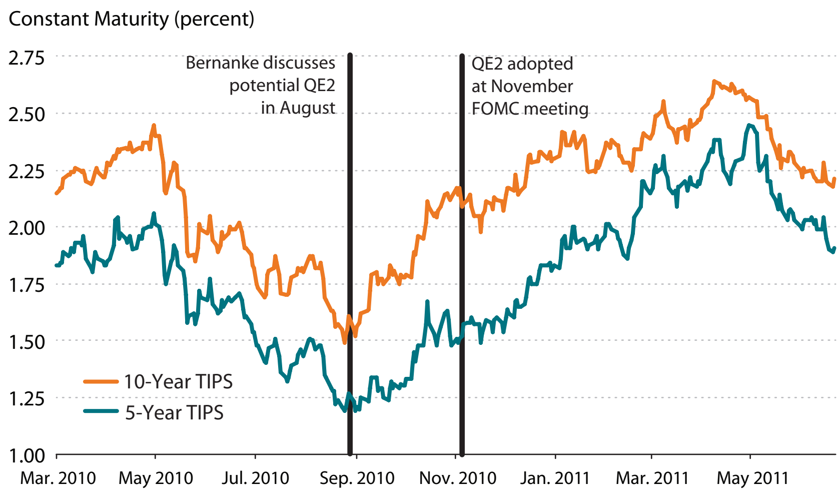


SOURCE: Bloomberg.

of QE2 in August 2010 and continued rising after the policy was adopted at the November 2010 Federal Open Market Committee meeting.[4]

Some of the variables in the ECB's economic landscape in May 2014 were somewhat similar to those in the Federal Reserve's in November 2010: (i) The federal funds rate target had been 0 to 0.25 percent since mid-December 2008, while the ECB benchmark rate had been 0.25 percent since November 2013. (ii) The U.S. unemployment rate was 9.8 percent in November 2010, slightly lower than one year earlier, while that for the euro zone was 11.6 percent in May 2014, 0.4 percentage points lower than one year earlier. (iii) U.S. consumer price index (CPI) inflation was 1.1 percent in November 2010 and declining relative to the previous year, while euro zone CPI inflation was 0.5 percent in May 2014 and declining relative to the previous year.

U.S. Treasury Inflation-Protected Securities (TIPS) Breakeven Inflation Rates



SOURCE: Bullard (2011).

If the two central banks were operating in roughly similar macro environments, the reasons for the dissimilar breakeven inflation expectations could be attributable to differences in the policies adopted. The key difference between the ECB's lending facility and QE2 is that the ECB's operates only if banks actually take the loans, while QE2 does not require market participants to take special actions.[5] Furthermore, although the ECB announced a possible QE program, some market participants may not find this announcement completely credible.[6] Two obstacles exist for outright asset purchases by the ECB—both related to the type of assets to purchase: (i) Selecting which sovereign bonds to buy is politically difficult. Should they be Spanish, Italian, German, or something else? (ii) Mortgage-backed securities markets throughout the euro zone are relatively thin. ■

NOTES

[1] Blackstone (2014).

[2] Black and Riecher (2014).

[3] ECB (2014).

[4] Bullard (2011).

[5] More specifically, the ECB lending facility has two parts. First, banks are allowed to borrow up to an amount equivalent to 7 percent of their nonfinancial private sector loans excluding mortgage loans outstanding as of April 30, 2014. Second, between March 2015 and June 2016, banks will be allowed to borrow up to three times their quarterly net lending (outlays minus repayments) to the euro zone nonfinancial sector excluding mortgages (Siedenburg, 2014).

[6] Grimm and Blackstone (2014).

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