LONG SHADOW OF FORWARD GUIDANCE

By Johanna M. Treeck, Senior ECB Correspondent

The European Central Bank's forward guidance may be too weak to effectively decouple Europe from any potential U.S. Federal Reserve tightening, but its introduction suggests that the bar for further easing measures is not very high.

Earlier this month, the ECB broke away from its long-standing mantra of never pre-committing to future policy action by noting an expectation that interest rates should remain "at present or lower levels for an extended period."

The initial market reaction to this announcement was quite impressive but has already begun to fade. After falling on the announcement, shorter-dated Eurozone sovereign bond yields have since rebounded. Forward rates on three-month Euribor interbank lending rates initially fell before edging up again. Eonia overnight rates have also resumed firming.

NON-COMMITTAL

The reversal is largely due to more dovish tones by the Fed since the Eurotower issued its forward guidance. ECB policymakers' comments highlighting the non-committal nature of its forward guidance may also have played its part.

The phrasing of the ECB's forward guidance offers no promises of ultra-low rates, but merely an "expectation" that hinges on "the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics."

In simple words: The ECB does not expect to raise rates before inflation pressures warrant it. So very little appears to have changed (other than we should expect – whenever the day dawns that the ECB considers raising rates – that it should neutralise its current forward guidance language first).

"This is a change in communication but not in monetary policy strategy," ECB Executive Board member Benoit Coeure said.

Fellow Governing Council members, Bundesbank President Jens Weidmann and his Finnish counterpart Erkki Liikanen, stressed that the ECB retains its flexibility and can react at any time to changes in the economic outlook.

Don't expect the ECB to behave any differently than in the past, Governing Council member Ardo Hansson, governor of the Estonian central bank, told MNI last Friday. "My own reaction function cannot change too much. We have not changed the mandate of the definition of price stability," he said. "It is not a change where you are moving towards multiple objectives, you are still looking at everything through this lens of medium-term price stability."

Calls for a more committed enunciation of forward guidance - such as one that offers a concrete timeframe or specific economic signposts - are already growing louder. The Fed's move into forward guidance during the global financial crisis was itself an evolutionary process, first promising low rates for an "extended period" in March 2009 before offering a more specific timeframe on its intentions more than two years later. A shift from this calendar-based approach to one of indicators or triggers for decision-making, including unemployment rates, followed some time after that.

Pressure for added ECB commitments will only increase should the Bank of England – as is widely expected – offer forward guidance linked to specific economic data points in August.

Draghi, pragmatic as ever, did not exclude the option: "The Governing Council feels like it has already undertaken a very significant step forward, and frankly it's too early to speculate on future developments in the communication now," he said when asked about the possibility of providing more detailed forward guidance in future.

In any case, it appears unlikely that the ECB would reach a consensus on a more concrete expression of its forward guidance as its next easing step should the current announcement fail to stem in a durable way a rise in market rates.

It is thought that specifying the timeframe may carry risks with limited added benefits. Discussing the option of offering a specific timeframe at its Governing Council meeting earlier this month, ECB policymakers voiced concerns that the minimum period could be misinterpreted as a start date for tightening, and risk ratcheting up tensions as the date draws nearer.

At the same time, the Fed's experience has shown that such timelines can be subject to repeated revisions if the economy fails to stage the expected recovery, thus offering only limited clarity over the policy path ahead. The ECB's singular price stability mandate may force the Eurotower to give a more conservative horizon for low rates than the Fed did, accentuating the problem for the Eurozone.

Linking the rate path to a specific economic indicator, such as unemployment -- a trigger-approach -- is seen as more complicated in the Eurozone given the vastly diverging levels of economic competitiveness and development across the region. In addition, some Governing Council members will argue that attaching excessive importance to any particular economic indicator could be seen as moving away from the ECB's price stability mandate.

"We have a clear single mandate ... so it is a bit different from central banks that have other mandates," Hansson told MNI.

Of course, arguments can be made that drawing on real economic indicators does not necessarily conflict with the price stability mandate. Similarly, offering a more specific and prolonged timeframe may be a key to ensuring price stability by averting deflation threats. Such arguments may well fly around the table in future Governing Council meetings.

Importantly, however, the chances that such debates will lead to a shared assessment on the Governing Council appear slim. Draghi rightly stressed the importance of unanimity on this month's forward guidance decision, which was in all likelihood secured precisely because it did little to alter the ECB's reaction function.

Forward guidance is a communication tool and unless you have all Governing Council members on board, any communication offensive may quickly prove ineffective. Even those Governing Council members favoring more concrete guidance should recognize that a vague formulation that enjoys the backing of the Bundesbank and other northern Eurozone countries will prove more effective than a concrete guidance that is under constant fire from a small but central number of decision-makers.

Embellishing on the solely communicative nature of its foreward guidance might be one way around that. One form of embellishment would be the launch of another long-term refinancing tender with the rate fixed to current or lower levels rather than the average official interest rates over the life of the tender. Should it remain a pure communication tool in the months ahead, forward guidance is likely remain vague.

LOW BAR

Perhaps more important than the actual guidance announced last week, however, was the decision to introduce it. The move underlines that non-traditional thinking is gaining traction on the Governing Council and points to a bar for further easing measures that may not be very high, as Draghi's dovish rhetoric would seem to support.

"What the Governing Council did today was to inject a downward bias in interest rates for the foreseeable future, linked to its assessment of these three sets of variables," Draghi said during his press conference.

He also offered the unprompted assurance that the current 50 basis point level for the main refinancing rate "is not the lower-bound" and repeatedly stressed the importance of injecting a downward bias not only on that rate, but on all "key ECB interest rates."

MNI understands that last week's Governing Council meeting had to contend with calls made at the June meeting for a rate cut to accompany a forward guidance announcement**.** German weekly Der Spiegel reported that "seven board members, mainly from northern European member states, were arguing sharply against a rate cut."

So a minority of Governing Council members may have managed to scuttle a rate cut in July, possibly in return for supporting a loose form of forward guidance. By this reckoning, should monetary conditions begin to tighten once again, the balance might quickly tip toward a rate cut.

Risks of further fallout from the U.S. Federal Reserve's possible unwinding of its asset purchase program later this year are not benign. The trend could be accentuated by the decline in excess liquidity - which at current repayment rates could fall by October below the E200 billion level many consider the minimum support needed to keep overnight rates close to the zero per cent charged on the ECB's deposit facility.

The 'if' and 'when' of another rate cut will of course hinge on the development of economic data and monetary conditions ahead. But the chances are the Eurotower will add to the summer lull in August.

"We'll have to see what the market reaction has been, is and will be to this statement," Draghi told the European Parliament when asked if the ECB move would be enough. The central bank may want to give more than a few short weeks to see how its tweaked communication approach impacts markets.

The recent more dovish tones from the Fed may also limit pressure for immediate action, allowing Draghi et al to await the new ECB staff forecasts for growth and inflation that will be available ahead of the their September meeting before re-assessing the monetary policy stance.

A NEW LTRO?

As noted above, the ECB could use a long-term liquidity operation to make a more reliable commitment to easy monetary policy by capping the maximum cost over its term at 0.5%. While this remains an uncertain possibility, it appears likely that another long-term operation is in the pipeline.

ECB Council members have stressed the success of previous very long term refinancing operations and have signaled their readiness to consider further operations if necessary to ensure the stability of funding over the medium term.

Even Joerg Asmussen, who has assumed the role of the superhawk on the Executive Board, signaled that he harbors no significant concerns over stepping up liquidity support. "We will continue to do our part on the liquidity side," Asmussen said last week. "If needed, we are going to do more."

Especially in light of the upcoming ECB bank asset quality review and stress test, the Governing Council appears poised to offer another tender that goes beyond the traditional three-month period to smooth over any possible tensions.

Draghi said last week that the central bank is "continuously searching" and has "an open mind towards instruments". However, the chances of any radically different measures aimed at improving the monetary transmission mechanism appear slim in the near term.

In his appearance before the European Parliament, the ECB chief appeared to exclude any direct purchase of securities backed by loans to medium-and-small companies in the region (ABS). "The Commission and the European Investment Bank are looking into possible ways to support SME financing, notably in the form of joint risk sharing instruments," he said. Draghi wanted "to make clear" that as regard the ABS market, the ECB is merely operating in an advisory role.

In Draghi's words, the ECB has taken a "significant step forward." Chances are that more steps will follow although the next once will likely be of a more familiar kind using already existing instruments.

Johanna M. Treeck
jtreeck@mni-news.com