Flossbach von Storch
RESEARCH INSTITUTE

ECONOMIC POLICY NOTE 7/12/2015

ECB signals and market reactions

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- ECB officials have taken the view that economic fundamentals and not monetary policy has been responsible for driving long-term interest rates to record lows. In a recent note we contradicted this view and argued that central banks exert a key influence on long-term interest rates.
- In the present note we provide more evidence of the key role of central banks in the determination of prices in financial markets. Previously, we analyzed interest rate developments in four countries or currency areas over almost 25 years with econometric tools. Now, we discuss intra-day developments in three euro area financial markets on two days.
- Our conclusion remains the same: Central banks exert a very important influence on market interest rates and through this on financial market prices.

In a recent note („Understanding low interest rates", Economic Policy Note 23/10/2015) we concluded that central banks exert a key influence on long-term interest rates. Hence, our results contradicted the claim made by ECB chief economist Peter Praet that *"the underlying drivers are not so much central bank policies as global and euro area-specific economic factors, some of which are more secular in nature and others which are more associated with the legacy of the post-Lehman financial crisis"*.[1] Instead, they supported the view of BIS economist Claudio Borio that *"central banks set the nominal short-term rate and influence the nominal long-term rate, through signals of future policy rates and purchases of assets. Market participants adjust their portfolios based on their expectations of central bank policy, their views about the other factors driving long-term rates, their attitude towards risk and various balance sheet constraints."*[2]

In the following, we provide more evidence of the key role of central banks in the determination of prices in financial markets. Previously, we analyzed interest rate developments in four countries or currency areas over almost 25 years with econometric tools. Now, we discuss

[1] Peter Praet, The low interest rate environment in the euro area. Keynote speech at a Pension Funds Conference organised by De Nederlandsche Bank in Bussum, The Netherlands, 10 September 2015.

[2] Claudio Borio, On the centrality of the current account in international economics. Keynote speech at the ECB-Central Bank of Turkey conference "Balanced and sustainable growth - operationalising the G20 framework", Frankfurt, 28 August 2015.

intra-day developments in three euro area financial markets on two days. Our conclusion remains the same: Central banks exert a very important influence on market interest rates and through this on financial market prices.

The test setting

Two months ago, the European Central Bank sent a message that virtually all ECB watchers interpreted as a signal of a further expansion of monetary policy. In the introductory statement to the press conference following the Governing Council meeting on October 22, ECB President Draghi said:

> *While euro area domestic demand remains resilient, concerns over growth prospects in emerging markets and possible repercussions for the economy from developments in financial and commodity markets continue to signal downside risks to the outlook for growth and inflation. Most notably, the strength and persistence of the factors that are currently slowing the return of inflation to levels below, but close to 2% in the medium term require thorough analysis. In this context, the degree of monetary policy accommodation will need to be re-examined at our December monetary policy meeting, when the new Eurosystem staff macroeconomic projections will be available. The Governing Council is willing and able to act by using all the instruments available within its mandate if warranted in order to maintain an appropriate degree of monetary accommodation. In particular, the Governing Council recalls that the asset purchase programme provides sufficient flexibility in terms of adjusting its size, composition and duration."*

During the question-and-answer session after the introductory statement, Draghi repeatedly underlined the strong willingness to do more in the weeks to come:

> *"…we will examine all incoming information and we are open to a whole menu of monetary policy instruments. To this extent, the Governing Council has tasked the relevant committees to work on different monetary policy instruments that could potentially be used, to examine the pros and cons of different instruments. In other words, if one had to summarise what was the attitude or the stance of the Governing Council discussion today, one would say it was not "wait and see", but it was "work and assess."*

Subsequent data releases did not fundamentally alter the picture Draghi painted at the October 22 Council meeting. Hence, Draghi's support to further monetary policy accommodation expressed during the hearing at the European Parliament's Economic and Monetary Affairs Committee on November 12 was just confirming his determination to do more. It also did not come as a surprise to analysts when he said at a conference on November 20, about two weeks before the next Governing Council meeting on December 3:

> *Putting the whole picture together, we have a situation where we cannot yet say with confidence that the process of economic repair in the euro area is complete. The moderate growth and price dynamics imply that we need to monitor closely whether – if left to its own forces – the economy will be able to reach a self-sustaining growth trajectory in conditions of price stability. If not, then it will require more monetary stimulus, which the ECB will not hesitate to provide.*
>
> *At our December Governing Council meeting, we will thoroughly assess the strength and persistence of the factors that are slowing the return of inflation towards 2%. We will use as one input the Eurosystem staff projections. Another input will be the work of our*

staff in consultation with the Eurosystem Committees on the monetary policy stimulus that has been achieved so far, and the range of instruments available in case more accommodation is seen as necessary.

If we conclude that the balance of risks to our medium-term price stability objective is skewed to the downside, we will act by using all the instruments available within our mandate. In particular, we consider the APP to be a powerful and flexible instrument, as it can be adjusted in terms of size, composition or duration to achieve a more expansionary policy stance. The level of the deposit facility rate can also empower the transmission of APP, not least by increasing the velocity of circulation of bank reserves.

In making our assessment of the risks to price stability, we will not ignore the fact that inflation has already been low for some time. Looking forward, monetary policy will remain accommodative for as long as needed to secure a sustained adjustment in the path of inflation. That means we want to feel suitably confident that inflation will not only converge to, but also stabilise around levels close to 2% over the relevant medium-term horizon.

So let me reiterate what I said here last year: if we decide that the current trajectory of our policy is not sufficient to achieve that objective, we will do what we must to raise inflation as quickly as possible. That is what our price stability mandate requires of us."

Again, ECB watchers concluded that the ECB President had reaffirmed his determination of taking a whole range of expansionary monetary policy measures at the next Council meeting on December 3. In particular, most observers felt that the ECB would use "all the instruments available", including the size and duration of the asset purchase program as well as the level of the deposit rate.

At its December meeting, the Governing Council decided to lower the ECB's deposit rate by 10 basis points to -0.3%, to extend monthly purchases of EUR60bn of securities until the end of March 2017, to reinvest principal payments on securities purchased, and to extend the range of securities that will be purchased.[3] In the press conference following the meeting, ECB President Draghi commented:

"Our new measures will ensure accommodative financial conditions and further strengthen the substantial easing impact of the measures taken since June 2014, which have had significant positive effects on financing conditions, credit and the real economy. Today's decisions also reinforce the momentum of the euro area's economic recovery and strengthen its resilience against recent global economic shocks. The Governing Council will closely monitor the evolution in the outlook for price stability and, if warranted, is willing and able to act by using all the instruments available within its mandate in order to maintain an appropriate degree of monetary accommodation. In particular, the Governing Council recalls that the APP provides sufficient flexibility in terms of adjusting its size, composition and duration."

During the question-and-answers session he was asked:

"…financial markets appear to be disappointed. So what is the reason there? Do you think that something went wrong in your

[3] The Council also decided to continue conducting the main refinancing operations and three-month longer-term refinancing operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the last reserve maintenance period of 2017.

communication in the run-up to the decision?..."

To which he responded:

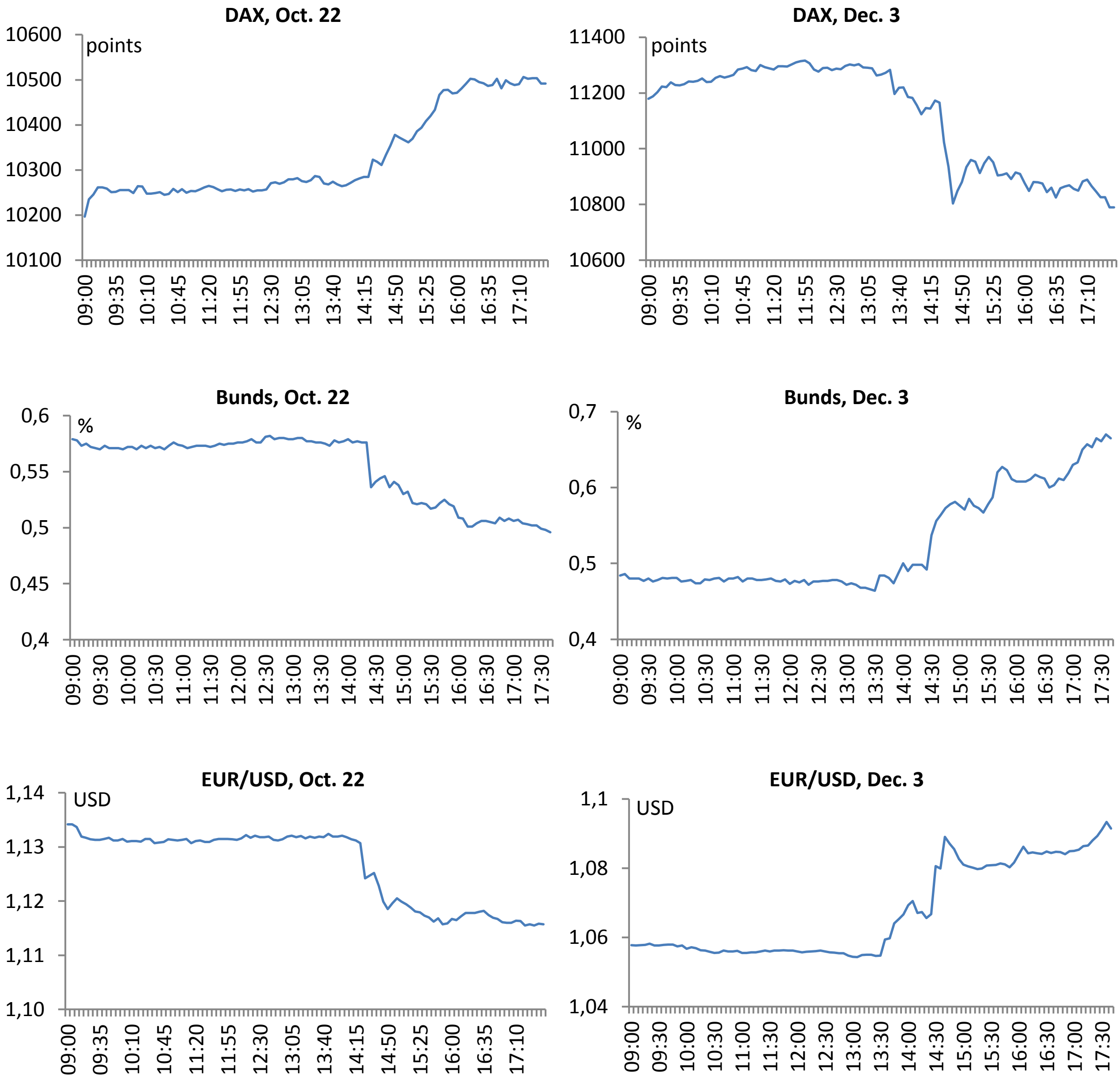
"I don't think so. I don't think our communication was wrong. I think these measures need time to be fully appreciated, and we will see."

Most ECB watchers concluded after the meeting that ECB President Draghi had overpromised and underdelivered.

The test results

We now turn to a short discussion of the developments of bond and equity prices as well as the exchange rate during the day of the ECB

Figure 1. Intra-day developments of the German equity index DAX, German 10-year government bond (Bund) yields, and Euro-US dollar (EUR/USD) exchange rate on October 22 and December 3.



Source: Bloomberg.

Council meetings on October 22 and December 3. For bonds and equities we use the 10-year German Federal Government Bond yields and the German equity index DAX; for the exchange rate, we use the Euro-US dollar rate. If markets price financial securities primarily on the basis of economic fundamentals, central bank decisions and communication should not have a decisive influence on market pricing.

On October 22, the apparently "dovish" comments by the ECB President during the press conference sent the German equity index up by almost 2%. The yields on the German 10-year bonds (Bunds) decreased by about 8 basis points in the two hours around the press conference[4], and the Euro-US dollar exchange rate weakened by 1.2% from 1.131 US dollar per EUR at 14:15 to 1.117 at 16:00 hours.

On December 3, the reaction to the decisions reflected significant disappointment of market participants over the weaker-than-expected further easing of monetary policy by the ECB. The DAX lost 340 points or 3.1%, falling from 11,143 points at 14:15 to 10,803 points at 14:40 hours, shortly after the full package of measures was announced. Ten-year Bunds became cheaper, with yields increasing by 16 basis points from 0.46% to 0.62% immediately after the press conference and by further 6 basis points an hour after the end of the question-and-answer session. Finally, the Euro appreciated by 4.5% against the US dollar, which represented the largest intra-day move since 2009 and one of the largest in its history. Overall, the markets' reactions to the December decisions and communication were stronger than to those in October, based on the interpretation of supposedly very "dovish" comments by members of the ECB Governing Council ahead of the policy meeting.

Conclusions

In this note we tracked the development of financial prices during two days of major ECB policy announcements. We found that markets responded forcefully to central bank signals. In our view, the development of markets during the two days we observed would have been different if markets priced financial securities primarily in response to the development of economic fundamentals and only secondarily with regard to central bank policy. As economic fundamentals barely changed between the two days considered, markets should have taken ECB decisions and comments in stride. They did not. Hence, the conclusion we drew from the analysis in our previous paper remains the same: Central banks exert a very important influence on market interest rates and through this on financial market prices.

Finally, we note that, contrary to the views expressed at previous occasions, the ECB itself seems to regard long-term interest rates under their control. In a speech delivered in New York on December 4, ECB President Draghi said:

> *"…since we launched our credit easing package in June 2014, composite lending rates for firms have declined by more than 80 basis points for the euro area as a whole, and by between 110-140 basis points in stressed economies. That is a formidable pass-through. ECB staff estimates suggest that we would have needed to reduce the standard policy rates by around 100 basis points in June 2014 to achieve a similar effect on bank lending rates."*[5]

[4] The government bonds in the rest of the euro area were affected as well. In the euro area periphery, the yields of the 10-year government bonds reacted even stronger than those of German bonds.

[5] "Global and domestic inflation" Speech by Mario Draghi, President of the ECB, Economic Club of New York, 4 December 2015.

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Editorial deadline: 7 December 2015