Article | 10 October 2019

ECB minutes highlight extent of the rift

We agree to disagree. This is the main message of the just-released minutes of the ECB's September meeting

Judging from the latest series of news reports, press statements, interviews and rumours, the ECB seems to be in the middle of a War of the Roses. The just-released minutes of the ECB's September meeting provide the dry and matter-of-fact arguments for the controversies and show that ECB members were heavily divided on which course to take.

Here are the highlights from the minutes, illustrating a rift at the ECB on almost every major topic:

- **Macro outlook.** While some ECB members considered the ECB's growth outlook to be too optimistic, others still expected a rebound in activity.
- **Policy decisions.** Interestingly, the minutes stated that "all members agreed that a further easing of the monetary policy stance was warranted to support the return to sustained convergence to the Governing Council's inflation aim". However, while some ECB members were even prepared to cut interest rates by more than 10 basis points, others needed more evidence for the need to cut at all. In diplomatic ECB language, this translates into: "A number of reservations were expressed about individual elements of the proposed policy package...Although the rational for a comprehensive package was widely shared, members assessed the case for specific elements differently..." There was also no unanimity of the changes to forward guidance, with some members wanting to stick to the date-related

rather than the state-related condition. Finally, even the decision on a tiering system for the deposit facility was not made unanimously, with some ECB members stating that the bank transmission channel was functioning well.
- **Fiscal policy.** The only area of harmony at the September meeting. With all members agreeing that "governments with fiscal space should act in an effective and timely manner. In response to the significant risks related to geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets, policies other than monetary policy would be more effective and were better suited to address country-specific shocks." Unfortunately, judging from yesterday's Eurogroup statements, this is a ball in the government's court, which they are not yet willing to pick up.

Unprecedented War of the Roses

It is not the first time in ECB history that there have been dissenting voices in the Governing Council, but they have rarely been as loud and persistent as they are now. In our view, the discussion about being right or wrong could continue endlessly. In the end, this is economics and not a natural science. As Alan Blinder, former vice-chairman of the Federal Reserve once said, "central banking in practice is as much art as science". We tend to agree. There are no doubt adverse effects from negative interest rates and unconventional measures, and it is uncertain how effective the latest round of ECB easing will be, but at the same time, we will never know how the eurozone economy would have looked without all these measures. The key word here is "counterfactual".

The intensity of the ongoing rift within the ECB was also illustrated by this morning's article in the Financial Times, which said the ECB's monetary policy committee had advised against restarting quantitative easing at the September meeting because long-term interest rates were already low. Apparently, the ECB's legal committee also had reservations about restarting QE, which explains why the ECB did not address the issue of bond scarcity at the September press conference.

Today's FT article is only one part of a long series of press statements (Klaas Knot and the group of former ECB members), interviews (Jens Weidmann and Robert Holzmann) and resignations (Sabine Lautenschläger). Needless to say, watching this War of the Roses has a high degree of entertainment. The much more important question is, what do the hawks want to achieve and what impact will this have on the ECB's monetary policy under the new leadership of Christine Lagarde?

What are the reasons for the rift and what do the hawks want to achieve?

- **Frustration.** First of all, the series of public complaints seems to stem from a high degree of frustration. Dissenting views are nothing new at the ECB but in the eight years under Mario Draghi, the bank returned to speaking with one voice (quickly) after policy decisions in order to cement their effectiveness. The latest developments and comments clearly run the risk of lowering at least the psychological effectiveness of the September package.
- **Policy reversal.** It is hard to believe that the hawks really want to see an imminent reversal of the QE decision at the December meeting, the first one under Christine Lagarde. Theoretically, this is not impossible but in practice, such a reversal would damage the ECB's credibility. It would also damage Mario Draghi's legacy.
- **Longer-term influence.** One goal of the current opposition could be to regain influence over the ECB's decisions. In recent years, most decisions have been prepared by Mario Draghi and a smaller inner circle. It seems as if the hawks are trying to gain more influence

in the Lagarde ECB, as expectations are that Lagarde will be less steering and guiding than Dragh in the monetary policy debate. In this regard, it will be interesting to see who succeeds Sabine Lautenschläger on the Executive Board. With potential candidates like Isabel Schnabel or Claudia Buch, the Executive Board would gain more economic weight. In the event of of a more political appointment, the Executive Board would be increasingly dependent on the current Chief Economist, Philip Lane, probably shifting the balance of power more towards the national central bank president.

- **Reorientation of monetary policy.** As part of the longer-term influence, it looks as if the hawks are steering towards a change in the ECB's general conduct of monetary policy, slightly moving away from a de facto inflation targeter. In our view, they will be pushing for a strategic review under Lagarde, which eventually could lead to the ECB focusing on a target range of, for example, 1.5% to 2.5% in the medium term, rather than the current "close to, but below 2%".

Lagarde's first mission: fix the rift

As entertaining as the current divisions at the ECB might be, it harms the bank's credibility and consequently its effectiveness. Therefore, Christine Lagarde's first task as new ECB president will be to urgently fix the rift. As long as it remains, we do not expect any imminent additional easing measures from the bank, even if the economic outlook gets worse.

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