ECB preview: Lagarde's first test case today

Today's ECB meeting will be the first test case for ECB president Christine Lagarde. With hardly any ammunition left and confronted with an external shock which cannot be tamed by economic policies and recent market turmoil, the ECB will have to fight two battles at the same time

ECB President Christine Lagarde wore an owl brooch at Thursday's meeting

The ECB's somewhat more upbeat tone on the eurozone economy currently looks like a fading memory from the past. Today's meeting will be all about the impact of the coronavirus on the eurozone economy, recent financial market turmoil and how the ECB will react to it. Against this background, the latest round of staff projections will probably also get less attention than normally. In fact, the projections will be outdated the moment they are published. The cut-off date for the forecasts was some two weeks ago, just before the virus broke out in Italy, sending shockwaves over financial markets and the economy. This means that the staff projections will very much paint the picture of a eurozone economy without a significant impact from Covid-19, besides some weaker demand from China and some supply chain disruptions. The economic impact from the preventive measures taken in recent weeks, to slow down or stop the virus from spreading in Europe, will not have been taken into account in the staff projections.

Trying to cope with Covid-19

To come up with a credible and final assessment of the economic impact from Covid-19 on the eurozone economy is impossible. Not only for us but also for the ECB. The economy is confronted with an unprecedented mix of supply-side and demand-side shocks. Think of weaker demand from China, supply chain disruptions but also less travel, less going to leisure activities, companies sending employees home, etc. To make things worse, the recent market turmoil has increased the risk of a negative feedback loop, back from financial markets to the real economy. This is a significant difference when comparing the current crisis with the 2008/09 crisis. Back then, the crisis originated in the financial sector and financial market turmoil had severe knock-on effects on the real economy. This time around, the crisis originates outside any reach of economic policies, has a negative impact on the real economy and financial markets only react to developments in the real economy. A severe market turmoil, however, could in itself lead to a vicious circle with increased tensions in the financial sector, adding to downside risks in the real economy. Against this background, the ECB will have intensive discussions on what to do.

It is clear what the ECB under the leadership of Mario Draghi would have done. This ECB would very likely have joined the Fed last week, trying to demonstrate its ability and willingness to act. Another 'whatever it takes'. The ECB under the leadership of Christine Lagarde, however, up to now has looked less sensitive to financial market developments than it did under her predecessor Mario Draghi. In fact, there had even been a growing awareness of the adverse effects of the ECB's unconventional measures, lowering the likelihood of, or at least the willingness for, additional monetary policy easing. The ECB under Christine Lagarde seemed to prefer the old 'wait-and-see' approach. Also, financial markets play a less important role in the transmission mechanisms of monetary policy in the Eurozone than in the US. This explains why the ECB opted against a coordinated move with the Fed last week. The short official communique on the ECB's website, signalling the ECB willingness for 'targeted' action, illustrates the ECB's preferred next steps. Howewever, this week's market turmoil as well as leaked comments from Lagarde at Tuesday's video conference call of European government leaders shows that the ECB is having second thoughts. A 'whatever it takes' Lagarde-style could be in the offing.

What to do at today's meeting?

Since the start of the week, the ECB has a new problem. It is no longer not only fighting the negative impact from Covid-19 on the eurozone economy, it also has to prevent a negative feedback loop from recent financial market turmoil.

As regards the economic impact from Covid-19, the ECB's dilemma is not only that it has basically run out of ammunition but also the fact that there is very little the ECB can actually do to cushion the economic impact from the unprecedented mix of supply-side and demand-side shock. Even cheaper money alone will not do the trick. The task to tackle the current shock is mainly for fiscal policy, state guarantees, bridging loans, (temporary) tax relief, subsidised short-work schemes or even tax forbearance would be more effective than additional monetary easing. The only effective measures the ECB could take would be credit-enhancing measures, eg, like more purchases of corporate bonds, (temporary) changes to the collateral rules, targeted liquidity injections to support extensions of bank loans to companies with financial problems due to Covid-19 or a general liquidity injection.

As regards the negative feedback loop from recent market turmoil, however, the ECB's most powerful instrument is QE. This is the language financial markets understand. Stepping up the monthly QE purchases could be a targeted measure to stabilise financial markets.

All in all, the "why should we do anything" has become a "why shouldn't we do anything". Doing nothing no longer looks like a real option for the ECB. However, the very short-lived positive reaction after the Fed's rate cut last week will be a warning to many ECB officials to take it slow and easy. As a result, we expect to see Philip Lane's handwriting in Thursday's decision, as at the September meeting. Back then, the ECB opted for a combination of several smaller measures, following the motto 'small can also be beautiful'. For this meeting, we expect a 'targeted' approach, with a new TLTRO aimed at SME lending, a (temporary) shift or even increase of the QE purchases towards the CSPP and possibly some easing of the collateral rules. All of this could be garnered with a cut of the deposit rate by 10bp and some tweaks to the tiering system.

Lagarde's first test case

All in all, it will be a very uncomfortable situation for the ECB this week. It has been clear for a long while that there would be very little the ECB could still do to support the economy in a new crisis situation. This crisis situation has now come faster and earlier than all of us had hoped for. The call for fiscal policy will become even louder. Being unable to make a significant difference, while your institution has built a reputation of being the lender of last resort in almost every situation. A rather challenging first test case for Christine Lagarde as markets are looking for her way to say 'whatever it takes'.

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