

ECB preview: Trying not to get lost in transition

Confidence indicators are still falling but there is some bottoming out in sight. With that in mind, the ECB will have to balance between pre-emptive action, which could be perceived as panic, and a relaxed wait-and-see attitude, which could be perceived as complacency



Source: Andrej Klizan

When the European Central Bank meets for its March policy meeting, the jury on the actual state of the eurozone economy is still out. Since the January meeting, most confidence indicators have continued their downward trend, which started last summer, but recently some tentative signs of a stabilisation have emerged. Whether these are credible green shoots of a bottoming out to be followed by a rebound in the economy, or simply a pause in the continuing deterioration, is simply too early to tell.

The latest ECB staff projection are very likely to show a downward revision of 2019 GDP growth (1.7% in the December projections). However, any revision which does not go lower than the current consensus of 1.4% is simply proof of the ECB's sense of reality and no reason to panic. Any significant downward revisions to the ECB's 2020 and 2021 GDP growth forecasts (1.7% and 1.5% in December) would be a much more alarming signal, particularly as this time around any changes

to the forecasts would be mainly driven by changes in the fundamental assessment of the economy and not by revisions to the technical assumptions. Compared with the December projections, there should be no new impulse from oil prices. The effective exchange rate and bond yields are somewhat lower but not low enough to push growth and inflation forecasts higher. This, in our view, also means that there will be hardly any changes to the ECB's staff projections for inflation (1.6%, 1.7% and 1.8% for the period 2019-2021 in the December projections).

Even though the latest round of ECB staff projections was supposed to provide more clarity and guidance, chances are high that the ECB will not be able to judge whether the current downswing is transitory or more structural. In fact, the only thing that is for sure right now is that the transitory period is lasting longer than the ECB had anticipated. For the rest, the eurozone still wobbles between decent domestic demand and increased external risks, and it remains unclear, in which direction the pendulum will eventually swing.

The bigger picture of possible next ECB steps

In this situation of increased uncertainties, a normal ECB reaction would be to sound dovish, stay on high-alert and tackle the situation with words not action. However, recent comments by several ECB officials have given rise to speculation about changes in the forward guidance on interest rates and the announcement of new Targeted Longer-Term Refinancing Operations (TLTRO). In our view, the discussion on these issues is ongoing but will not be concluded today. In more broader terms, what are these issues all about?

- The “funding for lending” scheme, TLTRO-2, has provided some €700 billion into the banking system. The first tranche of this TLTRO-2 will expire in June 2020 but due to regulatory requirements, a liquidity bottleneck will occur in June this year. In order to avoid any market disruptions, there is a need to present an exit plan for banks. This does not necessarily have to be another TLTRO at negative interest rates but a way should at least be found to allow banks to roll over their net exposures.
- When discussing new TLTROs, the important question is what the goal of another TLTRO should be. Is it to help banks? Is it to lower lending costs? Is there a supply or demand issue for lending? The ECB often refers to a functioning of the transmission mechanism of monetary policy, meaning that interest rates across the eurozone should be the same and not distorted by regional (banking) problems. However, there is no guarantee that new TLTROs would lower bank lending rates. Maybe they simply increase margins.
- More generally speaking, the ECB will eventually have to find tools in order to avoid an unwarranted tightening of monetary policy. As regards liquidity and bank lending rates, there are also other possible options like a deposit rate hike, LTROs at flexible rates, higher volumes on the interest rate free current account facility, new facilities for banks to park excess liquidity or a combination of two or more of these options. The big challenge for the ECB will be to balance the pros and cons of different options. For example, while another TLTRO would bring more relief to Spanish and Italian banks, a deposit rate hike would probably be welcomed by banks in core eurozone countries.
- In theory, forward guidance on rates is an easier instrument to adjust. With increased economic uncertainty, changing forward guidance to “interest rates to remain at their current levels at least until the end of the year” would be a no-brainer. However, this won't necessarily happen at today's meeting but rather at some point in the future. Also, a change in forward guidance could be used to sell a deposit rate hike as a pure technical correction by postponing a first policy rate hike for beyond the timing of a deposit rate hike.

Finally, more clarity on the length of the reinvestments, i.e. an extension, could also be applied as a dovish instrument but more so in a situation of unwarranted increases at the long end of the yield curve.

Main goal: avoiding unwarranted tightening

The discussion at the ECB has only just started. The economic situation and the inflation outlook are still too uncertain to decide on either new stimulus, an extension of the current stance just to avoid unwarranted tightening or even some further normalisation. Consequently, the ECB will keep most of its cards close to its chest. However, at the current juncture, a traditional wait-and-see stance runs the risk of unintentional tightening of monetary conditions. Therefore, the ECB will have to carefully balance between too hasty action, which could be perceived as panic, and too much complacency. Everything the ECB does in the coming weeks and months will be aimed at avoiding unwarranted tightening, rather than shifting towards new easing of monetary policy.

As a result, we expect the ECB to announce that the Governing Council asked the relevant committees to look into options on how to deal with liquidity bottlenecks and bank profitability. The April meeting will then be the meeting where the real ECB action is. This, however, does not mean that today's meeting will be dull. Just getting a glimpse of an interesting and probably controversial discussion behind closed doors can be thrilling.

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