ECB preview: Worries of an ageing superhero

The final showdown between Mario Draghi and the hawks should end with monetary fireworks

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The script has been written so many times in all kinds of versions: the ageing or retired superhero, sports hero or music hero is facing apparently insurmountable challenges, has been written off, sent into retirement or sidelined by competitors. Then comes this final challenge. The final showdown in which the ageing hero is triumphant and shows how he still has the magic touch.

But before, I get lost in this fantasy, to a certain extent, this is probably going to be the script for the next ECB meeting this Thursday. The (almost) final showdown, with all eyes on Super Mario (Draghi), the key question will be whether he's able to pull yet another monetary firework against increasing opposition within the ECB.

Downward revisions to new staff projections

The macroeconomic situation since the July meeting has definitely not improved. Instead, despite the latest stabilisation of some confidence indicators, there are tentative signs that the industry slowdown and external problems have reached the domestic part of the economy. Even if the eurozone is not at the brink of a severe recession, a period of stagnation will do very little to lift inflation back to where the ECB would like to see it.

Also, lower oil prices and the stronger effective exchange rate of the euro at the cut-off date of the latest projections are likely to weaken the ECB's inflation outlook. Back in June, ECB staff projected GDP growth to come in at 1.2% in 2019 and 1.4% in both 2020 and 2021. Inflation was expected to accelerate from 1.3% in 2019 to 1.6% in 2021. We expect downward revisions.

Case for ECB action is strong

With further downward revisions to growth and inflation and particularly a widening gap between inflation forecasts and the ECB's target, the case for new ECB action is strong. Admittedly, there are increasing doubts that additional monetary easing will be a game-changer for the economic outlook. The latest slogan used by ECB officials and last week by Christine Lagarde is "monetary policy is not the only game in town". Another hint that the ECB would like to see governments and fiscal policy stepping in.

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And indeed, with interest rates across the entire board close to record lows, financing conditions never been more favourable and adverse effects stemming from unconventional measures, one might wonder what difference another round of monetary stimulus would make. However, to paraphrase Jean-Claude Trichet, the ECB only has one needle in its compass and that needle is price stability. With no signs of inflation picking up any time soon, doing nothing is not an option.

How much and what will the ECB do?

There seems to be a broad agreement at the ECB to do something this week. However, the latest comments by several hawks suggest that there still is a heated debate on which policy measures the ECB should implement. The traditional hawks like Jens Weidmann from Germany, Klaas Knot from Netherlands and Sabine Lauthenschläger on the ECB's Executive Board voiced their opposition at least against a restart of QE. Lauthenschläger, for example, stressed that QE should be the ultima ratio in case of a deflation risk. While these are the usual suspects, similar comments by traditionally less hawkish ECB members like Francois Villeroy de Galhau of France and Mads Müller from Estonia created somewhat more uncertainty amongst market participants as the group of hawks seems to grow. However, Villeroy de Galhau and Müller do not hold voting rights at this week's meeting.

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In our view, even if the group of QE-skeptical hawks has grown, it still looks like a vocal minority. With inflation expectations probably deviating further from the ECB's target, there will in our view be a vast majority in favour of new action. And despite the hawks opposition, it is doubtful that only a rate cut will be sufficient. In this regards and to better understand how many at the ECB are currently thinking, a speech by ECB Chief Economist Philip Lane from last week provides interesting insights.

According to estimates Lane presented, the ECB's unconventional measures since 2014 had lifted both growth and inflation some 0.5 percentage points higher. Interestingly, almost half of the impact came from QE. Don't forget that when the ECB started QE in 2015, the staff projections predicted an acceleration of inflation from 0.5% in 2014 to 1.3% in 2016. Currently, the risk of dropping from an environment of de facto economic stagnation and low inflation into deflation is probably as high as in 2014/5.

Therefore, we continue to see the ECB starting a final monetary firework at this week's meeting: a 20bp rate cut of the deposit rate, a small tiering system, a repricing of the TLTROs and a restart of QE with some 30 billion euro per month. Even though there is the risk that the hawks' opposition could lead to a delay of QE.

Draghi's last stunt

It will not be an easy meeting for Mario Draghi. Opposition inside and outside the ECB against more monetary stimulus has probably never been stronger or at least more vocal than now. Nevertheless, if the ECB is really serious about closing the gap between inflation expectations and its own target, anything else but a big package can be the outcome of Thursday's meeting.

The costs of waiting or only delivering parts of a big package and then trying to get ahead of the curve at a later stage will be higher - an experience eurozone policymakers have had quite a few times during the last ten years. This might be his last stunt but we expect Mario Draghi to conquer the barricades once again and put on his Super Mario costume one last time on Thursday.

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