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How long can the ECB talk the talk without walking the walk?

Minutes of the June meeting stress the European Central Bank's determination to deliver more

ECB President Mario Draghi delivers a speech at the European Parliament in Strasbourg back in January

The just released-minutes of the June meeting demonstrate the ECB 's willingness to prop up inflation expectations. Interestingly, the June decisions were not unanimous, as illustrated by the phrase that "there was broad agreement, that, in the light of the heightened uncertainty, which was likely to extend further into the future, the Governing Council needed to be ready and prepared to ease the monetary policy stance further by adjusting all of its instrument." Also, there were some disagreements on the different adjustments of forward guidance and the TLTRO (targeted longer-term refinancing operations) pricing at the June meeting.

The tone of the minutes reflects the ECB's concerns about the growth and inflation outlook

In general, the tone of the minutes both reflects the ECB's concerns about the growth and inflation outlook as well as its determination to do more. The latter is clearly shown by the sentence that "should the environment of too low inflation continue to prevail, considerations of a more strategic nature might be warranted in order to reinforce the credibility of the ECB's monetary policy and support the achievement of a sustained adjustment in inflation to its inflation aim." In this regards, there were some subtle hints at a more symmetric inflation target, allowing for overshooting of inflation expectations and projections in the future. A discussion, which in our view might gain momentum under the new president, Christine Lagarde.

Getting closer to imminent ECB action

For the ECB, at least until Mario Draghi's term ends in October, there are two main factors driving its action: the price stability mandate and showing determination to act. In the eyes of the ECB, there is hardly anything worse than a central bank admitting it has run out of ammunition. Consequently, as long as inflation expectations and the ECB's own inflation projections for the next years remain clearly below 2%, the ECB will fire on all cylinders. No matter whether additional stimulus still reaches the real economy or not.

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Looking ahead, Mario Draghi's Sintra speech has made clear that the question regarding the short-term outlook for the ECB is no longer "what negative surprise is needed for the ECB to cut rates" but rather "what positive surprise could actually prevent the ECB from cutting rates". This is how we read Draghi's comments that, absent economic improvements, more stimulus will be needed. Predicting the exact timing is somewhat more complicated though. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of Q2 GDP in mid-August and the next ECB staff projections and then take a decision only at the September meeting. Draghi's track record in overdelivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting.

Economic data out of the Eurozone as well as the Fed's de facto announcement of a July rate cut have clearly pushed the ECB closer towards July action, rather than waiting until September. After some tentative signs of stabilisation at the end of the first quarter, the Eurozone economy seems to have slipped down once again. What is also worrying is the fact that there are the first signs of the solid domestic part of the economy faltering as well. Here, German data is worrisome in particular, with an increase in short-time work schemes, fading momentum in the labour market and dropping retail sales.

What's on the ECB's menu card for the summer?

The realistic options for the ECB in the coming months are the following:

- **Cut the deposit rate.** Markets have currently priced in a cut by 10bp at the September meeting. However, the risk is increasing that the ECB follows the saying that a bird cannot fly on one wing and cuts the deposit rate by 20bp. A rate cut would very likely be combined with a tiering system for banks and would in our view mainly weaken the euro exchange rate, rather than increasing bank lending.

- **Extend forward guidance.** A very popular tool within the Governing Council up to now, as it comes for "free". Forward guidance has been extended already to mid-2020 but could be extended further and could also be broadened to interest rates will "remain at their present or lower levels…". However, in our view, forward guidance is only a powerful tool when markets start speculating about possible rate hikes, not when interest rates are low and markets are expecting cuts.
- **Restart QE.** To send a powerful message and to show its determination to do "whatever it takes" to bring growth and inflation to higher levels, the ECB would have to start QE again. As discussed before, technical limitations to sovereign bond purchases would push the ECB towards more buying of corporate bonds, potentially even bank bonds, and somewhat more supranationals (EIB, ESM etc). The monetary policy aim of this would be to further bypass the banking transmission channel and provide cheaper market funding for corporates.
- **Buying equity.** Not an option for the time being.

While in the past, we often believed that the ECB would prefer to deliver new stimulus in small steps and in sequences, this view has changed. In Philip Lane's first encompassing speech on monetary policy as ECB chief economist, he clearly pointed to a packaged set of measures rather than a sequencing of smaller individual measures. This means that instead of smaller steps, the ECB seems to shift towards bolder package action.

What does this mean for the July meeting?

In our view, latest disappointing macro data, tentative signs that the resilience of the domestic economy is faltering, a potential rate cut by the Fed and continued dovish communication from ECB officials since Sintra have all pushed the ECB closer to action at the July meeting in two weeks from now. In fact, the ECB and Mario Draghi have let the genie of more action out of the bottle and it will be hard to get it back in.

The ECB can hardly continue talking the talk without walking the walk. The only question is whether words alone, as dovish as they might be, will be enough at the July meeting. We think the only option to once again only talk the talk would be a change in forward guidance, including "or lower", and thereby opening the door for rate cuts. Then, September could see a bigger package than initially anticipated, possibly consisting of a 20bp cut in the deposit rate and a restart of QE. With an increasing risk that this package will already be delivered in two weeks from now. Whether it is July or September, Mario Draghi will definitely leave office with a bang.

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