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ECB preview: One final talk before walking the walk

It's a very close call but we expect the European Central Bank to change its forward guidance next week and effectively pre-announce a package of new measures at the September meeting



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

A dovish press conference after the June meeting, an even more dovish speech by Mario Draghi in Sintra and very little evidence that the economic outlook is about to improve any time soon.

Against this backdrop it will be very hard for the European Central Bank to send a sufficiently dovish message without actually delivering at next week's meeting. In our view, the discussion within the ECB's Governing Council will be an exciting and heated one.

Dovish, more dovish, most dovish or simply action?

In fact, 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.

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 once again. What is also worrying is that there are signs the solid domestic part of the economy may be faltering as well. In particular, German data is worrisome with an increase in short-term work schemes, fading momentum in the labour market and falling retail sales.

Consequently, for next week's meeting, the main question is whether the ECB can afford to wait six more weeks before delivering new monetary stimulus or whether it should surprise financial markets by frontloading new measures. In fact, traditional ECB watching argues in favour of compiling more data, waiting for the release of 2Q GDP in mid-August and the next ECB staff projections and only then taking a decision at the September meeting. Draghi's track record of over-delivering and trying to be ahead of the curve, however, could bring new ECB action at the ECB's July meeting. It's a very close call, which will only be decided during the meeting next week.

What we expect the ECB to do next week

To keep a somewhat friendly balance between the doves and hawks, a typical European way out would be to step up the dovishness once again. And to be frank, it will be the very last time the ECB can talk the talk without walking the walk. In this regard, the only way out is to change the forward guidance to say that interest rates will "remain at their present or lower levels...". A pre-announcement of a rate cut in September and a clear hint that the bank is once again considering quantitative easing.

This approach would allow the ECB to collect more data and, in case macro data continues to disappoint, cut the deposit rate by 20 basis points in September, introduce a tiering system for the deposit facility and (possibly) even restart QE.

While in the past, we often believed that the ECB preferred 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 package of measures rather than a sequencing of smaller individual steps. This means that instead of incremental moves, the ECB appears to be shifting towards bolder, bundled action.

If we are wrong and the ECB wants to frontload new monetary stimulus, next week's meeting could bring rate cuts and a clear indication that QE could restart in September.

One final talk before walking the walk

In our view, the 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 to the point of no return. In fact, the ECB and Mario Draghi have taken the genie of more monetary action out of the bottle and it will be hard to get it back in. The only question is whether words alone, as dovish as they might be, will be enough. It seems as if the ECB will try to talk a very final talk before walking the walk in September. However, the risk to this call remains that Mario Draghi will try to surprise financial markets. It would not be the first time.

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