ECB: Under pressure

With the economy facing new uncertainties and markets speculating about additional easing measures, the European Central Bank will be under pressure at this week's meeting

Source: Andrej Klizan

When the ECB meets in Vilnius this week, it will not only be the first meeting with Philip Lane on the Executive Board and Peter Praet in ECB retirement but also a meeting in which the ECB is facing new easing speculation by financial markets. The latest drop in (market-based) inflation expectations, combined with somewhat higher uncertainties surrounding the growth outlook after the latest round of trade conflict, has triggered speculation about another rate cut. In our view, this speculation is premature. However, we expect the ECB to convey a slightly more dovish tone, probably with an announcement of favourable TLTRO-3 terms.

During the meeting and the press conference, the following topics and discussions should garner the most attention:

1 Macro assessment and new projections

It's time again for a fresh round of ECB staff projections. It will be interesting to see how the ECB balances the better-than-expected first quarter with still fairly weak confidence indicators. The projections are the first of any official institution after the release of first quarter GDP data. Up to now, all downbeat projections for the eurozone were mainly driven by a weak first quarter and a gradual rebound throughout the year. The former, at least, is outdated. At the same time, confidence indicators are struggling to rebound significantly and the latest escalation of the trade conflict, as well as more negative macro news from China, suggest that it could take until the third quarter for any rebound to take place. As a consequence, we do not expect major changes to the ECB projections. Rather, we will carefully listen to what ECB President Mario Draghi has to say about the growth profile. Overall, for the time being, it seems as if the ECB's base case scenario remains one of a soft patch, with the manufacturing sector suffering while services and domestic demand stabilise the economy.

2 Inflation outlook

As regards inflation, the ECB will probably restate its "delayed, rather than derailed" take on headline inflation converging to the ECB's target. This story, however, will get increasingly difficult to tell if the economy slows. In fact, if not for oil prices and some temporary factors, inflation would have hardly moved to the upside. Here, the underlying profile will say more about the ECB's take on inflation than marginal changes to the annual projections. Another interesting aspect is the sharp deterioration of market-based inflation expectations, with 5Y5Y and 2Y2Y inflation swaps currently trading close to all-time lows. In the past, the announcements of new ECB stimulus often coincided with sharp drops in market-based inflation expectations. However, history might not always give the best guidance for the future.

3 Details of TLTRO-3

In March, the ECB announced a new round of Targeted Longer-Term Refinancing Operations (TLTROs), starting in September this year. Since then, no details about the pricing have been released. Draghi's comments during the April press conference, as well as the minutes, were not entirely clear on whether the ECB would announce any details at this week's meeting or wait until the summer. In any case, the modalities will depend on bank transmission and the economic outlook. Don't forget that credit growth is already elevated in some core eurozone countries, while it is subdued in the periphery. As revealed by the minutes of the April meeting, there is still an ongoing discussion at the ECB on whether the new TLTROs should serve as a backstop or as a potential tool for adjusting the monetary policy stance. In our view, market speculation and new uncertainties surrounding the growth outlook could force the ECB to announce some details of the new TLTRO this week. The most likely outcome is another kind of built-in incentive, probably as a spread on the main refinancing operation (MRO). The option of a spread gives the ECB more flexibility as it could use a negative spread at the beginning and then gradually move towards a positive spread if growth and inflation were really to accelerate.

4 The tiering debate

The hot topic some months ago, the discussion on a possible tiering of the deposit rate seems to have moved to the backseat. Now, even Governing Council members who initially advocated some measures to compensate banks for the adverse effect from negative deposit rates have changed their (public) views. Also, the April Bank Lending Survey showed a positive impact on lending volumes from the negative interest rate policy. Therefore, we expect Draghi to repeat the earlier phrase introduced by Peter Praet that there has to be a "strong monetary policy case" for the ECB to introduce a tiering system. In our view, the ECB will only go there if it really considers further rate cuts.

Under pressure

The ECB has turned off cruise control and is back to good old data-dependence. Knowing that actually there is not a lot it can do to really kick-start growth if needed, the ECB will stick to its current easing bias, adding a dovish comment here and an easing element there. New pressure from financial markets has increased the probability that the ECB will reveal (some) details of the new TLTROs this week. Under pressure or not, the ECB will do everything it can to keep the "whatever it takes" spirit alive.

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