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ECB: GETTING READY TO EASE AND REVIEW STRATEGY

Berenberg Macro Flash

Since ECB President Mario Draghi lowered the bar for further monetary stimulus with his speech at Sintra on 18 June we expect the ECB to cut its deposit rate and announce a new asset purchase programme at its 12 September meeting. Following the release of the account of the 6 June ECB meeting, speeches by Governing Council members, economic data and the nomination of Christine Lagarde to become the next ECB President we reiterate that call.

"Adverse contingencies" at June meeting: Back in June, the ECB pushed out its guidance to keep rates at present levels to the first half of 2020 and clarified the pricing terms on the new round of TLTROs. The ECB also stressed it had started to plan for "adverse contingencies". According to the minutes, "there was broad agreement that, in the light of the heightened uncertainty, which was likely to extend into the future, the Governing Council needed to be ready and prepared to ease the monetary policy stance further by adjusting all of its instruments".

"Absence of improvement" at Sintra: A few days after the June Governing Council meeting, in his speech at the ECB Sintra forum, Draghi went further and pointed to additional ECB stimulus in the "absence of improvement". While industrial production held up in May in Germany and Italy, with a strong showing from France, the Eurozone manufacturing sector will still likely be a drag onto GDP in Q2 after the very weak start in April. We, therefore, stick to our own growth forecasts of 0.1%, 0.2% and 0.4% qoq in Q2, Q3 and Q4. Our calls are below the ECB's projections of 0.2%, 0.3% and 0.4%, respectively. Eurostat publishes industrial production data for May tomorrow. Amid the current slowdown in demand growth, underlying price pressures are hardly going to surprise on the upside later this year.

Guidance change in July, policy package in September: In response to the weak growth and still subdued inflation, the ECB will likely adjust its guidance in July and vow to keep rates at "present or lower" rather than just at "present" levels. In September, the ECB could decide to cut its deposit rate from -0.4% to -0.5% and to re-launch net asset purchases of around €40bn for 12 months starting in Q4. Both moves would probably require the ECB to take two additional measures: 1) In the case of a further deposit rate cut, the ECB would likely introduce a tiering system for bank reserves to ease the pain for banks. 2) To give itself some headroom for government bond purchases, the ECB would probably lift its self-imposed 33% issuer/issuance limit to 50%.

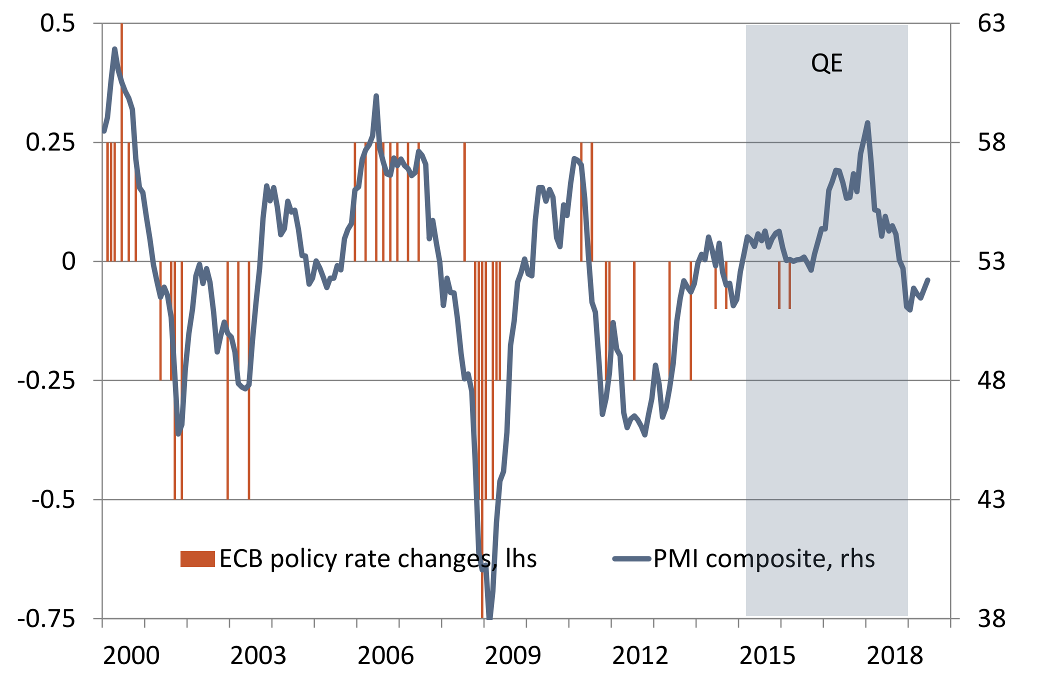
Risk for more in July: Of course, the ECB could decide on more than just a forward guidance change already at its meeting later this month, including a bigger than 10bp cut and more than just €40bn in net asset purchases (see Charts 1 and 2). Inflation expectations dropping visibly in the next Survey of Professional Forecasters due in late July could be such a trigger, or a very poor showing of both the Eurozone PMIs and German Ifo for July, published on the 24 July and 25 July, respectively.

Four reasons why ECB will wait for September: 1) Traditionally and judging by recent speeches including by Chief Economist Philipp Lane, the ECB looks likely to come out with a comprehensive policy package in one go, rather than in a number of steps. 2) We do not think the economic data warrants a comprehensive policy package immediately. Data has not surprised on the upside, but also not much on the downside. Trade tensions have not escalated further. 3) The ECB usually takes big policy decisions on the basis of updated forecasts – the next are due in September. 4) Christine Lagarde's nomination for the ECB presidency somewhat lowers the need and urgency for Mario Draghi to push ahead with the contingency planning and stimulus implementation. On the basis of previous comments by Lagarde, markets have priced in that, in terms of QE and other unconventional tools of monetary policy, continuity will prevail at the ECB. We share this view.

Will it work? It is unclear how much bang for the buck a further rate cut into the negative territory will give the ECB. US experience with re-launching asset purchases has been mixed. But in the absence of a big fiscal stimulus and amid very low core inflation, an ECB led by Draghi – and to be taken over by Christine Lagarde in November – probably believes it is worth trying. The minutes of the 6 June Governing Council meeting also note 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". Reading between the lines, the ECB opens the door to more creativity in the choice of its instruments to hit its inflation target. The discussion will only intensify with the arrival of Lagarde.

German Constitutional Court hearing adds some QE uncertainty: A new hearing by the German Constitutional Court on the legality of the ECB's asset purchases on 30-31 July has made the news recently. After the European Court of Justice (ECJ) summarily dismissed the case against asset purchases, the German Constitutional Court will unlikely deviate much from that. After all, the German Court had asked the ECJ for its view on the issue. On the Outright Monetary Transactions (OMT) programme, the German Court had accepted the ECJ's ruling in 2015. This time, the German judges will probably allow net asset purchases to proceed under somewhat narrowly defined circumstances without ruling asset purchases undertaken so far as illegal under German law. A potentially quite relevant issue could be whether the German Constitutional Court opposes a future softening of the ECB's issuer limit. That could seriously constrain the ECB's room to act in the future, forcing the ECB either to stick to its current 33% self-imposed limit or to embark on a course which one key member country officially regards as illegal under its national constitution.

Chart 1: Still in easing territory



Ppt change in refi rate until 2014, in deposit rate from 2015. For PMI composite, a value above/below 50 signals expansion/contraction. Source: ECB, Markit, Berenberg

Chart 2: Bond purchases – potential firepower for ECB if it raised issuer limit to 50%

duration (in months)	monthly purchases (in bn euros) 15	25	35	45	55	65	75
12	180	300	420	540	660	780	900
18	270	450	630	810	990	1170	1350
24	360	600	840	1080	1320	1560	1800
30	450	750	1050	1350	1650	1950	2250
36	540	900	1260	1620	1980	2340	2700
42	630	1050	1470	1890	2310	2730	3150
48	720	1200	1680	2160	2640	3120	3600

Raising the issuer limit from 33% to 50% would open up c€1.1trn euros of government bonds for a new ECB purchase programme. Green (red) shaded combinations are (not) possible in that case. Numbers show total amount of a new purchase programme in €bn. Sources: Bloomberg, ECB, Berenberg

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