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ECB: COMING AS CLOSE TO ACTION AS IT GETS

Berenberg Macro Flash

Ready for a policy package? Following the Governing Council's meeting today the ECB left no room for guesses about what comes next. It decided to task ECB staff to examine "ways to reinforce its forward guidance on policy rates, mitigating measures, such as the design of a tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases". In his press conference after the meeting, ECB President Mario Draghi pointed to the economic outlook "getting worse and worse" and that regarding inflation the ECB did "not like what we are seeing". But, according to Draghi, the Governing Council did not discuss to take policy decisions today. The ECB probably felt more comfortable waiting for updated forecasts which are due at the next meeting in 6 weeks time. We continue to look for a big policy package on 12 September including a deposit rate cut and a re-launch of net asset purchases (QE).

Worried about below target inflation: More prominently than before, the ECB stressed that it was committed to the "symmetry in the inflation aim". The ECB's inflation target is 'below, but close to 2%', which differs slightly from other major central banks including the Fed and BoE. By emphasising the 'symmetry' around the target Draghi signalled – of course, not for the first time – that the ECB would tolerate above target inflation for a while. Forward guidance can be a powerful tool for central banks but whether Draghi has the powers to talk inflation up decidedly remains to be seen. What comes in September in terms of the policy measures will matter far more for that. In addition, the ECB vowed to keep rates at "present or lower" rather than just at "present levels". This was largely expected. The market implied probability for a rate cut in September of at least 10bp before the meeting was 80%.

We expect the ECB to come up with a package along the following lines:

- **Rate cuts:** A 10bp cut in the deposit rate looks most likely. That the ECB mentioned a tiered system for reserves to ease the pain for banks in the press release makes such a measure almost a done deal in case of a rate cut. On the basis of end of June data, Eurozone banks were charged a penalty of €7bn. If 10 times the amount of minimum reserves were excluded from the ECB's penalty rate, the cost would drop to c€2.5bn. If the deposit rate was cut to -0.5%, the cost would rise to c€9bn and the same tiering system as in the example of a -0.4% rate would lower the cost to c€3bn.
- **Asset purchases:** After Draghi hinted to adjustments to the ECB's self-imposed limits in his speech at Sintra, a new asset purchase programme will likely be tilted towards government bonds again. If the ECB were to lift the 33% issuer limit to 50%, the ECB could purchase up to c€1.1trn before it would face a shortage of German paper. In our view, the ECB could start with buying €35bn in government bonds for 12 months. Adding €5bn in corporate bonds, total monthly purchases could amount to €40bn. Draghi did not shed more light on whether (unsecured) bank bonds or ETFs would be added to the portfolio of eligible bonds. For the time being, we think their inclusion in a purchase programme is unlikely.

- **Forward guidance:** Of course, the ECB could easily extend the time-contingent leg of its forward guidance from "through the first half of 2020". If the ECB strengthened its state-contingent leg by announcing that rates would remain at present or lower levels and asset purchases would run until core inflation hits, say, 1.5% yoy for a number of months, the impact would probably be stronger. That looks rather improbable, though.

Draghi stressed that monetary stimulus would be more effective if **fiscal policy** came to the rescue, too. Especially, if the outlook was to worsen, fiscal policy would become "of the essence" as its results were more effective, quicker to materialise and would come with less side effects.

On his nominated successor **Christine Lagarde**, Draghi said she would be an "outstanding" ECB president. Just before the ECB press conference Lagarde took the next hurdle on her way to being appointed ECB President. The ECB's opinion Governing Council released its official opinion that it had "no objection" to Lagarde. Now, the European Parliament has to follow with a positive opinion before the European Council can formally appoint Lagarde as Draghi's successor.

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