
ECB: A STITCH IN TIME SAVES NINE

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European markets are positioned for further accommodation at this week's European Central Bank (ECB) meeting on 25 July. In our opinion, macroeconomic data has not changed meaningfully; in fact, it has stabilised. What's changed is that the balance of recent ECB-policymakers' commentary has tilted in favour of further stimulus sooner rather than later. The ECB's dovish change in communication has resonated across bond markets where yields have declined considerably.

Based on the dovish ECB communication, coupled with the accounts of the last ECB meeting, our view is that the first phase of the ECB's policy easing is tilted towards interest rate cuts rather than Quantitative Easing (QE). At this week's meeting on Thursday, we expect the ECB to change its forward guidance, reduce the deposit rate by 10 basis points (bps) and introduce a tiered rate system to mitigate the adverse effects of negative interest rates on banks. The ECB could also outline the details of a new QE programme that would be launched in September should there be a further deterioration in economic data.

ECB communication in favour of earlier action

ECB President Mario Draghi led the direction of communication at his recent speech in Sintra, Portugal, by stating that additional stimulus would be required in the absence of improvement in economic data. Recent comments by ECB officials Philip Lane and Benoit Coeure have added impetus to expectation of monetary policy easing sooner rather than later. In a speech at the Bank of Finland Conference, Philip Lane—who joined the Executive Board as chief economist in June—commented that below-target inflation outcomes implied that the ECB needed to prove its commitment to price stability by taking relatively earlier action than if inflation outcomes had been closer to target. Benoit Coeure in an interview to BFM business on 9 July said that monetary policy needs to be accommodative “more than ever” adding that the central bank could cut interest rates and restart net asset purchases.

Accounts of the ECB meeting in favour of stimulus

The accounts of the ECB meeting in June revealed that the ECB are seriously considering easing. Given the heightened uncertainty over the Eurozone economy and ongoing risks, the governing council stands ready and prepared to unleash new stimulus measures. The accounts highlighted that the ECB's toolkit could come in the form of further extending and strengthening the governing council's forward guidance, resuming net asset purchases and easing policy rates. More importantly, the council members remain open to introducing a tiered rate system in the future.

While the ECB's negative interest rate policy has supported loan growth, the accounts noted that this assessment might not hold for lower policy rates or for horizons longer

than those envisaged in the governing council's forward guidance. Interestingly, not all council members believed the ECB's strategy needed to be revised. However, the minutes did raise the possibility of considerations of a more strategic nature to reinforce the credibility of the ECB's monetary policy should the environment of too low inflation continue to prevail. At the same time, the point was reinforced that care needed to be taken to ensure any considerations of a strategic nature would not interfere with the ECB's main inflation targeting goal.

QE delayed unless data deteriorates further

Unless we see a further collapse in economic activity by September, the governing council is unlikely to launch a new QE programme. Under the current rules, the ECB's renewed QE programme is likely to be limited to €30Bn over the next 12-18 months and would avoid changing the parameters of the programme. If the QE programme is scaled up to a larger amount for a longer duration, the ECB would face a potential shortage of assets to purchase, in other words German bunds. It would raise the need to potentially consider altering the issuer limits and/or move into alternative asset classes such as bank loans or even consider equities. Mario Draghi has already indicated that the ceiling for issuer limits could be raised from the current 33% to 50%.

However, the final decision of the German Federal Constitutional Court regarding raising the issuer limit of German government bonds in the QE programme is still outstanding and expected later this year. Given the resistance of the council members towards QE and the need to avoid legal battles, we expect the ECB to pivot to rate cuts complemented with a tiered interest rate system at this week's meeting in lieu of re-launching QE.

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