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ECB: committed to ease in September, but how much?

■ The Governing Council has tasked Eurosystem committees to examine its monetary policy options ■ Given the insistence on its determination to act, Thursday's meeting outcome was basically a pre-announcement of easing in September ■ Being aware of the importance of maintaining the ECB's inflation targeting credibility, Mario Draghi was very explicit in expressing his dissatisfaction with current inflation and its outlook, adding that a highly accomodative monetary policy is here to stay for a long period of time

Yesterday's press conference of ECB president Mario Draghi was rich in messages, but the most important one was the following: the Governing Council is concerned that inflation will continue to fail to sufficiently converge to its target and hence will do whatever is necessary to achieve its objective. Yet, markets were not impressed and Bund yields rose somewhat as Draghi spoke. This is not a surprise: bond yields had been moving down for weeks after his Sintra speech end June, which suggests some expectation for easing had been priced in. The decision to leave policy unchanged on Thursday triggered some profit taking, despite a message which was nothing less than a pre-announcement of monetary easing at the next meeting on 12 September. By then the relevant Eurosystem committees which have been tasked "*with examining options, including ways to reinforce our 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*" will have come up with their recommendations. New ECB staff projections will also be available on that occasion.

Conscious about the importance to maintain credibility as a central bank, Mario Draghi explained, during the Q&A part of the press conference, in great detail to what extent the message from the Governing Council had changed: 1) the introduction of the easing bias through the introduction of the word "lower" in the forward guidance [i] 2) there was the acknowledgement "*that inflation rates, both realised and projected, have been persistently below levels that are in line with our aim*" 3) the insistence on being determined to act, hence tasking committees to examine policy options 4) the insistence on the "*commitment to symmetry in its inflation aim*", which means that getting closer to target would not automatically imply that tightening is imminent.

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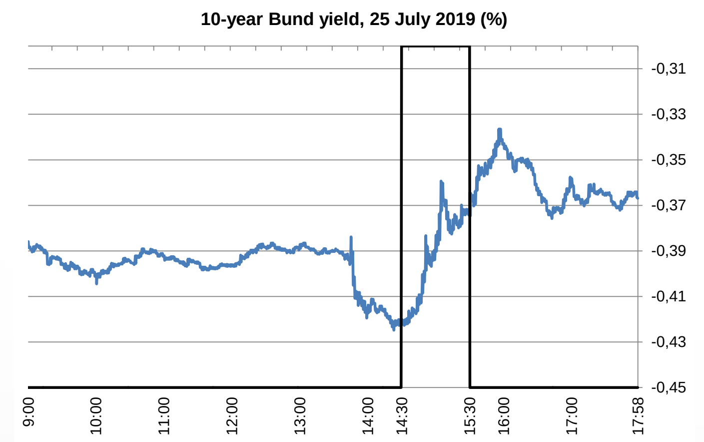
10-YEAR BUND YIELD, INTRADAY*



*Data from 9.00 until 18.00 Paris time. The press conference was between 14.30 and 15.30.
Source: Bloomberg, BNP Paribas

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For the avoidance of doubt, the Introductory Statement says the Governing Council "*therefore stands ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner*". At the moment, the monetary authorities are far from this aim, hence the numerous times Mario Draghi expressed his dissatisfaction about this situation.[ii]

Whether that will change any time soon will of course depend on how the economy develops. Based on the ECB President's comments, one can argue that, on the one hand, the risk of a recession is considered to be low thanks to resilience in the labour market, the services sector and the construction sector. In addition, loans to non-financial corporations are growing at a robust pace and those to households see a gradual improvement. On the other hand, recent data point towards weakness of growth extending into the third quarter and the outlook is worsening further in the manufacturing sector. This may end up weighing on services as well. Moreover, risks remain tilted to the downside. Importantly, the pass-through of wage increases into final prices is taking longer than expected. As a consequence, eurozone core inflation remains stubbornly low, market-based indicators of inflation expectations have declined and the same has happened in the Survey of Professional Forecasters.

The inflation dynamics will also depend on the extent of policy easing and its effectiveness. On the latter, the ECB President sounded a word of caution: together with his colleagues, he believes monetary instruments are effective but there may be decreasing returns. However, this should not "*exempt monetary policy from doing what is necessary or what we believe necessary based on the current information*". Easing on 12 September is a given now. The question is how and how much. We expect a 10 basis points cut in the deposit rate in combination with the introduction of tiered system for reserve remuneration.

William De Vijlder

[i] "(…) we *decided to keep the key ECB interest rates unchanged. We expect them to remain at their present or lower levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to our aim over the medium term*." Source: ECB, Introductory statement to the press conference on 25 July 2019

[ii] During the Q&A, there were six, explicit or implicit, references in this respect: *"we say we don't like the current inflation. So, there is no question about accepting lower inflation as we are seeing today", "we don't like what we see on the inflation front", "We don't accept permanently lower inflation rates", "on the inflation front we don't like what we see", "With the admission – and that's again very important – with the admission that we don't like this.", "1.6% is the inflation rate that we see in 2021 in our projections. That's something about which the Governing Council said today in the introductory statement: we don't like it."* Source: ECB, Transcript of the press conference of Mario Draghi and Luis de Guindos on 25 July 2019