

Research

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Sarcasm aside, we've seen better ECB Presidents than Lagarde

- **I still have no clue.** About whom will succeed Christine Lagarde as President, not about ECB policy in the next twelve months. ECB monetary policy has been quite predictable. And it will stay that way for a while longer even though we must make do with a cacophony of ECB-speak instead of forward guidance – which has long since been ditched – to light the way;
- **For the record, the world infamous World Economic Forum could nominate Lagarde as Chair as soon as next month.** Whether or not she leaves soon after a potential nomination to become the female version of the James Bond villain Blofeld eludes me (for some reason former WEF Chairman Schwab reminds me of Blofeld from the 1960s Bond movies, see the pic below).



- **Regardless, there's nothing unusual about her quitting early.** Barbarians are the gates and the establishment wants to populist-proof the Eurosystem. French President Macron ushered out Banque de France head Villeroy de Galhau before his term was over and replaced him with a safe pair of hands (Moulin).
- **We've seen this movie before.** The prime example is the conservative Greek government nominating its Finance Minister Stournaras as Governor of the Bank of Greece in 2014 after resounding victory of the upstart far left Syriza party in the elections that year. Stournaras ended up being the thorn in the eye of the Syriza government and its quest for debt write-downs. Better said: arch-nemesis. Under Stournaras, the Bank of Greece was complicit in Greece's financial asphyxiation during the Syriza government's debt relief negotiations

with the Eurogroup, the informal body of Euro Area Finance Ministers (though it was Berlin calling the shots).

- **The establishment, if that's what I may call French President Macron, isn't waiting around to find out what happens after the French Presidential elections in the spring of 2027.** Macron seems pretty damn sure that National Rally leader Marine Le Pen will succeed him. And ECB President Lagarde must have seen the writing on the wall too. And while Le Pen has discarded her euro-exit plans, we know too damn well where her loyalties lie.
- **Don't count out the Germans when it comes to the populist upheaval.** In the polls, the euro/EU unfriendly far right AfD party is leaving all other parties in the dust. Contrary to what my German friends tell me, I believe that the next Chancellor will hail from the AfD. From a 'milder' AfD, mind you. There are no longer overt euro exit plans (the AfD ditched them quiet recently). Regardless, federal elections seem ages away – in 2029. But that's assuming the weak and ineffectual Merz government manages to limp on to the finish line two and a half years from now. At this rate, the 'grand coalition' of CDU/CSU and SPD will have been obliterated in the polls by 2029.
- **In the echo chamber of journalists covering the ECB and ECB-watchers, two names keep popping up as potential successors of Lagarde.** Former Dutch central bank head Klaas Knot and former Bank of Spain boss Pablo Hernandez de Cos. In my decade of ECB-watching I've become intimately acquainted with their public personas, having even spoken with Knot in person a couple of times. I don't think either gent is a Draghi-type: someone who bends an institution to his will. Or forces the market to dance to his tune instead of the other way around.
- **While certainly not the most talkative Governing Council member, Knot was something of a talker, generating plenty of Bloomberg and Reuters headlines.** Earlier in his career, Knot was very hawkish and Weidmann-lite (former Bundesbank President Weidmann was an unrepentant hawk, even voting against Draghi's bond-buying program that ended the Eurozone crisis). As the years passed, he moved closer to the center, realizing that he had to shed his hawkish feathers as a prerequisite for the top job.
- **De Cos, on the other hand, was the silent Harpo Marx type.** In the cacophony of ECB-speak, his name came up very little. From what I gather, he was a centrist with some dovish leanings. To be sure, I never had the feeling De Cos influenced the (public) debate on monetary policy. Though I must add that I didn't rate Knot highly either. I took my cue from other ECB-speakers.
- **As a communicator, Knot should do well.** I can't say the same thing about De Cos for the simple reason that I haven't seen the guy give a speech or talk to journos. Still, both should do well – relatively speaking. Quite frankly, improving over Lagarde's waffling is a low bar to pass. This is not the Great Helmswoman leaving the ship. And unlike Lagarde, I don't think either of them will need verbal clarifications from other ECB Board Members at the beginning of the term. In 2020, the ECB chief economist was forced to throw Lagarde a life vest when she had talked herself into trouble on regular occasion.
- **To conclude: is it going to be Knot or De Cos or a dark horse candidate?** I don't know. Unlike the US, where the President simply picks a Chair and the Senate votes on the nominee, the ECB Presidency nomination is part of the European top jobs carousel (the two other top jobs being European Council and EU Commission presidents). It involves lots of political horse-trading, backroom dealing, and whatnot. When the Byzantine process is concluded,

white smoke emerges from one of those monstrous EU buildings. In any case, I think both names are continuity candidates who won't rock the boat.

- **Concluding with the nitty gritty of previewing Thursday's Governing Council meeting, a hold is all but assured.** More importantly, the ECB will stick to its guns and remain uncommitted to future rates. Lagarde & Co refuse to call a spade a spade. You won't hear her say 'rate hike cycle'.
- **As I wrote in my October 27 Markets Blog, yours truly has ruthlessly stuck to his call for one final quarter point ECB hike in December.** And not even budging during the worst of the early autumn bond market tantrum. As per the ECB's Q3 Bank Lending Survey, with only a couple of hikes the ECB and without flagging a rate hike cycle, the central bank has engineered plenty of tightening of financial conditions. Banks have tightened credit standards further. They expect loan demand to shrink further, with a particular strong decline in interest rates-sensitive mortgage demand expected. That's a lot to stomach for the bank lending-reliant Eurozone economy.
- **And speaking of tightening financial conditions, ECB-speakers have been taken aback by the increases in long end yields earlier in the autumn.** The French bond market turmoil was the proverbial nail in the coffin. France has neutered even the hawks. You won't hear much from them about rate hikes.
- **On the inflation front, things are pretty bad.** But, given the aforementioned tightening of financial conditions, it isn't enough to force the ECB to adopt a hawkish stance. Both crude oil futures and natural gas futures prices have exceeded the 'adverse' scenario in the September staff forecasts. Energy price inflation has printed substantially higher than implied by futures prices, rising to 18.9 percent YoY in September. And come December, ECB staff will be again forced to increase their inflation forecasts for this year and the next.
- **Core inflation has stayed relatively muted.** At around 2.5 percent YoY, readings are only a couple of tenths of a percent higher than pre-war levels. More importantly, when I strip out package holidays (useless because too volatile) and government administered prices, one needs a looking glass to detect an uptrend in underlying inflation. Still, given the energy shock, I expect that core will peak at 2.8 percent next spring. If I think we reach 3.0 percent or more, I might even pencil in a March 2027 quarter point hike.
- **While economic growth has held up well in the face of the worsening energy shock, the October PMI was a bit of a letdown, with output and new orders growth softening, and input price inflation rising more strongly, which was partially offset by slower output price growth.** The PMI is consistent with OK-ish quarterly GDP growth of 0.3 percent. However, my proxies are consistent with a more meagre 0.2 percent growth rate.
- **On the open market operations front, there's a risk that the ECB decides to take its chances and doubles Minimum Required Reserves (MRR) to 2 percent as per my base case.** That would sterilize about 170 billion euros in reserves and push excess reserves just below 2.0 trillion euros. The MRR increase should come into effect in the second maintenance period of 2027. The reporting month for that period is January 2027. Which would avoid a cliff-edge scramble for reserves ahead of the year-turn.
- **With repo rates stabilizing following the early-October spike, there is still a window opportunity to pull the trigger.** Especially when considering that banks increasingly find their way to the LTRO/MRO window.
- **And speaking of Eurosystem lending to banks, outstanding MRO/LTRO lending has jumped to almost 50 billion euros combined following the**

October 27 auctions. That's up strongly from the month's long prior range of 30-35 billion euros. I strongly suspect Italian and German banks are responsible.

- **Regarding the former, as I postulated in the late August Money Market Update, I penciled in Italian banks borrowing 50 billion euros in reserves in Q4.** With a large chunk of that amount borrowed from the Bank of Italy. The aim here is for Italian banks to keep their regulatory reserves at adequate levels (assumptions are an LCR of 140 percent and a ratio of reserves to net liquidity outflows of 25 percent). Furthermore, my analysis of the ECB's consolidated bank balance sheet data suggests that Italian banks minimum comfortable level of reserves to total assets/liabilities is 1.5 percent. With ECB QT destroying reserves, henceforth there will be a consistent money market bid from Italian banks. As well as increased recourse to Eurosystem borrowing.
- **Regarding German banks, German banks are notionally speaking the second largest borrower of the Eurosystem after Italian banks.** With German banks losing 67 billion euros in reserves to banks elsewhere in the Euro Area in September, I am sure that German banks are increasingly turning to the Eurosystem – the Bundesbank in this case – too.
- **To conclude, Thursday's ECB meeting should be a relatively boring affair monetary policy-wise.** Perhaps money market aficionados can eat their heart out and snoozing bankers wake up if the ECB announces the MRR increase. Otherwise, Lagarde could spice things up by dropping hints about her future career. But I am certainly not holding my breath.

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