ECB Watch: the Germans want a dove at the helm too

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Research

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Berlin's not-so-secret dirty little secret

- **With the benefit of hindsight, it's fairly obvious that former Bank of Spain Governor Pablo Hernandez De Cos will be awarded the ECB Presidency and not his northern rival, former Dutch central bank President Klaas Knot.** The former is dovish leaning while Knot leans hawkish, having shed some of his hawkish feathers over the years in an obvious attempt to become palatable to politicians. Not just politicians down south, but especially up north.
- **As a veteran ECB watcher and someone who pays close attention to Eurozone politics and public finances, I really should have known better.** Why would Germany, with its increasingly decrepit fiscal budget (more on that further down below), want a hawkish guy leading the ECB? Berlin could always count on the French picking a softer candidate. And obviously, Berlin prefers the French taking the flak of having pushed for a 'dove' to lead the ECB. Plausible deniability that De Cos isn't Berlin's preferred choice and all that.
- **As part of the stich-up with Paris, Berlin gets to pick the next Chief Economist.** The French will reportedly be handed the Open Market Operations portfolio**.** Berlin's choice for Chief Economist: Markus Brunnermeier. While not a (post-)Keynesian in the macro-economic modelling sense, his academic work on financial instability is heavily inspired by Hyman Minsky. That's as Keynesian as it gets. Brunnermeier is also one of the brains behind the proposal of a synthetic Eurozone safe bond dubbed ESBies backed by tranches of actual government bonds. Given the dire straits public finances are in (including in Germany), the safe aspect of government bonds has aged like milk. Bottom line: he's certainly not your hard-nosed ordoliberal hawkish German economist. And there's more than a few of them still around.
- **There's a pattern here.** Berlin was perfectly happy with Mario Draghi as ECB President even though then Chancellor Angela Merkel certainly didn't shout her approval from the roof. His "whatever it takes" ad-lib saved the euro and the Eurozone, Germany's export racket.
- **Berlin chose Draghi over its own man, Bundesbank President Jens Weidmann, who was Chancellor Merkel's key economic advisor before he moved the central bank**. In 2011 Weidmann succeeded Axel Weber, who had quit in protest over ECB bond purchases of Southern member states. By the way, Weber wasn't the only German to quit the Governing Council. ECB Chief Economist and Board Member Jürgen Stark quit that

year for the same reason as Weber: the sacrilege of the Eurosystem buying government bonds in the secondary market. Berlin duly picked the more pliable Jörg Asmussen as Stark's successor on the Board.[1]

- **Under Draghi, interest rates sank to punitively low levels**. Negative levels even. And with its QE program the ECB gobbled up so many Bunds that it created an outright shortage in the market. Punters paid for the privilege of lending to Germany. I can still remember the countless studies paraded in the German press about the hundreds of billions of euros the government saved in interest payments.
- **I can't stress enough that De Cos won't be a hapless stooge all too happy to do France's bidding.** Under De Cos, the ECB will not ease the conditionality for its never-activated and never-courts tried 'TPI' bond buying program. The central banker guild doesn't give carte blanche to governments, fortunately (take note, Marine Le Pen). If turmoil returns to the OAT market and Le Spread blows out further, the ECB will stand aside unless Paris adopts a proper austerity budget and clears a path towards stabilizing the debt-to-GDP ratio before gradually lowering it. I could see the ECB addressing collateral damage of an OAT market blow-up: buying Portugal, Spain, or even Italy. Portugal has a solid budget, Spain is OK-ish, while Italy is a bit borderline (but still managed to secure an outlook upgrade for its BBB+ rating from S&P.
- **In a 'nightmare' scenario where Jean-Luc Mélenchon becomes President of France and then threatens to default on the OATs held by the Banque de France, De Cos will turn to the Greece playbook**. Tighten the screws on the government while at the same time protect the French banking system as much as he can. He won't give the French a pass. Even if the reason is 'only' the notion that France shouldn't get away with fiscal largesse while Spain at least pays lip service to fiscal soundness.
- **Neither will De Cos give up in the fight against inflation**. But it won't be a fight to win anytime soon. If necessary, he will raise rates further at a gradual quarterly pace with 25bps increments. What I don't see him doing unless he's truly with his back against the wall, is overtighten. I am talking about the classical over-tightening central bank that squeezes inflation out the economy and triggers a recession while doing so.
- **There's nothing revolutionary in cautiously tightening monetary policy (also known as wanting your cake and eating it) to fight inflation.** We've seen President Christine Lagarde do it. Former Fed Chairman Jerome Powell applied the same method. The flipside is that while most inflation dissipates, it still lingers above target. Obviously so in the case of the US. But also in the Eurozone, where underlying measures of inflation never reached two percent. In the Eurozone an undercurrent of inflation remained alive and well. Then events intruded – Iran – and the rest is history as they say.
- **I think what we will end up with, is that this decade inflation will never really settle at target.** Save a year or two if we're lucky, we'll be (clearly) above target. In that way, the De Cos ECB will be a continuation of the Lagarde ECB.

[1] True, Berlin did send the hawkish Bundesbank Vice President Lautenschläger to the ECB Board during the Draghi era. But like all the German hawks, they're ineffectual, get frustrated, and leave long before there terms are over.

- **My forecasts for a De Cos ECB aren't different from Lagarde sitting out her term till the end.** I have penciled a quarter point hike in December, obviously. The bulk of the Governing Council is inclined towards at least one more hike next year. While I haven't officially penciled a hike in 2027, it seems obvious that we should expect another move in March. Perhaps even in January, which would bring the deposit rate to the nice round number that is three percent. And give De Cos a bit of breathing space at his first meeting as President come March.
- **On the operational side, De Cos has plenty of decision to take**. The ECB has published its Quantitative Tightening schedule for 2027 some time ago. But there's no word yet about 2028. A year from now, excess liquidity will be around 1.5 trillion euros. That's taking into account LTRO and MRO uptake rising by 5 billion euros every quarter. That back of the envelope assumption about uptake is likely too low though. In every scenario I run, Italian banks must either borrow tens of billions of euros from the Eurosystem and/or in the market to keep (regulatory) reserves at adequate levels. A year from now, the Spanish banking system will be in the same position. The Dutch banking system will follow soon after.
- **When excess reserves are around 1.5 trillion euros, the ECB must have decided on sticking with the current framework of letting banks tap the LTRO or MRO to satisfy growing demand for reserves stemming from so-called autonomous factors: currency in circulation, the 'digital' euro, and other liabilities on the Eurosystem balance sheet**. That, or start buying modest amounts of bonds for what the ECB has dubbed the 'structural' bond portfolio to meet banks' demand for reserves. The ECB could pair bond purchases with 'structural' (there's that word again) longer term LTROs to banks. With tenors of a year, structural loans will help banks meet Net Stable Funding Ratios – or at least that is what bankers are demanding our friends at the ECB will do. Bankers tend to get their way more often than not. Re the ECB finally giving in to bankers and renumerate instant payment TIPS-balances at the deposit rate. In any case, I think the borrowing rate for the longer term LTRO will be the marginal lending rate, not the MRO rate.
- **And speaking of reserve regimes, if the ECB decides to make the situation of ample reserves a little bit less comfortable for our dear banker friends, the corridor should be widened from the current 15bps, which is way too narrow.** 25bps would be a good start. The ECB could also decide to end fixed rate/full allotment for the LTRO and the MRO. Money markets are becoming more competitive. So, why should the ECB not follow suit?
- **Bottom line: I think the ECB will end QT in December next year**. I don't see the ECB experimenting with a lower level of reserves. Nor do I expect much in the way of 'structural' bond purchases. The ECB will satisfy banks' growing reserve demand by and large with LTROs and MROs. I am not so sure about longer term 'structural' LTROs. But stand to be convinced otherwise about structural LTROs.
- **Still up in the air is the increase in Minimum Reserve Requirements to two percent from one percent**. The increase will sterilize about 170 billion euros in reserves. With stability returning to the repo market following the early October rate spike (coinciding with the French bond market turmoil), there's still a window of opportunity for the ECB to make a

move. As discussed in my recent Money Market Updates, an increase to two percent announced no later than the December meeting is my base case. At this juncture, it will have a marginal to modest effect on money market spreads. Less than a bp of tightening in BOR-OIS, GC repo – DFR, and ESTR – DFR spreads.

- **The ECB can now sell an MRR increase as a tightening move: in harmony with the rate hike cycle**. Bankers be bankers though. They will charge (wholesale) depositors for the deadweight cost of zero-interest bearing reserves on the asset side of their balance sheet. That effect might make itself pronounced around reporting dates. However, in the greater scheme of things, the tightening effect of a lower level of free reserves will wash out the effect of bankers trying to shift the cost of deadweight reserves to their depositors in the form of lower rates. Regardless, the ECB will increase the MRR not to tighten money markets, but to help shield its dreadful PnL from the trillions of euros of low-yielding bonds still sitting on the balance sheet.
- **Finally, I want to conclude with a vastly different topic that I alluded to at the beginning of this note: the fiscal situation**. And the German fiscal situation in particular. The EU Commission published its biannual forecasts on Tuesday. And the German fiscal outlook isn't pretty, to say the least. The Commission upped its forecasts for the headline deficits for 2026 and 2027 to 4.0 percent and 4.4 percent, respectively. That's up from the spring forecasts of 3.6 percent and 4.0 percent, respectively. For 2028 the Commission has penciled in a 4.6 percent of GDP headline deficit. That year, the constitutional debt brake is supposed to kick again. Clearly, the Commission expects the German political class to find ways around the constitutional hurdle. With good reason. This morning, the so-called 'grand coalition' of CDU/CSU and SPD finally managed to agree on something: a tax cut and a cap on fuel prices. While both measures are temporary – the electricity tax cut is a one-year measure – I am certainly not holding my breath for the coalition, a most unpopular government, returning to fiscal rectitude in 2028.
- **And for the record: the Commission's deficit forecasts for Germany are only a percentage point lower than those of France**. More importantly, the Commission hasn't taken into account France passing an austerity-lite budget for 2027. If the government manages to get its budget adopted, the deficit will more likely be 5.0 percent of GDP.
- **For fiscal health up north, nothing comes close to the Netherlands**. We have no government – we have one but in name only – but the EU Commission's deficit forecast speak for themselves: 2.1% of GDP in 2027 and 2.3% in 2028. With debt below fifty percent of GDP, by the way. Bunds should not just trade NETHER flat (which they mostly do these days!), they should trade with a spread over NETHER. Long live the Netherlands! Or at least our bonds.

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