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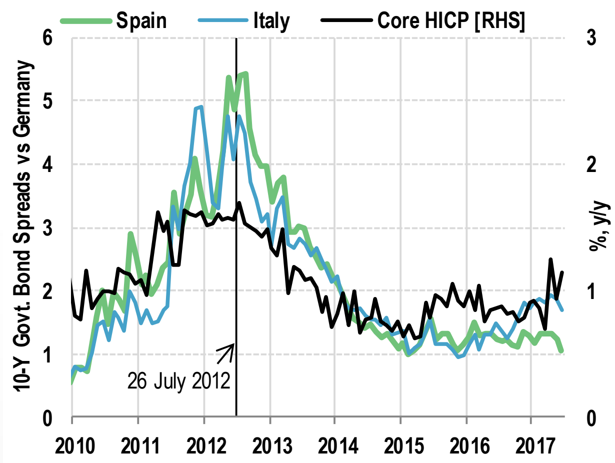
From "Believe me it will be enough" to "Believe me it will be slow enough"?

■ Mario Draghi's speech on 26 July 2012 was instrumental in calming down markets ■ The dominating concern today is how to bring monetary policy normalisation without creating market disruption

Using a search engine reveals that Mario Draghi's famous London speech on 26 July 2012 is celebrated every year since. Several factors explain its importance and the enduring admiration. On a practical note, the message was punchy and hence easy to remember. Moreover, the timing was great with market nervousness rising exponentially in the weeks and days before. Finally and most importantly, the speech offered a credible 'open envelope' promising "whatever it takes". The concrete action plan was communicated after the Governing Council meeting of 6 September which saw the creation of the Outright Monetary Transactions instrument. It would enable the ECB to address severe distortions in bond markets by buying sovereign bonds with a maturity of between one and three years, without ex ante quantitative limits but under the condition of "strict and effective conditionality attached to an appropriate EFSF/ESM programme".

The huge subsequent narrowing of peripheral spreads versus Bunds was driven by a dual belief that countries would accept the conditionality and that the ECB under these circumstances would deliver on its promises. Credibility was such that OMT never had to be used. The speech proved sufficient to calm down markets but insufficient to address persistent economic imbalances (ongoing deflation worries, fragmentation of bank credit markets). This eventually led to a negative deposit rate, QE and an effective lower bound of nominal market interest rates well below zero.

EUROZONE: SPREAD VERSUS 10 YEAR BUND YIELD AND CORE INFLATION



Sources: Datastream, BNP Paribas

The Eurozone is now in the process of achieving several years of above potential GDP growth. This should lead to a closing of the still negative output gap, a slow pick-up of trend inflation and eventually the start of policy normalisation. However, relief about macroeconomic performance comes with market concern: given the ECB's past influence on financial markets, in particular sovereign and corporate bonds, the normalisation process will be a tricky one. Paraphrasing the London speech, investors would love to hear "on normalisation, believe me it will be slow enough"...

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