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ECB: A rate cut becomes increasingly likely.

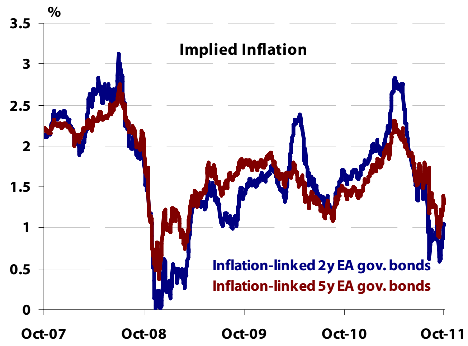
- The ECB is likely to cut its intervention rate by 25 basis points by year end, on the backdrop of mounting headwinds and elevated uncertainty over the Greek debt sustainability.
- Injection of liquidity to the financial sector is expected to be scaled up, in order to smooth money markets tensions.
- Looking ahead, the ECB should be more tolerant to relatively high inflation and keep rates low, in order to boost growth amid strict fiscal austerity.

The ECB paused its tightening cycle in September due to deteriorating global economic climate and escalating tensions in the debt crisis front. In the September announcement, the council acknowledged the mounting headwinds to the euro area economy, as reflected in the downward revisions of the ECB staff projections. In particular, midpoint forecasts for real GDP growth declined from 1.9% and 1.7% in June to 1.6% and 1.3% for 2011 and 2012, respectively. Rhetoric about inflation expectations was also changed, with risks to inflation now considered as balanced.

In our view, a rate cut becomes increasingly likely, on the ground of as series of very downbeat leading indicators and slow moving political developments concerning the Greek debt sustainability. Rate hikes earlier in the year were justified by soaring commodity prices and robust performance in core countries, most notably in Germany. Since last summer inflation expectations have abated (Figure 1), while the economic slowdown is synchronized, affecting both periphery and core members. In our central scenario, the ECB will likely decrease its intervention rate by 25 basis points by year end, (likely in the November meeting). Additional austerity measures recently approved by the Italian, Spanish and French governments are in line with the ECB's appeals for governmental action to tackle fiscal woes, opening further the door for monetary easing. A further rate cut down to 1% should not be excluded, if growth prospects deteriorate and financial turmoil due to contagion fears persists.

In our view, the ECB governing council will not cut rates in this week's meeting, as ECB members will want to wait for additional evidence of economic weakening, before they decide to deliver a rate cut. Higher than expected posting of euro area inflation in September (3%) is likely to add pressure against lower rates. Scaling up liquidity provision (as discussed below) and/or widening of the interest rate corridor could be an alternative before the ECB reduces its key policy rate. The spread between the marginal lending facility and deposit facility currently stands at 50 basis points. Lowering the deposit rate, could induce bank lending, given abundant liquidity.

Figure 1

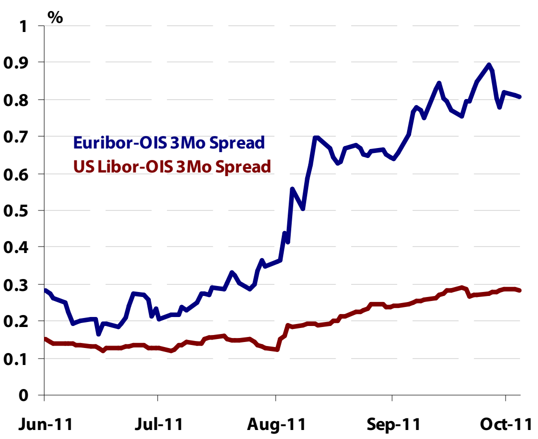


Source: Ecowin

As debt crisis tensions spill over to the financial sector, money markets remain hampered (Figure 2) and several financial institutions, especially in the periphery, remain heavily dependent on the

ECB for liquidity provision (Figure 3). Against this backdrop, the ECB has been prompted to inject more liquidity to the banking sector. In particular, the bank performed a six-month refinancing operation and has announced three US dollar provision operations. It has also eased collateral requirements for banks, by accepting as collateral assets that are not traded in regulated markets (effective from January 2012). Looking ahead, the ECB will most likely keep providing liquidity at full allotment well beyond the first quarter of 2012, while longer term refinancing operations, namely 1 year LTROs or longer, are likely to be set. Covered bond purchases is another option in the ECB's toolkit that may be implemented. The ECB reactivated its Securities Market Program in August, when Spanish and Italian spreads started widening to uncomfortable levels. Sovereign debt purchases have more than doubled since then (Figure 4), currently standing at €160.5bn. While the program is highly controversial among ECB members, with German objections standing out, the ECB will keep buying bonds at the secondary market, until the EFSF takes over.

Figure 2

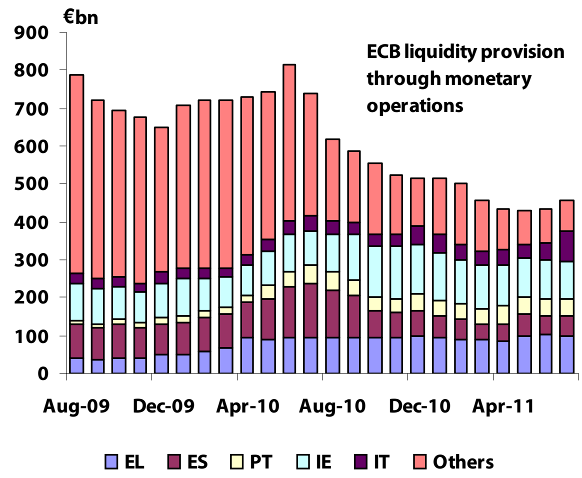


Source: Bloomberg

While the ECB is likely to fully reverse its tightening cycle by a cumulative 50 basis points rate cut, further reduction of the intervention rate below 1% seems unlikely due to the fact that inflation is expected to remain above the 2% threshold for the remainder of the year and early 2012. Instead, further provision of liquidity would be favored, if need be, in order to smooth financial tensions while at the same time preserving the bank's credibility.

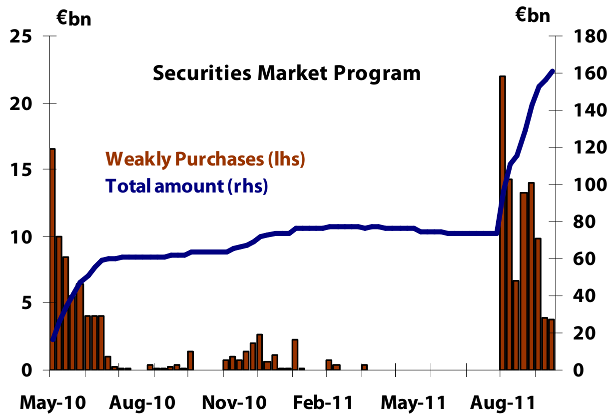
In the next few years, growth in the euro area will likely remain subdued due to large scale fiscal consolidation. In our view, the ECB should maintain monetary policy loose, even if that means tolerating inflation persistently above the 2% threshold. That way, easy monetary conditions could counteract the drag from fiscal austerity.

Figure 3



Source: Bloomberg, ECB.

Figure 4



Source: Bloomberg

Impact on EUR/USD

Easier monetary policy is expected to weigh against the euro. So far, tighter monetary policy by the ECB relative to the Fed was the main driver of the EUR/USD cross, favoring the euro. However, mounting uncertainty over the debt crisis has caused the euro to depreciate. Despite damage to confidence by brinkmanship during the debt ceiling negotiations and rising concern about the US debt sustainability, the US dollar retains its safe heaven status, suggesting that it will likely over-perform versus the euro. That said, the later may gain strength if bold political action by euro area policymakers succeeds in stemming contagion fears and reversing the negative sentiment about euro area growth prospects.

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