ECB: We expect another rate cut by 25bps in December.

- Mr. Draghi surprised by cutting rates by 25bps. Although unexpected, the rate cut is justified by materializing downside risks.
- Full reversal of the monetary tightening cycle is anticipated in December. We believe the ECB would feel uncomfortable to deliver further rate cuts. Therefore, we expect the policy rate to remain unchanged at 1% at least until the end of 2012.
- There were no comments suggesting a more decisive use of the SMP program. Although the ECB did not take center stage in the recent decisions taken to combat the euro area crisis, we believe that its theoretically unlimited ability for intervention is required to manage the crisis and should be implemented whenever the need arises.

The ECB Governing Council unexpectedly cut all its main interest rates by 25bps in the November meeting, bringing the main refinancing operations rate down to 1.25%. According to a Bloomberg survey, 51 out of 55 analysts expected no action this month by the ECB. The rate cut was unexpected mainly on the ground that Mr. Draghi would prefer to refrain from a rate cut in his very first Governing Council as a President, in order to avoid sending a dovish signal that would probably not be well received by Germany. In addition, the last ECB meeting did not reveal much signaling for a rate cut. This implies that under Mr. Draghi's presidency there may be a shift away from predisposing markets when a rate change is very likely towards a less revealing communication style.

However, a lower policy rate is, in our view, justified by deteriorating economic sentiment and increasing uncertainty. The PMI leading indicators continue sliding deeper into recessionary territory, revealing worsening economic confidence across all euro area members (figure 1). The Italian manufacturing index posted a monthly record drop in October by 5 points to 43.3, pointing to weakening economic momentum. Meanwhile the political situation in Greece took a take for the worse, fuelling fears worldwide of a disorderly default. As is evident by persistently high interbank borrowing costs (figure 2), the financial situation remains adverse, owing to the negative feedback loop between sovereigns and banks. Our forecasts point to a GDP contraction in Q4 that may be followed by another quarter of negative growth before the economy picks up moderately later in 2012.

Against this persistently unfavorable economic environment with materializing downside risks, we anticipate another rate cut in December, most likely by 25bps. Thus, we expect the ECB to fully reverse its tightening cycle that started in March. Mr. Draghi mentioned that a downside revision of staff projection for 2012 GDP growth is very likely, which we interpret as a signal of an imminent rate cut. With respect to inflation, the ECB appeared softer than last month, as it expects inflation to recede below 2% next year due to abating pressures on prices, costs and wages.

Despite mounting evidence of a weakening business cycle, we believe the ECB is unlikely to lower its MRO rate below 1%. Although inflation is projected to decline, it will probably remain above the 2% threshold for quite some time, implying that the ECB would feel uncomfortable to cut rates more drastically. Instead, the ECB could enhance its liquidity provision measures, mainly by conducting longer term refinancing operations, as well as scale up its covered bond purchase program. Therefore, beyond December we expect the main policy rate to remain unchanged at 1% at least until the end of 2012.

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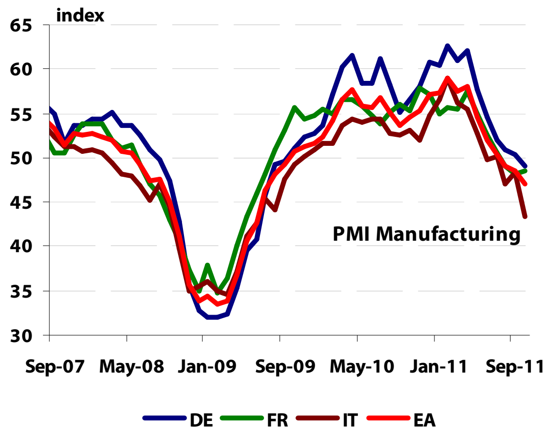
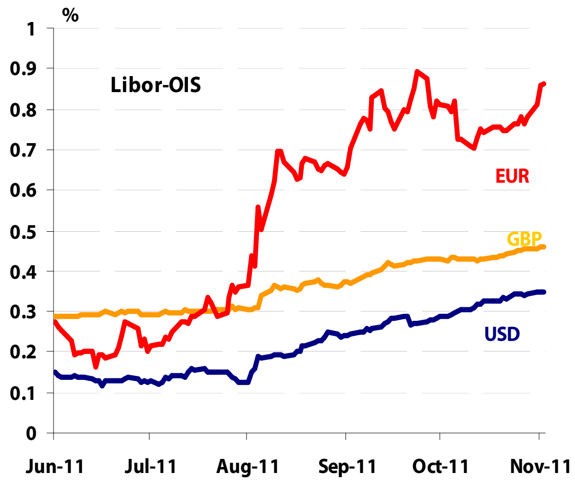
In our view, the ECB should maintain monetary policy loose, even if that means tolerating inflation persistently above the 2% threshold. That way, easy monetary conditions could counteract the drag from fiscal austerity.

Figure 1



Source: Bloomberg

Figure 2



Source: Bloomberg

Mr. Draghi did not make any comments suggesting a more decisive use of the controversial Securities Market Program, other than mentioning that it is temporary, limited in amount and it intends to restore the monetary transmission channel. The ECB reactivated its Securities Market Program in August, when Spanish and Italian spreads started widening to uncomfortable levels. Although the ECB did not take center stage in the recent decisions to combat the euro area crisis, we believe that its theoretically unlimited ability for intervention is required to contain contagion and should be implemented whenever the need arises. Its SMP program should remain active at least until the EFSF leverage scheme becomes operational.

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