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FOCUS NOTES

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# ECB Meeting preview

- The ECB is expected to cut its main rate by 25bps to 1% on the backdrop of persistently adverse economic conditions. The ECB will remain on easing bias and it may even lower its policy rate below 1% in the first quarter of 2012 if the economic outlook keeps deteriorating.
- New non-standard liquidity provision measures are expected to be announced to improve the funding conditions of banks, including the introduction of 24-month LTROs and expansion of the list of eligible collateral in the refinancing operations.
- Mr. Draghi gave a hint that the ECB might acquire a more active role in stabilizing government bond markets on the condition that credible commitment to ensure fiscal integration is adopted by the Euro area policymakers.

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Following the rate cut by 25bps in November, we expect the ECB to lower its main policy rate to 1% in the upcoming meeting of the Governing Council, thus fully reversing the monetary tightening cycle that started in April. More accommodative monetary policy will be justified on the continuing deterioration of economic conditions (Figure 1). In his appearance before the plenary session of the European Parliament, Mr. Draghi conveyed his concerns about the economic outlook using a more downbeat language that in the November ECB meeting. The PMI leading indicators remain well within contraction territory, i.e. below the threshold of 50, revealing an ongoing erosion of confidence among economic agents. In a similar vein, the European Commission's gauge of economic sentiment bodes well with a contraction of the business cycle. Besides soft data, hard data are also illustrating the gloomy picture of the Euro area economy. Industrial production fell on a monthly basis in September, while we expected it to have remained weak in October, based on a sharp decline in new orders. The unemployment rate continued inching higher for the third month in a row in October, now standing at 10.3%. Given that labor markets respond with a lag, unemployment is likely to rise higher in coming months.

Last September, the ECB staff projections for GDP expansion had been lowered to a mid point growth of 1.6% for 2011, from 1.9% projected earlier, and to 0.9% -from 1.1%- for 2012. We expect the ECB to announce further downward revisions this week, mainly on the grounds of tougher fiscal austerity and the impact of this may have on economic activity. However, the new GDP growth forecast for 2012 may turn out more upbeat than ours, which argues for growth stagnation (0.0%) in the following year.

In our view, a reduction of the main policy rate below 1% in the first quarter of 2012 should not be excluded if further deterioration of the economic environment materializes. A rate cut below 1% would be unprecedented; rates held above that level even during the Great Recession, whereas this time around markets expect a rather shallow GDP contraction. However, in the current situation the existence of the Euro itself is challenged by markets due to the pronounced erosion of credibility. Getting to grips with the sovereign debt crisis seems a lot more complex for the Euro area policymakers now than it has been in the initial

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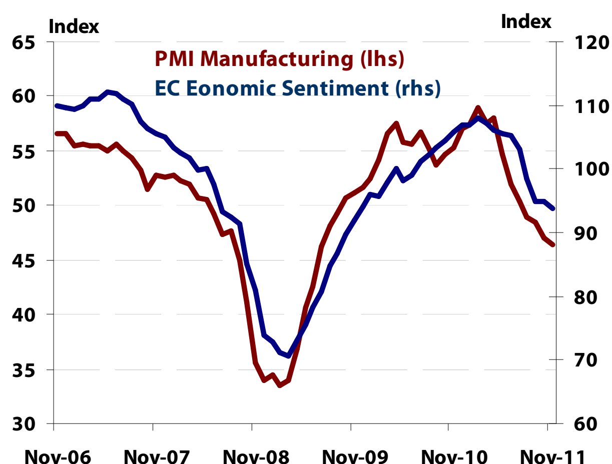
phase of the financial crisis, mainly due to the structural inefficiencies of the Euro zone institutions. As a result, risks to the economic outlook remain to the downside, implying that a clear deterioration of the economic outlook may prompt the ECB to deliver drastic rate cuts.

**Figure 1**




*Source: Bloomberg*

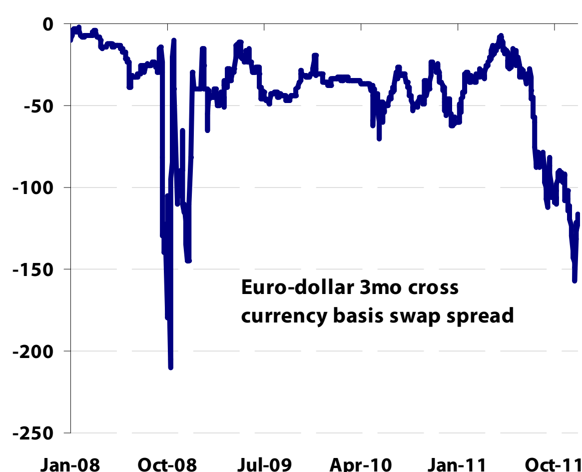
The tightening of monetary policy earlier in the year was mainly justified by soaring energy prices that threatened price stability, mainly in core countries which were experiencing strong growth. However, inflationary pressures have abated in the second half of the year. Baseline effects stemming from oil price increases are expected to turn favorable next year. Moreover, elevated unemployment and muted consumption growth are likely to keep wage pressures in check. Inflation remained at 3% for the third month in a row in November. Inflation has likely reached peak at this level and we expect it to retreat to lower readings in the period ahead. Current elevated inflation would not avert a rate cut, as the ECB expects inflation to decline below 2% in the course of 2012. Our forecast for 2012 argues for average annual inflation of 1.8%. Upside risks to our projection stem mainly from further tax increases to address likely fiscal slippages.

With respect to non-standard measures of liquidity provision, we argue that expectations remain on the upside, as Mr Draghi acknowledged significant tightness of funding markets. In particular, we expect the ECB to introduce 24-month long refinancing operations in an attempt to facilitate the maturity match management that would allow banks to inject more credit to the real economy. The introduction of even longer term operations should not be excluded, as the ECB seems keen to improve the monetary transmission mechanism. We also expect the ECB to extend its commitment to fixed rate full allotment operations well beyond mid-2012.

In addition, the Governing Council may liberalize its collateral rules, as Mr. Draghi has explicitly referred to a scarcity of collateral. The sovereign crisis has resulted in a deterioration of the valuation of banks' assets, which now need to post more collateral to get the same amount of liquidity. The expansion of the list of eligible collateral would ease tensions on the banking sectors of stressed periphery members, where the problem of scarce collateral is most acute. Likely measures would include reduction of the haircuts applied to assets used as collateral, a reduction in the threshold of quality of the assets accepted, currently A rating with the exception of Greek, Irish and Portuguese bonds, and acceptance of non-Euro denominated assets. In 2008, the ECB had enlarged the eligibility criteria to include non-Euro denominated assets. The expansion remained in force until the end of 2009, while the respective assets were subject to a uniform haircut add-on of 8%.

This week's monetary policy action will follow the recent coordinated initiative of major Central Banks to extend bilateral swap lines to February 2013 and provide cheaper US dollar liquidity. The rate on Euro-dollar swap arrangements has been reduced from USD OIS rate plus 100 basis points to USD OIS rate plus 50bps. Before the initiative, the 3-month cross currency basis swap spread had widened to levels similar to those observed during the most acute phase of the financial crisis (Figure 2), illustrating the loss of confidence to the Euro area banking sector. Investors reacted favorably to the initiative, with bond yields falling considerably. While the debt crisis resolution will take a lot more than the establishment of cheaper FX swap lines, in our view, the positive reaction is mainly attributed to the coordinated and unexpected nature of the action between the Central Banks that sent to markets a strong signal of determination to stabilize global financial markets and boost credit supply.

**Figure 2**

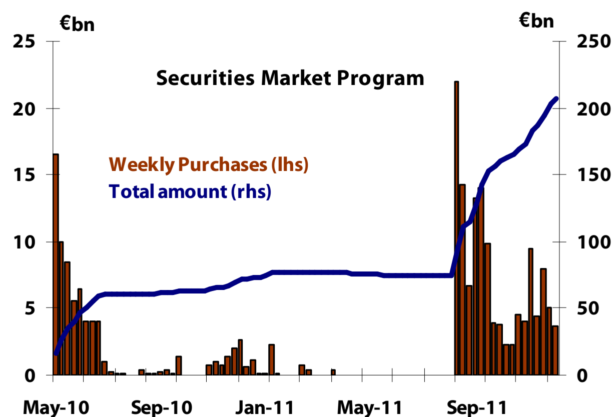



*Source: Bloomberg*

It becomes more widely accepted that, the ECB remains the only mechanism that can credibly backstop contagion of the sovereign debt crisis, as the only institution possessing unlimited firing power. Leverage of the EFSF through external funds remains problematic as loss of credibility scares international

investors away. Mr Draghi hinted in the European Parliament speech that the ECB may adopt a more active role in the debt crisis battle, provided that credible commitment to ensure a common fiscal compact is adopted by the Euro area policymakers. Therefore, we do not expect to hear much about the government bond purchases program (Figure 3) at the ECB meeting on Thursday. Chancellor Merkel and President Sarkozy reached a deal on Monday concerning the enhancement of fiscal discipline and surveillance in the euro area. However, whether the rest of the countries will accept automatic sanctions and scrutiny by the European Court of Justice over their public finances remains to be seen. We believe that acceptance of strict fiscal surveillance and discipline that would reduce moral hazard could curb German apprehensions and open the door for the ECB to attain a more active role in stabilizing government bond markets.

**Figure 3**




*Source: Bloomberg*

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