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FOCUS NOTES

ECB to remain on hold in view of encouraging economic data

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- We expect the ECB to remain on hold due to encouraging incoming economic data but it is a close call.
- Weakness in price developments reflects, to a large extent, external factors, while components pertaining to domestic demand are inching higher. Market data show that inflation expectations remain anchored.
- Developments in money markets do not call for immediate action.
- Potential negative side effects of policy rate cuts put an obstacle in building consensus in the Governing Council for additional conventional easing.

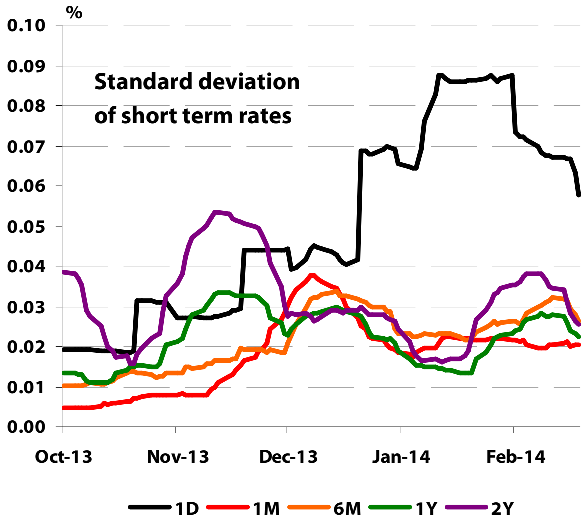
In February, President Draghi explained that the ECB remained on hold due to high degree of uncertainty and that additional data would be required in order to allow the Governing Council to assess more accurately the economic developments. Since then, most economic data have been on the positive side, suggesting that the ECB will remain on hold in its upcoming meeting, as well.

Both soft and hard data corroborate the ECB's, and ours, baseline scenario of a continuing weak recovery. GDP estimates for the final quarter of 2013 surprised on the upside, showing that the economy is expanding in several core and periphery countries. Leading indicators are also in line with a benign scenario of continued economic recovery. The EC's Business Climate Indicator beat expectations in February, while the PMI Index, though it gave back some previous gains, it still points to improving business activity.

President Draghi has specified that unwarranted tightening in money markets would trigger further monetary easing. Yet, overnight inter-bank lending rates have remained below the main refinancing rate, despite a decline of the excess liquidity to about €114bn in late February, compared to above €800bn in March 2011. Even if the EONIA rate converges to the MRO rate, the ECB might not interpret such a convergence as unwarranted tightening in the context of declining excess liquidity and continuously normalizing financial markets. In a recent interview, executive member Benoit Coeure has hinted that persistent volatility in short-term rates rather than actual levels would be the motive for additional action. In the February meeting, President Draghi also highlighted that volatility in spot EONIA observed in January has not been transmitted to longer maturities (Figure 1). Adding to the ECB's comfort, euro short term rates have recently decoupled from US rates (Figure 2), implying a muted impact from Fed tapering.

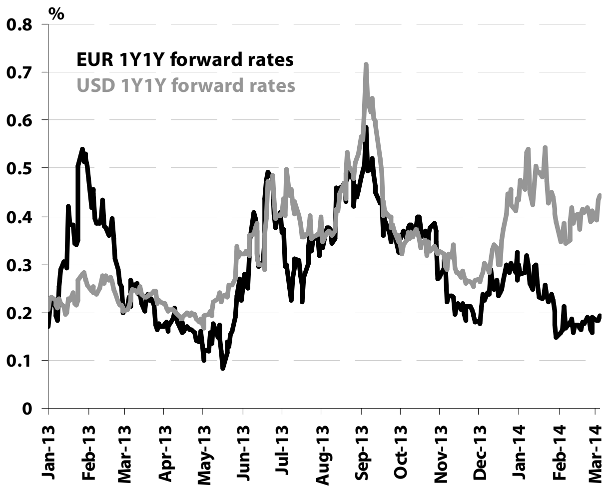
Turning to disinflationary pressures, higher than expected inflation printings reinforce our view that the ECB may remain on hold. According to preliminary estimates, core inflation has climbed to 1% y-o-y in February (Bloomberg consensus 0.8%), while the headline figure remained resilient at 0.8% y-o-y the last two months (Bloomberg consensus 0.7%). Energy prices exert a heavy downward pressure on headline inflation, while the component pertaining to services, which is a gauge of the impact of domestic demand on inflationary developments, has been inching higher both in January and February.

Figure 1
Volatility in spot EONIA has not been transmitted to longer term maturities



Note: Volatility has been calculated as the standard deviation of a 30-day rolling window
Source: Bloomberg

Figure 2
EUR short term rates have recently decoupled from USD rates

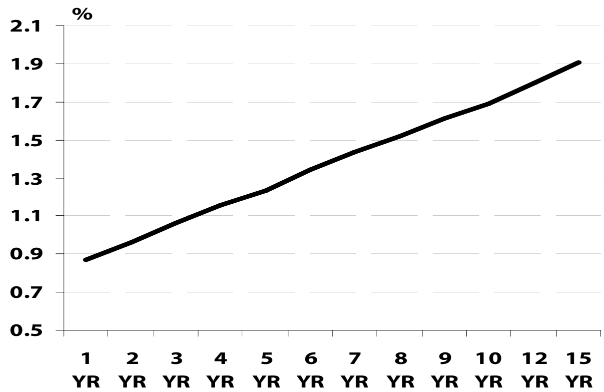


Source: Bloomberg

Moreover, market data reveal that inflation expectations remain anchored (Figure 3). In the medium term, investors expect inflation to hover at levels much lower than the ECB's target of 2%, in line with expectations of a U-shaped recovery. However, longer term, inflation expectations remain close to 2%, illustrating markets confidence on the ECB's credibility in keeping prices stable. In line with market expectations, several ECB executives have repeatedly stated that the risk of outright deflation (defined as a broad based and persistent decline in prices in several countries) is limited.

Apart from recent encouraging data, possible negative side effects of additional rate cuts may lead the ECB to remain on hold. Trimming the main refinancing rate by 10-15bps, while keeping the deposit facility rate at zero, could hinder inter-bank activity. The Governor of the Dutch Central Bank, Klaas Knot, has warned that narrowing the ECB's corridor would reduce banks' incentive to borrow from other banks. In particular, banks reliant on ECB's liquidity might be less inclined to re-integrate in the inter-bank market. To avoid the negative effect of a narrower corridor on further normalization of inter-bank market, the ECB could combine a MRO rate cut with a deposit rate cut to below zero. In addition, a negative deposit rate would weaken the EUR and could boost inflation, at least temporarily, through the fx channel. However, the consequences of experimenting with negative rates on credit growth are not clear. Negative deposit rates could hurt banks' interest rate margins, leading to higher cost of borrowing from banks, especially in the periphery where spreads between lending and deposit rates are narrower.

Figure 3
Euro area inflation swap rates: market inflation expectations remain anchored



Source: Bloomberg

On the negative side for the euro area economy, monetary data keep painting a bleak picture. Credit to private sector (adjusted for sales and securitization) continued contracting by 2% in January, showing no sign of improvement relative to past figures. Weak lending activity reveals a still fragmented banking system which poses a great headwind to economic recovery. In view of persistent downside risks on a fragile recovery, we would not exclude the ECB delivering another rate cut as early as tomorrow. Nevertheless, in our view, conventional monetary easing would be a rather symbolic measure with very limited clout to reduce financial fragmentation. Instead, some form of unconventional action, possibly including the removal of risk from banks' balance sheets (e.g. through purchases of ABS securities), would be more effective in increasing banks' incentives to boost credit growth.

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