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FOCUS NOTES

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ECB: a rate cut is the most likely outcome in the upcoming meeting

- The ECB will most likely cut its main policy rate by 25bps to 0.5% in the upcoming meeting on the backdrop of ongoing economic weakness in both periphery and core countries and well anchored inflation expectations.
- However, conventional monetary easing is unlikely to have a meaningful impact on the euro area economy. In periphery countries, a lower policy rate is unlikely to translate into lower lending rates due the broken monetary transmission mechanism. In core countries, money market rates are unlikely to move substantially due to abundant liquidity.
- The periphery needs targeted unconventional monetary measures to overcome the credit crunch. However, in the current economic and political context it is easier to build consensus for a rate cut than for credit easing measures that entail a distribution of credit risk.

The ECB seems ready to cut its policy rate.

In the last meeting, President Draghi signalled that a rate cut has risen up on the agenda. Indeed, prevailing economic conditions give scope for additional monetary policy easing. In our view, signs of weak economic conditions spreading to core countries would increase the likelihood of lowering the policy rate. In this context, recent releases of leading indicators of economic activity in Germany and France may trigger a decline in the refi rate by 25bps to 0.5% as soon as the next ECB meeting. The April reading of the INSEE index, a leading indicator for French GDP growth, pointed to ongoing weakness in the second quarter while in a similar vein, a larger than expected decline of the Ifo index in April implies that the German economy may struggle to remain the locomotive of the of the euro area economy. Recent releases of the PMI indicators (closely watched by the ECB) also paint a bleak picture for the two largest euro arera economies. In France they have been stubbornly hovering well below the threshold of 50, below which the index signals economic contraction. In Germany, the PMI subcomponents of both the services and the manufacturing sector have disappointed to the downside in March and April. They have now both dropped below 50, indicating a broad based correction of economic activity.

With respect to price developments, inflation has been on a declining path since last August, now standing at 1.7%, below the ECB's threshold of 2%. Additional projected decline in commodity prices in conjunction with base effects from last year are expected to keep inflation expectations contained, lifting one of Germany's main arguments against a rate cut. Indeed, recent comments by hawkish Bundesbanks' President Weidman on cutting rates if economic conditions deteriorate are indicative of a waning German opposition to easier conventional monetary policy on the ECB's board. As a result, the ECB may yield to voices demanding a lower policy rate.

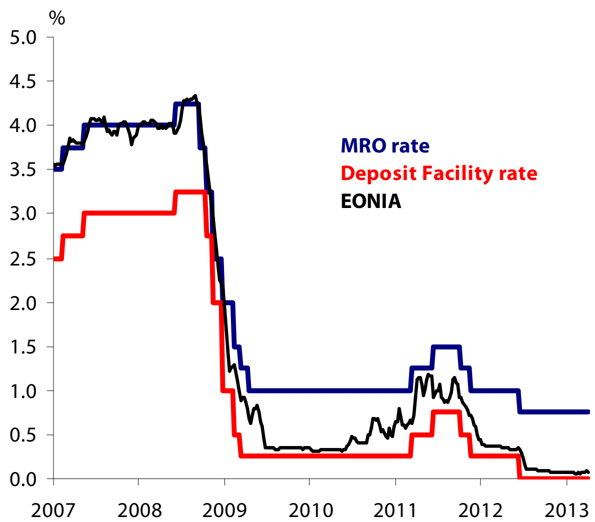
Overall, a rate cut seems the most likely outcome in the upcoming Governing Council's meeting. Nonetheless, we would not exclude the possibility that the ECB may wait for more data to confirm the weakness suggested by the April leading indicators before it sets a lower policy rate.

However, a rate cut is not the most promising tool to stimulate growth

A rate cut would certainly be a positive policy signal providing credibility to the ECB's commitment to keep monetary policy accommodative for as long as needed. It would also provide some relief to banks that rely heavily on liquidity provided by the central bank. Furtermore, it could induce some weakening of the euro as it would align the ECB's policy with the softer stance of other major central banks.

Nevertheless, despite its symbolic and communicative importance, in our view, the clout of a rate cut to affect the real economy of either core or periphery countries is rather limited. In the former group, proper functioning of the monetary policy mechanism implies that a policy rate cut could translate into easier lending conditions. However, in times of abundant liquidity, short term rates are defined by the ECB's deposit facility rate, which act as a floor, rather than by the main refinancing operations rate (Figure 1). Thus, to meaningfully affect the market rates the ECB should also cut the deposit rate below zero. Yet, the ECB will likely refrain from such a move as it has repeatedly commented that a negative depo rate would bring it to uncharted territory, with unknown repercussions on the functioning of money markets.

Figure 1

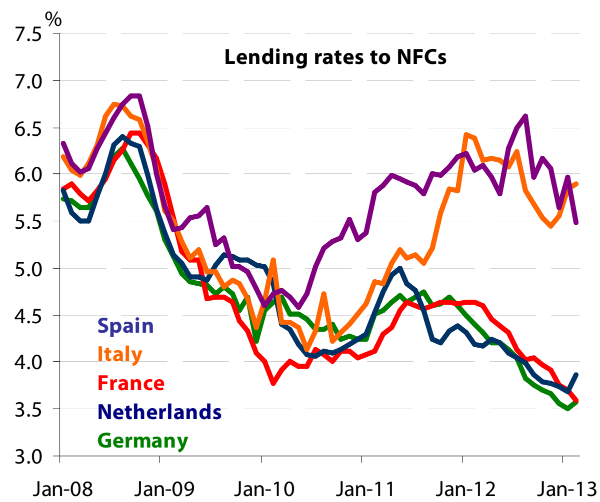


Source: Bloomberg

Conventional monetary loosening is expected to have a muted effect in periphery countries, where monetary stimulus is most required, as the negative feedback loop between financial tensions and sovereign bond markets issues does not allow lower policy rates to pass through to the real economy. As mentioned above, a rate cut could ease funding conditions for banks but it remains questionable whether that would lead to lower lending rates for households and firms. Banks may use lower funding costs to widen profit margins and improve their capital position, a positive development but with little immediate impact in closing the gap between core and periphery lending conditions (Figure 2).

In our view, targeted unconventional policy measures could be more beneficial to overcome the credit crunch in periphery countries. In April's meeting President Draghi mentioned that the board is "thinking 360 degrees" for actions to boost lending to companies, albeit he also admitted that that there is no "obvious" tool to kick-start bank lending. Given its deep consideration on tight credit conditions the SMEs are facing and the importance of the latter in the economy of periphery countries, the ECB may ponder initiatives such as the use of loans to SMEs as collateral for liquidity provision in future LTROs. However, unconventional measures entail credit risk sharing through the ECB's balance sheet, implying that consensus on this sort of initiatives is more difficult to build. Moreover, the ECB seeks to coordinate its actions with institutions that could provide funding (e.g the EIB and the EIF). As a result, we would not expect the ECB board to announce concrete decisions on the unconventional policy front as early as the upcoming meeting. Nonetheless, we would expect some form of unconventional easing in the summer or later in the year.

Figure 2



Note: Loans up to €1m, over 1 year and up to 5 years, new business.
Source: ECB

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