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TRENDMACRO LIVE!

On the December ECB Policy Decision

Thursday, December 6, 2012

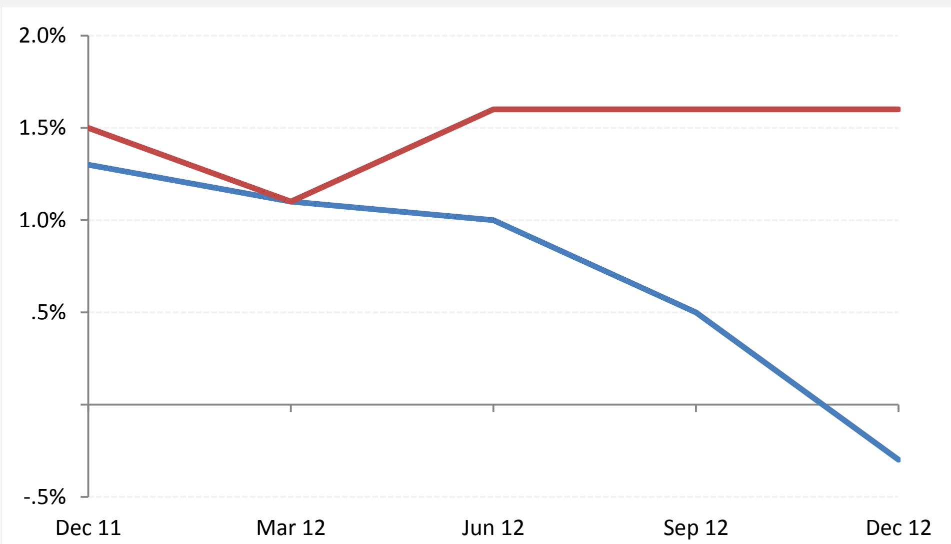
Lorcan Roche Kelly

Projections for negative growth and below-target inflation make a rate cut a certainty.

As expected, both the Bank of England and the European Central Bank stood pat on their monetary policy stances. With no comment being made by the BOE, the important indicators for 2013 came from the ECB press conference where President Mario Draghi announced the ECB's latest projections.

- There was a major cut to the ECB's projection for growth for 2013 with the median projection turning negative to -0.3%, having been positive at 0.5% just last quarter (please see chart below).

ECB projections for calendar 2013 — Real growth — Inflation



Source: ECB, TrendMacro calculations

- While the inflation projection for 2013 remained unchanged at 1.6%, this is still below the ECB's stated target of "close to, but below 2.0%."
- Taken together, these projections -- especially the large downward revision to growth -- point to further accommodative policy from the ECB.

Update to strategic view

ECB, EUROPE MACRO: No changes in monetary policy from either the BOE or the ECB today. But projections from the ECB for euro area growth next year were revised strongly down, with the central projection now for negative 2013 euro area growth. The 2013 inflation projection was left unchanged at 1.6%, below the ECB's target. So a rate cut from the ECB early next year is now a near certainty. Longer term, the potential for higher inflation in Germany than in the rest of the euro area could make it difficult for the ECB to stay as loose as the euro area needs it to be.

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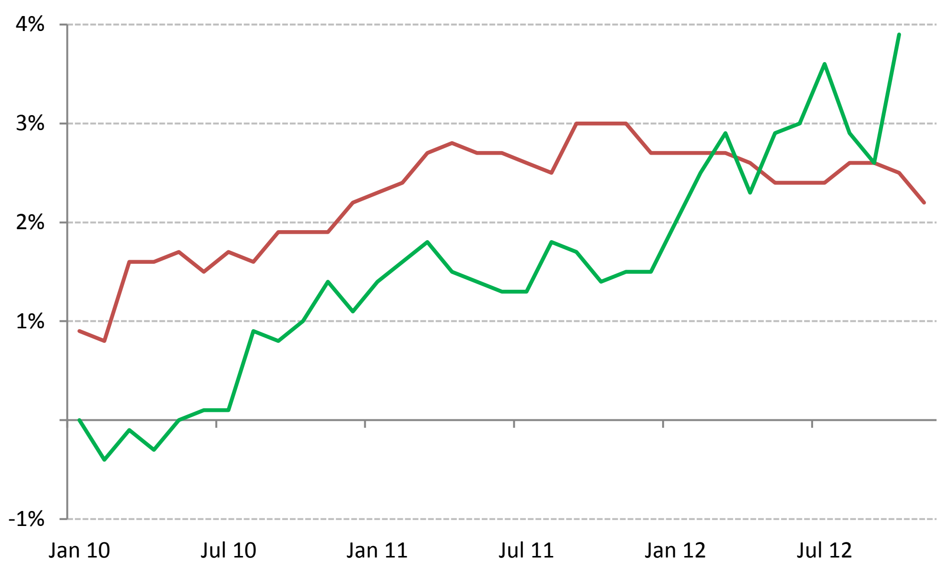
- Asked about a rate cut, Draghi said it was discussed, and that the ECB is "operationally ready" for the negative deposit rates that would come from a rate cut. ECB deposit rates are currently at 0%, so for any cut, maintaining the 0.75% corridor between deposit and refinancing rates would necessitate a negative deposit rate.
- So expectations are set for another rate cut by the ECB in early 2013.

There are a few things, on the face of it, that may stay Draghi's hand.

- While the ECB counts its success by the level of inflation, it is M3 -- the ECB's measure of broad money supply -- which it looks to as a leading indicator for future inflation. The latest print for M3 was an upside surprise at 3.9% (please see chart below). While this is still far below its historical norm of closer to 6%, it could be argued that it points *directionally* towards an easing of lending conditions within the euro area. But in the press conference Draghi said that the jump was partly due to what he called "a specific transaction leading to an increase in overnight deposits belonging to the non-monetary financial sector." He is referring to the capitalization of the European Stability Mechanism (ESM) in October. Draghi added that he would want to see a longer timeframe before making a decision based on such data.

M3 money supply, YOY growth — Inflation



Source: TrendMacro calculations

- In the real economy, there was positive news from Germany again today, with industrial orders rebounding strongly in October to show growth of 3.9%, with upward revisions of September data, too.
- Again, one statistic does not make a recovery. The German data has to be viewed in light of most recent data from the periphery, with Italian September industrial orders, for example, showing a drop of 4.2%.

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Recommended Reading

Eight Common Sense Suggestions for the Fiscal Discussions
Charles Blahous
E21
December 5, 2012

Polls Show Below-Average Post-Election Approval Bounce for Obama
Micah Cohen
New York Times Five Thirty Eight
December 3, 2012

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- So for the moment Draghi can still ignore upside surprises in individual countries, while the euro area as a whole is underperforming.
- Importantly, as we have often stated (see, among many, "Draghi: Off the Reservation" August 3, 2012), Draghi is determined to run monetary policy for the euro area as a whole, not just whatever suits Germany.
- Currently, inflation is running at 2.1% in Germany -- close to the overall euro area level. But if the robust health of the German economy leads to higher inflation there than in the rest of the euro area -- as is likely -- then Draghi may face heightened political pressure to tighten too early and damage a nascent euro area recovery. He has correctly resisted German demands for tighter policy so far, but that will get harder for him if Germans experience higher national inflation -- especially ahead of national elections there next fall.

Finally, Draghi said that the ECB continues to see downside risks to the global economy, including from "fiscal policy decisions in the United States, possibly dampening sentiment for longer than currently assumed."

The euro weakened on Draghi's comments, because the market now expects a rate cut early next year, as do we.

Bottom line

No changes in monetary policy from either the BOE or the ECB today. But projections from the ECB for euro area growth next year were revised strongly down, with the central projection now for negative 2013 euro area growth. The 2013 inflation projection was left unchanged at 1.6%, below the ECB's target. So a rate cut from the ECB early next year is now a near certainty. Longer term, the potential for higher inflation in Germany than in the rest of the euro area could make it difficult for the ECB to stay as loose as the euro area needs it to be.