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TRENDMACRO LIVE!

## On The March ECB Policy Decisions

Thursday, March 7, 2013

Lorcan Roche Kelly

The ECB hints at a rate cut -- but admits it would be ineffective. It probably won't happen.

As we expected (see ["On The February ECB Policy Decision"](#) February 7, 2013) the European Central Bank kept [rates unchanged](#) at today's governing council meeting. In [his speech](#) at the press conference following the decision, President Mario Draghi downplayed the growth prospects for the euro area in 2013 and highlighted that inflation is expected to run far below the [official target](#) of "below, but close to, 2%."

- Significantly, Draghi said that the governing council did discuss a rate cut at today's meeting, but what he described as "the prevailing consensus" was for not cut this time.
- With ECB staff projections pointing to contraction -- between 0.1% and 0.9% in 2013 and inflation projections subdued, there certainly is room for cut. But as Draghi pointed out, the monetary policy transmission mechanism continues to be a concern.
- This concern means that the ECB doubts the effectiveness of any rate cut at the moment.
- Draghi highlighted the continued lack of lending to the small and medium enterprise (the SME sector) -- a problem that will not be solved by a 0.25% rate cut -- as still the biggest risk to economic growth, and to the monetary policy transmission mechanism.
- He did say that the ECB would continue to be accommodative, assuring that the current full allotment, fixed rate monetary policy regime would continue.
- He did not repeat his comments on the strong euro posing a downside risk to the euro area that he made last month.

It is significant that Draghi elevated the idea of a rate cut today by saying it was discussed -- a change from recent meetings where he claimed there was no discussion. This increases the chances of a rate cut at the April meeting. But in our view a rate cut will only come if Draghi feels that it is both necessary and effective. From today's press conference, it is clear he still seems unconvinced that it is either.

Aside from monetary policy, Draghi had interesting comments on issues facing the euro area economy.

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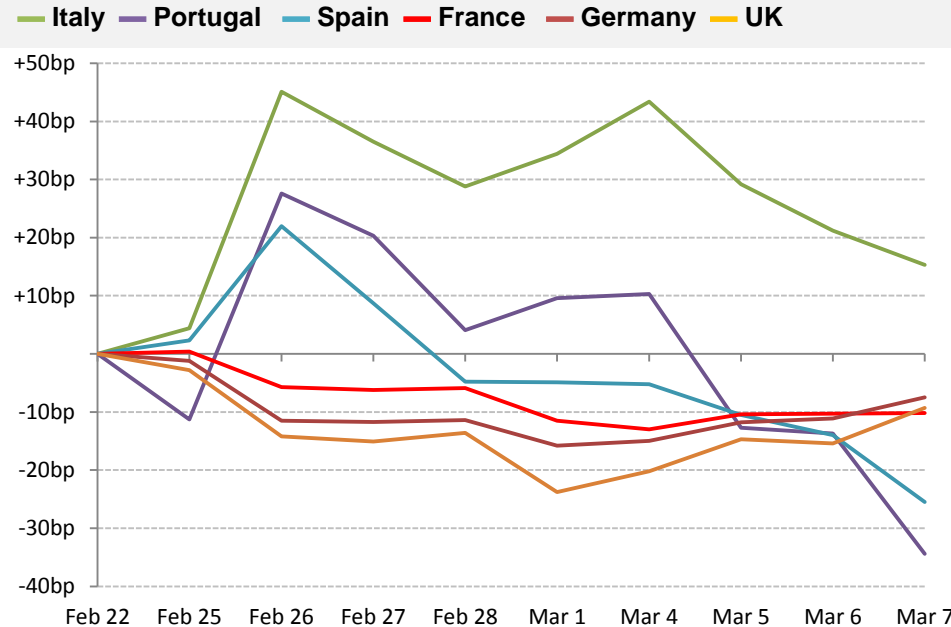
### Update to strategic view

**ECB:** As expected, there was no policy change from the ECB today. Draghi did hint that there may be a rate cut coming, admitting that the ECB at least discussed one today. However, we believe that the ECB's concern about the effectiveness of a cut due to the continued difficulties in the monetary policy transmission mechanism makes a cut in April unlikely.

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- In answer to a question on the Italian election, Draghi said that both the politicians in Italy and "you" -- pointing at the journalists in the room -- care, but the market doesn't care.
- He was certainly correct in this assessment. After an initial shock right after the election, sovereign yields in Europe's core and its periphery quickly recovered, and are now at lower levels than they were before the election (please see the chart below). No signs of contagion here.

### 10-year yield, change from before Italy election



Source: Bloomberg, TrendMacro calculations

- Draghi seemed unconcerned about the threat to structural reforms in Italy from the uncertain election outcome, saying the reform process would continue "on auto-pilot." This seems like an egregiously blasé statement, considering the urgency that reform continue across Europe as both a spur to growth, and an enabler of fiscal integration. We assume that, as an Italian, Draghi felt a stronger statement might have been seen as meddling in Italian politics.
- He referred several times to the ECB's Outright Monetary Transaction (OMT) program, saying "we all understand how it works." One journalist pushed him on this -- since the ECB has, in fact, never explained to the public how it works -- so Draghi said that the ECB will publish the legal documents underpinning the OMT "soon."

For now, the ECB is willing to continue with its current policy stance. Draghi's softening on a rate cut will be viewed as significant, but we think it would be a mistake to presume that this will lead to a cut in April. It certainly increases the likelihood of one, but it should not become any investor's base case at this time.

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[How the Nation Resolved Its First Debt Ceiling Crisis](#)

Kenneth Garbade  
NY Fed Liberty Street  
Economics  
March 4, 2013

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**Bottom line**

As expected, there was no policy change from the ECB today. Draghi did hint that there may be a rate cut coming, admitting that the ECB at least discussed one today. However, we believe that the ECB's concern about the effectiveness of a cut due to the continued difficulties in the monetary policy transmission mechanism makes a cut in April unlikely. ▶