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KBC Flash

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ECB Cuts... And Runs?

- … ECB cuts policy rates by 25 basis points…
- …and raises obstacles to further easing, but we think rates will fall again in early 2012.
- ECB takes strong action to support bank liquidity…
- … but Mr Draghi downplays hope for decisive ECB action in debt crisis.

The European Central Bank cut interest rates by 25 basis points and announced a wide range of new mechanisms intended to improve the liquidity situation of Euro area banks. However, the most important aspect of today's press conference was a seemingly **firm rejection of the idea that the ECB will alter its bond buying programme or that it will opt for more radical measures to ease the sovereign debt crisis.**

The comments made by ECB President Mario Draghi today coupled with a relatively high inflation forecast for 2012 in the ECB's new projections dampen the prospect of a further rate cut in the near term. That said, continuing downside risks to the economic activity mean another easing remains likely in the first quarter of 2012. In the current crisis, the level of policy rates is probably of secondary importance though. The key question emerging from today's ECB press conference is whether a seemingly strong rejection of the sort and scale of actions markets believe are necessary to stabilise Euro area bond markets are **a tactical ploy to force stronger action by Governments or simply reflect the ECB's immoveable opposition to such actions**. The former is difficult to understand, the latter unpleasant to contemplate.

Extremely weak growth prompts limited response

Strong evidence of deteriorating economic conditions and increasing tensions in financial markets of late meant today's decision to cut all the main ECB policy rates by 25 basis points did not come as a surprise. Significantly, Mr Draghi said that this decision **was not unanimous** even if dissent focussed primarily on the timing rather than the substance of the decision. He also indicated that **a larger 50 basis point reduction was not discussed**. These are slightly surprising comments but they send a clear message that within the ECB Council conservatism still prevails. They have to be seen against a backdrop of growing concerns about a sharply weaker outlook for growth that centre on the Eurozone, but have spread across most of the western world in recent months. In these circumstances, all the ECB has done to this point is reverse what the policy tightening it implemented in April and July. It can reasonably be argued that continuing downside risks to a fragile Eurozone economy justify altogether stronger policy action.

Mr Draghi's acknowledgement of continuing downside risks to the ECB's new growth projections which centre on an increase in GDP of just 0.3% in 2012 implies the ECB recognises the possibility of exceptionally poor economic conditions in the coming year. The ECB's expectation that growth will recover to around 1.5% in 2013 may reflect a somewhat complacent view that current problems are temporary in nature. Importantly, it should be noted that the particular weakness of the ECB's growth projection for 2012 also implies **the risk of substantial disappointment in relation to the trend in the public finances of most Eurozone countries next year**.

Is inflation still worrying the ECB or just conveniently high?

Mr Draghi noted that '*cost, wage and price pressures should remain modest over the policy relevant horizon*', but today's statement surprisingly failed to repeat last month's assertion that '*inflation should remain in line with price stability over the policy relevant horizon*'. This might suggest there is **increased uncertainty** within the ECB about inflation prospects, but such an interpretation is not signalled elsewhere in the statement. Significantly, Mr Draghi said today that he sees no high probability of deflation. **So, the references to price stability shouldn't encourage a dovish interpretation.** Instead, today's new ECB projections entail a marginal and understandable increase in the 2011 inflation forecast from 2.6% to 2.7% and a more surprising rise in the 2012 inflation forecast from 1.7% to 2.0%. Although the 2013 inflation estimate falls to 1.5%.

It may be that some of the more hawkish members of the ECB Governing Council feel that the near term inflation outlook remains too uncomfortable to contemplate aggressive policy easing at this point. They may also be concerned that 'real' policy rates are dangerously low. If inflation remains at 3% in December, the inflation adjusted refinancing rate at -2% will be at an all-time low and also far below the near zero average of the past four years. In view of the ECB's primary mandate of price stability, the prospect of stubbornly high inflation in the near term conveniently emphasises limits to its capacity to act in other areas.

We still think the ECB will cut rates further in early 2012 but, in a strange way, today's words spoke louder than its actions and as such emphasise the ECB's reluctance to undertake aggressive policy measures.

Liquidity actions more substantial than expected

If the ECB signalled a little less should be expected from it on the interest rate front than many in the market had anticipated, the reverse is true in terms of its actions to support the liquidity position of Euro area banks. **The ECB announced more aggressive liquidity actions today than were generally envisaged. Two new three year refinancing operations, a cut in the reserve ratio from 2% to 1% and an easing in the criteria for collateral at its refinancing operations go some distance towards dealing with technical constraints damaging the functioning of money markets at present. Unfortunately, of their nature, these measures can't deal with the broader confidence question that haunts the markets at present and the ECB's continuing reluctance to contemplate more radical policy action means that confidence will remain absent and at best markets will continue to misfire.**

One perhaps understandable but slightly worrisome aspect of today's new liquidity measures is the decision to delegate responsibility to National Central Banks to accept banks loans on collateral. In a practical sense, this reflects national differences in loan characteristics and proposes a solution tailored towards local needs. However, set alongside the widespread Emergency Liquidity Assistance measures now in place, it adds further to a sense that the Euro area banking system has increasingly drifted towards mechanisms that operate almost completely separately on distinctly national boundaries.

ECB hides the bazooka

If the ECB didn't hugely disappoint expectations in relation to interest rates and went further than expected in regard to liquidity measures, **Mr Draghi failed miserably to match hopes that the ECB would signal a decisive intervention in the sovereign debt crisis**. His comments a week ago at the EU parliament that 'other elements would follow' agreement on a new fiscal compact had raised hopes the ECB was prepared to play a more significant role once European Governments gave an irrevocable commitment to a more disciplined Budget policy. In the run-up to today's press conference, a number of reports attributed to ECB sources failed to dampen these expectations. As a result **Mr Draghi's unprompted intervention today that his remarks of last week had been misinterpreted came as quite a surprise to markets**.

Mr Draghi said the ECB could not help countries directly because of its mandate. His comments that '*we continue the Bundesbank tradition'* and repeated references to '*the spirit of the treaty*' **suggest a continuing strong opposition within the Governing Council to aggressive purchases of the sovereign debt of pressurised countries**. The fact that as Mr Draghi was speaking, newswires were running stories that the National Central Banks of Eurozone countries would make additional contributions to the IMF highlights continuing major divisions within Europe and unsettling inconsistencies in official comments on this topic. **After today's ECB press conference, it will be difficult to arrive at a compromise solution on Eurozone sovereign debt without some party making a major climb-down**. Unfortunately, a workable solution to the debt crisis that completely excludes the involvement of the ECB is almost impossible to imagine at this point in time. This suggests no early resolution to current market tensions can be expected.

A rockier road ahead

In summary, today's ECB rate cut was widely expected to serve as an appetiser for more substantive action in the weeks and months ahead once Governments agreed on much stricter budgetary rules. This now looks far less certain. The idea of a neatly choreographed resolution of the sovereign debt crisis appeared to be substantiated by comments the ECB President made to the EU parliament last week that dovetailed with encouraging comments from other European policymakers. After today's ECB press conference, the road ahead looks altogether rockier. While a compromise should eventually be reached, **the ECB either seems unhappy with the measures it expects Governments will adopt this weekend or it remains resolutely unable/unwilling to play the full role normally expected of a Central Bank**. This means that even if this weekend summit is notably more successful than its recent predecessors, serious doubts will remain about Euro area policymakers' capacity to put in place a cohesive policy regime that will allow a gradual unwinding of current market tensions and a correspondingly healthier outlook for the Euro area economy.

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