

## Maintaining narrow focus on bank lending

- *Interest rates on hold at 1% for foreseeable future*
- *Little hope of bolder unconventional support for now...*
- *...but more might be required in future*

The ECB looks almost certain to leave interest rates on hold at 1.0% this month, where we expect them to remain until at least the end of 2010. There is little hope that any new unconventional policy support will be announced. The Bank's attention is likely to remain focused on measures to support bank lending and it will probably argue that its latest offer of unlimited 12-month liquidity has been particularly successful. But with the economy not yet on a clear recovery path and deflationary pressures mounting, bolder policy support might still be required in future to avert a particularly long-winded downturn.

### Still lagging behind

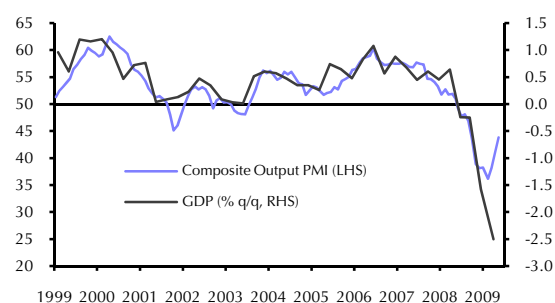
By leaving interest rates on hold and simply revealing details of previously announced modest covered bond purchases, the ECB did the least that might have been expected at its last meeting. While the Bank has just about kept up with other central banks so far as interest rates and lending to commercial banks are concerned, President Trichet stressed that it is not engaged in outright 'quantitative easing' and gave no hints that it was about to embark on such a policy. Accordingly, the ECB continues to lag behind in its support.

### Fewer green shoots than elsewhere

Admittedly, the latest data have brought further tentative signs of improvement, suggesting (on the face of it) that extraordinary policies might be becoming less necessary. **However, evidence of so-called 'green shoots' has been markedly less convincing than elsewhere.** The composite PMI increased only marginally in June, leaving it still pointing to quarterly falls in GDP of around 0.5%. This would be far better than Q1's 2.5% drop. But

the euro-zone PMI has picked up by less than the UK equivalent, which, if taken at face value, already appears consistent with *positive* growth. Comparable surveys of activity in the US have also improved by more than those in the euro-zone.

CHART 1: EURO-ZONE COMPOSITE PMI & GDP GROWTH



Source – Thomson Datastream, NTC Research

What's more, the few hard data that are available for Q2 point to a sharper contraction than the surveys suggest. We expect GDP to fall by 5% this year and stagnate in 2010, which is broadly in line with the ECB's latest staff forecasts.

### But we think that the downturn will have a more marked impact on inflation than the ECB expects.

Producer prices were already falling at an annual rate of 4.6% in April, pointing to more downward pressure on consumer price inflation in the pipeline. What's more, we expect wage growth to drop towards zero next year as the rapid increase in unemployment takes effect. Accordingly, we see inflation averaging just 0.5% in 2010, lower than the 1.0% projected by the ECB's staff, and a sharp pick-up seems unlikely even in 2011. Indeed, very supportive monetary policy will be required to avoid a sustained period of deflation.

### Interest rates on hold well into 2010

Against this economic background, it seems unlikely that the ECB's policy stance will change markedly this month and there is little chance of another interest rate cut. Various council members have stated over recent weeks that rates are still at an appropriate level and some, particularly Bundesbank President Axel Weber, feel that there is no scope for further cuts in future.

**But while rates might not fall any further, they look set to remain at a record low for quite some time.** Austrian central bank Governor Ewald Nowotny hinted in a recent speech that they would probably remain on hold throughout 2010. This is in line with our long-held view, but contrasts with markets' current expectation that rates will start to rise in early to mid-2010.

### Credit easing, *not* quantitative easing

So far as *unconventional* policies are concerned, the ECB will remain focused on stimulating bank lending, which is a particularly important source of finance for firms in the euro-zone.

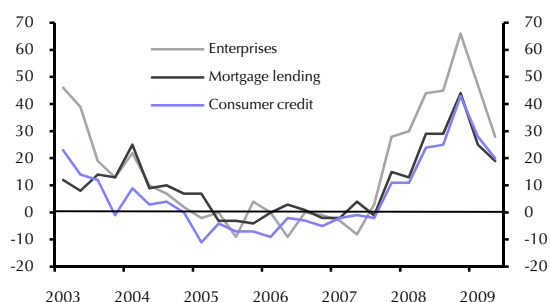
**Here, it will probably argue that the recent extension of the maximum maturity of its loans to commercial banks has been successful.** The first auction of 12-month funds on 24<sup>th</sup> June attracted a lot of interest and the ECB ended up lending €442bn at the policy rate of 1%, which is the most that it has ever lent in a single operation. Taken in isolation, this amount would *double* the stock of outstanding ECB bank loans before the 12-month auction and boost the monetary base by a massive 45%! Two further auctions of 12-month funds are scheduled for 30<sup>th</sup> September and 16<sup>th</sup> December.

But, while this is encouraging, especially if banks use their funds to lend to the wider economy or purchase other assets, there are good reasons not to take the surge in liquidity provision at face value. For a start, ECB lending to banks had been falling before the auction of 12-month funds and the latest boost alone would leave outstanding loans a more moderate 20% above their January peak. **What's more, it seems likely that the surge in 12-month lending will have replaced demand**

**for shorter-term ECB loans.** In the coming weeks and months, maturing short-term loans are unlikely to be renewed, implying that total lending will fall back sharply again.

**And, most importantly, there is clearly no guarantee that banks will lend their extra cash to the wider economy.** It is not surprising that they have taken advantage of such cheap funding, but they might simply use it to repay other loans or as a buffer in case of future losses. The ECB's bank lending survey shows that most banks intend to continue tightening lending conditions for both firms and consumers. (See Chart 2.) What's more, with unemployment rising sharply and the outlook for demand still uncertain at best, it seems unlikely that firms or households will *want* to borrow, even if banks are willing to lend.

CHART 2: NET % OF BANKS EXPECTING TO TIGHTEN CREDIT CONDITIONS



Source – ECB Bank Lending Survey, April 2009

**Accordingly, we still think that a bolder policy response is warranted to make any real difference to the economic outlook.** Whether or not this will be forthcoming is highly uncertain. Governing Council members have been quiet on this front over the past month and there has been no strong push towards outright 'quantitative easing'. In the end, the growing risk of deflation might well force the ECB into bolder asset purchases. But for the time being, the Bank will stand by its policy of restoring 'normality' to the banking sector, which is sadly unlikely to be as successful as it hopes.

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## ECB BACKGROUND INFORMATION

Interest Rate Meetings	Meet twice monthly. Policy setting meeting usually first Thursday of month.	
Release of minutes	No minutes published, but press conference 45 minutes after interest rate announcement.	
Disclosure of voting	No	
Inflation Target	Asymmetric target of below but close to 2.0% over the medium term.	
Policy Guidance	Quarterly ECB Staff Macroeconomic Projections (Mar, Jun, Sep, Dec)	
Members	22 members of the Governing Council = 6 members of the Executive Board + 16 Governors of national central banks	
President (tenure, end)	<b>Jean-Claude Trichet</b> , President of the ECB (8 years, 31 <sup>st</sup> October 2011)	
The other 5 members of the Executive Board	Lucas D. <b>Papademos</b> , Vice-President of the ECB (since 1 June 2002) Lorenzo <b>Bini Smaghi</b> José Manuel <b>González-Páramo</b> Juergen <b>Stark</b> Gertrude <b>Tumpel-Gugerell</b>	
The 15 Governors	Guy <b>Quaden</b> , Governor, Nationale Bank van België / Banque Nationale de Belgique Axel A. <b>Weber</b> , President, Deutsche Bundesbank George <b>Provopoulos</b> , Governor, Bank of Greece Miguel Fernández <b>Ordóñez</b> , Governor, Banco de España Christian <b>Noyer</b> , Governor, Banque de France John <b>Hurley</b> , Governor, Central Bank and Financial Services Authority of Ireland Mario <b>Draghi</b> , Governor, Banca d'Italia Yves <b>Mersch</b> , Governor, Banque Centrale du Luxembourg Nout <b>Wellink</b> , President, De Nederlandsche Bank Ewald <b>Nowotny</b> , Governor, Oesterreichische Nationalbank Vítor Manuel Ribeiro <b>Constâncio</b> , Governor, Banco de Portugal Erkki <b>Liikanen</b> , Governor, Suomen Pankki / Finlands Bank Marko <b>Kranjec</b> , Governor, Banka Slovenije Athanasios <b>Orphanides</b> , Governor, Bank of Cyprus Michael C. <b>Bonello</b> , Governor, Bank of Malta Ivan <b>Šramko</b> , Governor, Národná Banka Slovenska	
<b>Interest Rate Meetings</b>	<b>Date</b>	<b>Outcome/Forecast*</b>
2008	3 <sup>rd</sup> July	25bp hike to 4.25%
	7 <sup>th</sup> August	No change
	4 <sup>th</sup> September	No change
	2 <sup>nd</sup> October	No change
	7 <sup>th</sup> October (co-ordinated, emergency action)	50bp cut to 3.75%
	6 <sup>th</sup> November	50bp cut to 3.25%
	4 <sup>th</sup> December	75bp cut to 2.50%
2009	15 <sup>th</sup> January	50bp cut to 2.00%
	5 <sup>th</sup> February	No change
	5 <sup>th</sup> March	50bp cut to 1.50%
	2 <sup>nd</sup> April	25bp cut to 1.25%
	7 <sup>th</sup> May	25bp cut to 1.00%
	4 <sup>th</sup> June	No change
	<b>2<sup>nd</sup> July</b>	<b>No change*</b>
	<b>6<sup>th</sup> August</b>	<b>No change*</b>

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