

Another rate cut, but no silver bullet

- **Rates to be cut to 1%**
- **Two or three-year loans to be offered to banks**
- **But bond purchases will remain limited and sterilised for now**

The European Central Bank will respond to the growing evidence that the euro-zone economy is heading back into recession by cutting interest rates to 1% at its December 8th meeting. What's more, President Draghi is likely to announce the provision of longer-term loans to commercial banks at maturities of two or three years in an attempt to address strains in the sector. Crucially, however, the ECB will continue to resist calls for it to fire a silver bullet into the heart of the debt crisis by printing money to buy up huge quantities of highly indebted governments' bonds.

Facing facts

At his first meeting as ECB President last month, Mario Draghi's very downbeat tone and the surprise decision to reduce interest rates suggested that the ECB was facing up to the severity of the euro-zone's situation. The President even acknowledged that the region might head into a "mild recession". But while he said that the Bank would continue to buy indebted governments' bonds, he stressed that the policy was limited and temporary. There was no evidence that the ECB was willing to respond to the growing calls for it to resolve the debt crisis by printing money to finance a dramatic increase in its bond purchases.

Economy heading into recession

Since that meeting, there has been firmer evidence that the euro-zone is indeed heading into a recession, although it seems unlikely to be "mild". Despite a slight increase in November, the headline composite index of the PMI business survey remained below the "no-change" level of 50 and consistent, on past form, with falls in GDP of as much as 1% per quarter. Other business

surveys paint a similarly dismal picture and the hard data have begun to deteriorate too. Note that euro-zone industrial production fell by 1.9% in September, providing a very weak base for Q4 and unemployment rose for the sixth month running to reach a euro-era high.

What's more, the ECB must surely acknowledge the likely damage to future economic activity from the escalating debt crisis and its effect on business, consumer and financial market sentiment. **Accordingly, the Bank's new set of staff forecasts published alongside the December meeting is likely to reveal substantial downward revisions to the outlook for both growth and inflation.**

Our view that a limited form of euro-zone break-up is likely has led us to revise down our own forecasts dramatically. (See our latest *European Economics Focus*, "How and when will the euro-zone break up?") **We now see euro-zone GDP contracting by 1% in 2012 and by 2.5% in 2013, with a real risk that deflation sets in.**

The ECB will not judge that the outlook is this dire. However, we see the Bank revising down the mid-point of its growth forecast for 2012 from 1.3% to something like 0.5% or a bit higher. (The latest consensus forecast is 0.4%) **Inflation is likely to be projected to be below the target of "close to 2%" in the medium term, easily warranting a 25 basis point cut in interest rates to 1.0%.**

For now, we suspect that this will be the end of the line for conventional policy loosening. After all, the Bank has not cut rates below 1% before, even in times of deep recession. A further reduction would force the Bank to narrow the so-

called “corridor” between its deposit rate (currently 75bp below the repo rate) and the marginal lending rate (75bp above the repo rate). Such a move would reduce the return on interbank lending relative to riskless ECB deposits and hence discourage such activity. But recent comments from Council members suggest that a reduction below 1% cannot be ruled out altogether. Mr González-Páramo of the ECB’s Executive Board recently stated that “The fact that 1% has been the historical low means only that. Every month we assess the situation and take the decision.”

Increasing support for banks

As for unconventional policies, the ECB will probably remain focused on supporting the banking sector. Signs of strain have grown lately, with interbank interest lending rates rising and banks placing more money on deposit with the ECB instead of lending to each other. Accordingly, borrowing from the ECB has also surged, with the amount demanded at the one-week maturity reaching a 2½-year high last week.

The ECB recently co-ordinated with other central banks to announce a reduction in the price of dollar liquidity, which Banks in the region are particularly struggling to obtain. It might well complement this move by announcing the provision of euro-denominated loans at longer maturities. So far, the ECB has provided unlimited loans for up to one year (the next offering at this maturity will take place on 20th December) but there has been speculation that it will extend that to two or even three years in order to reduce uncertainty and improve confidence in the sector.

All of this will be very welcome, particularly to banks in the region’s periphery, which are still heavily reliant on ECB funding. Even those in “core” countries like France and Austria have suffered from rising risk aversion lately, implying that they too will benefit from more ECB support.

No silver bullet

However, the Bank still seems unlikely to tackle the root cause of the euro-zone’s problems by

buying enough bonds to restore confidence in the region’s indebted governments. Admittedly, it has upped its bond purchases lately – buying over €20bn in the past few weeks alone. But it still owns only 6.5% of the outstanding debt of Italy, Spain, Portugal, Greece and Ireland. And it has continued to sterilise its purchases by taking in bank deposits to prevent any impact on the narrow money supply and avoid inflationary effects. Admittedly, it failed to attract enough deposits to sterilise its most recent purchases, but this outcome was *not* intended. Past experience suggests that the shortfall will probably be met by larger deposits at the next operation.

Mr Draghi is likely to rebuff calls for the ECB to make much larger, unsterilized purchases at the forthcoming press conference. The Bank fears that such a policy would create moral hazard, risk the central bank’s independence and possibly generate inflation. What’s more, Council members have argued that such a policy would be illegal.

One possible way around the legality issue that has received some attention lately is for the ECB to lend to the IMF, which would then purchase the bonds. The benefit would be that the IMF bore the risk of default instead of the ECB. However, if such loans still required the Bank to print money, it would still fear the inflationary consequences (rightly or not). Similarly, using the IMF as middle man would clearly not overcome the problem of moral hazard.

With policymakers struggling to come up with anywhere near enough funds to draw a line under the crisis, even with a leveraged EFSF, the ECB might well have to intervene in the end. But we suspect that it will refuse to do so until the euro-zone governments have agreed on much clearer rules to prevent governments from running up such high debts in future. **That this could take quite some time.**

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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	23 members of the Governing Council = 6 members of the Executive Board + 17 Governors of national central banks.
President (tenure, end)	Jean-Claude Trichet , President of the ECB (8 years, 31 st October 2011)
The other 5 members of the Executive Board	Vítor Constâncio , Vice-President of the ECB Lorenzo Bini Smaghi José Manuel González-Páramo Jürgen Stark Peter Praet
The 17 Governors	Luc Coene , Governor, Nationale Bank van België / Banque Nationale de Belgique Jens Weidmann , President, Deutsche Bundesbank George Provopoulos , Governor, Bank of Greece Miguel Fernández Ordóñez , Governor, Banco de España Christian Noyer , Governor, Banque de France Patrick Honohan , Governor, Central Bank and Financial Services Authority of Ireland Mario Draghi , Governor, Banca d'Italia Yves Mersch , Governor, Banque Centrale du Luxembourg Klaas Knot , President, De Nederlandsche Bank Ewald Nowotny , Governor, Oesterreichische Nationalbank Carlos Costa , Governor, Banco de Portugal Erkki Liikanen , Governor, Suomen Pankki / Finlands Bank Marko Kranjec , Governor, Banka Slovenije Athanasios Orphanides , Governor, Bank of Cyprus Josef Bonnici , Governor, Bank of Malta Jozef Makuch , Governor, Národná Banka Slovenska Andres Lipstok , Governor, Eesti Pank

Interest Rate Meetings	Date	Outcome/Forecast*
2011	13 th January	No change
	3 rd February	No change
	3 rd March	No change
	7 th April	25 bps hike to 1.25%
	5 th May	No change
	9 th June	No change
	7 th July	25 bps hike to 1.50%
	4 th August	No change
	8 th September	No change
	6 th October	No change
	3 rd November	25 bps cut to 1.25%
		8th December
2012	12th January	No change*
	9th February	No change*
	8th March	No change*
	4th April	No change*
	3rd May	No change*
