KBC Flash

From KBC Market Research Desk - More research on www.kbcdealingroom.com

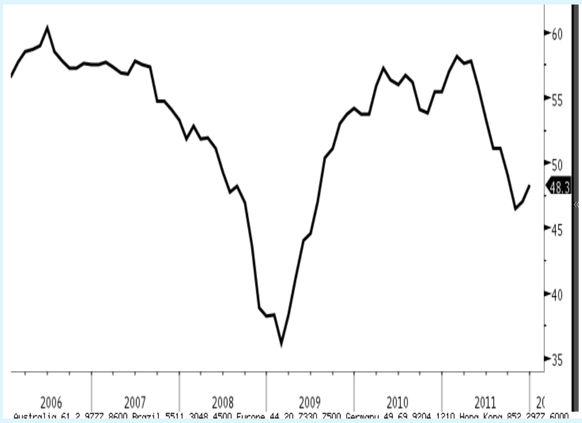
ECB to take a pause

- … Economic and inflation developments don't point to the need of a third consecutive rate cut….
- as the ECB doesn't want to be considered too aggressive
- … Mr. Draghi to confirm ECB position on SMP programme….
- ….All in all, the meeting may have no lasting impact on markets
- …

At the December policy meeting, **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 the press conference was a seemingly **firm rejection of the idea that the ECB might alter its bond buying programme or that it will opt for more radical action to ease the sovereign debt crisis. The ECB is likely to forcefully stick to this view on Thursday. We also think it is unlikely that it will cut rates further this month for a number of reasons we elaborate on in the next paragraphs.**

Economic outlook unchanged

Since December, the economic situation as painted by the most recent set of data hasn't changed a lot. The outlook remains bleak, with negative growth likely in Q4 2011 and probably also in Q1 of 2012 likely. However, the PMI Business Index increased in December for a second month in a row. At 48.3, the composite indicator still suggests a decline in activity, but the pace of deterioration has moderated. There was a somewhat poorer message from the European Commission economic confidence index, which lags slightly the PMI, but which also has a broader scope, including for instance consumer confidence. Industrial confidence, a sub-index, did improve slightly in December, but only for the first time. Global industrial confidence was higher and most recent US eco data, notably the labour market indicates are encouraging.



Graph 1: Composite PMI rises for second month.

So, tentatively, **the outlook for the euro area has stabilised or even improved slightly**, even if downside risks remain considerable. So, recent data hold out the possibility that the EMU recession may remain mild and limited in time. Of course, one month of data doesn't make a trend, and some analysts say the recent improvement is only due to seasonal adjustment issues, but we think it is warranted to give more weight to the possibility that some mild improvement is indeed at hand. Significantly, several German eco indicators, including the IFO and the labour market data surprised on the upside. A clearer picture may take several months, but that itself is a significant argument for the ECB to keep policy unchanged in January.

Euro area inflation dropped in December to 2.8%, according to the flash estimate, from a cyclical peak of 3% in November. This decline was widely expected and even slightly disappointing as some anticipated a bigger drop. Some easing in inflation was of course also widely anticipated by the ECB. Since oil prices are a bit higher ($113/barrel now versus $109), and the trade weighed euro weakened by about 4%. Since the December meeting, the outlook for inflation remains somewhat unclear. While inflation shouldn't be a problem given the longer term outlook for economic activity, **the inflation environment certainly hasn't surprised to the downside of late.**

Policy considerations

Besides the economic and inflation developments which show no need for an immediate extra easing of policy, there are a number of other "soft" (but no less important) elements that point to at least a pause in the easing cycle. In December, the ECB took a lot of far-reaching measures to support the banking sector including the provision of 3-year liquidity and a softening of collateral requirements. It has also cut rates twice in succession in November and December. These steps had certainly their merit, but **by continuing this break-neck pace of policy changes, the ECB would appear extremely pro-active, a break with its tradition and raising some questions about its reputation for continuity, consistency and credibility.** We don't think that the majority of the ECB governors would stand behind a radical policy shift at this juncture. Indeed, the influential Germanic wing of the board might get very alarmed. Mr. Draghi knows very well that he needs the backing of Germany if he wants to be successful as president of the ECB.
With real official rates still very negative, monetary policy is already accommodative for the Eurozone economy as a whole in the sense that base money is abundant available. Of course, the transmission mechanism has been damaged by the banking crisis and the sovereign debt markets are dysfunctional. However, given how low official and market rates are at present, one cannot reproach the ECB for keeping policy rates too high. One more rate cut, which we think will be implemented at some point in coming months won't make a lot of difference in this regard. Of course, **while the credit channel is clogged, lower rates may still ease policy via for instance the weakening of the currency**. However, we think that many ECB governors won't want to push this too rapidly, even if the recent weakening of the euro will be (silently) welcomed.

Another rate cut at this meeting might also frighten markets, as investors may wonder whether the ECB is focussing on something even nastier than traders expect at present. New measures on liquidity or collateral are also unlikely given the scale of measures taken as recently as last month.

Press conference: still no sign of lender of last resort ambitions

As usual, a lot of ground will be covered in the press conference. **On the subject of the ECB playing the role as lender of last resort, we don't expect any evolution**. Last meeting, Mr. Draghi clearly rejected the idea and we don't see why he (ECB) should have changed his mind since. His comments on the first 3-year liquidity LTRO will be interesting too, as will his comments on numerous other subjects, like the euro.

Market reactions

Economists are preponderantly betting on unchanged rates. Out of 53 analysts surveyed by Bloomberg, 47 favour unchanged rates. While this is an overwhelming majority, it would be wrong to discard the six dissenters, who all go for a 25 bps rate cut. The market does speculate on lower refi-rates now, but only (mostly) at a later meeting.

Piet Lammens, KBC Brussels
Austin Hughes, KBC Dublin

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41		
Peter Wuyts	+32 2 417 32 35	Brussels	
Didier Hanesse	+32 2 417 59 43	Corporate Desk	+32 2 417 45 82
Joke Mertens	+32 2 417 30 59	Commercial Desk	+32 2 417 53 23
Mathias Van der Jeugt	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research (KBC Bank Ireland)			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Jan Bures	+420 2 6135 3574	New York	+1 212 541 06 97
		Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8809	Prague	+420 2 6135 3535
		Bratislava	+421 2 5966 8436
Warsaw Research (Kredytbank)		Budapest	+36 1 328 99 63
Piotr Radzewicz	+48 22 6345 946	Warsaw	+48 22 634 5210
Budapest Research (K&H)		Moscow	+7 495 228 69 61
Gyorgy Barcza	+36 1 328 99 89		

Our reports are also available on: www.kbcdealingroom.com