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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

Sonsoles Castillo
s.castillo@bbva.com

María Martínez Álvarez
maria.martinez.alvarez@bbva.com

Cristina Varela Donoso
cvarela@bbva.com

Alejandro Neut
robertoalejandro.neut@bbva.com

Europe

Miguel Jiménez
mjimenezg@bbva.com

Agustín García
agustin.garcia@bbva.com

A rate cut in the near future is likely

- **Recent economic data disappoint, a worryingly gloomy outlook at the start of 2Q13 is spreading**
- **Dovish comments from ECB´s Governing Council members hint to a rate cut**

Bottom line: It is very likely that the ECB will soon cut its main policy rate by 25bps, as recent economic data show worsening conditions spreading to core economies, including Germany. We see more likely the rate cut to occur at June´s meeting, although it could be brought forward to May. The ECB will probably leave unchanged both deposit and marginal lending rates (the ECB has said in several meetings that "any negative rate is uncharted waters"), thus reducing the the interest rate corridor from +/-75bp to +/-50bp. Any surprise on this front should be read as a more innovative turn.

Lastest data: Despite the continued improvement in financial market conditions, April´s Flash PMIs slightly disappointed and did not reverse the sharp fall of February and March.More importantly, the weakness seems to be spreading further to Germany. Germany´s PMI and Ifo survey came below expectations, adding to doubts to the expected gradual recovery projected for the rest of the year. Moreover, signs of some slowdown in other economic areas (China and US), together with the impact of Japan´s aggressive policy move, have added to the risk of lower exports and growth. While it is unlikely that Europe´s growth will be worse than prevailing ECB staff forecasts, Europe´s outlook remains uncertain and risks have increased to the downside.

Regarding price stability, inflation in the euro zone continued to ease since Q412, not only due to the significant base effect in energy prices, but also to moderation in inflation of core components, reflecting the weakness of domestic demand. We expect inflation to slow further to 1.4% y/y for April then, it should hover around 1.5% y/y during the second half of the year, well below to 2% the implicit inflation target. Core inflation is likely to remain more stable, fluctuating around the current rates (1.4% y/y) along this year. In addition, the prospects of new upward shocks from oil prices are very low, while the risks from higher indirect taxes (with perhaps the exception of Italy) seems to dissipate, especially given the more relaxed approach to fiscal austerity perceived from EU authorities.

Latest declarations: With disappointing growth data on one hand and well anchored inflation expectations on the other, ECB´s Governing Council members have recently used a more dovish tone, stating that a rate cut would be possible if the economic situation remains weak. In particular, Joerg Asmussen echoed last week´s remarks from Jens Weidman by saying that "the ECB has already *done quite a lot* to help the euro-area economy and could cut interest rates further if data show a need for it." "The pass-trough of rate cuts to the periphery would be limited… rate cuts would further relax already unprecedently easy financing conditions in the core. This is not per se a problem -…". Klaas Knot has added that the central bank still has "conventional and unconventional monetary policy measures at its disposal", while Vitor Constancio highlighted that a rate cut is "always a possibility". All of them emphasised that the ECB will stand ready to act if economic data deteriorates. It seems that the case for a rate cut, that has already been under discussion for the last few months, could have gained ground.

Expected policy announcement and effect: The rate cut would be justified on the above weaker-than-expected activity data and the risk it poses to the gradual recovery projected for the second half of the year. In the last ECB meeting, Mr Draghi already said that the ECB was "monitoring very closely all incoming information on economic developments," also showing concern for peripheral weaknesses´ reaching core countries.

Certainly, we consider that the effect of this rate cut would be limited, as the credit channel of monetary policy is not functioning properly. Nonetheless, a *refi* rate cut would work to reduce banks' funding costs, especially in peripheral countries where banks rely much more on ECB liquidity. However, amidst an environment of increasing downward risks on activity, the ECB could signal that it is ready to go ahead using the available margin, trying to increase confidence.

More needs to be done. As Draghi also pointed out earlier this month, non-standard measures are under discussion, particularly to stimulate loans to SME´s, although recent comments from ECB´s Governing Council members suggest that the eventual use of such measures is neither easy not imminent and that probably other EU and national institutions could and should do more to revive credit than the ECB. Still, the ECB, together with the EIB, could follow that road in the months ahead.

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