RESEARCH

ECB Watch

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Economic Analysis

Financial Scenarios Unit
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

Jaime Costero
jaime.costero@bbva.com

Europe Unit
Miguel Jiménez
mjimenezg@bbva.com

Time to take action: better this week

The ECB approaches a crucial meeting where there will be an intense debate

At their last meeting, the Governing Council (GC) said that it would need more information before taking any action: "The reason for today's decision not to act has really to do with the complexity of the situation … and the need to acquire more information."

Inflation has not deteriorated any further, yet remains persistently weak: it stood at 0.8% YoY in January (slightly below expectations) and also in February (surprising slightly on the upside for the first time in some months). However, future rather than past inflation is more relevant for the ECB´s decision making. Next Thursday, ECB staff will start releasing their inflation and growth estimates for 2016, the first time they will have published estimates with such a long horizon. What should we expect? A preliminary proxy for this projection can be found in the latest quarterly Survey of Professional Forecasters (SPF), in which inflation is expected to average 1.4% in 2015, 1.7% in 2016 and 1.9% in 2018 (signalling that long-term inflation expectations remain well anchored but below ECB´s self defined objective). However there are some worrying signs: the probability distribution of 2015 inflation has shifted slightly downwards in the last two quarters, doubling the chances that inflation ends below 1% in 2015.

For those who place great predictive power to Phillips curve analysis, there is little room for complacency. Economic indicators continue to be consistent with a moderate recovery: confidence indicators continue strengthening despite a slight drop in February's PMIs Flash (yet the fall was from January´s high PMI levels, the highest in the past two and a half years). On the other hand, hard indicators continue to lag, cautioning us on the pace of recovery. Externally, emerging markets (EM) seemed to have stabilized after decisive actions were taken in key countries. However, idiosyncratic and political risks may be magnified as both the Fed´s tapering strategy and EM´s downward cycle continue. The ECB is not indifferent to such risks: their last statement included a reference to recent volatility in emerging markets and its potential effect on activity. Against a backdrop of increasing risk aversion, Europe continues to benefit from capital inflows, which have strengthened the euro and benefited periphery debt.

Credit growth remains sluggish. In January, money supply grew at 1.2% but loans to the private sector continued to contract (loans to the private sector contracted by 2.2% YoY, after a record 2.3% contraction in December). Thus momentum in credit and money supply remains subdued.

On the political front, in early February the German Constitutional Court took an unprecedented step when referring the OMT to the European Court of Justice. Now, any decision on that matter will likely take time, making the ECB even more cautious about making any move that would involve any type of action buying sovereign bonds.

But throughout February, ECB council members have been on the alert, stating that any measure is possible if inflation expectations worsen. Benoit Coeure said "if we see downside risk to medium-term price stability then we will have to act." Peter Praet recognized that "the pressures on prices are weak, and that this weakness in price development is extending into the medium term." Also, Mr. Draghi recently said that persistently low inflation increases the odds of "potentially negative developments," and "the Governing Council is willing and ready to take action in case these risks materialize - not even materialize, but strengthen." While no member has made explicit any immediate action, the tone of these declarations has contributed to boost market expectations.

Considering the sluggishness of most indicators and the tone of the ECB´s recent communication, lack of action by the ECB in March would be difficult to explain and could be costly in terms of clarity. Thus we expect the ECB will make some kind of move. Yet the decision will be a close call, as strategic arguments by different factions within the GC could weigh significantly in the final decision.

Positions within the GC seem far from being aligned, ranging from members who think it is unnecessary to act, as deflation is a distant risk and that ECB´s action when those risks materialize would be enough to fight it; to those who favour a "decisive" move to hedge against those risks or to make sure that a powerful signal is given about the symmetry of the ECB´s concern about low inflation, now that their commitment to react when inflation is above its target is well anchored. As a consequence of these different views, we expect no aggressive measures as the eurozone, despite the current disinflationary process and weaknesses in the growth outlook, as we are still far from a deflationary scenario and the ECB is unlikely to agree on pre-emptive measures.

More likely, members within the GC might find common ground implementing a gradual approach that does not exhaust all their munition at this stage, but that could have an impact using a combination of different measures.

Which of all its tools is the GC more likely to use? In principle, the most obvious option is to cut refi rates further, but its limited effectiveness should weigh heavily against taking this measure in isolation. Apparently, ending the sterilisation of SMP purchases is very likely (resistance by some GC members seems to be waning). This measure would inject €175.5bn of liquidity in the system (a potent signal, despite not being a significant amount compared to the liquidity injected by the past 3Y LTROs). The reduction in the deposit facility rate into negative territory is more controversial, having been described as "uncharted waters". However, it could lead to an weakening of the EUR, something the ECB should consider given the persistent strength of the euro and its pass-through to the disinflationary process. It may also help reactivate the interbank market, and subsequently reduce current fragmentation. We thus expect a combination of all or some of these actions as soon as in the next ECB meeting. It is not unlikely that it decides to wait, and just signalling its strong willingness to act, but we find this strategy riskier at this stage considering the current outlook and market expectations, driven by recent statements.

We also expect that the ECB will retain its dovish bias, in case more needs to be done in the future. What else could be done? The strengthening of its forward guidance through the announcement of LTROs at fixed rates is, in our view, a potentially much more effective measure, as it would anchor expectations of interest rates. On the other hand, we do not contemplate the outright purchases of sovereign bonds (QE): this measure would only be implemented in reaction to outright deflation. Purchasing other assets is very much on the table, considering Mr Draghi´s comments in past press conferences.

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