5 November 2013

Flash Comment

ECB preview: inflation top of the agenda

- **At the ECB meeting the most important topic will be inflation, which is much lower than the ECB's 2% target.**
- **Mario Draghi is likely to be dovish and signal that he will act to ensure that medium-term inflation expectations remain 'anchored' if needed.**
- **A rate cut will be discussed and even though it is not our main scenario, it is possible the ECB will react quickly to the low inflation rate. We expect the ECB to cut the refi rate in December when new forecasts are released.**
- **Excess liquidity continues to decline and money market rates have been slowly pushed higher. The ECB does not like *de facto* monetary tightening and looking ahead it is likely it will act by using non-standard measures.**
- **The market has built up expectations of the ECB, but the pricing does not give a clear answer on the probability of a refi cut versus providing liquidity. For the November meeting some probability of a refi cut is also priced in.**

Inflation to get almost all of the attention

Inflation in the euro area was down at 0.7% in October, which is much lower than the ECB's target of maintaining inflation below but close to 2% over the medium term. Hence, it is likely to get almost all of the attention at the ECB meeting on Thursday. We expect Draghi to be very dovish when talking about the development in inflation and send a strong signal that he will act to ensure that medium-term inflation expectations remain 'anchored'. Looking ahead, we expect the ECB to cut the refi rate by 25bp at the ECB meeting in December, *(see 'Flash Comment: ECB expected to cut the refi rate in December' from 1 November 2013).*

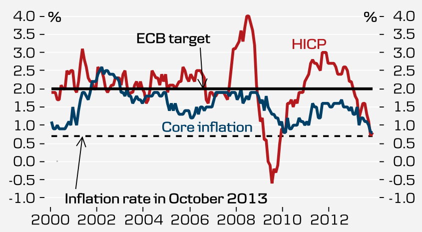
The inflation rate of 0.7% in October was not a one-off and the likelihood that Draghi will describe it as transitory is limited. The lower rate followed as energy prices declined more than in September, food prices increased at a slower pace and also core inflation increased less than in the preceding month. The decline in core inflation was due to a slower increase in service prices. This is largely explained by high unemployment and the associated low wage pressure due to the high dependency of labour as an input in the service sector. The development in energy and food prices can to a large extent be explained by the end of the super-cycle in commodity prices.

Even in the introductory statement we expect Draghi to be much more dovish on the inflation outlook. He might exclude his comment that there is an upside risk to the outlook for price developments *'relating in particular to higher commodity prices'*. However, he could wait until the December meeting when we expect a rate cut.

Discussion of a rate cut

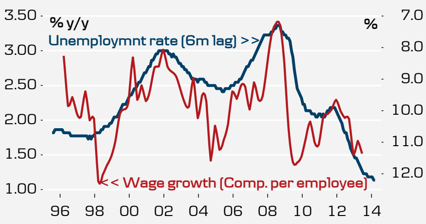
The ECB Governing Council will definitely discuss a rate cut at the November meeting and even though it is not our main scenario, it is possible that the ECB will respond quickly to the low inflation and cut the policy rate this week. In our view, it will use this meeting to signal a rate cut in December.

Euro inflation as low as in 2009...



Source: Eurostat

... due to low nominal wage pressure...



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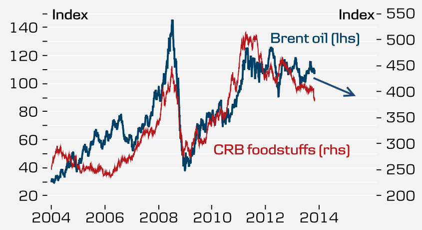
... and declining commodity prices



Source: Macrobond

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Waiting a month also implies the ECB will have one more observation for inflation and that the rate cut will come together with the ECB's new inflation forecasts released in December.

We currently estimate inflation to come out at 0.8% in November, which would confirm the need for monetary easing. There is a small upside risk of around 0.1pp to the estimate from the effect of the Italian VAT increase in October. However, this effect would be temporary and should not be an argument for the ECB not to cut the policy rate. Looking ahead, we expect the ECB to lower its inflation forecast for 2014 to 1.0% from 1.3%, while the first release of the 2015 projection should come out at 1.4%.

Even though the inflation rate is not even close to the ECB's 2% target and the outlook for inflation is subdued, there are still arguments against further easing. The recovery is gaining ground and the newly released Bank Lending Survey suggests that the credit channel is becoming less restrictive for growth. This implies the Governing Council could be split about the need for further accommodation and as Mr. Draghi said in September, *'Some governors of course observed that improvements in the economy would not justify this discussion'.*

We expect growth in the euro area to surprise on the upside; however, the ECB's arguments for a rate cut outweigh those against as the primary objective of the ECB is to maintain price stability. Nevertheless, the improvement in the economic outlook implies our expectation of a rate cut in December is a close call. However, even for the hawks in Germany it will be harder to argue against the need for accommodation as German flash HICP is also below the 2% target and declined to 1.3% in October.

Excess liquidity continues to decline

Another topic at the ECB meeting will be excess liquidity, as it continues to decline. It is now down around EUR175bn after its highest number since April was repaid Friday. The decline has already pushed short market rates upwards and as excess liquidity has fallen below the EUR200bn mark, the general perception seems to be that there will be a more pronounced effect on interest rates from falling excess liquidity. Our *analysis* suggests that there was not a kink at EUR200bn but that the impact gradually increases as excess liquidity moves towards zero.

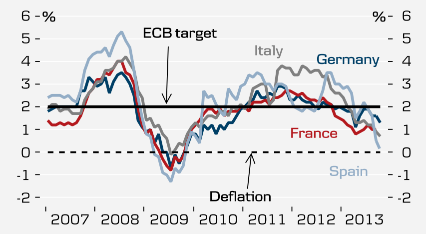
The Governing Council is not pleased with the *de facto* withdrawal of monetary accommodation and this could be another argument for the ECB to act. However, as inflation is the main argument for policy action we expect a rate cut and see it as more likely the ECB will respond with a new LTRO if excess liquidity pushes short-end rates higher. This possibility has been mentioned by a number of Governing Council members and recently Ewald Nowotny said that the ECB wants to avoid a cliff effect at the end for the LTRO programme. He also suggested new LTROs would be more tailored to countries perceived to have funding requirements but in our view it would be a little hard to implement.

Nevertheless, there have also been some more hawkish comments about new LTROs since the ECB meeting in October. Executive board member Yves Mersch has said new LTROs may not be necessary while Vitor Constancio has said that the ECB was not actively preparing for further LTRO loans. Hence, the signals from the ECB members are a bit mixed and a new LTRO is not our main scenario at the moment.

Other instruments are possible if short-end rates increase

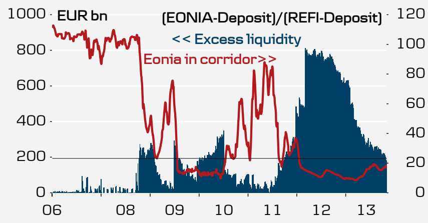
Executive board member Asmussen has made some dovish comments. He said the ECB is watching the EONIA closely and indicated that the ECB has a number of options on the table besides rate cuts and another LTRO. He mentioned a cut in the reserve requirements, which would free up more than EUR100bn in liquidity.

German inflation also below ECB target



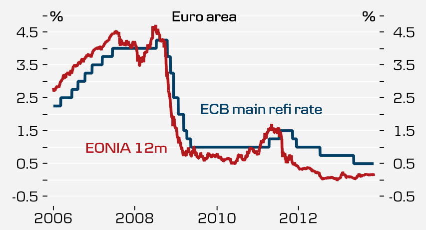
Source: Eurostat

Declining excess liquidity puts upward pressure on money market rates



Source: Reuters EcoWin

Short market rates slowly increasing



Source: Macrobond

Liquidity, reserve requirements and autonomous factors

Source: Reuters EcoWin

Most interesting were his comments that the ECB could consider halting the sterilisation of the SMP (Securities Markets Programme), which was the initial government bond purchase programme later replaced by the OMT. This would at the current stage free up around EUR188bn in liquidity which is otherwise drained on a weekly basis. This would be somewhat of a surprise move, since it could be interpreted as the ECB allowing for QE. We see a new LTRO as the most likely response to higher money market rates despite the ECB having other options.

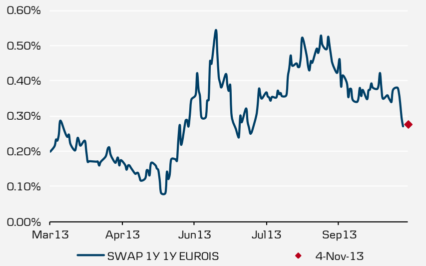
Market expectations

Since the 0.7% inflation print, expectations for some ECB action have increased significantly as rates have declined and the EONIA forward curve has flattened. At the same time, excess liquidity is declining and we have seen signs that we have reached the inflection point where the EONIA starts rising. The flattening of the EONIA curve suggests that the expectations for more ECB action are outweighing the declining liquidity situation.

The market is currently pricing the ECB to keep money market fixings almost flat for several months ahead. Furthermore, the 1M EONIA is only 0.25% around the time where the current LTROs are running out (Q1 15). Hence, it seems fair to assume that the market is expecting the ECB to do ‘something’ to keep money market rates stable. The market pricing does not give a clear answer on the probability of a refi cut compared to providing liquidity either through cutting the reserve requirement or through new LTRO (a combination could also be the expectation). As the EONIA forward curve is not inverse, we see no clear signs of deposit cut expectations materialising.

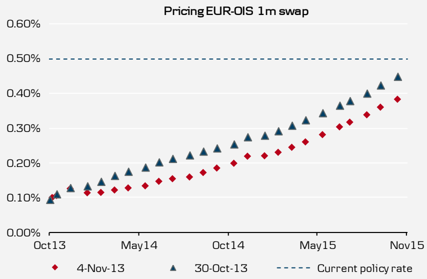
It is worth noting that the price on the November Euribor 3M is now below the current fixing, suggesting some expectation at the November meeting. As there will still be plenty of liquidity when the November Euribor is settled (18 November), we take this as a sign of some expectation of a refi cut being built into Thursday’s meeting.

Inflation print forced rates to decline



Source: Danske Bank Markets

Forward curve has flattened



Source: Danske Bank Markets

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