

## ECB Embraces Forward Guidance

Summary | Today's News in Detail | Latest Issues of Sovereign Debt Crisis Update | Macroeconomic Forecasts | Recent Research

### Summary

The ECB left its key interest rates unchanged, as expected, but unexpectedly enacted a new **'forward guidance' framework without having exhausted the existing room for manoeuvre on rates**. Comment: the decision was probably driven by inflation undershooting the target beyond 2014 and deterioration in monetary conditions brought about by higher market rates. We maintain our forecast of a 25bp rate cut in the refi rate in 4Q-13.

**ECB's Liikanen links forward guidance to economic weakness** and acknowledges the recovery expected by the ECB in H2 13 would be *"slower than before"*, suggesting that the ECB does not have great confidence in the 2H rebound, and was seeking to counteract some of the recent increases in the risk-free rate.

**Portugal – coalition partners "found a way to maintain the stability of the government"**, PM Passos Coelho announced yesterday. A rebalancing of power in the government coalition in favour of the junior party CDS-PP could reportedly be the solution to the current political crisis.

**Italy – IMF Article IV calls for Italy to move "beyond austerity"** and for the ECB to do more to help ease Italy's financing conditions. Article IV also stresses the critical situation of Italian banking system.

**Italy allowed to spend €7.5bn more in public investment in 2014** by the EU Commission's decision to exclude some public investment expenditures (co-financed by EU funds) from the official deficit calculations, according to government sources.

**Italy – government deficit re-widens for first time since 2010**, to 3.1% of GDP in the four quarters to Q1 13, higher than 2.9% in Q4 12. Primary balance (net of interest payments) worsened from a surplus of 2.5% of GDP to 2.3%.

**ECB threatens to pull the plug on Cyprus**, according to German newspaper *Die Welt*, probably by vetoing emerging liquidity assistance, if Cyprus authorities continue to demand changes to its rescue programme.

**Sarkozy resigns** from France's Constitutional Council.

**German KfW approves support for Spanish SME lending** for €800mln.

**German FinMin Schäuble** does not see the euro crisis returning.

**Germany – Real wages fell in Q1**, nominal wages rose by 1.4%YY.

5 July 2013

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Economics

Western Europe

Industrialised G7 Countries

### Recent Research

#### ECB — Unanimous Governing Council Enacts Forward Guidance

##### Western Europe

The ECB left its key interest rates unchanged, matching consensus expectations. What surprised us and investors most was the unanimous decision by the Governing Council to enact a new 'forward guidance' framework without having exhausted the existing room for manoeuvre on rates. The introductory statement indicates that the GC expects "the key interest rates to remain at present or lower levels for an extended period of time". We maintain our forecast of a 25bp rate cut in the refi rate in 4Q-13.

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#### Euro Area — Portugal's Political Crisis

##### Western Europe

The resignation of the leader of the government coalition's junior party CDS-PP, Paulo Portas, from his position as

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**Spain – industrial output rose by 0.3% MM in May**, likely to be flat QQ in Q2.

## Today's News in Detail

**ECB embraces forward guidance** – The ECB left its key interest rates unchanged, matching consensus expectations. What surprised us and investors the most was the unanimous decision by the Governing Council (GC) to enact a new 'forward guidance' framework without having exhausted the existing room for maneuver on rates. The introductory statement indicates that the GC expects *"the key interest rates to remain at present or lower levels for an extended period of time"*. Comment: the ECB's decision to modify its communication strategy by introducing a bias and guidance on the current policy stance was likely warranted by the fact that in its non-published forecast (beyond 2014) inflation will probably continue to undershoot the 'less but close to 2%' medium-term objective for some time, but also because of the likely deteriorating in monetary conditions brought about by higher market rates. We maintain our forecast of a 25bp rate cut in the refi rate in 4Q-13. For more details, please refer to [ECB - Unanimous Governing Council Enacts Forward Guidance](#), 4 July 2013.

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**ECB's Liikanen links forward guidance to economic weakness** – Finnish central bank governor Erkki Liikanen was the only Governing Council member yesterday to give some colour on the ECB's decision to adopt forward guidance. Mr. Liikanen speaking in Finland warned that *"when there are changes, they will be taken into account. Everything depends on the development of the economy"*. Mr. Liikanen argued that the ECB had wanted to create *"confidence"* in markets, but also indicated that the recovery expected by the ECB in the second half of 2013 would be *"slower than before"*, arguing that *"as long as debt levels are high, demand stays weaker and the growth stays muted"*. Comment: it seems that the ECB does not have great confidence in the 2H rebound, and was seeking to counteract some of the recent increases in the risk-free rate. It will be interesting to see what the hawkish members of the board have to say about the topic in coming days, having previously expressed satisfaction at the recent increase in German bond yields. Note that while the ECB cannot really have much control of the longer-dated maturities, the *"extended period"* reference should allow for a clear disconnect between the euro short-end and that in the US.

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**Portugal – coalition partners "found a way to maintain the stability of the government"**, PM Passos Coelho announced yesterday after meetings with the President of the Republic and with the leader of junior party CDS-PP Paulo Portas, who earlier this week resigned from his post as foreign minister and threatened to bring down the government. No clarification was given on what are the conditions to keep the government coalition together, but newspaper *Publico* reports that the junior party CDS-PP is asking for more power in the Economic Ministry, and generally more balance of power in the government for the junior party. The President of the Republic has scheduled hearings with all parties represented in Parliament for Monday. Comment: the political crisis is not yet over, as the President's hearings of all parties suggests that alternatives to the current government coalition are being explored. However, even if a government reshuffle may keep the current government in place for now, we think the difficult decisions of the next few months will continue to exert a destabilising pressure on

foreign minister, a day after the departure of the technocrat Finance Minister Vitor Gaspar, appears to have put the Portuguese government on the verge of collapse. Even if the current fracture is recomposed in the next few days, the difficult political decisions of the coming months will likely keep the risk of a coalition break-up very high.

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## UK — MPC Set the Stage for Guidance

### Western Europe

Unusually, the MPC accompanied their "no-change" decision with a statement. The MPC stress that recent economic data are broadly in line with the May IR projections and do not imply upside to that forecast. Second, the MPC argue that the recent rise in market rates is not desirable and will dampen the outlook. And third, the MPC give a hint – more than a hint, really – that they intend to start forward guidance at the August meeting in order to put more direct downward pressure on yields.

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## Recent Research

### Scandi Economics Update —

#### Western Europe

Sweden — FinMin pledges easy fiscal stance as market turmoil could deepen in 2H — Government announces additional labour market measures — Riksbank wants to know how much Swedes borrow Norway — Setback for manufacturing production.

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Portuguese politics (see [Portugal's Political Crisis](#), 4 July 2013)

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**Italy – IMF Article IV calls for Italy to move “beyond austerity”**, by adopting more structural reforms to support growth, and calls on the ECB to do more to help ease Italy’s financing conditions. In particular the IMF suggests the ECB should adopt “*direct asset purchases, such as for SME credits, another LTRO of considerable tenor, and lower haircuts on eligible collateral*” in order to lower bank funding costs and lending rates to the private sector. The Article IV also stresses the critical situation of Italian banks, which saw their NPLs growing by three times since 2007 and it calls for an acceleration of write-offs of bad loans to clean up banks’ balance sheets and support lending. A Financial System Stability Assessment report on Italy is said to be upcoming with more details on this issue. The IMF also called for “*a rebalancing of fiscal adjustment*” via a re-composition of the adjustment towards expenditure cuts and lower taxes. The IMF stresses how the risks for the economic outlook remains tilted to the downside. Comment: the increased focus on the tight financial conditions for the private sector as a major headwind for the Italian economy finds us very much agreeing with the IMF assessment. We doubt however that the ECB is ready to take any new action in terms of non-standard measures such as new LTROs or asset purchases.

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#### **Italy allowed to spending €7.5bn more in public investment by the EU**

**Commission’s** decision to exclude some public investment expenditures from the official deficit calculations. The EU Commission’s decision involves not counting in the deficit those investment expenditures which are co-financed by EU funds – but only for the countries that are not under an Excessive Deficit Procedure. Italy would be the main beneficiary of the measure, having exited the EDP in 2012 – one of the few euro area countries not to be under an EDP. The Italian government believes this implies an additional leeway for €7.5bn (0.5% of GDP) of additional spending in 2014. Comment: after the concession of fast repayment of €40bn (2.5% of GDP) in government arrears (some of which will have an impact on the 2013 deficit, for an estimated 0.5% of GDP), Italy wins a new way of expanding the fiscal deficit – and hoping to boost GDP growth – within the European fiscal rules. Both measures are likely to have a small but positive impact on the GDP dynamic around the end of 2013 and in 2014.

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#### **Italy – Government deficit re-widens in Q1 13 for first time since 2010.**

Quarterly data on the government budget showed that the fiscal deficit stood at €27.4bn in Q1 13, against €25.1bn in Q1 12. In annualised terms, this is equivalent to a deficit-to-GDP ratio of 7.3% compared with 6.6% in Q1 2012. As a more meaningful measure of the underlying trend, the 4-quarter sum of the fiscal balance showed a deficit of 3.1% of GDP in Q1 13, wider than 2.9% recorded in Q4 12. This is the first deterioration in the 4-quarter moving sum of the government’s fiscal balance since Q4 09. The primary balance (net of interest payments) worsened from a surplus of 2.5% of GDP to 2.3% in the four quarters ending in Q1. The slowdown in revenues has been the main driver behind the inversion in the narrowing trend of the deficit. Q1 total revenues were unchanged relative to Q1 12, after growing by an average of 2.5% YY in 2012. Falling indirect tax revenues (down 1.9% YY) mainly accounted for the revenue weakness, reflecting the sharp drop in domestic demand. Total expenditures were up by 1.3% in Q1 13; once lower interest payments are netted out, primary expenditures rose faster, by 2.1% YY in Q1, in a clear U-turn relative to the mild downtrend in primary spending observed since 2010. Comment: the deterioration of the fiscal accounts recorded

by the quarterly general government budget data is in line with the indications from the state sector borrowing requirement, which has showed some marked deterioration since the beginning of the year. One-off factors partly explain the higher cash funding needs, but today's data confirmed that a more underlying deterioration in public accounts has been taking place since the end of last year. This mainly reflects the sharp slowdown in the economy, especially in domestic demand, around the turn of the year, but also less strict control on public spending since the end of last year. This is a clear change relative to the downward (albeit mild) trend prevailing since 2010 in primary spending. These data confirm our view that the overall fiscal deficit is likely to re-widen again in 2013 above the threshold of 3% of GDP, after temporarily falling below that level in 2012.

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**ECB threatens to pull the plug on Cyprus:** According to German newspaper *Die Welt*, ECB Executive Board member Asmussen has threatened to stop the aid for Cyprus if it continues to demand changes to its rescue programme. The German government had already rejected renegotiation requests in mid-June. Comment: The ECB's financial role in the troika programme for Cyprus is restricted to providing liquidity to Cypriot banks, currently mostly under emergency liquidity assistance.

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**Sarkozy resigns from France's Constitutional Council** – Former French President Nicolas Sarkozy announced on Thursday that he would no longer sit in the Constitutional Council (CC) of which he has been a life member since the end of this five-year Presidential term. According to various press reports, this decision was prompted by the CC's decision to uphold a ruling from the election auditors that had rejected his 2012 presidential campaign accounts on the grounds that expenditure had exceeded the ceiling by 2.1% or €466,118. The overshoot resulted from the re-classification of some of Mr. Sarkozy's trips and meetings as being campaign-related instead of being associated with his Presidential role. Comment: with Mr. Sarkozy entangled in a series of legal cases, it is doubtful at this stage whether his decision to distance himself from his CC role will lead to a greater involvement in national politics. The next presidential elections are in 2017.

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**KfW supports Spanish SME lending:** The board of the German development bank KfW has approved an €800mn global loan to its Spanish counterpart ICO on Thursday to be lent on to Spanish SMEs. The loan is meant to pass on KfW's low financing costs, which are close to those of the German government which stands behind it. German FM Schäuble, who announced the programme jointly with his Spanish colleague, said that *"the programme should facilitate access to financing for companies with a solid business model and good growth prospects"*. Similar arrangements are being planned in Greece and Portugal, but are partially held up by the non-existence of state development banks in those countries. Schäuble dismissed suggestions that these initiatives constituted a change of heart by Germany about its approach to the crisis and said that they should not be seen as related to the upcoming German election.

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**Schäuble does not see the euro crisis returning:** German FM Schäuble dismissed fears that the euro area was heading back into crisis amid the political tensions in Greece and Portugal. Schäuble said that he *"thinks that the euro is seen as so stable by financial markets that even political situations in individual*

*countries, which always occur in democracies, don't mean a crisis for the euro."* He said he regretted the resignation of his Portuguese colleague Gaspar, and that he expects the troika report on Greece that is due to be presented on Monday to be positive.

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**Real wages in Germany fell in Q1:** Nominal wages in Germany rose by 1.4% YY in Q1, the German statistics agency reported, below the inflation rate of 1.5%. This was the first decline in 13 quarters and was driven by the cold winter and low bonuses due to the weak economy. For 2013, bargained wages are expected to increase by 2.8%, but these exclude overtime and other bonuses.

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## Latest Issues of Sovereign Debt Crisis Update

### **Euro Area: Sovereign Debt Crisis Update — Portugal remains in focus ahead of ECB press conference**

#### Western Europe

ECB expected to leave key interest rates unchanged today. Portuguese coalition parties try to heal fracture within govt. Greek negotiations ahead of Eurogroup. EU Commission to relax budget rules on public investment programmes. French pension reform talks begin. US-EU free trade talks to begin on Monday. German opposition's investment plans. Cypriot top officials meet Draghi. Irish unemployment falls.

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### **Euro Area: Sovereign Debt Crisis Update — Portugal's Government Coalition Breaking Down**

#### Western Europe

Portugal's Paulo Portas - Foreign Minister and leader of junior coalition party - resigned a day after the departure of FinMin Gaspar. Portugal's opposition party calls for early election. Greece in talks with troika ahead of Monday's Eurogroup. Merkel on youth unemployment, treaty change and OSI. French ecology minister sacked by Hollande, as 2014 budget discussions continue.

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### **Euro Area: Sovereign Debt Crisis Update — Portugal FinMin's resignation illustrates 'austerity fatigue'**

#### Western Europe

Portugal's FinMin Gaspar unexpectedly quits. ECB's Nowotny sees banking union delays. EU's Rehn cites EU recovery prospects. SPD Chancellor candidate does not want to rule out Grand Coalition. Italy's surprisingly large state sector budget surplus in June. Spain's registered unemployment drops in June. Greece: Eurogroup to decide on next tranche on 8 July. Belgium's savings to exit EDP.

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### **Euro Area: Sovereign Debt Crisis Update — No QE in sight from the ECB**

#### Western Europe

ECB denies QE discussions. ECB suspends Cyprus bonds' eligibility as Eurosystem collateral. France: pressure on 2014 & 2015 deficits after warning from audit court. Spanish budget deficit remains high in May. Portugal Q1 13 fiscal deficit deteriorates. Italy asks for more budget flexibility.

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## **Euro Area: Sovereign Debt Crisis Update — EU Council: Pennies for Youth Unemployment and SME Lending**

### **Western Europe**

EU leaders set aside €8bn to fight youth unemployment and also endorse proposal to foster lending to SMEs via leveraging up €10bn of EU funds. Comment: the amount of resources made available is minimal relative to the scale of the problem. ECB denies it is discussing QE. Spain – government set limits on regional budget debts and deficits. Cyprus restructures domestically-issued public debt. Greece's ND maintains poll lead. Ireland back in recession.

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## **Macroeconomic Forecasts**

### **European Economic Forecast Highlights — June 2013**

#### **Western Europe**

This companion piece to the Jun 19 edition of Global Economic Outlook and Strategy contains more detailed quarterly economic forecasts for the main European countries to end 2014 as well as annual forecasts for all countries out to 2017.

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### **Global Economic Outlook and Strategy — June 2013\***

#### **Global, CEEMEA, North America, Asia, Latin America, Australia**

We are again cutting our emerging market growth forecasts and lifting advanced economy forecasts. The multi-year period of increasing EM outperformance and resilient balance sheets is giving way to growth downgrades with worsening current accounts and rising private debts. We expect that expectations of extra BoJ easing will weaken the yen further. The ECB is likely to cut the refi rate again, but we doubt that this will provide much stimulus. The Fed is likely to signal that tapering will be gradual and data-dependent, and that any move to tightening is both distant and data-dependent.

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# Appendix A-1

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