

ECB

1Q Rate Cut No Longer Likely

- The ECB left its interest rates unchanged today, including the main refinancing rate at 0.75% and the deposit rate at 0.0%. According to ECB President Mario Draghi, no Council members requested a rate cut at the meeting and the decision to leave rates unchanged was unanimous. This is in contrast to last month, when only a *"prevailing consensus"* was reached to leave rates unchanged.
- The ECB assessment of the economy has not changed from December. The Governing Council expects the economy to stay weak at the beginning of 2013 with a gradual recovery later in the year. The ECB regards risks to this outlook to be on the downside. The ECB did not change its view on inflation, expecting a reduction of the inflation rate below 2% in the course of 2013 and contained inflationary pressures in the medium term, with broadly balanced risks to the inflation outlook.
- However, the press statement and Mr. Draghi's comments in the Q&A session were more upbeat on financing conditions than a month ago. While the January statement repeated the phrase used in December that financial market confidence has *"significantly improved,"* it added that there is now also *"reduced fragmentation"*. In the Q&A session, Mr. Draghi mentioned a large list of indicators, including falling bond yields and CDS spreads in the periphery countries, Target II balance reductions and a reduction in the ECB balance sheet as all suggesting reduced conditions. He also said that *"we are now back in a normal situation from a financial viewpoint"* adding that there might be *"exuberance in specific local parts of the financial system"* mentioning leveraged buyouts as an example.
- In the press statement, the tone on the need for government action turned tougher again. In addition to asking for *"further progress in fiscal consolidation,"* the statement requested that *"further structural reforms should be rapidly implemented to make the euro area a more flexible, dynamic and competitive economy."* Mr. Draghi warned politicians against becoming complacent in the improving environment, highlighting that the situation remains characterized by *"high uncertainty"*.
- **Comment:** By turning more upbeat on the assessment of financing conditions, the ECB statement was more hawkish than we expected. Unless there is a significant fall in the sentiment data, we no longer expect a cut in the refi rate in 1Q – we so far expected a 25bp rate cut. However, although the ECB may sound quite complacent on the improvement in financing conditions and its feeding through to economic activity, we expect the Governing Council to remain ready to react to a deterioration in the economic outlook, which would increase downside risk to price stability. As a consequence, backed by our scenario of ongoing economic weakness in the euro area, we forecast a 25bp refi rate cut to 0.5% in 2Q followed by a further rate cut to 0.25% in 2H. So both rate cuts are delayed by at least 1Q compared to our forecast so far. The second refi rate cut will probably come together with a 25 bp cut in the deposit rate, but this looks less likely to us now than it did before.

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Appendix A-1

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