ECB's Coeuré Sees Room to Cut Rates

23 April 2014

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Economics
Western Europe
Industrialised G7 Countries

Summary

ECB's Coeuré sees room to cut rates. He added that the Governing Council has expressed very clearly that it was *"unanimously ready to study unconventional tools, including QE, if required".* **ECB's Linde says inflation prints in April and May will be key inputs for possible action in June**, but that a quantitative easing programme would be *"not easy to implement"* in the euro zone.

ECB and EC debate admissibility of public support for precautionary recapitalisations. The ECB reportedly supports allowing public capital injections for *"precautionary recapitalisations"* of banks before bailing in creditors after the upcoming stress test, in cases of perceived financial stability risk.

Euro area consumer confidence continues to improve in April. The EU Commission's flash estimate of consumer sentiment showed a further gain to -8.7 from -9.3 in March, taking the index to 0.5 std above its long-term average.

Euro Area flash composite PMI was up by 0.9 points, reversing the March drop (of 0.2 points) and taking the index to the highest level since May 2011. Flash manufacturing PMI up to 53.3, flash services PMI up by 1.0 point in April to 53.1, highest since mid-2011.

German government expects 70k drop in unemployment in 2014, despite net inward migration of around 300k.

France: High Council of Public Finances sees downside risks to 2015-17 GDP forecasts. Meanwhile, the French government mulls adjustments to expenditure savings plan to ensure successful parliamentary vote. The budget deficit projection in the French Stability Programme is revised up to 3.8% of GDP in 2014 and 3.0% of GDP in 2015, which could be followed by extra expenditure savings of €4bn in the summer's supplementary budget for 2014. INSEE could add between 1 and 4pp of GDP to the 2011-13 data as part of the change to the ESA 2010 framework on May 15.

Italy – government asks for confidence vote on labour market reform, amid divisions within the governing coalition, with small centrist coalition parties wanting more flexibility in the use of apprenticeships and temporary contracts.

Spain – population continued to shrink in 2013 (by 0.9% relative to 2012) to 46.7m, with 546k (10%) of foreigners leaving the country last year.

Spain – Government to include a €5bn cushion to lower income taxes in 2015. The 2014 GDP forecast is expected to be raised to 1% (from 0.7%).

Greece – government to ask Eurogroup for corporate tax cuts, as part of a multi-year growth-enhancing plan financed also by EU structural funds.

Recent Research

Euro Area — The ECB And QE: "Whatever it Takes", Redux

22 April 2014

QE is probably coming to the euro area — The ECB has opened the door to QE, with a unanimous commitment to using unconventional instruments if necessary to cope with low inflation for a prolonged period of time. We believe that the chances of unsterilised large-scale asset purchases (LSAPs) of public and private assets being launched this year have therefore increased to more than 50:50.

Guillaume Menuet

Euro Economics Weekly — Portugal: "Clean Exit" or Precautionary Credit Line?

17 April 2014

The combination of improved economic and fiscal performance, the government's large cash buffers and the large share of public debt in official

Today's News in Detail

ECB's Coeuré sees room to cut rates, says QE will have to tick many boxes – ECB Executive Board member Benoit Coeuré gave an interview to *Le Monde* and in response to a question as to how the ECB could act against the strong euro, Mr. Coeuré replied that *"we still have room to act on the main refinancing rate"*, adding that the deposit rate could be cut into negative territory, while reminding that at the last meeting the Governing Council (GC) expressed very clearly that it was *"unanimously ready to study unconventional tools, including QE, if required"*. Mr Coeuré stressed that any QE programme would have to deliver on three key aspects: i) effectiveness: to ensure that actions taken are transmitted to the real economy, notably in terms of the provision of credit to firms, ii) feasibility: euro area financial markets operate differently to their US counterparts and therefore the QE would be different, and iii) prohibition of monetary financing of governments. Comment: we think that the ECB is gradually preparing the market for a negative deposit rate, partly to combat the strong euro problem, and to deliver some stimulus to the euro area economy in an attempt to lift inflation rates away from the danger zone of less than 1%. QE in 2014 now forms part of our base case, but we suspect that the ECB will first want to concentrate on standard measures before turning to the large scale asset purchases, probably in September.

ECB's Linde says inflation prints in April and May will be key inputs for possible action in June – Spanish central bank Governor Luis Linde indicated on Tuesday in an interview with *Market News International* that developments in headline euro area inflation over April and May will be crucial inputs for the GC in deciding whether to deliver additional monetary policy stimulus. Mr. Linde made reference to *"the danger of inflation being too low for too long"* and explained that the GC would have to *"decide that it's already too prolonged"*. If action is needed, M Linde said a quantitative easing programme would be *"not easy to implement"* in the euro zone. Comment: these remarks reinforce our impression that the Governing Council is more likely to cut interest rates in June than in May and that the difficulties associated with QE will probably delay any decisions on large-scale asset purchases for at least a few months until September. Please refer to ***The ECB And QE: "Whatever it Takes", Redux***.

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ECB and EC debate admissibility of public support for precautionary recapitalisations. *Handelsblatt* reports that the ECB is lobbying the EC to allow member states to recapitalise undercapitalised banks in some circumstances in the wake of the ECB's Comprehensive Assessment. This attempt is part of a broader discussion about how resolution rules should be applied after the Asset Quality Review (AQR) and comprehensive assessment. The article reports that the ECB would like to retain a possibility for states to be able to put capital into banks before bailing in private creditors in cases where it saw risks to financial stability, even when there are capital shortfalls under the base scenario of the stress test. This contingency should apply to *"precautionary recapitalisations"* when the bank in question would satisfy the minimum capital ratio of 4.5%, but would fall short of the 8% overall ratio. According to the article, the ECB rejected these suggestions and stated that capital shortfalls revealed in the comprehensive assessment should first be filled through private means and public funds should only be used once the private resources had been exhausted. Comment: this discussion is related to two linked issues: the uncertainty about what resolution rules should be applied after the stress test results (which are due in October 2014, while the new resolution rules only apply from January 2016) and the absence of a strong backstop for bank recapitalisations. The ECB is clearly (and rightly, in our view) concerned about the potential fragility that the lack of an effective backstop and of efficient bail-in loans will probably allow the Portuguese government to opt for a "clean exit" from the bailout programme in May. While the recovery in real GDP should continue, we expect nominal GDP growth to remain subdued due to persistent disinflationary pressures.

Giada Giani | Guillaume Menuet | Ebrahim Rahbari | Michael Saunders

UK Economics Weekly — Recovery, Rebalancing and Broadening

17 April 2014

The recovery has broadened significantly from the narrowly-based consumer-led growth a year ago. Business investment has outpaced consumer spending for four quarters in a row, and there has been a marked pick up in cashflow and job openings at SMEs. Gains in house prices and jobs are widespread in regional terms, while consumer confidence has risen above average for middle income quartiles. With recovery broadening , the need for such a loose monetary policy stance is rapidly receding.

Michael Saunders

UK — CPI Inflation Edges Down, Probably Near The Low

15 April 2014

CPI inflation edged down to 1.6% YoY in March from 1.7% in February, matching our forecast and the consensus. The YoY rate is the lowest since late 2009. Note that the YoY CPI inflation rate is calculated from unrounded indices. If the YoY rate is calculated from the index rounded to one decimal point (which is published in the press notice), then the YoY rate for March would be 1.7%. We believe that the recent drop in inflation has now largely run its course. .

Michael Saunders

Denmark — Quiet Stagnation

14 April 2014

Household debt rel to GDP is still the highest among advanced countries, and the adverse consequences on economic activity have been clear: real GDP per head has barely expanded during the period 2000-13. Although conditions on the housing market are improving, it

provisions could create.

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Euro Area flash composite PMI (weighted average of manufacturing and services output indices) **was up by 0.9 points**, reversing the March drop (of 0.2 points) and taking the index to the highest level since May 2011. Flash manufacturing PMI up to 53.3, against consensus expectations for an unchanged reading, partly reversing the two consecutive monthly declines in Feb and Mar. Flash services PMI up by 1.0 point in April, to 53.1, highest since mid-2011. At these levels, the composite PMI level is normally consistent with GDP growth of around 1¾% QQ annualised, suggesting some pick-up in Q2 GDP growth relative to Q1 may be in the cards. **Country-wise**, the German composite PMI was up strongly (to 56.3), fully reversing the March decline. French composite PMI was weaker in April, down by 1.3 points, but after a 4-point gain in March. As a result, we estimate the composite PMIs in Spain and Italy probably posted quite positive readings too in April, with Italy likely to show the largest gain (given lower level of the index and given the March drop).

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German government expects 70k drop in unemployment in 2014. *Die Welt* reports that the German Federal Labour Agency expects that unemployment in Germany will fall by 70k, despite high net inward migration of around 300k. The vice president of the agency said that there were around 1m long-term unemployed in Germany, with about 40% of them potentially incapable of *"holding down"* a regular job. He added that he favoured supporting the long-term unemployed with permanent subsidies rather than only two years of assistance and said that there was a need to provide older workers in some regions such as Eastern Germany with civil work or job opportunities as there was no regular work available.

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France: High Council of Public Finances sees downside risks to 2015-17 GDP forecasts – France's independent fiscal watchdog issued a statement reviewing the government's 2014-17 macroeconomic assumptions. The assessment is that while the 2014 GDP growth forecast of 1.0% is *"realistic"*, the 2015 GDP forecast of 1.7% is described as *"not out of reach"* but composed of *"several weaknesses and is subject to different risks"*, being dependent on a rebound in household confidence and revenues from recently announced supply-side measures. The council also described the 2016 and 2017 GDP forecasts of 2.25% as *"optimistic"*. Comment: we could not agree more with the Council's conclusions: fiscal consolidation often impacts GDP growth negatively in the short term, and the confidence improvement resulting from policy action often takes time to materialise, making the 2015 forecast looks a little high. Turning to the 2016-17 forecasts, they rely on a series of optimistic assumptions about external and internal demand dynamics that are unlikely to be achieved unless there were to be a significant improvement in confidence, together with a very noticeable effort in regaining competitiveness, which seems difficult to envisage without a much weaker exchange rate path, given the government's generous implied trajectory for private sector wages.

France: government mulling adjustments to expenditure savings plan to ensure successful parliamentary vote – PM Valls is considering making some alterations to the government's programme of expenditure savings ahead of the bill's review in parliament on April 29. The main points of contention for some MPs of the government majority are the announced freezes in public sector remuneration and social benefits. Various press reports suggest that the new PM is willing to contemplate a slight softening with respect to small pensions, while public sector workers' pay could be reviewed every year instead of the plan to freeze them over the remainder of Mr. Hollande's presidency. *Le Figaro* reported

rests on fragile grounds, and debt-laden consumers remain reluctant to spend. With the scope for fiscal stimulus about exhausted, we conclude that although Denmark will not be in crisis, it will likely continue to face quiet stagnation.

Tina Mortensen

Scandi Economics Update — Riksbank: Sweden not in Deflation, and not Turning Japanese

23 April 2014

Sweden — Riksbank: Sweden not in deflation, and not turning Japanese — Riksbank speeches — Sticky unemployment, strong employment growth — Reinfeldt seen as most trusted.

Norway — Wage talks for the financial sector begin today.

Tina Mortensen

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that President Hollande was satisfied that MPs were not trying to reduce the €50bn of expenditure savings, merely discussing modest alterations in the package. PM Valls will present his deficit-cutting plans later today during the weekly cabinet meeting. Comment: on the surface, Mr. Valls is showing that he is willing to listen to some of the MPs in order to ensure the bill's safe passage in the lower house. But meeting the budget deficit requirement of 3% of GDP in 2015 will demand sacrifices in terms of the expenditure trajectory in light of the promise to cut some taxes and a projected low GDP growth scenario. We expect the bill to be approved by parliament at the end of the month.

France: budget deficit to be 3.8% of GDP in 2014 and 3.0% of GDP in 2015 – Business daily *Les Echos* notes in Wednesday's edition that the Stability Programme's budget deficit trajectory is likely to be revised up by 0.2ppt to 3.8% and 3.0% compared to 3.6% and 2.8% previously. The government will also deliver extra expenditure savings of €4bn in the summer's supplementary budget. *La Tribune* indicated that the Stability Programme will be sent to the European Commission on May 7. Separately, the paper notes that INSEE will unveil on May 15 its new GDP estimates based on the ESA 2010 framework for 2011, 2012 and 2013 that will likely add between 1 and 4 points of GDP, ie between €20bn and €80bn, which will also lower the budget-deficit and debt-to-GDP ratios, as well as reducing the overall level of taxation as a share of GDP. The inclusion of R&D, purchase of IT services or military equipment will be added to gross fixed investment instead of being formerly classified as intermediate consumption and excluded from GDP.

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Italy – government asks for confidence vote on labour market reform, amid divisions within the governing coalition. The two small centrist coalition parties – NCD and Scelta Civica – have reportedly opposed the current version of the labour market reform proposed by the Renzi government. The reform aims at extending the rolling over of apprenticeships and temporary contracts, *de facto* reversing some of the measures of the last reform introduced in 2012. Centre-left PD's changes aim at reducing the degree of flexibility envisaged in the original proposal, which are favoured by the centrists. The government has therefore decided to call a confidence vote on the bill in the Lower House this afternoon, even though PD retains a parliamentary majority. NCD leader Alfano said his party still aims to make changes to the bill in the Senate, where PD needs its vote to reach a majority. Comment: the divergence within the governing coalition is to be put in the context of the electoral campaign ahead of the EU elections next month, as parties are trying to differentiate from one another. The substance of the labour market changes is not going to be substantially altered by the changes introduced in the parliamentary readings.

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Spain – population continued to shrink in 2013, by 0.9% relative to 2012, to 46.7 million, according to INE data released yesterday. In particular, the data showed that 545,980 foreigners (313,446 from EU countries and 232,534 from non-EU countries) left the country in 2013, which represents a fall of 9.8% in foreign residents living in the country relative to 2012. Spanish citizens increased by 0.3% in 2013. Last year INE released its 10-year population projections, showing an expected decline of 2.6 million (or by 5.6%) over the next 10 years, as a result of population aging and a continuation of migration outflows similar to those observed in 2013. Comment: the sizable shift from hefty population growth in pre-crisis years (due to native demographic trends and high immigration flows) to population declines should significantly reduce potential GDP growth in Spain in the next decade.

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Spain – Government to include a €5bn cushion to lower income taxes in

2015. Spain's updated Stability Programme, to be sent to the EU Commission next week, is expected to include resources of €5bn potentially available to cut personal income taxes in 2015, without encompassing additional spending cuts/tax hikes, daily *Expansion* reports. The government is also expected to raise its 2014 GDP forecasts to at least 1% (from 0.7% currently), *Expansion* noted. Comment: the government has pledged a reduction in both personal and corporate income taxes for next year as part of a general overhaul to the tax system expected to be announced in coming months. Recent improvements in tax revenues (estimated to have risen by 6% YY in Q1 according to PM Mariano Rajoy) on the back of a stronger-than-previously-estimated economic recovery is likely to provide some room for selective tax cuts next year.

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Greece – government to ask Eurogroup for corporate tax cuts. *Ekathimerini* reports that Greece is set to ask the Eurogroup on May 5 for permission to gradually reduce corporation tax rates as part of a wider plan to boost growth. A growth plan to run until 2020 is reportedly being drafted by the Greek government, with the purpose of asking for more EU structural funds in order to alleviate the poor liquidity position of the domestic economy.

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Latest Issues of Sovereign Debt Update

Chances of QE Have Increased to More Than 50:50

22 April 2014

The ECB and QE – our note "Whatever it Takes", Redux argues that the chances of unsterilised large-scale asset purchases (LSAPs) of public and private assets being launched this year have increased to more than 50:50. We think that the ECB will use standard and non-standard measures first in June to coincide with a fresh round of downward revisions to staff inflation forecasts. QE, if it happens, will likely come in September or December 2014.

Guillaume Menuet | Giada Giani | Ebrahim Rahbari

France: Unconventional policy is the part of solution

17 April 2014

EP President supports revamp of the EU's Stability and Growth Pact – whereby the Pact would distinguish between public consumption and investment spending.

Guillaume Menuet | Giada Giani | Ebrahim Rahbari

French government confirms intention to hit 2015 deficit target

16 April 2014

EU Parliament approves BRRD and SRM legislation. The Banking Recovery and Resolution Directive still needs to be transposed into national law by the member states, while a couple of steps remain for the formal adoption of the Single Resolution Mechanism

Guillaume Menuet | Giada Giani | Ebrahim Rahbari

EU mulling additional sanctions against Russia

15 April 2014

EU Council: new sanctions against Russia, Ukraine financial support –putting more people under asset freezes and visa bans. French foreign minister Fabius noted that "if necessary, there may be a meeting of heads of states and government at the European level next week, which could decide on new sanctions". The EU Council approved €1bn in macro-financial assistance in the form of loans with a maximum maturity of 15 years.

Guillaume Menuet | Giada Giani | Ebrahim Rahbari

The ECB on the Euro Strength

14 April 2014

ECB warns that stronger euro will require monetary policy response – Mr. Draghi said two things would drive any decision to deliver additional monetary policy stimulus: "one is an unwanted tightening of monetary and financial conditions, and the second is deterioration of our medium term outlook". More specifically about euro strength, Mr. Draghi noted that "I don't want to give you a level where we will act or not. I am giving you an orientation."

Guillaume Menuet | **Giada Giani** | **Ebrahim Rahbari**

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Macroeconomic Research

European Economic Forecast Highlights — March 2014

27 March 2104

This companion to Global Economic Outlook and Strategy - March 2014 gives detailed quarterly forecasts for the main European countries to end 2015, as well as annual forecasts to 2018 for growth, inflation, current balance, fiscal balance, primary balance and government debt.

Ann O'Kelly | **Michael Saunders** | **Guillaume Menuet** | **Giada Giani** | **Ebrahim Rahbari**

Global Economic Outlook and Strategy — March 2014

26 March 2014

Our global growth forecasts are unchanged this month. Within that, we again trim our EM growth forecasts, and lift forecasts for advanced economy growth. We believe risks to our EM growth forecasts remain to the downside. The spillovers from the Russia-Ukraine crisis are likely to keep geo-political tensions high near term. We expect easing from the BoJ, ECB and PBOC in Q2/Q3, whereas rising capacity use is likely to prompt the BoE to hike rates in late 2014, with the Fed hiking in H2-2015.

Willem Buiter | **Guillermo Mondino** | **Michael Saunders**

Emerging Markets Macro and Strategy Outlook — What happens to EM when US short-term rates rise?

27 March 2014

How will EM be affected if short term US interest rates go up sooner rather than later? One important way of assessing the significance of rising short term US rates is to think about what impact it might have on the behavior of commercial banks in managing their cross-border exposure to EM. The reason for this is that, by and large, banks fund themselves at the front end of the yield curve, and so an upward shift at the front end of the curve might cause a ‘second round' of capital outflows from EM, following the first round by portfolio investors that accompanied tapering fears in 2013.

Guillermo Mondino

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Appendix A-1

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