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ECB: Rate cut possibility not discouraged.

As with all policy decisions of late, there was no surprise that the ECB kept the refi rate at 1.50% after its latest Council meeting, having hiked for a second time in the current cycle in July. This month also brought no further change from the ECB in regard to its unconventional policy measures, adding no further bank liquidity measures and with President Trichet suggesting that the bond purchase program (SMP) remains up and running.

Policy on hold, but cuts possible

As for future conventional policy, it was clear that the ECB has abandoned any notion of hiking rates any further, thereby very much corroborating the policy outlook markets shifted to weeks ago. However, there was nothing explicit offered to encourage the idea that the ECB may start to cut rates in the near future, something that markets have started to price in. Indeed, Trichet started off his press statement by highlighting that inflation remains elevated, also going on to remind that rates remain accommodative and low.

Downside growth risks the main story

In addition, the updated ECB staff economic projections did not point to any explicit pointer to rate cuts. Admittedly, there were clear downward revisions to GDP projections for both this year (respectively to ranges based around mid-points of 1.6% and 1.3%), alongside the acknowledgment that risks around these have now moved clearly to the downside. However, the ensuing HICP projections were little changed with the range for 2012 narrowed but still based around a 1.7% mid-point. This may be a little below target, but with the ECB only downgrading the attendant risks to being balanced, ie hardly hinted that rate cuts are actively being considered.

Awaiting data and events

However, other comments suggest that the ECB is aware that events could push into a position where rates may need to be reduced. Most pertinent in this regard was the acknowledgment that financing conditions have tightened. This was followed with the very clear acknowledgement that that a very thorough analysis of data and developments in coming months was needed, surely a hint that the ECB accepts that a further blowing up in sovereign debt tensions and/or more weak data could both raise financing conditions further, possibly more so in real terms if inflation pressures and expectations were to abate further as a result. In addition, President Trichet underscored that the ECB would always do what is necessary, very much.

Bond purchases on-going

As a result, markets will not find much from this ECB update to discourage speculation that official rates could be cut in coming months, maybe not at what will be President Trichet's last press conference next month, but possibly at one of the first that his successor (Mario Draghi) may chair thereafter. In the meantime, bond markets should perhaps draw clear(er) comfort from the hint that the SMP will continue to be used appropriately, with President Trichet (somewhat irately) underscoring that such bond purchases are being used in order to ensure that the monetary policy transmission mechanism is supported. With this in mind, and as seems clear from its recent stepped-up pace of bond buying, the SMP is being used to address growing banking sector fragility rather than as a sop to persuade recalcitrant government into the kind of front-loaded budget cuts that the ECB is demanding of them.