DECISION ECONOMICS, INC.
Information for Decisions™

Western European Indicators and Insights

November 3, 2011

Andrew Wroblewski
Chief Economist, Eurozone and UK

London
+44 20 7959 3244
awroblewski@decisioneconomicsinc.com

ECB: Rates cut, ECB style changes?

In contrast to recent policy decisions, there was some clear surprise from the ECB after its latest meeting with the Council deciding to cut all three official rates by 25 bp, resulting in the high-profile refi rate dropping back to 1.25%. The move therefore unwound half the rate hikes put in place in April and July, also being the first cut since May 2009.

A more pro-active ECB?

This meeting was all the more notable as it was the first such gathering chaired by new ECB President Draghi. Partly as a result, the consensus was of the view that the new ECB president would have been more likely to wait a while before presiding over any easing, as cutting rates as soon as he took the helm of the central bank this may have served to undermine his anti-inflation zeal at least to the likes of doubting Germans. In this regard, all credit must be given to President Draghi in reacting promptly, albeit with the action being nothing more than what the economy is clearly demanding, with survey data for some time having been consistent with a lowering of official rates. Indeed, Draghi very much acknowledged that the rate move was a reflection of weak(er) economic data, especially in terms of recent surveys which have begun to suggest that downside risks were not only increasing but actually materializing to a degree that a mild recession may now be on the cards for Europe. As a result, he very clearly flagged that the ECB would cut back its growth projections clearly next month (the existing projection for 2012 is based around a mid-point of 1.7%), while also pointing to the likelihood that inflation would fall below the 2% target sometime next year.

No more code-words

Indeed, it has been strange that, despite the clearly weaker economic tone and increased downside risks that have emerged in the last month, market expectations regarding any conventional ECB easing at this juncture in fact diminished in the period since the last meeting on October 6. This may be a reflection of the fact that at the last meeting, then-President Trichet failed to use any of the rhetorical devices that the ECB has used in the last few years in order to flag a policy move one month later. However, these rhetorical devices have very much been the creation of Trichet and he may have been reluctant to use them last time around in order to allow his successor scope to manufacture his own presentational style.

A more pragmatic ECB as well

All of which underscores that the Draghi-led ECB may prove to be a different animal to that of his predecessor, ie willing to act on a timelier basis and with an entirely different communication style. As for the former, it is clear that Draghi is acting with pragmatism and possibly more pro-actively, implicitly underscoring that, rather than there being a limit, government bond purchases by the ECB may continue as long as there is a threat to the Eurozone monetary policy transmission mechanism. In this regard, it is notable that Draghi highlighted the need to watch credit data given the clear risk that a credit crunch may be developing. As for communication, without the use of code-words that ex-President Trichet was so fond of such as pointing to whether rates being appropriate or not, short-term ECB forecasting will be more difficult from here-on. Indeed, the latter means that a further easing move in December can neither be ruled out nor ruled in at least this juncture. But surely more ECB easing is on the cards, with the modest move this time around a reflection of the central bank preferring to keep some powder dry.