ECB still some distance from the Exit (Strategy)

- **Mr Trichet remains cautious on speed and scale of economic recovery.**
- **Inflation seen remaining at or below ECB target.**
- **So, interest rates unlikely to rise until late 2010.**
- **But some key policy challenges emerging.**
- **Dollar drop would pose a serious threat to Eurozone outlook…**
- **While Budget deficits may force the ECB to act more aggressively into 2011.**

It came as no surprise to markets that the European Central Bank left it's key interest rates unchanged today. Although there were some ripples earlier in the week following the decision by the Reserve Bank of Australia to raise it's key policy rate, **we still seem to be some considerable distance from any interest rate hike from the ECB or indeed any of the world's other 'major' central banks.**

Mr. Trichet indicated that ECB thinking hasn't changed much in the last month noting that *'incoming information and analyses since our last meeting in early September have confirmed our previous assessment'*. He sought to downplay any sense that the ECB feels that the Eurozone economy has improved to the point where there might be any suggestion of a tightening of policy in the near term. His comments in the press conference sought to emphasise that the ECB expects recovery to be a slow and uneven process.

Although the worst may be over, the ECB sees little prospect of a sharp or speedy rebound in activity. Mr. Trichet repeated one of his favourite metaphors of late that *'a bumpy road lies ahead'* and emphasised the ECB's cautious assessment of current conditions by saying that it would be *'absolutely wrong that it is business as usual.'* At the margin, this judgement would have been strengthened further by some slightly weaker than expected recent data both from the Eurozone and the US that disappointed some market hopes for a straight line recovery. However, the ECB is clearly looking beyond the vagaries of a couple of months data. It seems that the ECB is firmly of the view that significant challenges still lie ahead.

The profile for Euro area economic activity envisaged by the ECB implies a very non-threatening outlook for inflation. Once again, Mr. Trichet emphasised that inflation is set to *'remain at moderately positive rates over the policy relevant horizon'*. Viewed in isolation, this might be taken to suggest inflation will remain below the ECB's target and imply some further bias for policy easing but we don't believe that is the intended interpretation. Instead, **the ECB may want to emphasise that subdued inflation gives it ample room to leave policy at a very accommodative level for a significant period of time.**

If the general tone of today's ECB press conference was very dull, this is clearly as the ECB intended. As is the case with the Federal Reserve, the ECB wants markets to be confident that it can and will tighten policy when necessary but equally it wants markets to be reassured that this is still a distant prospect. **Another reason why the ECB may feel comfortable that there can be a protracted period before tightening looms is that the demand for ECB liquidity from commercial banks has shown a marked decline of late.** Mr. Trichet acknowledged that the drop in the demand for 12 month funds from the ECB to just €75 bio at last week's tender from €442 bio in June *'might appear as a sign of stabilisation'* although he neatly sidestepped a question on the still significant number of banks requesting funds. **If the drop in demand for ECB funds by Eurozone banks points to some improvement in financial markets and lessens the risks of an eventual surge in inflation, it also emphasises the limited contribution credit growth is likely to make to a recovery in activity in the coming year.**

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Although the ECB may be happy to sit on the sidelines for a prolonged period, it is sure to be weighing up the conflicting influence of a couple of factors that could greatly complicate policymaking in the next year. On one side there is little doubt that **market concerns about dollar weakness suggest a real risk of exchange rate volatility that could see the Euro once again emerge as the natural 'victim' of a flight from the US currency.** Already, the trade weighted value of the Euro has risen about 2 per cent above the levels used in the ECB's September projections for activity and inflation. Other things being equal, this would equate to the impact of a quarter point increase in policy rates. In itself, this scale of currency movement is unlikely to feature significantly in ECB thinking but given the doom-laden nature of some recent media pronouncements on the Dollar, the scope for major currency moves will not have escaped the ECB's attention. Against this backdrop, **Mr. Trichet's repeated reference today to *'US support for a strong Dollar'* might suggest little more than a measure of wishful thinking.**

If the exchange rate outlook implies some downside risks to the outlook for the Eurozone economy and a correspondingly more distant rise in ECB policy rates, the emerging outlook Government finances right across Europe points strongly in the opposite direction. Yesterday saw the EU Commission initiate excessive deficit procedures against another eight Euro area countries, with thirteen Eurozone members now running budget deficits above the 3 per cent of GDP threshold. As a result, **Mr. Trichet today sent a notably tougher message on fiscal policy** by indicating that *'the need for ambitious and realistic fiscal exit and consolidation strategies is becoming increasingly pressing'*. He also called for governments to show they are *'committed to ensuring the sustainability of the Public Finances'*. **Last week's French budget framework,** which envisaged a deficit equivalent to 8.5% of GDP in next year and still at 5% of GDP at 2013, **struck a very different note. So, there is a significant risk that the ECB and most Eurozone governments could be set on a collision course.** In the near term, the budget outlook will remain unclear and this could lead to a widening of government spreads within the Eurozone but **by late next year if governments appear unwilling to tighten fiscal policy, the ECB may feel it will need to be correspondingly tighter in it's monetary policy. That would further underpin upward pressure on the Euro or FX markets.**

We continue to believe that **the ECB is unlikely to raise rates until the end of next summer at the earliest.** Although there is a clear sense that the worst of the downturn may be behind us, Mr. Trichet again emphasised today that **the recovery is unlikely to develop in a way that would threaten the need for an early tightening of policy.** While the easing in demand for ECB liquidity is a sign of a technical improvement in market conditions, there is little doubt that far more **threatening fundamental challenges lie ahead**. Unfortunately, for the ECB **the potential threats posed by currency movements and budgetary policies lie outside the ECB's immediate area of influence**. While the current policy climate is relatively quiet, the **Dollar and budget deficits could make 2010 a very testing year for the ECB**.

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