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Economics Group

Special Commentary

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Will the ECB Ease Policy Further at Next Week's Meeting?

Recent indicators suggest that economic activity in the Eurozone continues to expand, albeit at a rather modest pace. Everything else equal, the ECB would not be inclined to ease further if economic activity is accelerating. On the other hand, inflation is very low and credit growth is benign, raising the probability that the ECB acts further. Although we believe that the Governing Council will keep policy unchanged next week, the ECB will remain "biased" to ease for the foreseeable future.

Figure 1

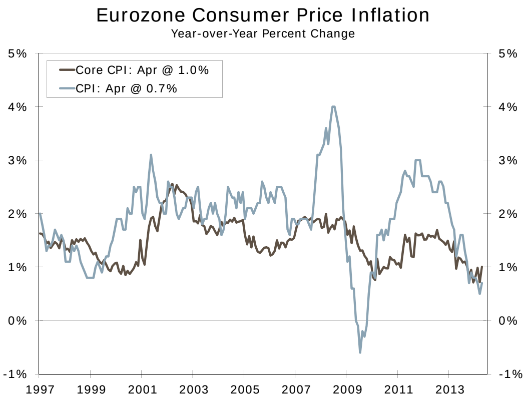


Figure 2

Source: IHS Global Insight and Wells Fargo Securities, LLC

Recent data from the Eurozone will complicate the decision at the European Central Bank's (ECB) policy meeting next week. On the one hand, the labor market in Germany, the single largest economy in the euro area, remains strong. The unemployment rate in April remained at only 6.7 percent, the lowest rate since reunification in 1991 (Figure 2). The recent stabilization in the unemployment rate in Italy, albeit at a significantly higher level than in Germany, suggests that the labor market in that country may be bottoming. (The unemployment rate in Italy stood at 12.7 percent in March.)

In addition, the manufacturing PMI in the overall euro area in April remained well above the demarcation line that separates expansion from contraction. In other words, recent indicators show that economic activity in the Eurozone continues to expand, albeit at a fairly modest rate. Viewed in isolation, these indicators suggest that the ECB would not feel compelled to ease policy further next week.

On the other hand, however, the overall inflation rate in the Eurozone did not rise as much as expected in April. Specifically, preliminary data showed that the overall rate of CPI inflation had risen to 0.8 percent in April from 0.5 percent in March. However, that rate was revised down to 0.7 percent when the "final" estimate was released this week (Figure 1). Moreover, the "core" rate of inflation, which is indicative of underlying inflationary pressures, remains very low at only

1.0 percent. In other words, there are very few inflationary pressures in the Eurozone at present. As we argued in a recent report, the euro area is one negative shock away from a potentially deflationary scenario. (See "Does Deflation Threaten the Eurozone" which is available upon request.)

In addition, credit growth remains anemic in the euro area (Figure 3). ECB policymakers have spoken publicly about their concerns about the apparent impairment of the monetary policy transmission mechanism in the Eurozone. That is, more accommodative monetary policy does not appear to be stimulating credit growth. Viewed in isolation, these recent price and credit developments would argue for further easing at next week's policy meeting.

Figure 3

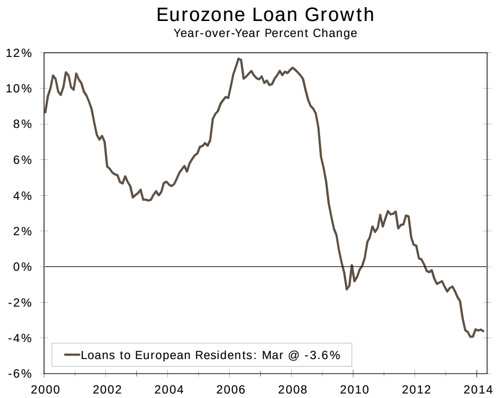
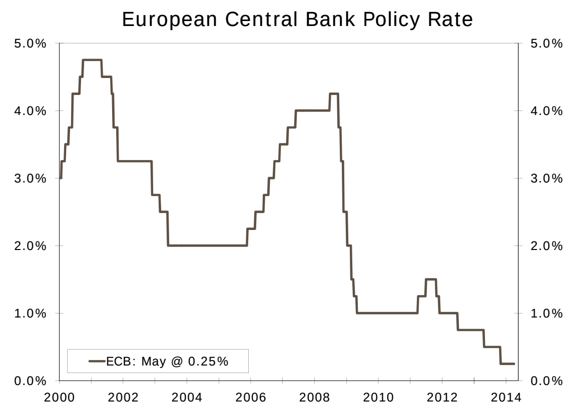


Figure 4



Source: IHS Global Insight, Bloomberg LP and Wells Fargo Securities, LLC

The ECB could conceivably cut its main policy rate from 0.25 percent to, say, 0.10 percent, but the effects of this policy change likely would be minimal. Given the weakness in bank lending, policies to encourage or subsidize lending could conceivably be put in place. ECB policymakers also seem open to the possibility of some sort of quantitative easing program. We think the Governing Council will opt to keep policy unchanged at its meeting on May 8, but we acknowledge the lower-than-expected print on CPI inflation in April and continued weakness in credit growth could spur the ECB to act. In any event, the ECB will remain "biased" to ease further for the foreseeable future.

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