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Economics Group

Special Commentary

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Will The European Central Bank Ease Further?

The European Central Bank held its first policy meeting of the new year this week and, as widely expected, did not make any changes to its policy stance. Most analysts had expected that the ECB would remain on hold due to recent signs that the recovery underway in the Eurozone continues, albeit at a tepid pace. The Economic Confidence index in the euro area rose for the eighth consecutive month in December, and it now stands at its highest level since mid-2011 when the Eurozone slid back into recession (Figure 1). More importantly, "hard" data are corroborating the optimism that the survey data are indicating. Retail sales in the euro area rose 1.4 percent in November relative to the previous month. Not only was the outturn significantly stronger than the consensus forecast, but it was the largest monthly increase in four years. The 1.9 percent rise in German industrial production in November adds to the evidence that the German factory sector is gaining strength again (Figure 2).

However, the ECB remains "biased" to ease policy further. In its policy statement that was released after the meeting, the ECB Governing Council reaffirmed that it expects "key ECB interest rates to remain at present or lower (emphasis ours) levels for an extended period of time." Although a recovery seems to be underway in the Eurozone, it is by no means firmly established yet. Moreover, the ECB's single policy objective is to maintain CPI inflation "below, but close to, 2 percent." With CPI inflation at both the "headline" and the "core" measures running below 1 percent at present—the "core" rate of CPI inflation fell to an all-time low of 0.7 percent in December— it is difficult to make the case that CPI inflation is "close to" 2 percent (Figure 3).

Figure 1

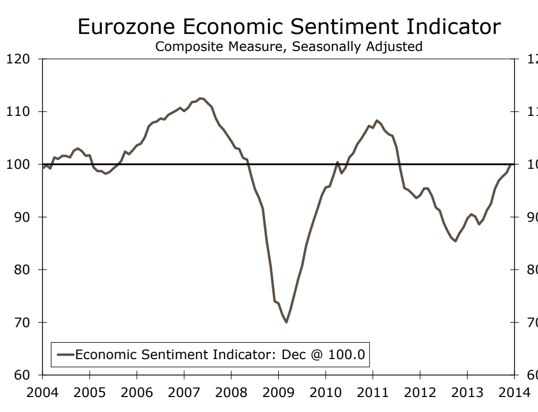
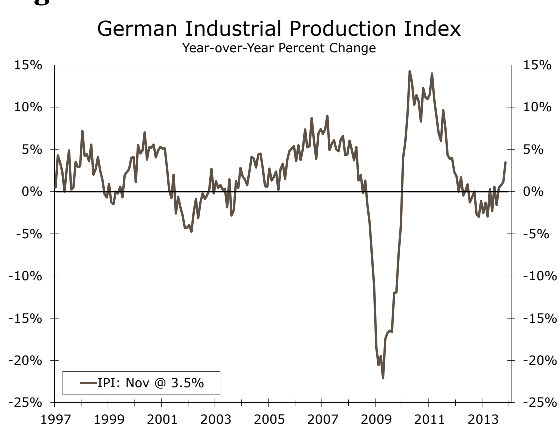


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

Although deflation has not set in in the overall euro area, there are some countries where extremely depressed economic activity has eliminated any inflationary potential, at least in the foreseeable future. CPI inflation is more or less flat in Ireland, Portugal and Spain at present, and the consumer price index in Greece is actually 2.9 percent lower today than it was a year ago.

Figure 3

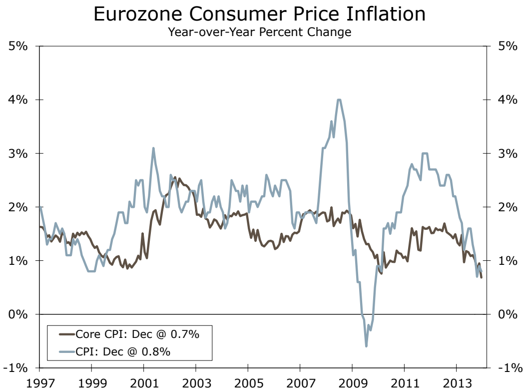
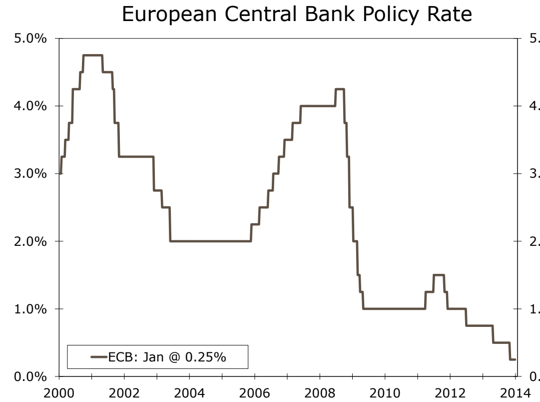


Figure 4



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

If our forecast of stronger GDP growth in the Eurozone proves correct—we project that real GDP in the overall euro area will grow a bit more than 1 percent this year following a contraction on the order of 0.4 percent in 2013—then deflation in the overall euro area likely will not take hold. However, we also forecast that CPI inflation will not return to 2 percent between now and the end of our forecast period (end of 2015). Therefore, we think there is a significant possibility that the ECB will cut its policy rates further at some point in the next few months. In our view, only extreme circumstances would lead the ECB to slash its deposit rate below its current setting of zero percent (i.e., taking the deposit rate into negative territory, thereby charging banks for the deposits they hold at the central bank). However, the refi rate, the ECB's main policy rate, currently stands at 0.25 percent (Figure 4). Although the ECB probably won't cut the refi rate all the way to zero percent, we think there is a strong case to be made for a cut to 0.10 percent. If so, the euro could encounter selling pressure.

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