

Research

Euroland: Arguments for ECB to hike in 2010

- The focus of the ECB now appears to be shifting from whether to implement more stimulus measures to when to begin withdrawing them.
- We believe that the euro area next summer will have recovered so much that the ECB will consider interest rates at historical lows as being inappropriate and will start hiking.
- When the ECB starts hiking it will probably deliver about 0.5 percentage points each quarter, which was the average hiking speed seen in the 2000-01 hiking cycle.
- The exit strategy is likely to begin with alterations of the conditions for the long-term refinancing operations.

The focus of the ECB is shifting toward an exit strategy

On August 19, Governing Council member Axel Weber said to the German newspaper *Die Zeit* that it is too early to withdraw stimulus measures. We fully agree with that, but while some misinterpreted this as meaning that more stimulation was needed we take note that the focus of the ECB now appears to be shifting from whether to implement more stimulus measures to when to begin withdrawing them.

Below we discuss in detail why we believe the ECB will find that the conditions are in place to start hiking next summer and outline what an exit strategy might look like.

Growth

Unless inflation is very high (as in July 2008) ECB policy tends to be driven by growth developments. In 1999 the ECB started hiking when PMI new orders were 59 and in 2005 it hiked when they reached 54. PMI new orders are currently at 49.5 and increasing strongly. We anticipate that they could reach 59, or more, in early 2010 and would thus send a strong signal for the ECB to embark on a hiking cycle.

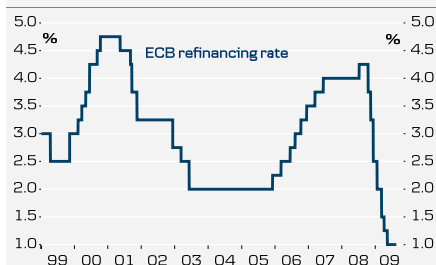
The ECB will have to revise its downbeat staff macroeconomic projections significantly up at the next Governing Council meeting. The ECB currently (June 2009) projects growth to remain negative until mid-2010, but with France and Germany out of recession in Q2 this year and the euro area in positive growth territory in Q3 – a year before the ECB officially expects – it will clearly have to change its view radically. We anticipate strong growth of about 3% q/q annualised in Q3 and Q4 09, driven primarily by the inventory cycle and exports. Thereafter we expect that growth will slow down to around 2% q/q in 2010 and become more broad based.

ECB hiking speed



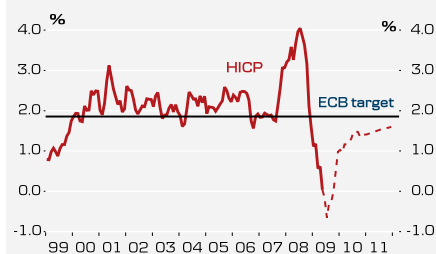
Source: Reuters Ecowin

ECB refinancing rate at historical low



Source: Reuters Ecowin

Inflation below target



Source: Reuters Ecowin

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At Jackson Hole on August 22, Governing Council member Ewald Nowotny signalled a more positive attitude from the ECB when saying that “The European economy will improve in the second half, driven by policy measures, but a sustained recovery will likely not take hold until the beginning of 2010”. ECB president Jean-Claude Trichet also signalled a more positive stance on growth, but also warned about the possibility of a very bumpy road ahead. We will get the updated ECB staff macroeconomic projections at the ECB Governing Council meeting on September 3.

The ECB assesses today’s policy rate as appropriate on the basis of existing information and analysis – i.e. in line with its extremely downbeat forecast. It is unlikely that the ECB will keep this stance on current policy rates for a prolonged period while at the same time undertaking significant upward revisions to its growth projections.

Significant upward revisions in ECB’s growth projections should also result in upward revisions in its inflation expectations. Higher growth would put upward pressure on commodity prices. It will also push core inflation up, although this effect will be moderated by the negative output gap.

When the ECB is confident that the euro area is back on a sustainable positive growth track it will be concerned that an interest rate level of 1% is too accommodative. This is likely to be the case when the labour market has stabilised, which we expect to happen in early-2010. Trichet is already emphasising that the ECB is committed to withdraw stimulus in a prompt and timely manner once the economic outlook improves sufficiently.

Output gap

The crisis has resulted in a large output gap, but this will not pacify the ECB. ECB executive board member Jürgen Stark said on August 12 that "caution is warranted" concerning inflation projections made on the basis of output gap estimates, since "such estimates are always liable to major uncertainties".

Stark also said that "we have to realise that potential output has gone down because of the deep recession". Indeed the European Commission has published a paper (*Occasional Papers No. 49/June 2009*), which concludes that the financial crisis has had a large negative impact on potential output (and possibly potential growth) in the short run. The output gap will thus be closed not only from below (because of positive growth), but also from above, because potential output (and possibly potential growth) has fallen. The ECB is well aware of this and will take into account not only the significant uncertainty that surrounds the size of the output gap, but also that the output gap is likely to be smaller than simple projections of potential growth based on historical performance would indicate.

Inflation

We expect that euro area inflation will increase to 1.3% in 2010 and will be around 1.5% in 2011. This is lower than ECB’s inflation target of “below, but close to 2% over the medium term” and from an inflation point of view there is little need for the ECB to hike. However, after a decade with a tendency for inflation to overshoot ECB’s inflation target they will be pleased to see inflation stabilising below their target rather than above, so an expected inflation rate around 1.5% is no hindrance for the ECB to start hiking.

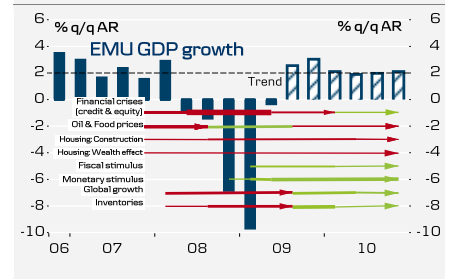
In addition the ECB considers the risk of deflation as very small and diminishing, so this concern should not keep the ECB from embarking on a hiking cycle. ECB board member Stark said on August 12 that "we see the dangers of deflation as very low... if there was ever a deflationary risk in the euro area, then today that risk is much lower”.

ECB and Danske Bank projections

%	2009	2010
GDP growth		
ECB	-4.6	-0.3
Danske Bank	-3.9	2.0
Inflation		
ECB	0.3	1.0
Danske Bank	0.4	1.3

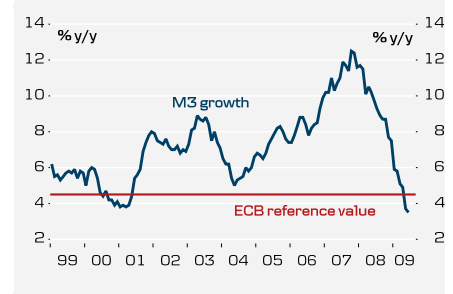
Source: Danske Markets

Danske bank’s more upbeat projection



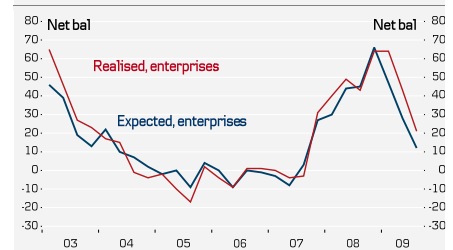
Source: Danske Markets (June 2009)

M3 growth below reference value



Source: Danske Markets

Tightening of lending standards



Source: Danske Markets

Asset bubbles

The ECB has also learnt the lesson not to keep rates “too low for too long”. The risk of fuelling new asset price bubbles by keeping the refinancing rate at its historical low for too long is a strong argument for starting the hiking cycle when sustainable growth has returned even if inflation expectations remain subdued.

In his *speech at Jackson Hole* on August 22 Trichet took up “leaning against the wind” as the first of three topical issues. Trichet argued that it is possible for central banks to use monetary and credit indicators to detect growing asset bubbles and then take steps to slow rapid asset price rises. He also noted that “a strategy of leaning against the wind could reduce moral hazard: by behaving more symmetrically, a central bank can encourage more responsible behavior on the part of investors and make a crisis less likely”. Trichet is, however, “doubtful that such a strategy can be implemented in a mechanical way”. Instead he suggests to use judgement that “encapsulates the essence of leaning against the wind without suggesting that central banks are in a position to manage closely – much less target – developments in asset prices”.

We would not be surprised to see the ECB lean against the wind during the next hiking cycle.

Monetary pillar

Annual broad money growth was 3.5% in June and is likely to decline further before it begins to pick up early next year. The reference value for M3 growth decided upon in 1998 is 4.5%. M3 growth has been above this target almost ever since. In this respect the ECB is certainly fine with money growth dropping to 3.5%, but it would not like to see it drop much further. Money growth, however, is expected to continue to decline – probably until the end of the year – before it begins to pick up. Next summer the trend in M3 growth will again be up. If the ECB extrapolate this pickup in M3 growth it could begin to fear that monetary growth could soon move above their target again – and almost certainly M3 growth developments will not give the ECB a reason to remain inactive.

ECB is also focusing on the main counterparts of M3 in particular annual growth in credit extended to the private sector, which has fallen to just 1.5% in June. Annual growth in loans to the private sector could turn negative before starting to increase again early next year as demand picks up and lending standards begin to ease.

The ECB also studies the lending surveys in great detail. The July lending survey showed that the number of banks that tightened credit almost halved from Q1 to Q2. The credit tightening cycle is likely to come to an end within a few quarters and as growth picks up and risk aversion declines we are likely to see some banks starting to ease credit in early 2010. This is another signal for the ECB that it can start to normalise interest rates without jeopardising the economy.

The Bundesbank has stated in its August monthly bulletin that there are “no signs of a general credit crunch in Germany”. The ECB is likely to agree with this view.

What will an ECB exit strategy look like?

The ECB has communicated that it has not decided on the sequencing of the exit strategy. In particular the ECB will not necessarily withdraw all non-standard measures before it starts to hike rates.

It is likely that a first step in an ECB exit strategy will be to alter the conditions for the long-term refinancing operations (LTRO) with guaranteed full allotment. The 12 month LTRO in late-September is likely to be on the same conditions as the auction in June, but at the 12 month LTRO in mid-December we expect a spread to be included. This is likely

to be interpreted by the market as an indication that the ECB expects to hike the refinancing rate within the next 12 months. As a next step the ECB could decide not to continue with new 12-month auctions in 2010 or it would decide no longer to have full allotment.

The EONIA overnight rate is currently below the refinancing rate. Instead of hiking the refinancing rate the ECB may wish to close this gap first by draining liquidity. Look for measures aimed to bring the EONIA overnight rate closer to the refinancing rate. A move to variable rate tenders from fixed rate tenders with full allotment is one possibility (adding a spread at the 12 month LTRO will also help). A normalisation of the spread could be a good signal that the next move from the ECB is to start communicating a forthcoming hike in the refinancing rate.

The signalling of the beginning of a hiking cycle could then take place in spring next year.

The exit strategy for the other non-standard measures will probably not be implemented until end-2010 or later. The ECB already announced in May that the temporary expansion of the list of eligible assets is to be prolonged until the end of 2010. We expect that the collateral pool will be narrowed thereafter, but this will probably not be communicated before we are well into 2010.

The covered bond purchasing programme runs until end-June 2010. After that we would expect the ECB to hold the EUR60bn portfolio until 2011 or later. The reduction of this portfolio could be one of the last steps in the exit strategy.

Hiking speed

When the ECB starts hiking it will probably deliver about 0.5 percentage points each quarter, which was the average hiking speed in the 2000-01 hiking cycle and the maximum pace in the 2005-07 hiking cycle. We expect PMI new orders to reach levels similar to those seen during the first of these hiking cycles – possibly higher – and we expect the ECB to react with a similar hiking speed.

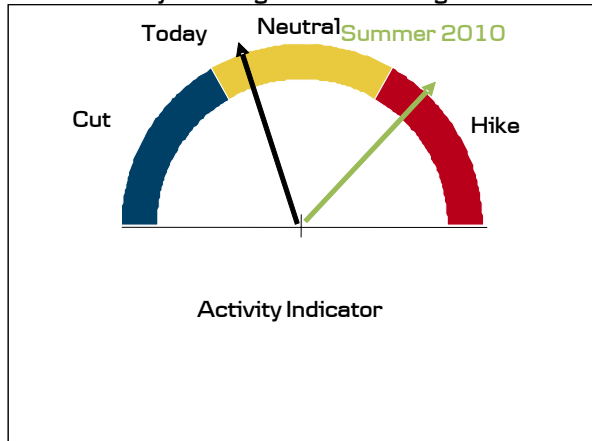
Given that the refinancing rate comes from a historical low the ECB has extra reason to favour a not too slow hiking speed. With a hiking rate of 0.5 percentage points each quarter, the refinancing rate would only have reached 2% at end-2010, which is still a very accommodative level – and it would not reach a neutral level before end-2011. Given that monetary policy has its maximum impact on a one- to two-year horizon this scenario actually implies that monetary policy will have a positive impact on the economy well into 2012.

The speed applied when monetary policy was relaxed in this rate-cutting cycle was much higher. The ECB could aim to implement a symmetric policy with rate hiking speed similar to the cutting speed. Although we believe the ECB will try to “lean against the wind” and be willing to hike despite low current inflation rates we do not believe that the hiking rate will match the speed we saw in the cutting cycle.

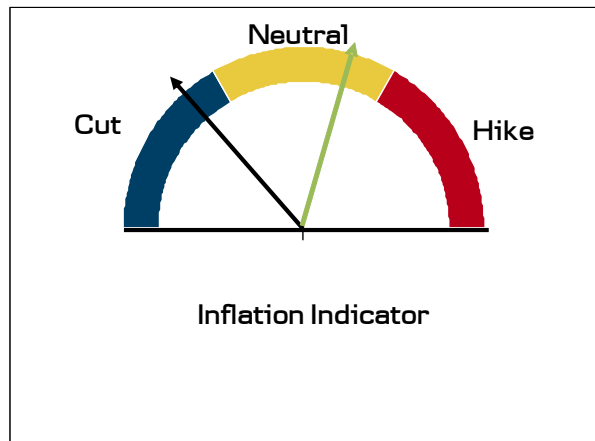
The market currently prices around 25bp in June and around 60bp in September 2010.

Danske Bank's ECB Monitor

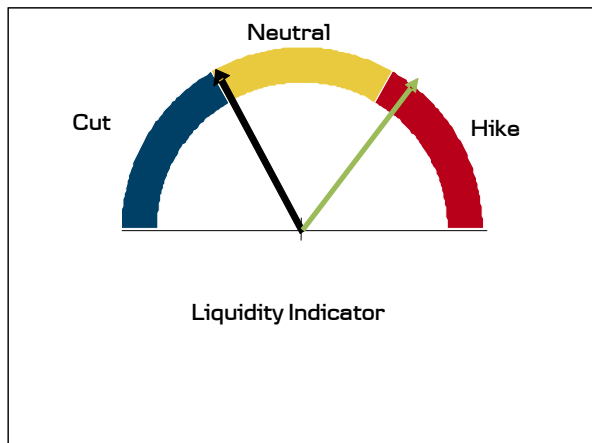
Activity heading towards hiking zone



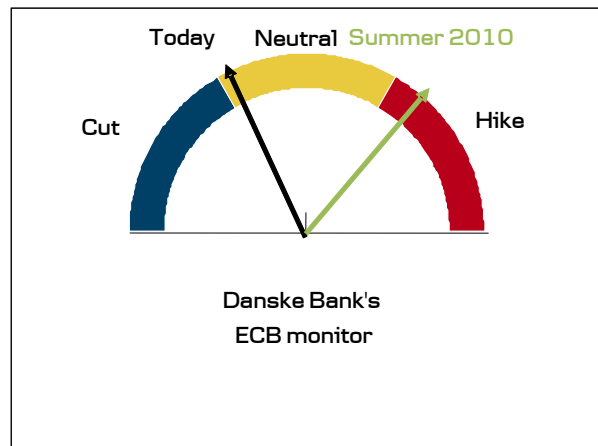
Inflation will soon start to increase towards 1.5 %



Liquidity is moderating and below reference value, but will increase in 2010



Cuts are on the agenda: Already in recession with worsening ahead and inflation is diving



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