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Eurozone

ECB's 'forward guidance' shifts to hint at action in June

- **ECB hints at action to boost economy in June if new staff inflation projections suggest stimulus is merited**
- **Recovering economy suggests any action, if any, may be limited**

The European Central Bank's Governing Council left policy unchanged at its May meeting, but hinted strongly that action of some form would be taken at its June meeting to help prevent low inflation becoming more entrenched if revised staff projections suggest action is warranted.

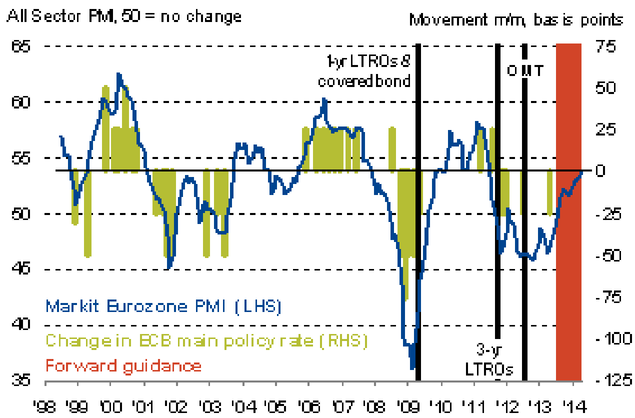
Despite signs that the economic recovery is gathering pace, ECB president Mario Draghi noted that the recovery was still weak and that it remained concerned about low inflation. Although consumer price inflation crept higher in April, according to the flash estimate, at 0.7% it remains well below the ECB's target of 'close to but below' 2.0%. It is also well below rates seen in other countries. Even Japan is 'enjoying' an inflation rate of 1.6% after policy stimulus has succeeded in beating down deflationary forces (prices were falling in Japan at an annual rate of 0.9% early last year).

The ECB, as well as many national governments, is also concerned that the euro's appreciation so far this year is hampering exports and therefore acting as a threat to the region's recovery.

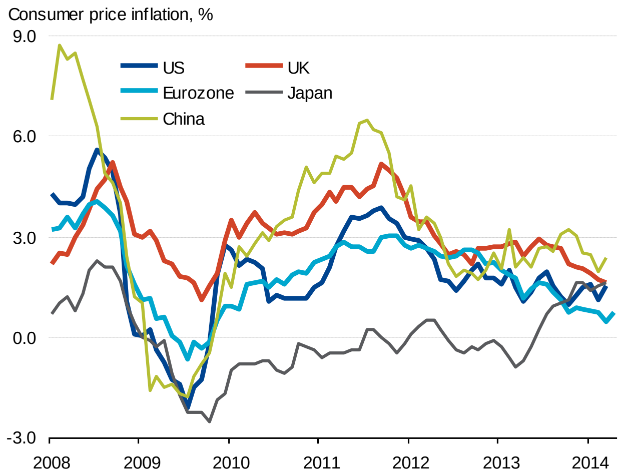
Since assuring that it would do all that is needed to preserve the euro in 2012, the ECB has successfully avoided the need to further action by simply using words. It's most recent policy of forward guidance, introduced last July, ditched the previous rule that the ECB "never pre-commits" to policy changes, by committing to keeping interest rates "at present lower levels for an extended period of time".

In the Q&A session after the policy announcement, it was stated that the May meeting should be considered as a "preview" to the June meeting, which will have the benefit of policymakers seeing updated staff economic projections. The Governing Council, Draghi noted, was

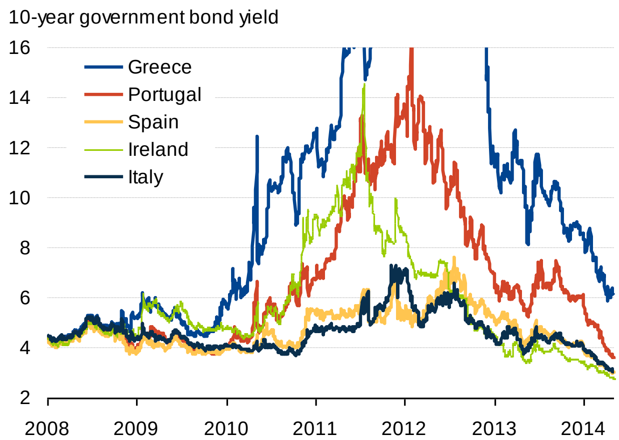
Policy announcements and the PMI



Consumer price indices



Government bond yields



"comfortable about acting next time", though this depends on whether the revised staff inflation forecast suggests such action is indeed merited.

Action likely to be limited …perhaps to just words

Even if the ECB does decide to act, it is likely that it will not be particularly significant, perhaps just electing not to sterilise previous bond purchases. After all, the recovery is gaining traction. The April PMI surveys signalled the fastest pace of economic growth for three years, suggesting the region will see a fifth successive quarter of rising GDP in the second quarter, with the rate of growth picking up to exceed 0.5% if the PMI continues to improve in May and June. This would push the PMI into territory that would, in normal times, be associated with a tightening of policy, and certainly not a further loosening.

In what other ways the ECB might act is subject to intense speculation. Certainly the bar to the ECB undertaking unconventional stimulus such as full-blown QE is high, not at least because of the political difficulties associated with the single central bank representing many different countries.

With sovereign debt yields also having fallen, the current problems do not lie with government borrowing costs. Instead, it is the corporate bond market and the provisional of credit in the economy where the main issues currently lie and where action perhaps needs to be targeted. Any QE would therefore perhaps be better targeted at corporate bonds.

There has also been much discussion of how useful it would be to lower interest rates further, for example by introducing a negative deposit rate (which is currently zero). This would mean banks would effectively be penalised for stashing money at the central bank rather than lending it out to businesses and households, but its effectiveness is by no means guaranteed and problems could arise from the profitability of banks being further reduced and there could be a huge shift into cash.

June's policy meeting certainly is being set to be one of the most important ones of the year. The suspicion is, however, that Draghi's words are just that, and that the revised forecasts may show that the recovery that is gaining momentum may lead to an upward revision to staff forecasts, obviating the need for further policy action. Meanwhile, the euro will have weakened, as desired.

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