

Expect the ECB to cut rates

Developments in economic sentiment and inflation suggest that interest rates in the euro area will come down rapidly in the months ahead, perhaps by 75 bps.

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The recent developments in financial markets have taken their toll on confidence or economic sentiment across the world. This is important for investors because it suggests that central banks may relax rates in the coming months.

To understand why, note that measures of economic sentiment or confidence can be thought of as real-time measures of the state of the business cycle. Thus, when economic conditions change, this is first noticed by households and firms and reported in surveys. Because of publications lag, however, such developments only become apparent in economic data after some time.

Central banks, however, look at a myriad of indicators when setting monetary policy. Thus, it seems plausible that their views of economic conditions are quite strongly correlated with subjective indicators of business conditions. However, since there is a risk that any change is merely temporary, central banks react only very rarely immediately to new data. Instead they for a while until it has become clearer what the data means. Overall, monetary policy is likely to follow subjective indicators of the state of the business cycle but to do so with a lag.

This is the case for the ECB. Figure 1 below shows that the repo rate follows with a lag of about seven months a measure of economic sentiment published on a monthly basis by Eurostat.¹ However, at times there are large discrepancies between the two series. One such episode occurred between 2002 and 2005 as it was not clear whether economic conditions were strengthening or weakening and the ECB took a wait and see attitude. The second episode of a large divergence is now: rates have fallen little since the financial markets turmoil started in 2007, but sentiment has collapsed to the lowest level since the ECB was established.

Why has the ECB not cut rates? Figure 2 shows that HICP inflation in the euro area is far above the 2% upper limit of the ECB's definition of price stability. So cutting rates is not an option. But inflation rates have been high because food and energy prices have risen to a high level.

However, both are now falling rapidly and inflation pressures may abate quickly. If so, three outcomes are possible. The first is that the sentiment remains weak and the ECB cuts rates rapidly in response to falling inflation. Such cuts could be large, even very large, say down to 2%.

¹ See http://ec.europa.eu/economy_finance/db_indicators/surveys9185_en.htm.

The second possibility is that sentiment picks up rapidly in response the measures taken across the world to shore up the financial system, obviating the need for the ECB to cut rates. That would require that sentiment rises as fast as it fell last year. This seems an unlikely scenario.

The third outcome, which is more likely, is that sentiment recovers, but only does so slowly, leaving the ECB to cut quite a bit as inflation comes down. How much, but 75 or 100 bps over the next six months seems not implausible.

Fig 1. ECB's Repo rate and Sentiment

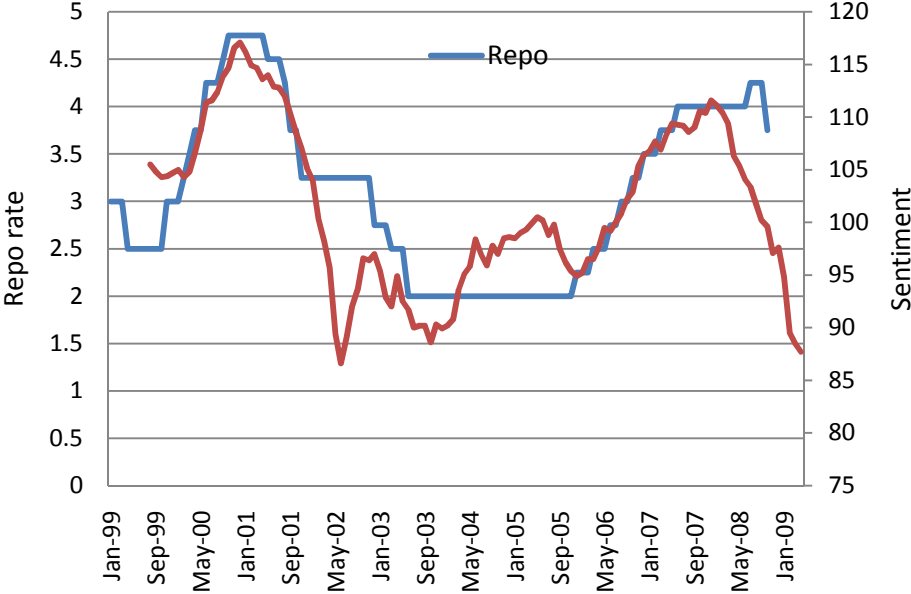


Fig 2. HICP Inflation

