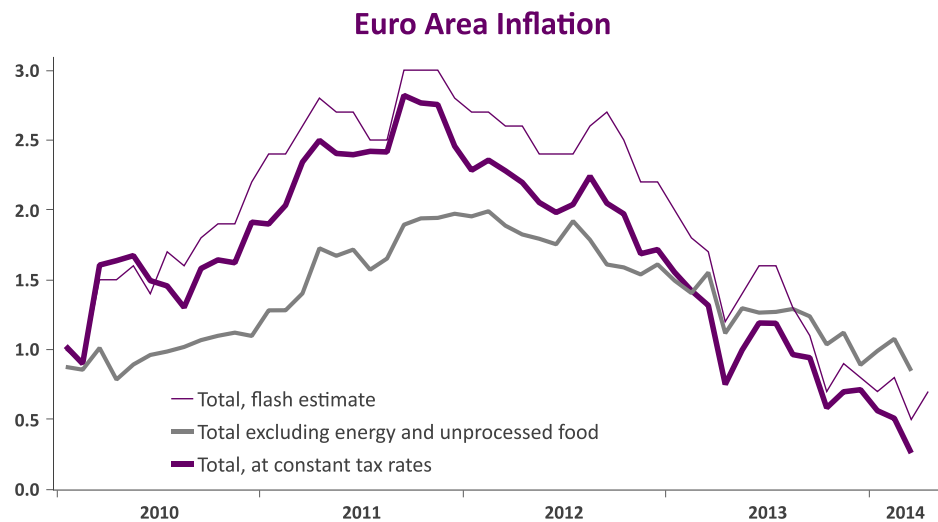


“Our currency, your problem”

Things are a little clearer since Mario Draghi’s press conference: the ECB considers the euro’s strength a deflationary risk factor. It is likely to move as a result, albeit in a measured manner starting in June then increasingly so thereafter if necessary, which will probably be the case. Against a backdrop where most other central banks are implementing monetary policies aiming to depreciate their currencies, the hesitancy of the ECB was no longer tenable. So that was a bit of good news but let’s not get ahead of ourselves: by taking such action Mr. Draghi is trying to give the other central banks a taste of their own medicine, making life hard on the Fed, BoJ and BoC, and not the other way around

Deflation risk increasing in the euro area, the ECB takes action



Although it couldn’t go the extra step and admit that restrictive fiscal policies, in place since 2010, are the biggest cause of latent deflation, the ECB did recognize that the appreciation of the euro is a factor that is weakening economic prospects and price levels. In doing so however, it has taken a big step. Not wishing to have to go back on his word, Mr. Draghi will wait for fresh data in June before taking action. The latest official scenario, published in March, was

hardly rosy and the 1% expected inflation for 2014 is looking increasingly unlikely.

Trends since early January are unequivocal: disinflation is spreading, even to the most solid European economies. During the 12-month period to end-March, consumer prices only increased (excluding indirect tax movements) 0.25%, down 2.5 basis points versus September 2011, i.e. a more marked fall than other data indicates. According to this same statistic, eight of the 18 euro area countries have seen absolute falls in their overall consumption (Cyprus, Greece, Portugal, Spain, Slovakia, Slovenia but also the Netherlands and Italy). Preliminary data from April does not yet depict a trend (excluding tax), but the risk of a further drop seems high given the data that is already available. Energy inflation's contribution has not been as negative as expected and is more telling than the rebound (0.2) in annual inflation (0.5-0.7%), at a time when the inflation rate of industrial prices, excluding energy, stands at 0.1% per year, versus 0.2% in March and 0.4% in February.

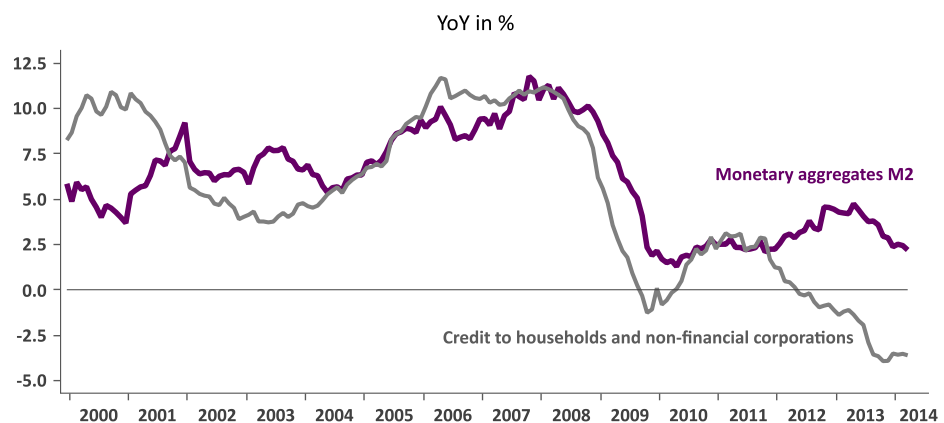
In April, softer inflation anticipations of households have gotten even softer in several countries, notably in France, Italy, Belgium and again in Spain.

In the end, it is highly likely that the ECB will review its scenario by several tenths and lower the mid-range of its provisional guidance to around 0.8-0.9% for this year, which is much higher than the figure we get from monthly changes that are identical to that from last year between May and December (0.7%).

Activity and credit disappoint

But beyond inflationary trends, the entire ECB scenario is currently adrift. Not only, in fact, is credit growth picking up at a snail's pace – amid a backdrop of extremely low growth of the money supply over a sustained period – but the most recent economic indicators from the euro area's top gun: Germany have faltered.

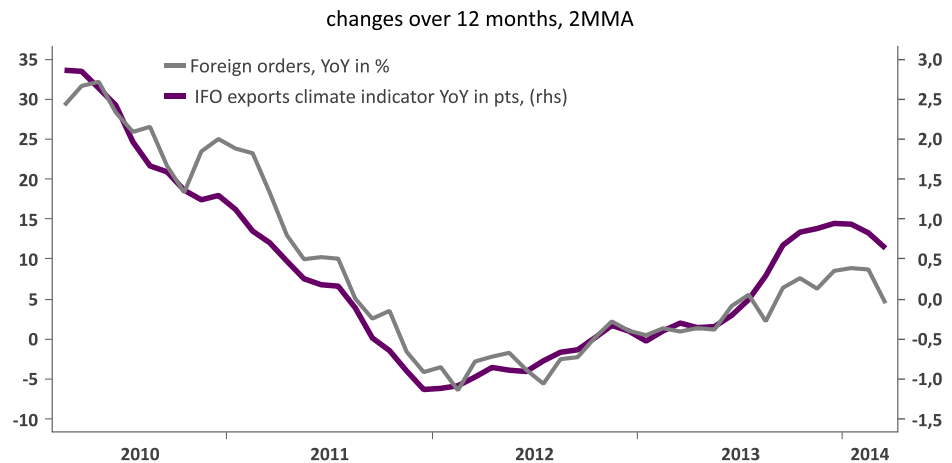
EMU: Monetary Aggregates and Credit to Private Non-Financial Sectors



Sources: RichesFlores Research, Macrobond

After several signs from the IFO survey, German orders and production published this week have confirmed a slowdown. Although it is too early to draw conclusions, the turnaround in leading indicators is now sufficiently clear to revive worries regarding the baseline scenario of a slow improvement in the euro area situation.

New Orders and Exports Climate in Germany



Sources: RichesFlores Research, Macrobond

Uncoordinated intervention

It will Broadly speaking, the reasons liable to push the ECB to modify its policy are firmly in place, according to our scenario, and are going nowhere fast. We can expect not only action in June but probably a rate cut combined with a slightly negative deposit rate, but also larger-scale actions thereafter, liable to take the form of 1) long-term funding operations, possibly tied to conditions, 2-asset purchases in whatever form.

The ECB's determination in the coming months will depend on the effects of Frankfurt's policy shifts on the exchange rate of the euro. At this point, it seems, however, probable that the policy will lead to depreciation, albeit a mild impact on the exchange rate, on a foreseeable horizon. There are three reasons for this:

- 1- the ECB will take action, it's a foregone conclusion, in a gradual manner. We are not on the eve of a shock to the system on par with initiatives undertaken by the Fed or the Bank of Japan, for example.
- 2- the chances of success of this policy in terms of credit expansion are relatively feeble. Demand is considerably hobbled at present and stimulus offered to banks to lend more could fail to have a material effect if the economy does not pick up more steam. Downwards price pressure risk to continue and thus stamp out any significant fall in the currency.

- 3- the effectiveness of the ECB's intervention could be hampered by measures being taken by other big central banks such as the Fed, BoJ and BoC. They are all implementing policies that depreciate (directly to varying degrees) their currency. By jumping into the fray, the ECB runs the risk of negating the effects of their policies, which could translate into an extension or amplification of monetary stimulus measures.

The bigger picture lends credence to our scenario that monetary policy will remain highly accommodative at the global level, including the probability of a widespread fall in long-term interest rates.

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