# European Central Bank – Main Refinancing Operations Interest Rate Forecast for March 2015

The European Central Bank's (ECB) main refinancing operations interest rate is the interest rate at which banks can constantly borrow from the ECB. The rate is currently 0.05%, and has been substantially reduced from 4.25% in July 2008, when Eurozone inflation was approximately 4%. It is the responsibility of the ECB to make sure prices stay stable throughout the Eurozone through the use of the interest rate. The target inflation level aimed for by central banks is in the region of 2%. The ECB can control this through the use of the interest rate level. If inflation is running high, the ECB may act by raising interest rates. This should discourage inflation, as it is now more expensive for people, firms and governments to borrow money. Investment and consumer spending is then reduced, as there is less money in circulation. This causes prices to dip, as the aggregate demand in the economy is lower.

After the collapse of the so-called "Celtic Tiger'' in Ireland, the bursting of the housing bubble, and the failure of the European banking system, there were three items that prevented Ireland and the Eurozone from returning to a state of economic growth; local consumption by taxpayers, high levels of household debts, and collapsed investment in the economy. These items combined with the job losses and austere budgets experienced by many European countries have lead to lower levels of disposable incomes in households around the EU, resulting in lower aggregate demand and increased government debts. In order for the European economies to return to economic growth levels of between 3-4%, there must be an improvement in either productivity levels of workers currently working, or an increase in the number of people working in the economy or both. By increasing both of these the GDP per capita is increased and the total output in the economy will grow. By increasing the value of national output, the Eurozone will see increases in the wage levels of workers, lower unemployment and government borrowing, while experiencing higher levels of investment in the economy, four factors which the ECB are desperate to see occurring. This will trigger demand in the economy as the AD curve shifts right (The economy is expanding) due to increased economic activity because individuals now have higher levels of disposable income as a result of job creation, higher wages etc. This results in higher inflation, which the ECB can control using the interest rate, as was explained above.

Since the financial crash in '08, the ECB has begun a policy of lowering the main refinancing operations interest rate in the hope of encouraging inflation and activity in the European economies. The ECB's main refinancing operations rate has now practically gone as low as it can go and unfortunately the ECB has not seen the results it had hoped for. If the ECB were to achieve the target 2% inflation level, the Eurozone would see reductions in the past value of existing government debt, allow restricted adjustment pressures to be placed on wage levels, moderate increases in production levels in the economy, and also prevent the threat of deflation in the economy, something the ECB are desperate to avoid

During 2014, inflation levels continued to dip as the Eurozone came close to re-entering recession. The falling inflation rate may be partly attributed to the huge decline in oil prices, an essential factor in the production process. Because of the current situation in the Middle East and the friction between the US and OPEC (Organization of Petroleum Exporting Countries), we have seen the price of a barrel of oil hit $44, a six year low. Despite the fact that lower oil prices can be seen as a positive for economic growth (Lower production costs lead to increased profits and supply), they can have a negative effect on the Eurozone's inflation rate because if everything is cheaper to produce, prices in turn will then fall, leading to a decrease in the inflation rate, and in extreme cases it can lead to deflation in the Eurozone. Also, the fall in the value of the Russian rouble combined with the economic sanctions placed on Russia has not helped inflation levels. The rouble is falling because of lower oil prices as mentioned before and because of the sanctions placed on the country as a result of the Russia-Ukraine Crisis. These sanctions have limited Russia's trade and reduced the surplus in their balance of payments, resulting in a fall of the value of the rouble.

However, inside dynamics and expectations play a large part in the market in our opinion. Inflation expectations are falling in the short term, now 0.8% for 2016. In 2013, the ECB had expected inflation rates to be at 1.8% during the first quarter of 2015, whereas January 2015 as of , the Eurozone interest rate is currently at -0.2%, meaning deflation is currently taking place, despite all of the measures taken by the ECB to avoid this. While long run expectations had remained stable for a long period, are now falling too with the “5-Year Forwards” rate below 2% at 1.58%.


There is currently a need for inflation in the Eurozone. As of the 29th of January, the euro is at a 9 year low of $1.1306, compared to $1.3324 this time two years ago. The outlook is not entirely negative though. In Ireland, the unemployment rate now stands at 10.6%, down 13% from this time last year. The overall consumption in the Irish economy is up 2.2%, while GDP has seen 3.6% growth over the past year. The Irish balance of payments account has a positive balance almost twice what it was two years ago. This may suggest that competitiveness is returning to Ireland and that is being seen as an attractive to invest here. However, Ireland has not yet seen significant wage growth with average Irish weekly earnings currently at €671.60, down 0.8% from last year. The European seasonally adjusted sales volume and consumption rose by 0.6% for November 2014. On the lending front, the number of Irish loans currently to households and non-financial corporations fell by 3.8% and 8.1% in the 12 months to 2014. This raises the question of whether the banking system is actually engaging in lending practices and whether there are adequate levels of credit available to consumers. If banks are not giving out loans, we will not see an increase in the amount of money spent in economies throughout the Eurozone.

We believe that the ECB has fully utilized the inflationary benefits of lowering the interest rate. At 0.05%, it is difficult to see the advantages and economic benefits of further decreases in the interest rate. We have seen a 0% interest rate in action in Japan since approximately the year 2000. In order to boost their economy they have had to undergo significant fiscal policy adjustments and several quantitative easing programmes. Although the Japanese economy is still under significant strain and has yet to undergo substantial structural reforms, it has seen improvements in the past few years with GDP growth now at 1% from -5.5% in 2008, unemployment of 3.5%, while attaining higher levels of inflation than the OECD prediction for European economies (-1.4% in 2008 to 2.9% in 2014). [1]

We believe that the ECB will keep the interest rate constant at 0.05% in March 2015. We think this will happen for the following reasons;

- We are not anticipating a hike in interest rates in March 2015 because the inflation outlook for the year 2015 is below the ECB target rate of 2%. We believe that to do this would be counteractive to the inflation process. We expect the low rate of inflation to continue through 2015 because of the low oil prices as was explained above, the fall in the value of the Russian rouble, a potential devaluation of the Chinese Yuan in 2015 due to a domestic slowdown, and the current threats of re-entering recession to the German economy.

- We do not think it is appropriate for the ECB to lower interest rates to a flat 0%. The economic benefits of this are not justified, as the marginal difference in the costs of lending is minimal and does not further encourage banks to lend out more. This again can be seen through the use of a 0% interest rate in Japan – the Japanese had to encourage a system of fiscal and monetary co-operation and unity, with the added boost of several quantitative easing programmes. The 0% interest rate alone did not stimulate the economy to the levels that were needed. The results of the 0% interest rate would most likely be the same in the Eurozone as they were in Japan.

- We do think that the ECB will keep the main refinancing operations rate constant, and encourage the EU countries to engage in more proactive fiscal policy and put the needs of their own country at the fore through structural reform– the ECB will then follow with an appropriate system of monetary policy on the back of this.

Mario Draghi has stated that he will do "whatever it takes" to save the Eurozone in his term as president of the ECB. We believe that 2015 needs to be the year of full-scale quantitative easing by the ECB. European countries have exhausted all options en route to financial recovery; we have experienced the austere budgets, the reduction in investment, and the extremely low interest rates imposed by the ECB. We are aware that the ECB has already engaged in it's ABS programme (asset backed securities) and holds a portfolio of covered bonds, however we disagree with the recent comment from Jens Weidmann, president of the German Central Bank; "As things are at the moment and if oil prices remain this low, inflation will be lower than expected, but growth will be better". We agree that structural reforms do need to take place in the Eurozone, but not on the back of sacrifices to vital inflation. With inflation, we think these structural reforms will be easier to carry out as nominal wage values and debts can remain static, while real values will fall. This eliminates the need for cutbacks in income levels or debt forgiveness. A policy of QE would most likely create more liquidity in the market, and reinforce these structural reforms. However, we are also alert to the risks posed by a European asset purchase programme. There is the risks of financial asset price inflation and that the whole benefit of QE may not be passed on to the European consumer. We have seen that the £375bn asset purchase programme imposed in the UK in 2009 provided a boost of 8p per £1 investment, which is not a large enough stimulus. This is something that the ECB would need to avoid as the consumers would not benefit enough and the wealth would still remain tied up.

A suggestion from our team to the ECB is that the ECB should try to involve the sovereign nation governments in their quantitative easing programme where possible. This would involve sovereign money creation. By electronically creating funds in the government's bank accounts, the governments can cut some taxes meaning consumers have more disposable income, increase spending and include more money transfers in its budgets. This would hopefully depress the value of the euro, and hence increase inflation due to higher import prices, while creating higher demand for EU products.

By Mark Balaski, Mark Benson, Enda Mulchrone and James Hughes. One thousand, nine hundred and thirty nine words.