ICICI Bank Global Markets

In Focus: Occasional
Treasury Research Group
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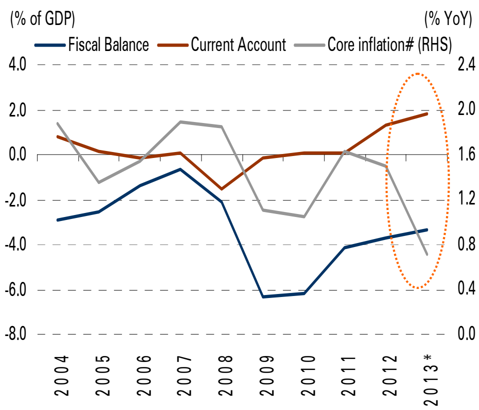
EZ: Why is further monetary easing needed?

- **Eurozone has made significant progress in its twin deficit. The improvement in current account is largely driven by periphery, while fiscal development is primarily attributable to core region. Notably, government debt in EZ also posted its first decline in six years in Q3 2013.**
- **Notwithstanding these improvements, stronger Euro, driven by persistent contraction in balance sheet of European Central Bank (ECB), and deflationary pressures, driven by continued banks' de-leveraging, could affect the region adversely.**
- **These developments demand further monetary easing by ECB, which must take actions to reverse shrinking balance sheet along with cutting policy rates further this year.**

Chart 1: EZ's improvement in twin deficit threatened by disinflation



Source: Eurostat, ICICI Bank Research
** For the first three quarters of 2013*
 # Year-end inflation

Eurozone has made considerable progress in twin deficit…

In the first three quarters of 2013, EZ current account has posted a surplus of 1.8% of GDP, almost double of that in the corresponding period in 2012. Similarly, EZ fiscal deficit (in seasonally adjusted terms), as % of GDP, has eased in 2013, falling to its lowest level in five years. What is more important is that the progress is shared by core as well as most of the periphery nations. Not only did the troubled periphery group—Greece, Ireland, Italy, Portugal and Spain (GIIPS)—moved in surplus territory on external account in 2013, fiscal deficit also narrowed considerably in Greece, Ireland and Portugal.

…and government debt also posted its first decline in Q3 2013

More importantly, government debt in EZ fell (in absolute terms) for the first time in six years in Q3 2013. Although it remains high, the fall is encouraging. What concerns us though is that region's government debt has fallen due to core nations rather than the periphery, as the latter's debt posted a fresh high in the third quarter of 2013. Within periphery, while Debt-to-GDP ratio fell in Ireland, Italy and Portugal, it moved up for Greece & Spain.

However, strong Euro & deflationary forces could undermine these efforts…

All these favourable developments in EZ fundamentals, nevertheless, are threatened by strong Euro and deflationary forces, which could reduce periphery's competitiveness and increase their debt burden in real terms. At the end of 2013, ten euro members had an inflation of less than 1%, of which two are already in deflation. In fact, core inflation in December 2013 was the lowest ever level, which picked up marginally in January 2014.

…which need to be addressed with further monetary easing

This is what makes us believe that the European Central Bank (ECB) will have to ease monetary policy further in 2014. As we had discussed in one of our earlier reports[1], ECB must reverse the contraction in its balance sheet in order to help weaken common currency. Besides, while negative deposit rate or a cut in main refinancing rate could send strong signal, these steps must be complemented with some form of targeted LTRO-3 (longer-term refinancing operations) or other measures to stop the contraction in ECB's balance sheet.

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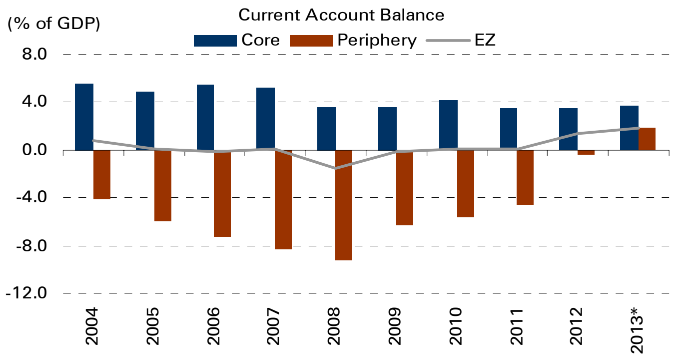
Please see important disclaimer at the end of this report

[1] http://treasury-research.icicibank.com/UploadFiles/Euro_Outlook_2014.pdf

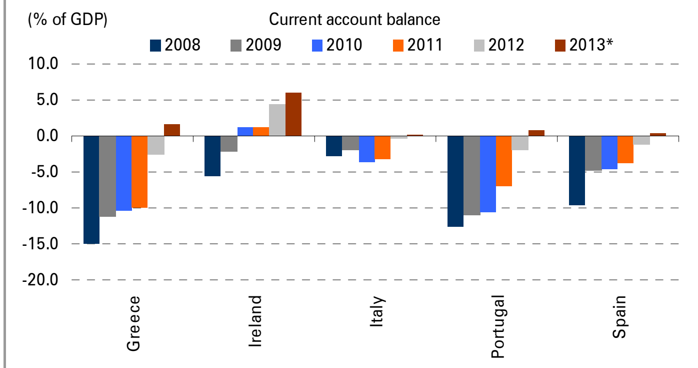
Story in Pictures

External deficit has narrowed drastically...



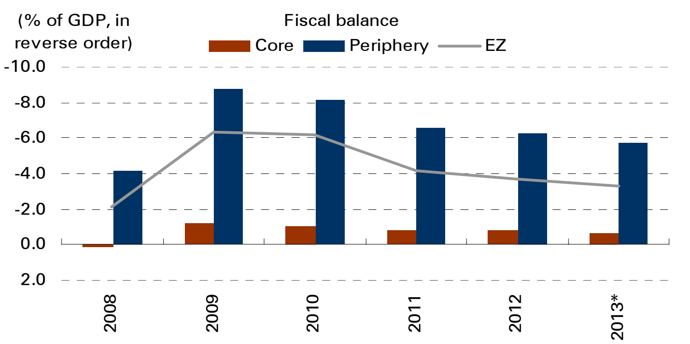
* First three quarters of 2013

...which is primarily driven by periphery region



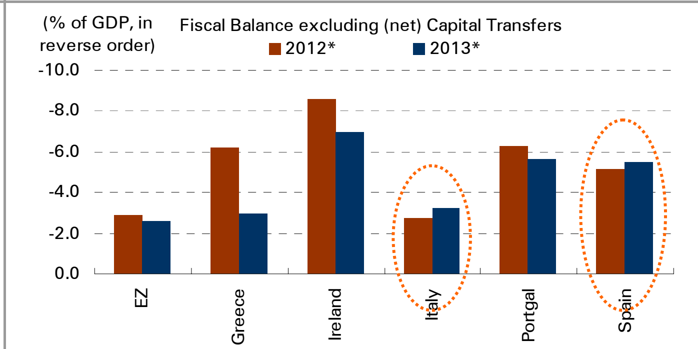
* First three quarters of 2013

Fiscal deficit has also narrowed...



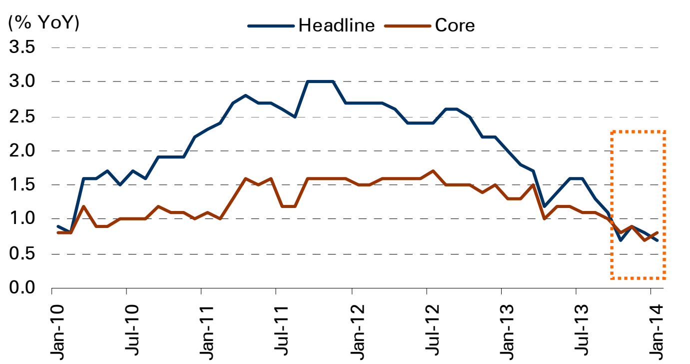
* First three quarters of 2013

...except in Italy and Spain

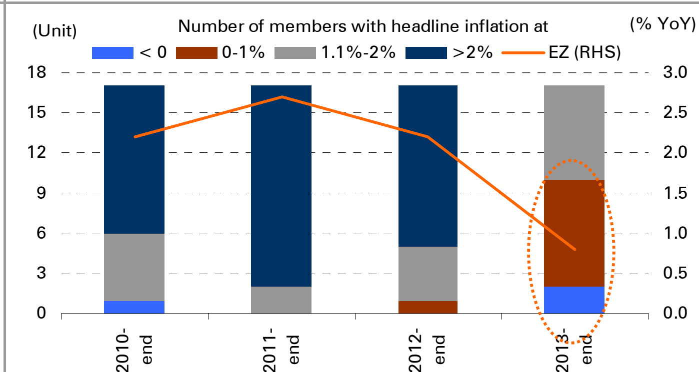


* First three quarters of 2013

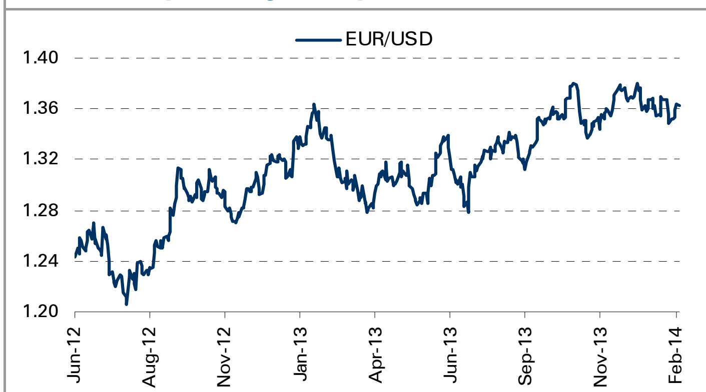
However, disinflationary forces are accelerating...



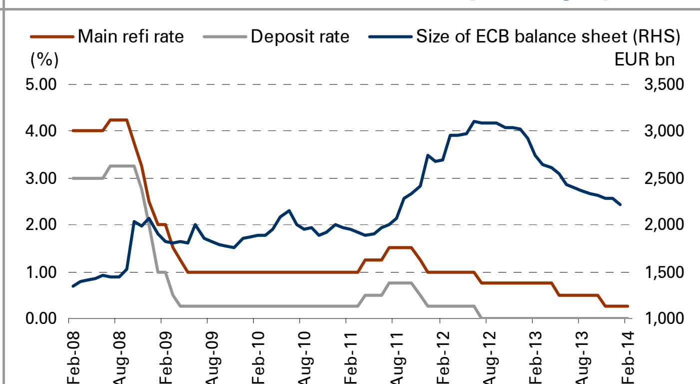
...which are spreading to core economies also



Additionally, strong Euro poses a serious risk...



...which demands further monetary easing by ECB

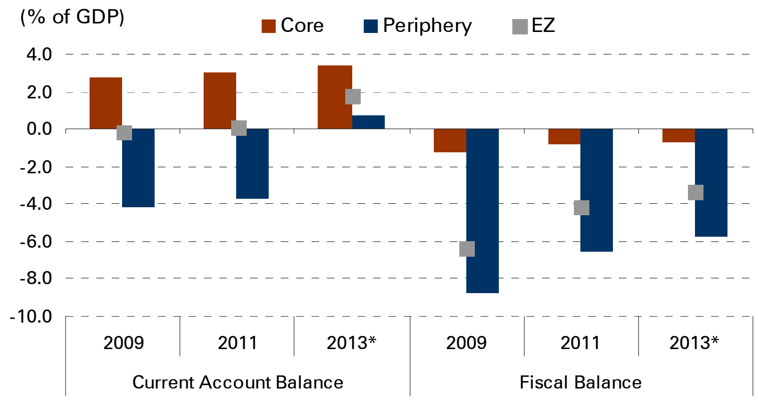


Eurozone (EZ) has made considerable improvement in twin deficit

As a group, periphery nations ran a surplus of 0.7% of GDP in the first three quarters of 2013, while the surplus of core group increased to 3.4% of GDP.

Chart 2 shows that 'twin deficit' in EZ, which increased considerably immediately following the crisis has eased significantly in the recent past. Twin deficit is defined as current account deficit (CAD) and fiscal deficit (FD). EZ CAD stood at 1.5% of GDP in 2008, primarily due to a deficit of 6.7% of GDP in periphery region (GIIPS). Core group, combined, witnessed a current account surplus of 2.8% of GDP in 2008. Five years later, EZ has moved into surplus, which stood at 1.8% of GDP in the first three quarters of 2013. Notably, all (five) of the periphery nations have made tremendous improvement on external account. As a group, periphery nations ran a surplus of 0.7% of GDP in the first three quarters of 2013, while the surplus of core group increased to 3.4% of GDP. In all periphery nations, imports have contracted faster in comparison to exports. In fact, exports picked up in Greece, Portugal & Spain in 2013.

Chart 2: Twin deficit in EZ has moved favourably

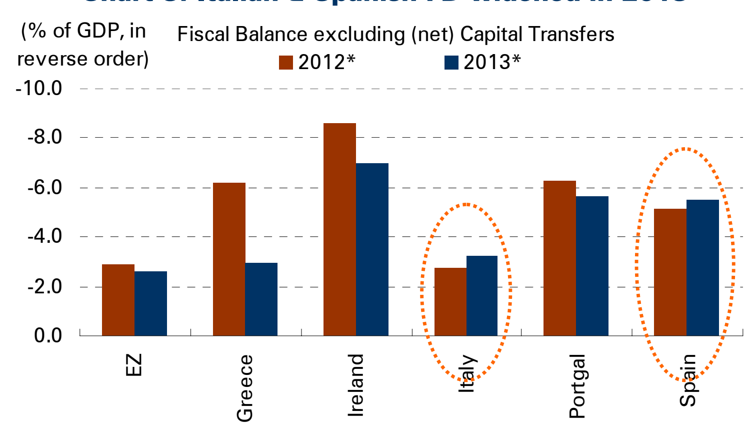


Source: Eurostat, ICICI Bank Research ** For the first three quarters of 2013*
Core includes Austria, Belgium, Finland, France, Germany, Luxembourg and Netherlands
Periphery includes Greece, Ireland, Italy, Portugal and Spain (GIIPS)
Germany & France do not publish quarterly budget data and thus not included in fiscal balance

Although fiscal deficit has narrowed in comparison to 2008-09 levels, chart 3 shows that while adjusted FD in Greece, Ireland and Portugal improved in 2013, it widened in Italy & Spain

Similarly, fiscal deficit has also narrowed in EZ, which is also largely driven by periphery region. Notably, the headline budget numbers could be heavily influenced by large one-off capital transfers in some nations. Although FD has narrowed in comparison to 2008-09 levels, chart 3 shows that while adjusted FD in Greece, Ireland and Portugal improved in 2013, it widened in Italy & Spain. Notably, while Greece & Ireland reduced their spending faster than the fall in receipts, spending grew faster than revenue growth in Italy & Spain. In Portugal, outlays grew slower than receipts.

Chart 3: Italian & Spanish FD widened in 2013



Source: Eurostat, ICICI Bank Research ** For the first three quarters of 2013*

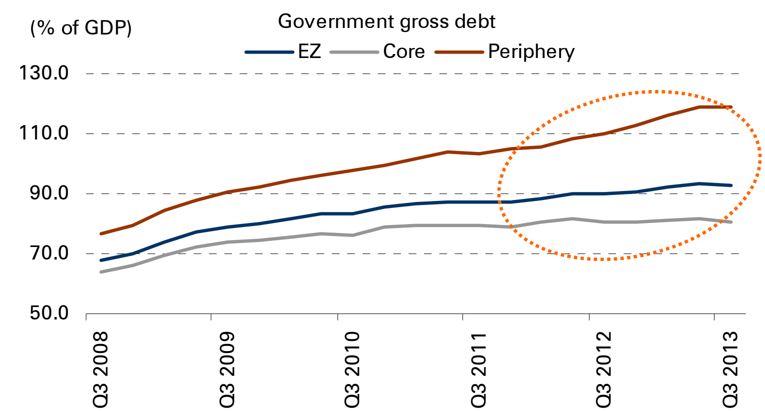
Government debt declined for the first time in six years in EZ…

Importantly, government debt posted its first decline in six years in EZ, as debt-to-GDP ratio fell from 93.3% in Q2 2013 to 92.7% in the third quarter of 2013. Although debt-to-GDP ratio is much higher than ~70% in early 2008, this is an encouraging move.

Debt-to-GDP ratio in periphery region inched up to 119.1% in Q3 2013, marking its new all-time high.

However, as chart 4 shows, debt-to-GDP ratio in periphery region inched up to 119.1% in Q3 2013, marking its new all-time high. However, a silver lining here is that, in absolute terms, government debt declined in periphery region also. It is only because of a sharper fall in Spanish nominal GDP that debt edged up in terms of % of GDP.

Chart 4: Government debt stays high in periphery region

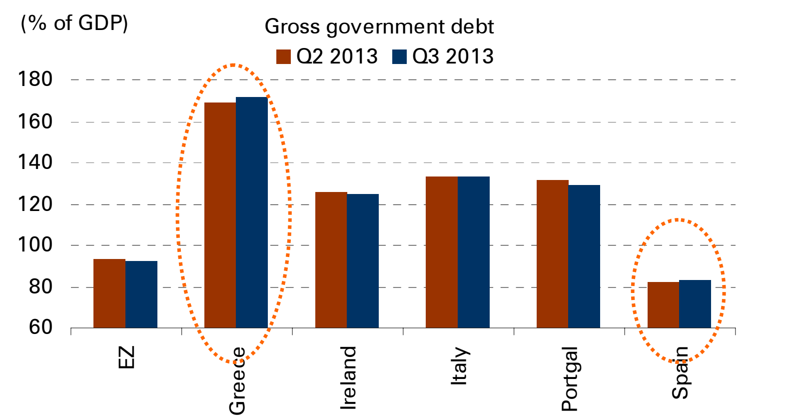


Source: Eurostat, ICICI Bank Research

While debt for the entire periphery region declined in absolute terms in Q3 2013, it increased for Greece, Ireland and Spain.

Chart 5 shows debt-to-GDP ratio for all five peripheral nations. As is apparent from the chart, while the ratio fell for Ireland, Italy & Portugal, it continued to increase in Greece & Spain. Notably, while debt for the entire periphery region declined in absolute terms in Q3 2013, it increased for Greece, Ireland and Spain. Since nominal GDP grew faster (slower) than debt in Ireland (Greece), its debt-to-GDP ratio fell (rose) in Q3. In Spain though, GDP contracted in Q3 leading to higher debt-to-GDP ratio.

Chart 5: Debt-to-GDP ratio continues to rise in Greece and Spain



Source: Eurostat, ICICI Bank Research

According to European Commission (EC) forecasts, government debt is likely to have peaked in Greece, Ireland and Portugal in 2013, while it will peak this year before falling in Italy. For Spain though, EC projects debt-to-GDP ratio to continue rising in 2015 also.

Stronger Euro could reverse recent improvements…

We believe that there are two related threats—strong Euro and disinflationary pressures—which could undermine the admirable adjustments in EZ. As of now, it looks that Mr. Draghi does not take any of these challenges seriously.

If this (strong euro) remains unchecked, it could have adverse impact on periphery's competitiveness, which might reverse the gains in current account

As we have explained earlier also[1], stronger Euro is likely to have adverse impact on periphery nations by hitting their competitiveness. In the past few years, adjustments in periphery EZ, coupled with weaker Euro, helped to improve external balance considerably in the past couple of years, which, in turn, is leading to stronger Euro. Now, if this remains unchecked, it could have adverse impact on periphery's competitiveness, which might reverse the gains in current account.

…and further aggravate disinflationary forces

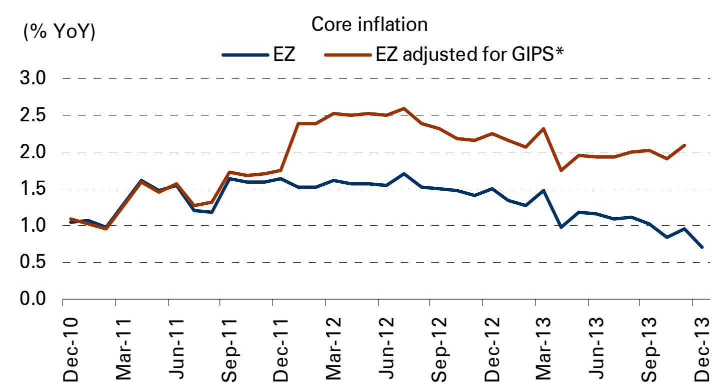
Secondly, stronger currency could help disinflationary pressures to tighten their grip. Another major reason for disinflationary forces has been persistent and severe de-leveraging by EZ banking sector, wherein the size of their balance sheet contracted to the lowest level since March 2008, primarily because they continue to keep lending at extremely subdued levels.

Banks' de-leveraging is largely considered a result of Asset Quality Review (AQR) of EZ banking sector, which will take 2013-end numbers as reference. However, there are no signs visible to us, which indicate that euro banks will reverse their de-leveraging process this year

What surprises (and worries) us is that ECB is largely ignoring all of these factors. Banks' de-leveraging is largely considered a result of Asset Quality Review (AQR) of EZ banking sector, which will take 2013-end numbers as reference. However, there are no signs visible to us, which indicate that EZ banks will reverse their de-leveraging process this year.

Moreover, ECB has been stating that it does not see deflation as a possibility threat though disinflation could extant for some time. In his recent monetary policy meeting, Mr. Draghi stated *"…we observe that much of the adjustment, much of the decline in core inflation, actually comes from "the four programme countries: Spain, Ireland, Portugal and Greece. All in all, this would signal more of a relative price adjustment than of a deflation phenomenon…"*. Chart 6 compares core inflation for EZ and EZ excluding four programmed countries, as Mr. Draghi puts it. The chart clearly shows that core inflation for adjusted EZ remains around 2%, as against less than 1% for the entire region. Nevertheless, then the obvious question is what drove ECB to act in November last year?

Chart 6: Programmed countries driving EZ core inflation lower



Source: ECB, ICICI Bank Research

Moreover, it is notable that periphery EZ remains extremely indebted. Neither government (as shown above) nor private debt has witnessed any significant reduction since the crisis began in 2010. With inflation remaining low, it will increase real burden on these economies.

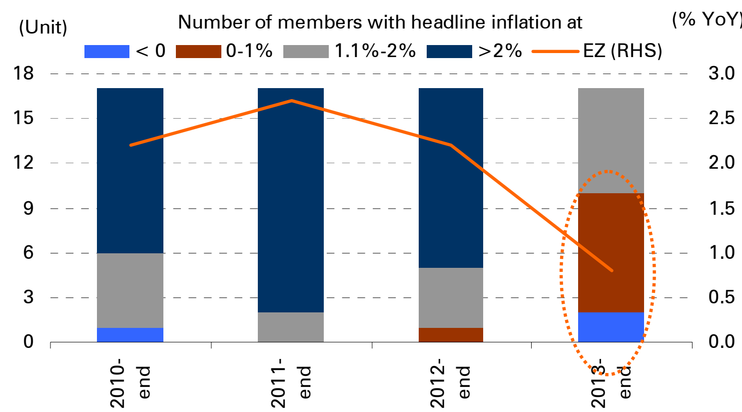
[1] http://treasury-research.icicibank.com/UploadFiles/Euro_Outlook_2014.pdf

ECB needs to address these issues with further monetary easing

While four programmed have driven headline EZ numbers lower, disinflation is spreading to core economies also. Notably, core inflation in Germany and France was also under 1% in December 2013

At the end of 2013, nine euro members (Ireland data not available) had an inflation of less than 1%, of which two are already in deflation. While four programmed countries have driven headline EZ numbers lower, disinflation is spreading to core economies also. Notably, core inflation in Germany and France was also under 1% in December 2013.

Chart 7: Majority of euro members have less than 1% inflation



Source: Eurostat, ICICI Bank Research

We believe that these issues need to be addressed and European Central Bank (ECB) needs to intervene promptly. We know that ECB has its limits; nevertheless, it should not delay the process to a stage where markets force them to act.

ECB can take several measures to address strong currency or arrest deflationary forces. It could start with cutting deposit rate to negative territory. Nevertheless, it would only act as a strong signal, rather than changing anything fundamentally. This is because the amount of excess deposits with ECB has fallen to very low levels (around EUR 50 bn) to have a significant impact on the entire region. Secondly, the Bank could lower its main refinancing rate to 0-0.25% range, like the US, effectively lowering it to around 0.1%. However, like November, this measure could also fail to have a sustainable impact on the currency.

What is important to have a lasting effect is to reverse the ongoing contraction in ECB's balance sheet, which could be achieved by asking the banks to postpone repayment of previous LTROs and complement it with a smaller but effective LTRO-3

What is important to have a lasting effect is to reverse the ongoing contraction in ECB's balance sheet, which could be achieved by asking the banks to postpone repayment of previous LTROs and complement it with a smaller but effective LTRO-3 (some form of targeted LTRO to make sure that it does not end up in gilts again)[2].

Alternatively, the Bank could stop sterilizing the Securities Market Program (SMP) with fixed-term deposits and let liquidity increase in the market.

Overall, we agree monetary policy has its limits and it can not solve all the issues at hand. Nevertheless, we believe that ECB still has some firepower left, which it needs to deploy as soon as possible.

[2] http://treasury-research.icicibank.com/UploadFiles/ECB_Balance_Sheet_November_2013.pdf

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