ECB and Euro Report

The 4-year low inflation data of 0.7% for October was the main reason why the ECB slashed the benchmark lending rate to a record-low of 25 basis points.

The latest rate cut was a follow-up to the same move the ECB did in May. At the time, unemployment hit a record high in March and annual inflation plunged to 1.2 percent in April, pressuring the ECB to cut rates to 0.5% - its first in 10 months - to honour its mandate to deliver price stability.

Interestingly, the ECB may not be done with the easing cycle. Here's why.

The eurozone has reported mixed economic data of late. Manufacturing activities have stabilised but business confidence has dropped. This "conflicting" data could be due to a strong euro, which has steadily trended higher since October. Hence, the ECB may still engage in accommodative policies until inflation bounces back up and unemployment starts to fall.

It wouldn't be far-fetched to say that the ECB may follow the same quantitative easing methods that the US has engaged in and expand its balance sheet once more. For the discerning trader, an inherent opportunity on the EUR/USD currency pair is looming. On one hand, the Federal Reserve is expected to taper its monthly bond-buying program from USD85 billion per month to USD75 billion a month in early 2014. On the other hand, the ECB is expected to further loosen its monetary policy to spur inflation and reduce unemployment.

This policy divergence will create numerous opportunities to short EUR/USD in the coming month, as long as the fundamentals remain.

These are some of the options the ECB may consider in the coming months to spur economic activity:

1) ***Further rate cuts to both the lending rate and the deposit rate***

On 22nd November, European Central Bank Governing Council member Ardo Hansson said that the ECB is prepared to cut borrowing costs further and is technically prepared to make its deposit rate negative. A separate Bloomberg News report said that the policy makers are considering a smaller-than-normal cut in the deposit rate, currently at zero, to minus 0.1 percent if more stimulus is needed. A negative deposit rate would entail the ECB charging banks to hold their excess cash. Of course, the end result in such a policy is to encourage banks to lend cash to households and companies instead, thereby bolstering a recovery.

2) ***Another tranche of Long-term refinancing operations (LTROs)***

At the height of the euro zone's debt crisis in late 2011 and early 2012, the ECB lent over one trillion euros to banks through two LTROs. In February this year, the ECB announced that 278 eurozone banks had repaid 137 billion euros. At the time, the markets had mixed thoughts on this. On one hand, the repayment was seen as positive because it demonstrated that the banks were doing well. On the other hand, the worry was that the repayment could bring the liquidity surplus below 200 billion euros causing upward pressure on the overnight lending rate.

The same scenario is playing out in the month of November 2013.

Latest figures showed that banks will repay another 7.9 billion euros before the end of November, taking the total that has been returned so far to 388.7 billion euros. This figure beat estimates in a Reuters poll of euro money market traders, which had expected banks to return 4 billion euros. By repaying the ECB's funds ahead of time, the amount of excess liquidity in the banking system is further reduced. The current figure is already at a two-year low of 156 billon euros, down from 620 billion euros at the start of the year and a peak of 813 billion euros in March 2012, just after the ECB finished flooding the system.

To ease market anxiety, the ECB said that banks will not allowed to pay back any of the ultra-cheap three-year loans between 23rd December and the second week of January to ensure there are no hiccups over the typically busy period when lenders get their books in order.

Historically, money markets start to become more reactive to fluctuations in liquidity when the excess drops to around 150-200 billion euros, and in the last week there have been signs that the current decline is starting to be felt.

While the ECB's move is seen as a temporary measure, I do not rule out the possibility of another LTRO to keep borrowing costs at low levels.

Other options include a verbal intervention, a move adopted by the Reserve Bank of Australia (RBA) and the Bank of Japan (BOJ), as well as a Funding Lending Scheme which is currently adopted by the Bank of England. As long as any one of these tools are employed, I expect the euro to fall significantly against its peers. However, I do not foresee any of these tools to be exercised in the next policy meeting in December, as manufacturing data has stabilized.

Overall, I see downside risk for the euro under the current environment. According to the latest FOMC minutes from the US, the Committee puts "tapering" under serious consideration and it

could be triggered in the next few months. A clue for traders is seen in the widening of the US/German 10-year yields' spread, which again implies the expectation of policy divergence between the US and the euro zone.

Although the EUR/USD currency pair hit a high of 1.3832 in the month of October (a two year high), the downside risk on the euro may push current levels towards 1.31 in the next few months.

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