



## KBC Flash

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### Has the ECB lost its cool?

- ... Economic data point to an unchanged ECB view regarding activity and inflation
- .... But ECB Trichet faces renewed grilling on Greece after....
- .....it loosened its collateral rules for the second time in one month
- To help specifically Greek banks....
- What is all those talk about buying government bonds?

The focus of the upcoming ECB meeting and press conference will be more on Greece and eventually the exit strategy than on the economy or inflation. We suspect that the press will grill Mr. Trichet extensively, as it did during the previous press conference. The eleventh hour decision, e-mailed at sunrise, to accept Greek collateral whatever its rating, will certainly be object of questions. However, also Trichet's quote that nothing has been decided on the purchase of government bonds and the impact of the recent government debt crisis on the exit policy merits some tough questioning of the Mr. Trichet. Has he lost his cool or is he aware of renewed stress in the financial system? We skip our comments on the economy and inflation and tackle the other, currently more urgent issues.

#### ECB accepts all Greek collateral regardless rating

Monday morning the ECB announced that it suspend the application of the minimum credit rating threshold for all marketable debt issued or guaranteed by the Greek government. The ECB justified its decision by pointing to the positive assessment of the Greek rescue programme and

the strong commitment of the Greek government to implement it.

We think that the ECB had no other reasonable choice than to waiver the rating requirements. The Greek draconic plan will push the Greek economy into a deep recession that will badly affect the Greek banks. The IMF/EU plan does recognize this and has earmarked €10B for the establishment of a Bank Stabilization Fund that will have to safe-guard the solvency of the Greek banks by keeping them well-capitalized. The ECB collateral measure will take care of the liquidity needs of the Greek banks. This is needed because Greek banks have lost access to the inter-bank market.

So, while the decision as such was maybe inevitably at some point in time, we think that the timing was unfortunate. The ECB stated for months that it would revert to the old collateral rules at the end of 2010, which would not be amended for the sake of any particular country. This meant that it would accept again only collateral with a minimum A- rating by one of the rating agencies. Last month, it decided to prolong the emergency measures that allowed ac-



ceptionation of collateral with BBB- rating. Now, less than one month later, the ECB threw in the towel and explicitly made an exception for Greece's government paper that will be accepted regardless the rating.

The current Greek rating is still A3 at Moody's, which means that still 4 downgrades at Moody's were needed before Greek collateral wouldn't be accepted anymore for liquidity-providing operations at the ECB. So, the timing of this decision was unfortunate, as there was no urgent need to change the rule. It might have contributed to investors' doubts about the Greek rescue package. If it was a strong package with enough chances on success the ECB should have expected the package was enough to make the collateral issue a non-issue. So didn't this express doubts on the side of ECB on the success of the package or at least on the market's reaction to it? Was it besides help for the Greek banks, a hint to other institutions that there was no reason to sell their Greek bonds? We suspect that Trichet will justify the decision by denouncing the recent attitude of the rating agencies. These have been fiercely accused of acting on market movements instead of fundamentals and the German chancellor Merkel has even proposed the creation of an European rating agency.

Confusion increased, as a press report recorded Trichet said **the ECB hasn't decided whether it will buy government bonds to prevent the spreading of the crisis**. This is an amazing statement, as it suggests that buying government debt paper is on the table. Of course, some observers said that the ECB should purchase (peripheral) bonds to break the negative spiral that risks spreading and intensifying the crisis. The law on the ECB doesn't seem to prohibit the ECB from buying government paper on the secondary market. However, the ECB financing government debt/deficits (even if it is indirect in the secondary market) is in the ECB context a very unusual step that risks to bring the ECB on collusion course with ....once more Germany. The decision on collateral and the hints at possible purchases of bonds are an indication that the ECB sees risks for renewed tensions in the euro wide banking system.

### Exit strategy to be revised?

The comments on collateral and the possibility of buying governments get more significance in the context of the market movements of recent days. The Greek crisis is spreading to other peripheral countries and some (extreme) voices about a break-up of the euro have been heard. If unchecked, these developments might indeed threaten the functioning of EMU and cause again stress in the financial system.

This puts the onus on the ECB exit policy and more in particular on whether the ECB may continue, as planned, to exit the emergency liquidity measures it took during the crisis. The ECB strategy aims at reducing the duration of the liquidity in the market, before eventually draining this liquidity. So, the 6- and 12-month liquidity providing operations have been disconnected in past months and the 3-month tender has been conducted recently via a variable rate/fixed procedure. The first 3-month tender showed that only a limited number of bank participated (24). However, the average rate of 1.15% and the marginal rate of 1.5% suggested that some banks are still in need of emergency funding.

The next big milestone will be at the end of June when the huge €442B 1-year liquidity matures. The ECB will conduct a special 7-day tender to smooth the impact and the 1 week and 1 month liquidity tenders will still be conducted under the full allotment/fixed rate procedure. Nevertheless, if the current market conditions persist, this redemption might create problems. Indeed, la arge part of the liquidity provided at the June 2009 tender was probably invested in short term (peripheral) government paper that yielded more than 1%. Those many banks that are very liquid probably won't ask the redeemed liquidity at another shorter-dated liquidity tender for various reasons, amongst others because of yield considerations. Indeed, while yields on shorter-dated government debt of peripherals is still higher than in June 2009, given the current crisis on these peripheral markets, it is unlikely there many banks are eager to renew these trades. As the pool of outstanding liquidity shrinks, we might see some weaker banks that lose their 1-year ECB liquidity eagerly looking for liquidity on the market. This may push interest rates higher in the money market. A second possible effect of

the reduced liquidity might be less demand for short-dated government paper, which evidently isn't in the current context wanted. So, it will be interesting to see whether the Mr. Trichet will elaborate on the subject, preparing the market for a partial reversal of its exit policy or a delay in implementing the next steps.

**Conclusion**

The May ECB meeting and press conference might be very interesting. The ECB won't have much to say on the economy or inflation, but the press will grill the president on its decision regarding the collateral rules, the comments on the purchase of government bonds and the fate of its exit policy, more in particular the effects of the redemption of the €442B liquidity at the end off June. More in particular, while the current crisis is a fiscal crisis that should be solved by the fiscal authorities, the ECB and Trichet might feel the temptation, as guardian of the euro, to intervene on the subject, one way or another. This is however a treacherous path that might bring it in conflict with the fiscal authorities and risk a loss of credibility. That would be unfortunate as the credibility of the ECB might still be of incalculable value in the current crisis.

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