



KBC Flash

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Which way will the ECB jump?

- ...Trichet says little new on Greece but hints at divisions within ECB.
- Government bond purchases 'not discussed'; this doesn't mean they're ruled out.
- While markets worry about fall-out from Greek turmoil, ECB seems more comfortable about recovery and a little more concerned about inflation.
- Focus on inflation doesn't threaten interest rate hikes before 2011 but hints at difficulties in acting to assist debt markets

For the second month in a row the monthly press conference of the ECB was dominated by questions about Greece but Mr. Trichet didn't experience anything like the level of discomfort that he had in early April. Understandably, he expressed confidence in the Greek adjustment programme and said forcefully that a Greek default is *'out of the question'*. **While the behaviour of interest rates spreads, equity markets and the foreign exchange value of the Euro point towards deep and widely held market concerns, there was little serious probing of Mr Trichet's views on Greece.** More surprisingly, last Monday's announcement that the ECB would continue to accept Greek Government bonds as collateral regardless of any future credit downgrading prompted relatively little tough questioning or criticism.

Differences of Opinion

Perhaps the only significant insight provided by Mr. Trichet in relation to Greece was that the decision to accept Greek bonds regardless of rating was not taken unanimously but by *'overwhelming majority'*. Although this may seem a minor distinction, **Mr. Trichet's repeated emphasis on the unani-**

mous nature of the ECB's analytical judgments on Greece hints that some on the ECB Governing Council have serious misgivings about providing additional assistance to Greece. It would not be surprising given comments he made yesterday and the scale of opposition within Germany to support measures for Greece if Axel Weber, the head of the Bundesbank was among those who opposed the ECB's concession to Greece on collateral. Yesterday Mr. Weber was quoted as suggesting that *'contagion fears do not justify all means'*. **There is little question that the strength of feeling in Germany in particular means that there are likely to be divisions within the ECB on the nature and scale of any future actions in support of Greece or any other Eurozone country. Such reservations are undoubtedly one if not the main element in the markets continuing worries about the potential for future tremors within the Eurozone.** (As an aside, it also seems likely that these sort of divergences may make it harder for Axel Weber to succeed Jean Claude Trichet as president of the ECB next year.)

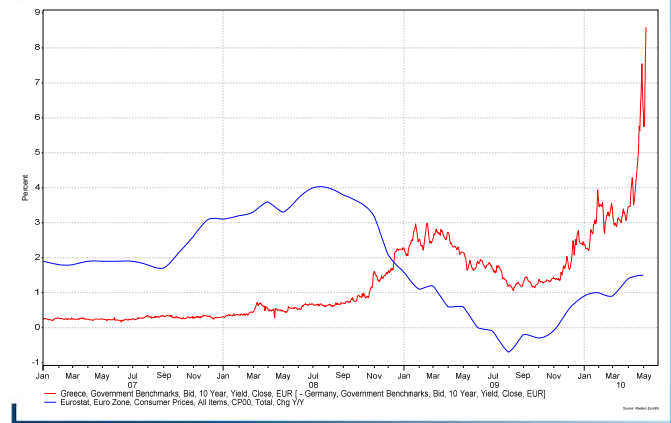
No Bond Buying... Yet

Mr. Trichet also batted away a number of questions on whether the ECB would contemplate buying Government bonds as a means to reverse the sharp increase in funding costs for a range of Eurozone countries of late. While this would have been regarded as extremely unlikely, comments made by Mr. Trichet last Sunday seemed to have opened up at least the possibility of such a course of action when he said 'at this stage, we have absolutely no decision on the purchase of Government Bonds'. In answers to a number of questions on this topic Mr. Trichet repeatedly answered that the Governing Council hadn't discussed the option of purchasing Government Bonds at today's council meeting. However, this answer may be less straightforward than it appeared. Knowing that Mr. Trichet was likely to be probed on this topic it would have been very easy for the ECB to discuss this matter outside the formal confines of today's council meeting.

Market speculation about the possibility of ECB purchases of Government Bonds is likely to be sustained by Mr. Trichet's observation in response to another question that 'the ECB's capacity to take rapid, unconventional decisions was shown in the case of Greece'. It seems very likely that the ECB has discussed the relatively straightforward mechanism of Government bond purchases. The treaty forbids direct purchases from Governments but the ECB could in theory purchase bonds on the secondary market from investors. However, the principle of purchasing sovereign debt is likely to be a contentious issue as it may be regarded as financing excessive Government deficits. For this reason, it is likely only to become an option in circumstances where Government bond markets become as dysfunctional as money markets did earlier in the crisis. Again, it is likely that there would be strong differences of opinion within the Governing Council on this topic but the crisis continues to teach us that we should never say never and today Mr Trichet clearly and carefully chose not to dismiss all possibility of Government bond purchases in the future.



Diagram 1: What's the Problem?



Can the ECB really be more concerned about inflation?

Another notable feature of today's press conference was further evidence of the ECB's tendency to try and separate developments in financial markets from those in the 'real' economy. This approach caused significant difficulties between late 2007 and autumn 2008 as the ECB attempted to tighten monetary policy while assisting liquidity conditions. The tightening backfired spectacularly in the decision to raise interest rates in July 2008 as the global economy teetered on the brink. The current condition of the world economy may not be as perilous but there is little question how fragile the Eurozone recovery remains. In recent weeks, financial markets have been focussed on the adverse implications for Eurozone activity of both the current financial turmoil and a promised step-up in fiscal adjustments in a range of countries. Today, however, Mr. Trichet seemed a little more confident about the recovery even if he acknowledged a high level of uncertainty. More significantly, the ECB seemed a little more concerned about inflation. It should be emphasised that the ECB assessment remains one in which 'price developments are expected to remain moderate over the policy relevant horizon' and, consequently, 'current interest rates remain appropriate'. However, it may seem somewhat surprising that the ECB should be paying more attention to upside risks to inflation when potentially major contagion risks from Greece's problems are occupying everyone else (see Diagram 1 across).

We think a number of reasons can be advanced to explain Mr. Trichet's comments beyond the possi-

bility that the ECB is again misdiagnosing the balance of risks in a very delicate environment. First of all, it is true that commodity prices accompanied by a weaker Euro are putting some short term upward pressure on the headline Eurozone inflation rate. However, it is difficult to imagine that current weakness in activity would allow this to translate into more generalised price pressures. It could also be that some on the ECB council could see the shadow of future inflation in the explosion in Government debt. A third argument could be a desire to ensure that the ECB's credibility is not tarnished because of its central role in the Greek adjustment programme. In this regard, it is important to emphasise that the ECB cannot be Europe's fiscal guardian. Instead, it sees itself as Mr Trichet noted as 'inflexibly attached to price stability'. However, today's comments on inflation seem a very clumsy way to remind us of the ECB's determination not to neglect its day job.

Importantly, today's focus on inflation may also create the impression that it will be notably harder for the ECB to provide more significant support to the financial system and sovereign debt markets if that is needed. Reflecting this, Government bond spreads widened in the wake of Mr Trichet's comments today. To an extent this movement may reflect unrealistic expectations that the ECB could and would have made a decisive intervention.

The ECB Disappoints

In summary, today's ECB press conference was disappointing in several respects. We gained little additional insight into ECB thinking on the crisis in sovereign debt markets although it seems clear that there are differences in thinking within the ECB on what could and should be done. At the margin, markets may feel this will cause the ECB to delay any decisive intervention. More disturbingly, there were some signs that some at the ECB are becoming focussed on potential upside risks to inflation. It has to be emphasised that the tone of Mr Trichet's comments suggested that interest rates are unlikely to change for some considerable time – probably no earlier than Spring of next year. More tellingly, the tenor of the remarks on inflation could suggest the ECB is looking in a very different direction to most financial market participants. That is not a particularly comforting thought in the current climate

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