



## KBC Flash

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### ECB: Where are you?

- ECB to keep rates unchanged, ...
- ...but more uncertainty about the fate of its liquidity exit strategy
- Trichet to be under pressure to explain ECB's recent unorthodox bond purchase programme as...
- ...rifts inside council on the programme are very visible and results of intervention meagre...

#### June meeting might be very interesting...

The ECB meeting could be extremely interesting. In spite of exceptional actions the government bond market is still frozen and tensions across the financial system have risen in recent weeks. **Mr Trichet must address these issues while seeking to restore credibility in the ECB and in the broader Euro project. The worry is that the ECB will again disappoint possibly excessive market expectations.**

Last month, the ECB statement was surprisingly hawkish and out of touch with current realities; higher inflation was signalled as a risk factor. Of course, markets have far more substantial near term concerns largely centered around their own difficulties. However, Mr. Trichet appeared to downplay such worries. Remarkably, he said that the ECB hadn't discussed government bond purchases as a means of dealing with problems in market functioning. Just three days later the ECB was forced to backtrack and start a bond purchase programme. It also partly reversed the first steps in its exit policy by re-introducing a 6-month LTRO and reverting to a full allotment/Fixed rate procedure in its 3-month LTRO.

It is inevitable that tomorrow's press conference will see **the media grill ECB president Trichet on what has been an extraordinary turnaround.**

**Given the market turmoil we don't expect the ECB to unveil new initiatives.** Trichet may sound more dovish in his comments on the economy and inflation. He will also need considerable skill to justify the recent changes in policy. Mr. Trichet's diplomatic capabilities will also be tested if he is to reduce perceptions of significant divisions within the ECB Governing Council in regard to its recent actions as well as broader questions in relation to inflation risks and the appropriate exit strategy from its exceptional liquidity measures.

In this note, we briefly preview the new growth and inflation forecasts that the ECB will provide tomorrow before elaborating on the ECB bond purchase programme and the ECB liquidity policy which are likely to be the two main areas of attention for journalists and market participants.

#### Higher growth and inflation forecasts likely

Tomorrow, the ECB publishes new quarterly staff economic and inflation forecasts. It is highly likely that inflation will be revised higher, as energy prices have gone up and the trade-weighted euro has declined significantly. Inflation may also have been boosted slightly by a number of tax increases. International organisations have revised their growth forecasts for the EMU trading partners higher. This will probably be only slightly offset by a tighter fiscal policy in a number of countries, as



most of this tightening has only recently been announced. In March, economic growth was forecast at 0.8% for 2010 and 1.5% for 2011, while the inflation forecast amounted to 1.2% for 2010 and 1.6% next year (mid-point range). This year's growth forecast may move to around 1.0%, but more important is the question of whether the ECB sees next year being notably stronger. We also expect inflation to be revised to 1.6% in 2010 and about the same level next year. Expected increases in ECB forecasts might seem a bit odd at a time when there is much greater focus on downward risks to the outlook for growth. However, part of the upgrade of growth in 2010 is due to overly pessimistic ECB forecasts in both December 2009 and March 2010. It should be emphasised that those forecasts are prepared by ECB staff and don't bind the ECB governing council, but understandably they attract more attention than the forecasts of other organisations. We would focus particularly on the 2011 inflation/growth forecast. If it is raised by more than 0.2%-point, it points to notably greater optimism. However, in the current context, the market shouldn't take it as a sign that monetary tightening will be brought forward.

#### Have ECB bond purchases been a failure?

In the early hours of Monday, May 10 the ECB announced it had initiated a Securities Markets Programme, which consists of interventions in the euro area public and private debt securities markets with the aim of restoring the functioning of severely disrupted financial markets. The ECB also indicated it would sterilize the injected liquidity via a newly created term deposit facility.

Coming just days after saying that the Governing Council hadn't discussed the purchase of government bonds, this decision raised a lot of questions. Of course, on the Thursday and Friday immediately following the ECB monthly council meeting, government bond markets effectively froze and there was a non negligible risk that the EMU crisis would morph into a global one.

We think the far-reaching ECB decision to purchase bonds was intended to complement the European Financial Stability Mechanism, and assist EMU countries under speculative attack. It seems that in return Trichet secured the promise of national governments to take fiscal action to adjust unsustainable budgetary positions. Within days, Spain and Portugal announced new austerity measures. It may be that the ECB programme was simply intended to be a temporary measure until the European Financial Stability Programme became fully operational. However, as there has

been very limited clarification, any number of interpretations can be suggested.

Importantly, Mr Trichet had to admit that the bond purchase decision was taken by overwhelming majority rather than by unanimity. **Bundesbank President Weber almost instantly criticized the decision as being potentially inflationary. Later on, he seemed to draw support from the Bank of Italy and Financial Stability Board chief, Mr. Draghi who said the ECB bond purchases will have to be discontinued, once markets spontaneously resume trading.** It seems that a number of other ECB governors, like Wellink, while maybe not voting against the decision, also have mixed views about what has been a radical departure for the ECB.

#### Trichet between a rock and a hard place

Opposition to the bond purchases has intensified of late, especially in Germany that already had serious reservations about the Greek rescue programme and the European Financial Stability package. This opposition intensified after Der Spiegel suggested (drawing on Bundesbank sources) that French banks were dumping their Greek bonds, and selling them to the ECB while German banks had promised their Finance Minister to keep their paper for at least three years.

**We suspect that the open opposition in Germany, the biggest economy in EMU seriously limits the room for manoeuvre of the ECB.** Recent data on bond purchases shows that the ECB has only bought very limited amounts that have gotten smaller with each passing week in spite of persistent strains in financial markets. In the most recent week, it bought only about €5B of bonds. **The ECB/Trichet apparently misjudged the market reaction on the Financial Stability Mechanism that is at least until today very disappointing, meaning that his supposed temporary and limited bond purchases at least until now had no meaningful impact.**

So, it seems that the emperor has no clothes. We are curious to see how the ECB will assess the situation and react to the absence of improvement in the government bond market. **Will they make an embarrassing climb down or will they take their role of market maker of last resort seriously and put a lot more money than the €40B spent in the first four weeks to restore normalcy, even at the risk of alienating Germany?**

**The deliberate absence of transparency about bond purchases has also caused problems and**



encourages market rumours that further undermine the credibility of the ECB and its president. So, journalists will try to obtain more details about the programme like its intended duration, the maximum amounts potentially involved, the countries whose debt is bought, and an assessment of the provisional results of the programme. Most likely, Trichet will stay silent on most of these issues

### ECB liquidity policy for H2 2010

**It has been a horrible month for the ECB, as it also had to backtrack on its exit policy.** In the fall of 2009, the ECB laid down its liquidity exit policy. In a speech to bankers, Trichet used a medical metaphor to justify both its emergency liquidity measures and its exit from these measures. He said: "once the patient (financial sector) falls seriously ill, medication is required. Strong and invasive painkillers may have to be administered. Contagion must be avoided." However he continued by stating that "over time the continued administration of painkillers can be harmful. They can create dependence or even addiction for the recipients. Such medicine (unlimited liquidity) cannot be a permanent solution." To avoid permanent dependence and "addiction" the ECB must begin to implement an exit strategy. The ECB indeed stopped in December its 12-month liquidity-providing and did the same with its 6-month operation in March, when it also announced to an intention to conduct its 3-month operation under a Fixed allotment/variable rate instead of a Full allotment/Fixed rate. Meanwhile, the regular weekly and the monthly liquidity-providing operations would continue to be conducted under a full allotment/fixed rate at least until 12 October 2010. **The aim was to shorten the duration of liquidity at first, and then remove it.**

However, the crisis on the government debt market and its potential effects on the banking sector have short-circuited the ECB strategy. On May 10, the ECB announced that it would hold an extra 6-month refinancing tender under Full Allotment/Fixed rate procedure and re-install the Full Allotment/Fixed rate procedure for the 3-month tender for the May and June operations.

**So, it seems that the ECB has not succeeded in making the banking sector less dependant on its liquidity provision.** Currently, open market operations outstanding total more than € 847B, sharply up from the end of last year and near the highest levels on record. At the same time, banks put (yesterday) a record high €364.6B in the overnight deposit facility of the ECB. **This suggests that the market has virtually collapsed to the**

**point where the key transactions are bilateral between the ECB and commercial banks.**

At tomorrow's meeting, **the ECB might give the market more guidance about plans for its liquidity policy for Q3 and possibly Q4.** At the end of the month, the €442B liquidity provided at last June's 1-year liquidity tender matures. The ECB has already taken some measures to smooth the transition with amongst others a 7-day quick tender and a Full Allotment/Fixed rate 3-month tender. In the market, **there is some speculation the ECB will announce another 6-month tender or even re-introduce a 12-month tender. So intense are market worries that there is even some speculation about a possible lowering of the ECB refi-rate, currently 1%.** The ECB must choose between the lesser of two evils: It could hope the market situation may improve sufficiently to allow it to resume its exit policy. Alternatively, it may opt for "safety first" and suspend or even reverse the exit strategy by re-introducing the 1-year or 6 month tenders. A cut in the refi-rate would go considerably further and might even backfire if the market took it as a sign that the ECB feels the financial system is in real danger.

**If the current market conditions persist and the ECB doesn't take additional measures, the redemption of liquidity at the start of July might create problems.** Those banks that are very liquid probably won't look for shorter-dated liquidity for a variety of reasons, including cost. 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 could 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 would be very unhelpful in the current climate. So, it will be interesting to see whether the ECB will take additional measures to address these potential negative outcomes or whether Mr. Trichet will elaborate on the subject.

### Will ECB issue debt certificates?

Today, at 8h57 the ECB announced via Dow Jones the sale of €10B of 3-month debt certificates later on Wednesday and one minute later it added that the sale would be at variable interest rates up to 1%. Seven minutes later "an ECB official says the announcement cited by Dow Jones was a test message, please disregard".

There was a lot of nervousness and disbelief in the markets. It is odd that the ECB would use such precise language in a test message. It raises the

question **whether the ECB might decide tomorrow on such a measure** and the ECB services were preparing the operational side. The ECB treaty allows the ECB to issue debt certificates (with maturities of up to 1 year) for use as a liquidity absorbing instrument. We cannot exclude that the ECB indeed introduces such an instrument. However, it is a bit odd that on the one hand the ECB lent to banks for unlimited amounts for 3-months while it at the same time it absorbs money for an identical period via the certificates. Something similar already exists for the one week maturity where the ECB lends for 1 week and at the same time absorbs via its deposit facility liquidity. The latter the ECB tells us is needed to sterilize the bond purchases, but given the unlimited amount of lending, this is just theoretically the case. **The issuance of debt certificates may have the disadvantage that it enters in concurrence with the government T-bills**, as it should offer a higher rate than the overnight deposit facility (currently 0.25%) and the 1-week term deposit (currently 0.31%) and thus might push up T-bill rates and even short term bond yields that are as low as 0.48% (2-year Schatz). **However, on the other hand, it might make sense to replace the 1-week term deposit facility with a 3 month certificates**, as the facility is now used to sterilize the bond purchases and these would stay for longer on the ECB balance sheet.

**In conclusion, there is enormous uncertainty about what the ECB will do next.** Given the unrest recent ECB actions have caused, **it might make sense for the ECB to stay put for now and be prepared to act instead at the next meeting when the stress would still be high.** One possibility to remedy the stress that, contrary to outright, non-sterilized bond purchases, would stay closer to the more orthodox way of policymaking and thus probably be more acceptable for Germany, would be **a two tier system whereby the ECB would lend liquidity at a lower than refi-rates when the transaction is backed by government paper and keep the 1-year refi-rate for liquidity operations with other than government paper as collateral.** It would lower the cost for the banking sector and enhance the attractiveness of government bonds.

Piet Lammens KBC Brussels  
Austin Hughes, KBC Dublin

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	Brussels	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Didier Hanesse	+32 2 417 59 43	Commercial Desk	+32 2 417 53 23
Joke Mertens	+32 2 417 30 59	Institutional Desk	+32 2 417 46 25
Bob Maes	+32 2 417 51 94	London	
<b>Dublin Research (KBC Bank Ireland)</b>		Frankfurt	+44 207 256 4848
Austin Hughes	+353 1 6646892	Paris	+33 153 89 83 15
<b>Prague Research (CSOB)</b>		New York	+1 212 541 06 97
Jan Cermak	+420 2 6135 3578	Singapore	+65 533 34 10
Zdenek Safka	+420 2 6135 3570	Prague	+420 2 6135 3535
Jan Bures	+420 2 6135 3574	Bratislava	+421 2 5966 8436
<b>Bratislava Research (CSOB)</b>		Budapest	+36 1 328 99 63
Marek Gabris	+421 2 5966 8809	Warsaw	+48 22 634 5210
<b>Warsaw Research (Kredytkbank)</b>		Moscow	+7 495 228 69 61
Piotr Radzewicz	+48 22 6345 946		
<b>Budapest Research (K&amp;H)</b>			
Gyorgy Barcza	+36 1 328 99 89		
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