



## ECB Says Little New But Sounds Slightly More Optimistic

- No major changes in ECB assessment of economy or financial markets
- 'Cautious and prudent' stance means rate hike still unlikely until late 2011.
- Trichet warns against 'excessively pessimistic' economic outlook; is he right?
- ECB provides little comfort that shorter dated money market rates won't rise further as liquidity support diminishes.
- Trichet also hints that bond purchases will reduce further.

...

Journalists who attended today's ECB press conference may not have been entirely happy but there is little doubt that the outcome – a fairly dull event, was that favoured by the ECB and financial markets. **There are many reasons why the ECB shouldn't be exciting at present.** First of all, **we remain some considerable distance from the beginning of an ECB tightening cycle. We think the first rate hike is unlikely until late in 2011** and markets seem to be pricing the first increase as far away as early 2012. **A second reason for relatively boring Central Banking is that financial markets remain fairly nervous.** Mr. Trichet struck a slightly optimistic tone in his comments in relation to the economy and financial but these probably reflect a desire not to add to volatility as much as they stem from a more positive

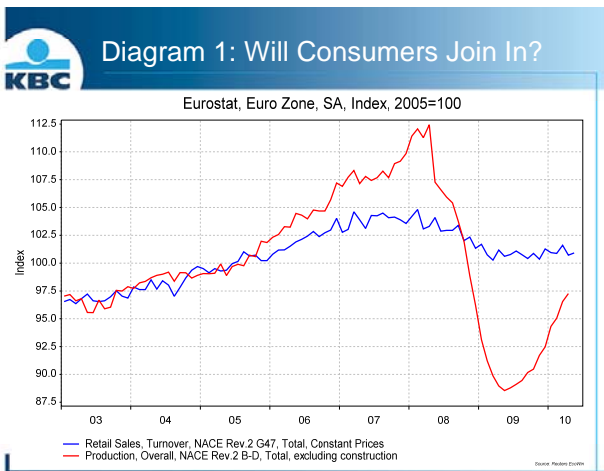
assessment of recent developments. **A final reason to be circumspect** and accordingly dull **is that some significant hurdles are fast approaching.** On the economic front, the global backdrop looks slightly less supportive of Eurozone export growth in the second half of the year. Looming even larger is the late July publication of stress tests for European banks, carrying with it the potential for heightened strains in financial markets.

So, **there were good reasons for Mr. Trichet to avoid saying anything remarkable** today and, **in large part, he succeeded although his comments on the economic outlook and liquidity conditions are of some significance.** The text of today's ECB statement was very close to that of early June. The ECB expects a *'moderate*

and still uneven pace' of recovery but Mr Trichet was a little more upbeat in his responses to fairly limited questioning on the economic outlook. **While he emphasised that the ECB remains 'cautious and prudent', he also argued against what he termed some 'excessively pessimistic' market commentaries.** In support of a more positive view, he highlighted an improving trend in Eurozone production of late which is clearly seen in Diagram 1. However, this improvement owes much to strong demand from outside the Eurozone. In contrast, the recent trend in Euro area retail sales gives little hint of a broadening upswing. **Mr Trichet is right to point out that growth in the second quarter is likely to be notably stronger than in the first but the prospects for late 2010 and next year remain extremely uncertain.**

the money market negotiated the ending of some €442 bio of 12 month liquidity support in the past week.

**The recent reduction in liquidity support was the main focus of questioning at today's ECB press conference** and while Mr Trichet repeatedly refused to offer any great insight on ECB thinking nonetheless what he did say was instructive in terms of the likely development of short term money market rates during the second half of the year. **Mr Trichet was very clear in emphasising that the rise in short term money market rates should not be interpreted as any signal on monetary policy. However, he refused to provide any comfort that money market rates would not rise further.** This message is entirely consistent with remarks made back in March that overnight rates 'would not rise in the short term' or prior to that in January that 'liquidity will be abundant for a number of months'. A sequence of questions today sought an equally encouraging response but this was not forthcoming. Mr. Trichet simply noted that if banks had bid for a larger amount of ECB funds last week, rates would likely have remained lower. These comments may be seen as a tacit approved of a trend increase in shorter dated rates towards levels more typically seen in the past. As diagram 2 indicates, there is still significant scope for further increases in these rates in the months ahead. How far and how fast shorter dated rates increase will depend on a range of influences. Mr Trichet said today that the ECB had already committed to provide unlimited access to 3 month liquidity for a number of months but he also indicated that the Governing Council hadn't decided to do 'anything more than that' at today's meeting.



It is understandable that policymakers would seek to emphasise the positive and Mr Trichet certainly wasn't wildly optimistic in his comments today but his remarks appear a little at odds with market concerns that the recovery could lose momentum as the year progresses. At the margin, his comments may reflect some slight easing in ECB concerns about the impact of the financial crisis on activity. In this respect, today's statement suggests the current climate is one of 'high uncertainty' rather than last month's depiction of 'unusually high uncertainty'. The ECB also seems quite encouraged by the relatively smooth manner in which

Mr Trichet also pointed towards what he said looks like a trend slowdown in bond purchases. So, **quietly the ECB is stepping back from its support to Eurozone markets although it should be emphasised that it continues to provide very considerable support.** It is notable that this is happening at a time when talk in the US is

turning towards the possibility of a step-up in asset purchases by the Federal Reserve in the event of a marked economic slowdown later this year. Clearly, if market chatter is to be believed, current ECB thinking is different to that at the Fed.

**It would be wrong to suggest today's press conference hints at any major change in ECB thinking of late.** The general thrust of Mr Trichet's message is very similar to that of the past couple of months. It should also be emphasised that the uptick in shorter dated money market rates is primarily a market driven phenomenon and as Mr Trichet underlined does not contain any signal for monetary policy.

**However, the slightly more positive tone of Mr Trichet's comments today, the tacit support for firmer money market rates and the inference that bond purchases are being scaled down, hint at a desire to take small steps towards reducing support to the markets.** The markets reading of these intentions (aspirations?) could lead to further upward pressure on interest rates and may lend support to the Euro on foreign exchange markets - at least as long as investors believe that the ECB is right to take a slightly more optimistic view.

**Austin Hughes, KBC Dublin  
Piet Lammens, KBC Brussels**

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		
<b>Dublin Research (KBC Bank Ireland)</b>			
Austin Hughes	+353 1 6646892	London	+44 207 256 4848
<b>Prague Research (CSOB)</b>		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Zdenek Safka	+420 2 6135 3570	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
<b>Bratislava Research (CSOB)</b>			
Marek Gabris	+421 2 5966 8809	Prague	+420 2 6135 3535
		Bratislava	+421 2 5966 8436
<b>Warsaw Research (Kredybank)</b>		Budapest	+36 1 328 99 63
Piotr Radzewicz	+48 22 6345 946	Warsaw	+48 22 634 5210
<b>Budapest Research (K&amp;H)</b>		Moscow	+7 495 228 69 61
Gyorgy Barcza	+36 1 328 99 89		
<b>Our reports are also available on: <a href="http://www.kbcdealingroom.com">www.kbcdealingroom.com</a></b>			
<small>This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the data of the report and are subject to change without notice.</small>			