

Flash Comment

ECB preview: Taking a pause on the exit path

- The ECB is taking a pause on the exit path. We expect the full allotment at all auctions to be extended until year-end and interest rates kept unchanged.
- As the risk of an economic downturn has increased we expect a softer tone at the press conference. Trichet is not going to announce new measures, but the door is still open.
- The staff growth forecast should be revised upwards – in particular for this year – while the inflation forecast should be kept practically unchanged.
- We expect a first interest rate hike from the ECB in Q4 2011. Current market pricing, based on EONIA forwards, suggests no hikes for the next couple of years.

Is Mr. Trichet still happy?

Will Mr. Trichet be as happy as he appeared at the last meeting? We believe not - US data have deteriorated a lot since the last meeting and it can only be a matter of time before the US downturn begins to drag on European growth. Nevertheless, the euro area did enter Q3 with strong momentum and seen from Frankfurt there is no cause for alarm yet.

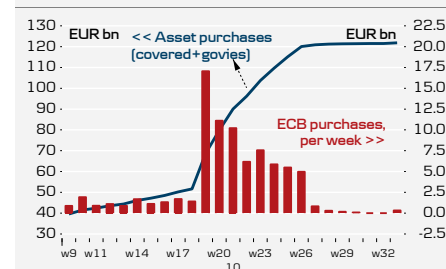
Will the ECB prolong full allotment? We are pretty confident that they will – at least until the end of the year. This has already been indicated by Axel Weber in an interview with *Bloomberg* on 20 August 2010, see *Flash Comment - ECB: No further exit before 2011*. Financial markets are still fragile and there is no good reason to “rock the boat” before end-Q3 and before year-end, when liquidity tends to become more scarce.

For instance, on 30 September, EUR225bn will mature with the expiry of 3M (EUR132bn), 6M (EUR18bn) and 12M (EUR75bn) long-term refinancing operations (LTRO). Some of these expiries are likely to be financed (rolled) through the 3M LTRO, which will also settle on 30 September with full allotment at 1.00%. It is, however, not likely that all of the EUR225bn will be rolled through the 3M LTRO. This would imply reduced excess liquidity in the euro system and could potentially increase volatility in money market rates as conditions tighten. Hence, it is not evident that the financial system is ready for more tightening than what is already likely to occur even with full allotment for the rest of the year. In addition to this, a more hawkish ECB stance is not supported by the monetary analysis, which shows that loan flows have turned softer in recent months.

The ECB has not purchased government bonds for significant amounts for many weeks now, although they did scale up their purchases to EUR330m last week (the total is EUR60.5bn). Trichet might signal that the ECB stands ready to scale up the purchases if needed, although he is not likely to be too specific. In the current environment of high uncertainty, the market needs to see action before spreads come down.

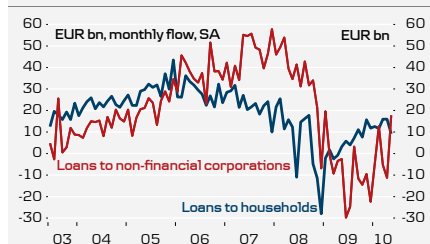
The ECB will revise their staff growth forecast up due to the better-than-expected outcome in Q2. We expect an upward revision of GDP growth from 1.0% to 1.5% in 2010 and from 1.2% to 1.4% in 2011. This can be achieved with moderate growth in H2 and 2011. The inflation forecast is likely to remain unchanged.

Limited government bond purchases



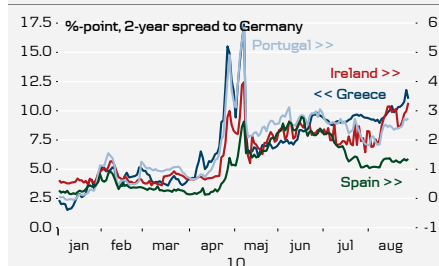
Source: Reuters Ecowin

Monetary analysis shows softness



Source: Reuters Ecowin

Spreads have widened again



Source: Reuters Ecowin

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Market comment

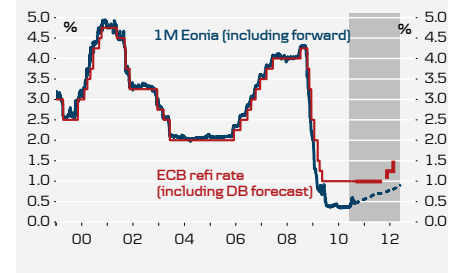
We still expect a first ECB hike in Q4 2011, which is in line with other ECB observers in a recent Reuters opinion poll. The current market pricing suggest no hikes from the ECB within the next couple of years.

We do not expect any major market movements from this week's ECB meeting. Should the ECB, against all expectations, decide not to provide full allotment at its liquidity tenders for the remainder of the year, it could lead to a sharp rise in short-dated money market rates, which in turn could lead to an upward move in EUR/USD. However, we find this outcome unlikely and we rather see risks being skewed in the other direction; for instance if Trichet put a lot of weight on the slowing of the US economy. This should lead to lower EUR rates and yields up to the two-year maturities.

Euribor rates have declined some in the last couple of weeks. This is partly down to the comments from Weber, but probably also because of a less tense situation in the money markets. Excess liquidity has stabilised around EUR100bn, which currently seems to be enough to avoid market participant concerns of a lack of liquidity.

Overall, we see very few drivers for higher short-dated rates and yields in the coming months. Hence, we expect money market rates to gradually decline ahead of New Year. For instance, we expect three-month Euribor to decline to 0.80% from the current level at 0.89%. Two-year schatz-yields have declined sharply in recent weeks and should thus have limited further downside potential in the short run, even if money market rates decline further.

No hikes any time soon



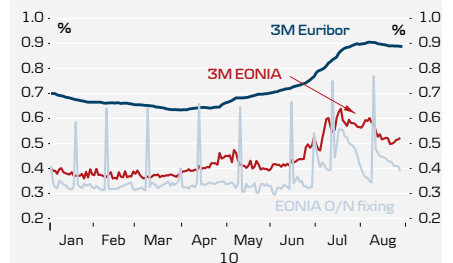
Source: Reuters Ecowin

Excess liquidity has stabilised



Source: Reuters Ecowin

Money market rates on the decline



Source: Reuters Ecowin

Recent comments from ECB Governing Council members

Trichet, Jackson Hole on hyperinflation, 27 August

“A recurrent suggestion for solving a debt overhang is the creation of surprise inflation. Again, let me clearly dismiss this type of action. The history of the debasement of money through hyperinflation has been disastrous everywhere. ... In addition, surprise inflation would destroy the hard-won credibility of central banks worldwide.”

Trichet, Jackson Hole on fiscal tightening, 27 August

“In countries with healthy household balance sheets, a virtuous effect can take place when governments announce and implement a reduction of the deficit. Expansionary fiscal contractions arise when the virtuous effects are large enough to offset the negative government demand effects. [17] There is some evidence suggesting that this outcome is not just a theoretical curiosity.”

Axel Weber on exit strategies, 20 August

“Most of these discussions about the continuation of the exit I think will be focused on the first quarter,”

Orphanides on liquidity, 9 August

“We remain sensitive to the liquidity needs in the banking sector and, as we have been doing since the beginning of the crisis, we will continue to provide liquidity as necessary, accounting for needs in the system and aiming towards an appropriately accommodative policy stance.”

Disclosure

This research report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority. The authors of this research report are Frank Øland Hansen, Senior Economist and Lars Tranberg Rasmussen, Senior Analyst.

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