Europe

ECB Watch

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Economic Analysis

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Limited news; focus on the stress tests

- In a relatively uneventful Q&A, the main novelty was Trichet's call for flexibility in the use of the EFSF (to recapitalize banks)
- As expected, the ECB does not seem to oppose the small rise of Eonia that followed the effective withdrawal of liquidity, and clarified it implies no message for policy stance
- The ECB is still reluctant to show further commitment to its bond purchase program

The ECB statement was very similar to the one last month. The issue of liquidity, which was expected to be the main focus on the Q&A, was finally overshadowed by questions on the stress tests.

Stress tests: Logically, Trichet was not willing to offer details on the stress test, since this is a CEBS responsibility. However, the ECB welcomed the transparency afforded by the publication of results on bank by bank basis. The most relevant piece of news, in our view, was that Trichet demanded flexibility in the use of the European Financial Stabilisation Fund (EFSF). We interpret this as a signal that he wants the EFSF conditions to facilitate the recapitalization of banks, which we think would be a good alternative. Stress test results will be released next 23rd July. The ECB has been reminding banks for months that they need to strengthen their capital base.

Liquidity measures: Trichet stressed that the rise of Eonia after the reduction of liquidity is not a signal regarding the stance of monetary policy. In addition, the reading of liquidity issues seems correct to us: there has been a net reduction of liquidity supply, and the amount may be reasonably estimated around €240bn. Finally, there is no announcement on further longer term auctions, as expected, while Trichet also said that current full allotment operations (3-month maturity) "at the present moment it seems to us appropriate". The increases of Eonia has been mild, so the ECB felt it was really no need to announce anything today. All in all, this suggests that the ECB may tolerate some slow rise in Eonia towards 1%, but that t. We are projecting the first raise at the end of 2011.

Bond purchases: Trichet did not reveal further details on Securities Markets Programme (SMP), without indicating as to when the ECB might end the programme. He just said that the ECB did not change in any respect the purpose of the SMP, signalling that "the level of interventions has been progressively diminishing". We think the message that interventions are less required is not really true. The ECB has been operating to ever falling degrees in recent weeks, so investors are unlikely to be surprised by this announcement. However, it could have been desirable to state more clearly that the ECB has a strong commitment to purchasing more bonds if necessary. It is true that market participants could be starting to factor the action taken by European governments, but there is nothing wrong in supporting this process.

European debt crisis: Trichet focused on ensuring fiscal consolidation process and the need of fiscal reform to avoid a similar situation in the future, emphasizing in the Q&A session that it is not opportune to include an orderly restructuring mechanism, while an independent fiscal watchdog is required in both EA and EU.

On activity: Caution but relative optimistic. “We remain cautious and prudent”, but “the second quarter is likely to be much better than the first quarter”. Indeed, our own sub-consensus projection is of 0.4% for Q2, after 0.2% in Q1, although we foresee some deceleration for the second half of the year. Additionally, Trichet highlighted the excessively pessimistic markets’ views about eurozone economy in the Q&A session when he was asked about the risks of a “double dip”.

On inflation: Nothing new. The risks of medium term inflation are moderate, as domestic price pressures are low. There is barely a change in the wording of the Statement.

Money aggregates: Trichet signalled that the monthly increase of loans to non-financial corporations might be an isolated observation, and we need more observations to see if it recovers (with a long lag, as in previous cycles). Our own reading is similar. At least, we have seen a clear stop in the deterioration of the annual growth series.

Market’s reaction: Market reaction was slightly positive, in line with a very calm press conference, as movements during the Q&A were not relevant if compared with past venues. European stock markets extended somewhat early gains of around 0.5%, with the ESTX 50 rising up to 1%, while in bond markets the yield on short term government bonds continued the positive trend observed at the start of the European session with Spain and Italy falling 10 and 14bps to 2.7% and 1.8%, respectively. In FX markets, the euro jumped to $1.27 from $1.266 at the start of the press conference, being now trade slightly above $1.265.

Summing up: After Today’s meeting, the ECB stance continues to be cautious, remaining at a standby mode as to see the effects of key events expected in coming months: mainly the impact of stress test results and the reaction of member states on the use of EFSF. The ECB is playing a positive role in demanding flexibility in the EFSF tool. In any case, it would be desirable to complement this with a signal that the ECB has a strong commitment to implement non-standard measures if necessary to calm markets’ strains. All in all, we expect monetary policy to remain loose for a while, and we keep our projection that the first interest rate hike will take place by end-2011.

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