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TRENDMACRO LIVE!

On the May ECB Policy Decision

Thursday, May 2, 2013

Lorcan Roche Kelly

A mostly meaningless rate cut -- but a strong new liquidity program and break for ELA.

As we grudgingly expected -- following disappointing recent data on inflation and money growth (see "Draghi's Troika of Troubles, Volume 2" April 30, 2013) -- the ECB decided to cut the main refinancing rate to 0.50%.

We continue to think that the rate cut itself won't have much effect on Europe's growth prospects. If this were all the ECB had done today, we would have urged taking profits on euro area peripheral debt. Happily, other policy changes announced today will have more positive effects, so we continue to see peripheral debt as a total-return play in a world desperately reaching for yield.

- The cut in the main refinancing rate by 25 bp was already priced in by markets. But in fact there was also a larger rate cut -- of 50 bp -- in the rate on the marginal lending facility (MLF).
- That's because, in order for there to be symmetry in the corridor between the ECB's key policy rates at 50 bp, when the main refinancing rate was cut by 25 bp to 0.50% -- a 50 bp spread to the deposit rate, which is at the zero bound -- the MLF rate had to be cut 50 bp from 1.5% to 1.0%.
- Extraordinary Lending Assistance (ELA) is generally priced off the MLF rate, so this will reduce the cost of access to that emergency facility (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).

Most critically, in his speech at the press conference, ECB President Mario Draghi also gave the longest forward commitment yet to the continuation of weekly fixed-rate full-allotment refinancing operations by the ECB: they will now continue until July 2014. As forward guidance goes, this is a pale shadow of the Fed's policies, but it is a major step for the ECB.

- This move is not exactly another long-term refinancing operation (LTRO). Rather, it is a long-term commitment by the ECB to provide limitless liquidity every week, on a short-term basis.
- It is roughly analogous to a 15-month LTRO that banks can access on a weekly basis.
- It renders meaningless much of the free option given by the 3-year LTROs. The two 3-year LTRO operations only extend for five and

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: The ECB's 25 bp rate cut won't help growth. But the extension for 15-months of weekly fixed-rate full-allotment refinancing operations to strengthen the safety net under the banks, and the cut of 50 bp in the rate on Extraordinary Liquidity Assistance (ELA) are more substantial positives. We give little credence to Draghi's trial balloon about negative interest rates. We are now able to reiterate our call on euro area peripheral sovereign debt as an excellent total-return play.

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seven months, respectively, beyond the new commitment from the ECB.

- This may well lead to increased early repayments of the current outstanding 3-year LTROs. For banks the upside to remaining in the operations has been largely removed today.
- As the terms are fixed until July 2014 at the earliest, banks can now be assured of funding when they need it in the short to medium term, without being forced to access it immediately -- as happened in the 3-year LTROs.

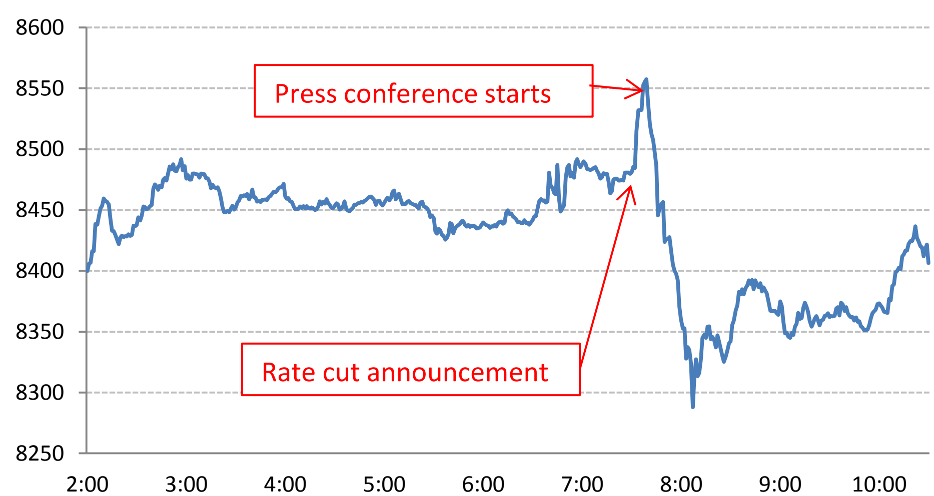
Draghi did not give anything specifically designed to help small business lending in the euro area.

- In his speech he said, "the Governing Council decided to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations."
- This refers to the ECB's preferred tactic in addressing the tight credit conditions facing peripheral borrowers -- involving the European Investment Bank (EIB) (see "The EIB, Not the ECB" April 12, 2013).
- But this does not give an immediate boost to lending, because negotiations on any program involving the EIB are outside of the ECB's political control. The EIB is an EU27 organization rather than an euro area organization, so any changes will need the agreement of non-euro governments, too.

Finally, it is notable that during the question and answer session after the decision, Draghi said that the ECB was "technically ready" for negative interest rates and that he has an "open mind" on the subject.

- We would not put it past Draghi to be launching a trial balloon here to judge reaction. If that was his intention, he certainly got an

IBEX Index of Spanish equities Intraday for May 2, EST



Source: Bloomberg, TrendMacro calculations

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answer from peripheral equity markets (please see the chart on the previous page).

- But we do not see negative interest rates as likely anytime soon from the ECB. With the refinancing rate at 0.5%, it is very unlikely that we will see a further cut from here. Deposit rates would only become negative if the ECB decided that both another rate cut is needed *and* that a 50 bp corridor would have to be maintained between the deposit and refinancing rates.

Bottom line

The ECB's 25 bp rate cut won't help growth. But the extension for 15-months of weekly fixed-rate full-allotment refinancing operations to strengthen the safety net under the banks, and the cut of 50 bp in the rate on Extraordinary Liquidity Assistance (ELA) are more substantial positives. We give little credence to Draghi's trial balloon about negative interest rates. We are now able to reiterate our call on euro area peripheral sovereign debt as an excellent total-return play.