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TRENDMACRO LIVE!

On The February ECB Policy Decision

Thursday, February 7, 2013

Lorcan Roche Kelly

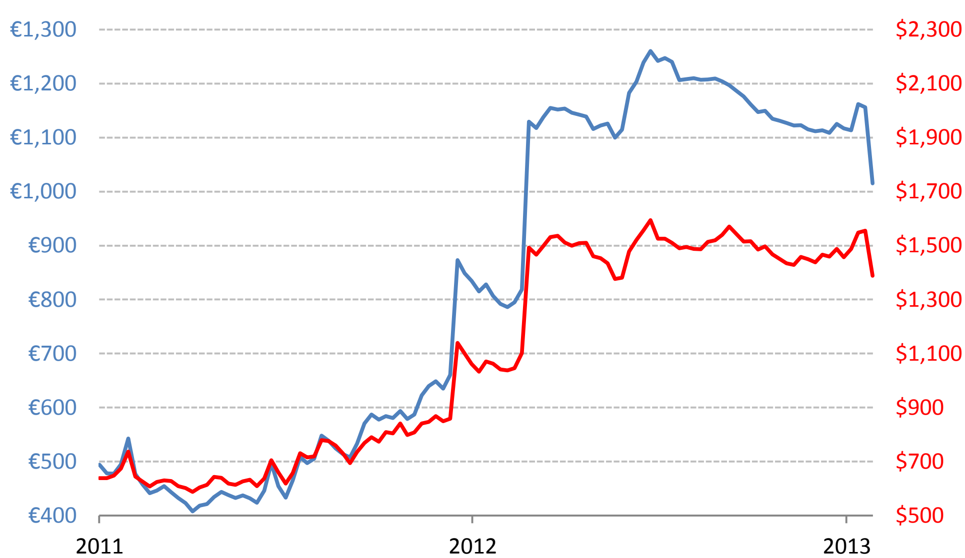
Markets now see the ECB is still highly accommodative, and Ireland's ELA comes to an end.

As expected, the ECB maintained its policy stance at today's meeting in Frankfurt. In his speech at the post decision press conference ECB President Mario Draghi characterized the ECB's stance as "accommodative" four times. He also noted that inflationary expectations were contained, meaning that there is no pressure on the ECB to start to tighten in the foreseeable future. Repeating what we said after the January meeting, we do not expect any tightening from the ECB until the second half of 2013 at the earliest (see "On the January ECB Policy Decision" January 10, 2013).

Even though there was no policy change, Draghi's comments were properly viewed as dovish by markets, with the euro currency falling strongly against the dollar -- from 1.355 to 1.341 -- while Draghi was speaking. This begins to correct the market's misunderstanding of the first round of 3-year LTRO repayments as being evidence of ECB tightening (see "On The First LTRO Payback" January 25, 2013).

- That said, today's euro move stands out as a small correction in the continued strengthening that began in July with Draghi's now famous "whatever it takes" speech (see "On Draghi in London" July

Total ECB refinancing operations — EUR billions — USD billions



Update to strategic view

ECB, FX, EUROPE MACRO: As expected, there was no change in the ECB's monetary policy stance at today's meeting. Mario Draghi emphasized how accommodative the ECB remains, with his comments being properly viewed as dovish by markets. -- the euro currency fell sharply while Draghi was speaking this morning. We expect the ECB to maintain its current stance until the second half of 2013 at the earliest. In another welcome sign of markets returning to normal, for Ireland there was ECB acceptance -- through non-refusal -- of proposals to eliminate the Central Bank of Ireland's ELA.

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26, 2012).

- The most recent leg up in the currency has come on the back of the first round of 3-year LTRO repayments which were reflected in the ECB balance sheet published on Tuesday of this week.
- In euro terms, the balance sheet is now the smallest it has been since February 2012. But this is not evidence of ECB tightening -- only the entirely voluntary return of liquidity seen as surplus by the banks that had held it.
- And even after being reduced by €140 billion last week by the repayments, ECB monetary policy operations are still larger now than they were in July in US dollar terms (please see chart on the previous page).
- We expect the ECB's balance sheet will continue to shrink in euro terms, as the second and larger 3-year LTRO becomes eligible for early repayment at the end of this month (see "On the Second 3-year LTRO" February 29, 2012). But again we emphasize -- as Draghi himself did in the press conference today -- that the reduction of the ECB's balance sheet does not mean that the ECB is tightening. It continues to run full-allotment liquidity operations -- so it is the banks, not the ECB, that are deciding how big the ECB's balance sheet is.

The other matter of interest from today's press conference was the resolution of the Central Bank of Ireland's emergency liquidity operation funding the Irish Bank Resolution Corporation (IBRC), formerly Anglo Irish Bank (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).

- The Irish government has decided to liquidate IBRC, and move its balance sheet to NAMA, the Irish "bad bank."
- The Emergency Liquidity Assistance (ELA) on the Irish central bank's balance sheet will be replaced with a combination of long term Irish sovereign debt and NAMA debt.
- This agreement will do nothing to improve Ireland's debt position. In fact, with €25 billion in new sovereign debt going onto the central bank's balance sheet, *reported* Irish debt will rise substantially.
- However as the new bonds are replacing the existing promissory notes, there will be no change in the *de facto* debt position of Ireland, as the government always had to repay the promissory notes anyway.
- For the ECB's part, Draghi said today it unanimously "took note" of the Irish decision. This strange use of language means that the ECB has decided to allow the deal to go ahead under the principle of everything being allowed unless it is expressly forbidden.
- For Ireland this is a positive development, as it normalizes what was an unusual operation. And for the ECB it allows the unseemly and persistent ELA operation at the Central Bank of Ireland to end.

This normalization of the position at the Irish central bank points to an over-arching theme in the euro area: things seem to be returning to normal

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(see "Calm Breaks Out in Europe" October 31, 2012). Much of the credit for this has to go to Mario Draghi at the helm of the ECB.

Bottom line

As expected, there was no change in the ECB's monetary policy stance at today's meeting. Mario Draghi emphasized how accommodative the ECB remains, with his comments being properly viewed as dovish by markets -- the euro currency fell sharply while Draghi was speaking this morning. We expect the ECB to maintain its current stance until the second half of 2013 at the earliest. In another welcome sign of markets returning to normal, for Ireland there was ECB acceptance -- through non-refusal -- of proposals to eliminate the Central Bank of Ireland's ELA.