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FOCUS NOTES

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ECB meeting preview

- In its upcoming meeting the ECB is expected to reveal details about the reactivation of its SMP program. We expect the ECB to focus on short term sovereign bond purchases in order to improve the monetary transmission mechanism and boost credit supply in the periphery. Such reasoning falls within the ECB's mandate of financial stability and is expected to contain criticism of government financing.
- The ECB will most likely avoid the announcement of explicit caps, as they would reduce the flexibility and conditionality of its interventions. Instead, it is anticipated to defend implicit targets with ad-hoc purchases. In our view, large amounts of purchases as well as a clear renunciation of seniority status are essential for the new bond purchases to be more successful in stabilizing sovereign debt markets than the SMP has been so far.
- A formal application for financial assistance to the EFSF/ESM seems to be a prerequisite for ECB intervention in a country's bond market, in order to ensure that pressure for structural reforms remains intact. In our view, moral hazard concerns raise the risk that financial assistance by the ECB may come with so strict terms that countries such as Spain, may be discouraged from asking for help, thus limiting the impact of the ECB's decisions on reducing risk premia.
- Further easing of collateral rules is likely, in order to alleviate individual cases of liquidity constraints. The ECB may also reduce its policy rate by 25bps to 0.5% on the ground of weaker projections of economic activity. A reduction of the deposit rate below zero seems less likely.

Following President Darghi's comments at its last meeting in August, the ECB is expected to reactivate its Securities Purchases Market Program which remains dormant since February 2012. At the upcoming meeting on Thursday, the ECB is expected to spell out details of the new round of bond purchases, concerning the size of intervention, the maturity spectrum targeted, the existence of explicit or implicit bond yield targets and the seniority status. President Draghi's commitment that the ECB will do "whatever it takes" to tackle the eurozone problems has given rise to wide speculation about what form the ECB's intervention in the bond markets may take. In our view, the ECB will focus on the short end of the sovereign yield curve (possibly targeting maturities up to three years) by buying bonds at the secondary market. The reasoning the ECB will likely provide is that as sovereign markets are integrated with financial markets, purchases of short term government bonds will improve the monetary transmission mechanism, reduce the fragmentation of financial markets across the euro area members and, thus, support credit demand, especially in the debt afflicted periphery countries.

Large enough purchases of short term bonds would lower their yields enough so as to prompt private investors to turn to longer maturities in search for higher returns. Thus, yields would decline across the yield curve, diminishing substantially the borrowing costs of stressed members, particularly of Spain and Italy. The justification of the second round of bond purchases as a tool to improve the monetary policy in the euro area would possibly allow the ECB to buy large amounts of bonds, which, in our view, is an essential element to boost the credibility of the ECB measures. If this proves the case, it will be in contrast to the "limited and temporary" nature of the SMP so far, which diminished its effectiveness as it eroded investors' confidence about the determination of the ECB to stabilize the

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sovereign bond markets. Nonetheless, the larger the intervention the greater is the risk of the ECB being accused of government funding.

Given that the Securities Purchases Program is highly controversial among the central bankers, with the Bundesbank Governor opposing fiercely bond purchases, the ECB Governing Council has to agree on a program that is effective in improving financial conditions across the monetary union, while at the same time keeping markets pressure on governments for structural reforms and fiscal consolidation intact. In our view, support from the Bundesbank is essential to ensure credibility of the ECB measures. As a result, we would exclude the announcement of any mechanical rules involving explicit yield or spread caps on government bonds. Indeed, to defend such caps the ECB should commit to unconditional bond buying that would not comply with its price stability mandate and most likely would be legally challenged. More important, it would also increase the risk of moral hazard as governments in weak states would be inclined to take a leisurely approach on their adjustment programs. Instead, the ECB is likely to defend implicit yield caps by conducting ad-hoc purchases that will allow the ECB to maintain maximum flexibility in its interventions.

The ECB is unlikely to start buying bonds, unless a country places a formal request for financial assistance from the EFSF/ESM. Applying for an EFSF/ESM program seems to be essential for the ECB, as it ensures reform pressure on governments, and allows the ECB to tie the continuation of its interventions in a country's bond market to that country's fiscal consolidation and reform progress. As the euro area sovereign debt crisis has proven so far, conditionality is hard to be applied, even under a strict troika program. Therefore, the ECB may want to have maximum guarantee that adjustment efforts will proceed as planed. In our view, this poses the risk that financial assistance by the ECB may come with so strict terms and conditionalities, that countries such as Spain, which is trying to maintain adjustment demands as limited as possible, may be discouraged from asking for help, thus negating the ECB's decisions for help provision.

With respect to subordination concerns, following President Draghi's comments that the issue will be addressed, the ECB is likely to renounce its seniority status in its SMP 2 program. Anything short of a clear renunciation of seniority would most likely dissatisfy markets. Dropping seniority status becomes increasingly important, if the scale of bond purchases is going to be large. Markets are spooked by the ECB's preferred creditor status, especially after its denial to accept losses on the Greek PSI program. By lifting subordination concerns, the ECB may maximize the effectiveness of its bond purchases in reducing risk premia and entice private investors back to the Spanish and Italian soverign debt markets.

Moreover, liquidity concerns of distressed banks are likely to be addressed by further relaxation of collateral eligibility. The ECB could either lower the minimum credit rating of assets eligible for liquidity operations or reduce the haircuts applied to assets it currently accepts as collateral. Despite individual liquidity problems, the banking sector as a whole is awash with liquidity, thanks to the two 3-year LTROs conducted at the turn of the year, which provided banks with more than a trillion of euros. Therefore, we do not expect the ECB to launch another long-term operation before next year.

Finally, the ECB is likely to cut the main refinancing rate by another 25bps to 0.5%. Although we believe that in the current circumstances unconventional monetary policy measures are of greater importance than conventional monetary easing, a rate cut in conjunction with the unconventional course of action could have a positive impact on credit conditions. From a symbolic point of view, it would also boost confidence over the ECB's determination to support the financial sector. A rate cut will be in line with leading indicators which are hovering at very low levels, suggesting a materialization of downside risks in the second half of 2012. According to the latest ECB staff macroeconomic projections in June, the euro area GDP growth was expected to contract by -0.1% in 2012 and expand by 1% in 2013 (both figures are midpoint estimates). The new projections published in September will most likely point to lower GDP growth for both 2012 and 2013, providing reasoning for easier conventional monetary policy. That said, the ECB may refrain from a rate cut in the upcoming meeting as it may prefer to first assess the impact of its unconventional measures on fixing the monetary policy transmission mechanism before it embarks on an even lower policy rate later in the year. Concerning the depo rate, based on Mr. Draghi's assessment in the August meeting that negative deposit rates would constitute 'uncharted waters', we would assume that the ECB will leave the deposit rate unchanged at 0%.

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