

ECB likely on hold for some time

The ECB will hold their next monetary policy meeting on Thursday, July 2. The ECB elected to hold rate policy unchanged in June. Since the financial crisis started last September the ECB has cut interest rates 325 bps to a record low 1%. The ECB has also implemented a plan to buy €60bn in bonds and to expand its liquidity operation for banks. The ECB has offered a record €442 bln in one year funds to EU banks to try and combat the recession. This offering by the ECB is effectively a de facto monetary policy ease and will provide a large amount of liquidity to the EU banking system. The liquidity offering should help push down borrowing costs. The combination of ECB bond purchases and new liquidity measures coupled with recent statements from ECB officials suggest that the ECB will remain on hold unless the EU economy experiences significant deterioration. ECB President Trichet said last week that the current level of interest rates is "appropriate." In addition, the ECB's Weber said that additional steps are not necessary from the ECB at this time. ECB officials have consistently downplayed the risk of deflation in the EU and continue to expect a modest rebound in the EU economy into year-end. Expect the ECB to hold rates unchanged at 1% and continue with its asset purchase plan at Thursday's policy meeting.

Press conference:

The trade will also look to the press conference following ECB policy meeting. No major policy initiatives are expected from the press conference. The trade will look to the press conference for the ECB's outlook on EU inflation and the economy. EU June inflation declined 0.1% compared to flat last month. The trade was looking for a 0.2% decline in the June inflation report. This report is unlikely to change ECB opinion that deflation is not a risk in the EU. Recent EU economic data has improved with manufacturing and services PMI posting modest gains along with rises in business and consumer confidence. Although the improvement in these reports comes from low levels, the data is enough to encourage ECB officials to look for EU economic rebound into year-end. The trade will be looking to see if ECB leaves the door open for future rate cuts. If ECB officials express concern about deflationary risk in the EU and continued risk to the EU economy the EUR may experience light selling pressure.

OECD calls for the ECB to cut interest rates quickly:

The impact of the ECB meeting should be limited because there should be few surprises. The main risk for the EUR is the possibility that investors become concerned that the ECB is not taking enough action to boost growth or fight deflation. The EUR could be pressured by speculation that the ECB is falling further behind the growth curve. In addition, the ongoing financial crisis in the Eastern European presents a major risk to the EU economy. EU governments and the ECB have yet to fully address the financial turmoil in Eastern Europe. The Organization for Economic Cooperation and Development (OECD) calls on the ECB to cut interest rates quickly to zero. The OECD expects the EU economy to contract by 4.8% in 2009 and growth to be flat in 2010. According to the OECD EU unemployment may rise to 12% in 2010 and inflation pressures will continue to moderate. In reaction to the OECD's call for ECB rate cut ECB president Trichet told the European Parliament that the ECB does not believe that a rate cut would improve the economic situation. ECB's Liikanen echoed Trichet's comments and said that the ECB's next move would be to raise rates. Swap rates are pricing a 40% chance of an ECB rate hike over the next twelve months. Despite the OECD call for lower ECB rates the ECB refinance rate will likely remain at 1% for the rest of the year.

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