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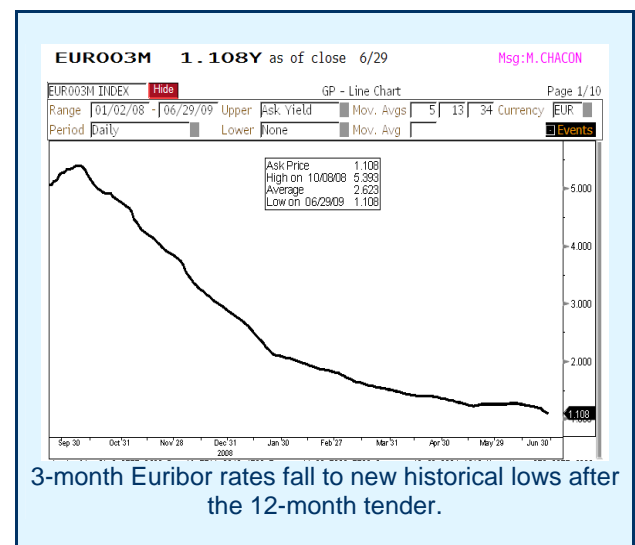
ECB awaiting impact monetary easing decisions

- ECB firmly on hold, as monetary stimulus works through the economy
- Economic outlook remains highly uncertain, despite recent signs of improvement
- Banks pressed to pass on lower interest rates/step up lending following massive 1-year tender
- ECB to start purchasing covered bonds, but more private asset purchases could still prove necessary

Following the drastic easing in monetary conditions since October last year, the ECB governing council has entered a wait-and-see stance. As such, we expect no new monetary policy initiatives at the July policy meeting. It is still unclear what conditions the Eurozone economy is in at present. In addition, the financial crisis has made the impact of recent monetary decisions on the real economy highly uncertain. So, the governing council will use the summer period to closely monitor whether the recent unprecedented monetary policy initiatives have the expected impact on the financing conditions in the euro zone.

Until now, the ECB governing council has focused its efforts on providing support to the banking sector given the primordial role of the banking sector in the financing of the euro zone economy. Therefore, it has cut interest rates dramatically from 4.25% to 1% and has adopted a number of non-standard measures under its 'credit enhancement scheme'. These should ease the bank's funding conditions and thereby support the flow of credit to the real economy. Therefore, the ECB provides the banking system at maturities of up to one year with unlimited amounts of liquidity at the main refinancing rate against an expanded list of collateral. And in July the ECB will begin purchasing €60B worth of euro-denominated covered bonds issued in the euro area.

As such, the ECB last week performed its first one-year refinancing operation in which it allotted a record amount of €442B to more than 1100 banks in the euro zone. In response, **most money market rates fell to new historical lows**. For example, the 3-month Euribor, which is a key reference rate in many variable loans, fell to 1.108% on Monday, while short-term yields also outperformed the longer end of the curve.



The question however remains to what extent these lower interest rates will filter through into the real economy and whether banks will step up lending again. Therefore, we will keep a close eye on the interest rates charged to households and non-financial corporations as well as to the credit growth data. Although it remains difficult to assess to what extent the sharp slowing in credit growth has been due to supply or demand factors, a further slowing or negative growth rates would indicate that the economic outlook remains very weak and that medium-term inflationary risks are currently very limited. This would give the ECB the room to keep rates low for a prolonged period of time and to expand their 'credit enhancement scheme' towards other sectors of the economy without endangering their price stability objective.

Over the coming weeks, it will therefore be interesting to see whether the record amount of liquidity injected in the banking system with the 12-month refinancing operation will be used to step up lending or will be deposited again at the ECB. In the immediate aftermath of the tender, the use of the ECB's deposit facility spiked up to €236B, the highest amount since January. Last week, ECB's Weber already warned that if banks do not step up lending, 'we have to bypass the banking sector'. In a similar vein, ECB executive board member Gonzalez-Paramo said that 'under extreme circumstances (notably, when the banking sector is no longer able to fulfil its institutional role as the main engine of financial intermediation), a central bank may reach the opposite (of the current) conclusion: exactly because of the banking sector's predominance in financial intermediation, its dysfunctional state might prompt a central bank to intervene before the entire economy comes to a halt'. **These comments suggest that the ECB may have to broaden its private asset purchases beyond covered bonds and to step up direct lending to the real economy.**

It's therefore of the essence that the underlying problems of the European banking sector are addressed immediately. According to the ECB's financial stability review, the banking sector may still face a further \$283B in write-downs by the end of next year after having already reported \$365B. In addition, the BIS annual report states that 'even though governments have taken on large commitments, they continue to be unwilling or unable to fully address the impaired assets on bank balance sheets' and stresses that 'a healthy financial system is a precondition for the effectiveness of expansionary policies and for stable long-run real growth'.

Limited progress on this issue and fears for a disruptive credit squeeze in the euro zone may force the ECB's hand after the summer. This may in first instance lead to a commercial paper/corporate bond facility, as concerns about their independence may withhold them from purchasing government bonds. Cutting the main policy rate further towards zero may also have few advantages as long as the transmission mechanism remains impaired and as the EONIA has already fallen closer to the deposit rate at 0.25% than

the main policy rate of 1%, due to the excess liquidity available in the money market.

Regarding the outlook for government bond yields. The expectation of a prolonged period of low ECB policy interest rates coupled to very slow growth and low inflation rates suggests that the recent rise in longer-term yields shouldn't go much further. On the other hand, the deterioration in public finances as well as rising longer-term inflationary concerns and higher risk premia may keep yields well above the cycle lows. **Therefore, range-trading within the recent range between 2.90%/3% and 3.75% looks the best option for now.**



In summary, at this week's policy meeting we don't expect the ECB governing council to announce new monetary policy initiatives. It will nevertheless be interesting to hear whether the council has become more concerned about a credit squeeze in the euro zone after comments from Weber and Gonzalez-Paramo, in which case the ECB could be forced to broaden its asset purchases beyond covered bonds. We however only expect a decision on this issue at the September meeting at the earliest.

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