

Flash Comment

ECB meeting: Withdrawing extraordinary liquidity

- Trichet signalled that it is soon time to begin withdrawing the extraordinary liquidity measures. The 12-month auction in December will be the last. We still expect shorter auctions with full allotment in 2010. As a minimum we expect the one-week actions with full allotment to continue.
- The assessment of the economic situation has become notably more positive and Trichet has said goodbye to the stabilisation phase. The ECB ought to revise its growth estimate for 2010 upward by a full two percentage points to get it right, but it is unlikely to revise it up by much more than half a percentage point in December.
- The ECB is becoming increasingly concerned that fiscal sustainability could become jeopardised, and the wording on fiscal policy has become harsh. There is however little the ECB can do apart from threaten governments with higher rates if fiscal stimulus is not withdrawn in a timely matter.
- Today's press conference was in line with our expectations – if anything a bit more hawkish. Thus we continue to anticipate that the ECB will follow the exit strategy we have previously outlined although with an increased risk that full allotment in 2010 will only be given at very short auctions or at three-month auctions with a spread.

Entering the exit phase

Trichet signalled that the 12-month long-term refinancing operation (LTRO) with full allotment in December will be the last 12-month auction. We still expect shorter auctions with full allotment, but probably not as long as previously anticipated (3 months). If the ECB schedules 3-month auctions with full allotment in 2010, we should expect a small spread to be added. As a minimum, we expect the one-week actions with full allotment to continue.

The shift in wording emphasizes that the focus is now on withdrawing extraordinary liquidity measures. Previously Trichet has said that "Once the macroeconomic environment improves, the Governing Council will make sure that the *measures* taken are removed in a timely fashion and that the liquidity provided is absorbed...", but today he said that "Looking ahead and taking into account the improved conditions in financial markets, not all our liquidity measures will be needed to the same extent as in the past. Accordingly the Governing Council will make sure that the *extraordinary liquidity measures* taken are phased out in a timely and gradual fashion and that the liquidity provided is absorbed..."

Trichet would not comment on the spread on the December LTRO. The decision is to be taken in one month. Given that this will be the last 12-month LTRO and the ECB is now focusing on liquidity withdrawal, we think that a 10-15 bp spread will be added.

The market initially reacted with higher rates, but they quickly came down again.

Goodbye to the stabilisation phase

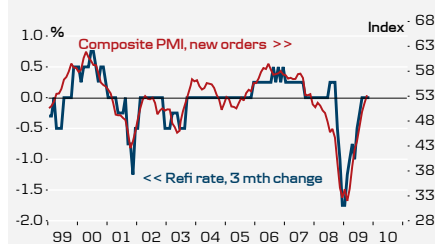
The ECB has become significantly more positive on the economic situation than it was a month ago. The reference to a stabilisation phase has gone. Last month Trichet said "the latest information further supports our view that the euro area economy is stabilising and is expected to recover at a gradual pace". This was changed to the much more positive assessment that "the latest information continues to signal an improvement in economic activity in the second half of this year. The Governing Council expects the euro area economy in 2010 to recover at a gradual pace".

Policy rates (November)

Actual	DB	Con	Last
Refi rate	1.0%	1.0%	1.0%
Deposit rate	0.25%	0.25%	0.25%

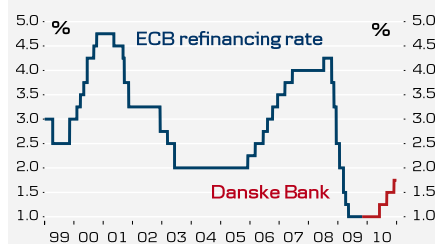
Source: Ecowin

PMI signals ECB on hold



Source: Reuters Ecowin and own calculations

ECB on hold until next summer



Source: Reuters Ecowin and own calculations

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We expect to see a notable upward revision of the ESCB staff growth projections at the December meeting. We think they ought to revise their growth estimate for 2010 a full two percentage points upward to get it right, but it is unlikely to revise it up by much more than half a percentage point.

Harsh on fiscal policy

Trichet is becoming increasingly concerned that fiscal sustainability could become jeopardized, and the wording on fiscal policy has become harsh. Today he warned that “many Euro area governments are faced with high and sharply rising fiscal imbalances. If not addressed by a clear and credible exit strategy, this could seriously risk undermining public confidence in the sustainability of public finances and the economic recovery. The very large government borrowing requirements carry the risk of triggering rapid changes in market sentiment, leading to less favourable medium and long-term interest rates”.

There is however little the ECB can do to achieve fiscal discipline apart from threatening governments with higher rates if fiscal sustainability is not withdrawn in a timely matter.

Trichet also said that tax cuts should only be considered over the medium term, when countries have regained sufficient room for budgetary manoeuvre. Saying this so shortly after the announcement of German tax cuts can be interpreted as a disapproval of these. He also emphasized that the commitment for fiscal consolidation to begin in 2011 was for all countries – the German tax cuts are primarily being phased in that year.

Inflation expectations remain well anchored

On inflation, Trichet reiterated in the introductory statement that “over the policy-relevant horizon, inflation is expected to remain positive with overall price and cost developments remaining subdued, reflecting ongoing subdued sluggish demand in the euro area and elsewhere.” The beginning of the rate hiking cycle will not be imminent as long as the ECB sticks to this sentence and does not add significant upside risks to its medium term inflation forecast.

Exchange rate

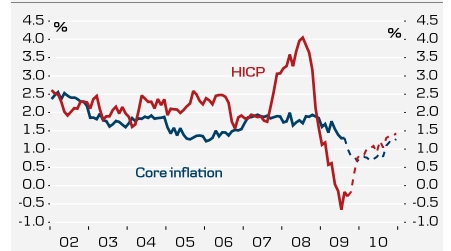
Little new was said on the exchange rate. Trichet reiterated his references to the strong dollar policy saying that “we appreciate the statements made by the U.S. secretary of the Treasury and the chairman of the Federal Reserve on the fact that a strong dollar vis-a-vis the euro and other major floating currencies is in the interests of the United States, and I echo these statements as something which is important in the present circumstances.”

ECB and Danske Bank projections

%	2009	2010
GDP growth		
ECB (September)	-4.1	0.2
Danske Bank	-3.7	2.2
Inflation		
ECB (September)	0.4	1.2
Danske Bank	0.3	1.2

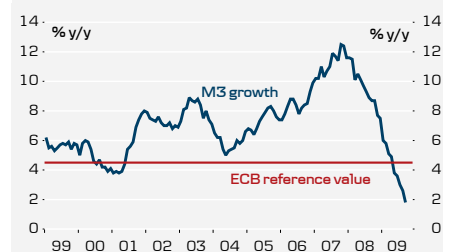
Source: ECB and Danske Markets

Inflation remains subdued



Source: Reuters Ecowin and own calculations

M3 growth below reference value



Source: Reuters Ecowin

EUR/USD on upward trend



Source: Reuters Ecowin

Disclosure

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