

Flash Comment

ECB preview: Announcing non-standard measures

- We expect the ECB to cut the refinancing rate by 25bp to 1.0%. This is likely to be the end of this cutting cycle as the governing council seems reluctant to go below 1%.
- The deposit rate is expected to stay unchanged at 0.25%. After this meeting, rates are likely to be kept unchanged for a long time before the ECB starts hiking.
- Trichet has promised to announce a package of non-standard measures that the ECB stands ready to implement. This package could include a 12-month auction, purchase of quantitative paper and changes in collateral criteria.
- There is a small risk that the ECB will use the last month's more positive developments in Euroland confidence and Asian hard data to take a wait-and-see stance. The risk is thus for a disappointment and higher yields.

The end of the cutting cycle

We expect the ECB to cut the refinancing rate by 25bp to 1% at its next meeting on Thursday and that this will be the end of the cutting cycle. At the last meeting, the ECB disappointed the market when it only delivered a 25bp rate cut against widespread expectations of a 50bp cut. This is likely to have been a compromise. At the press conference Trichet kept the door open for further rate cuts and the tone of the speeches given subsequently is in line with our expectation that another 25bp cut is due, but not more than that. There have been plenty of signals from members of the governing council that they are reluctant to go below 1%, although it has never been fully ruled out.

Since the last meeting of the governing council, global data have improved and Asian data in particular have signalled the possibility of a rebound. Euroland data have become less negative too. Most importantly, confidence indicators have improved and last week's bank lending survey showed that credit tightening is slowing. There is a small risk that the ECB will use these positive developments to take a wait-and-see stance – it could even have ongoing discussions about the risk of over-stimulating the economy in the medium term. On the other hand, the economy is still in a very bad state as emphasised by the European Commission's spring forecast, which projected a 4.0% decline in Euroland GDP in 2009. Indeed, a lot of hard data are still in virtual freefall. Certainly the council members are not carried away by the improved sentiment in April. Mr Weber, president of the German Bundesbank, said in a speech on Monday that he did not expect the German economy to return to growth before the second half of 2010. We thus stick to our expectation that the ECB will cut the refinancing rate by 25bp, which is in line with market expectations (in a Reuters poll all 79 participants expect a 25bp rate cut).

We expect that the ECB will leave the deposit rate unchanged at 0.25%. Some members of the governing council have expressed unwillingness to go to zero interest rates and there may also be practical reasons to keep a positive deposit rate. Nevertheless it cannot be fully ruled out that the ECB will lower the deposit rate to zero. The deposit rate has become more important since the ECB switched to full allotment at a fixed rate on the weekly auctions as it means overnight rates have been falling closer to the deposit rate rather than staying around the refinancing rate.

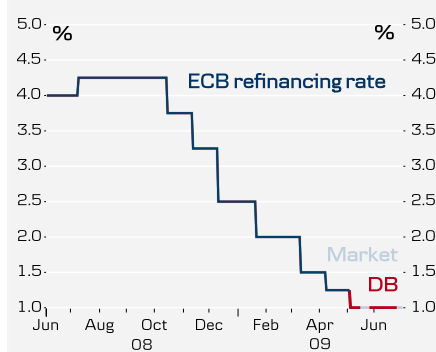
The policy rates are projected to be kept unchanged for a long time. We do not see a rate increase within 12 months. Nevertheless, the ECB will be careful to avoid keeping the policy rates low for too long.

Interest rate expectations (May)

	DB	Con	Last
Refi rate	1.0 %	1.0 %	1.25 %
Deposit rate	0.25 %	0.25 %	0.25 %

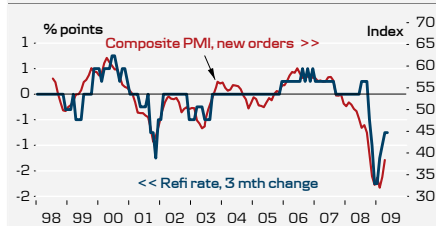
Source: Ecowin

The cutting cycle ends at 1%



Source: Ecowin

ECB's reaction function



Source: Ecowin

Senior Economist
Frank Øland Hansen
0045 4512 85 26
franh@danskebank.dk

A package of non-standard measures

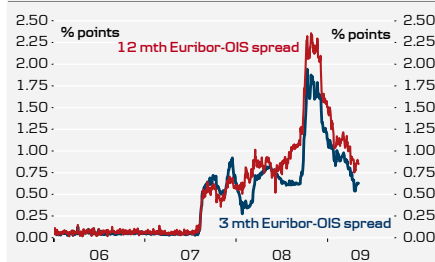
Trichet has promised that at the press conference after this council meeting he will announce a package of non-standard measures that the ECB stands ready to implement. These measures are likely to be focused on easing conditions for banks as banks account for 70% of Euroland lending.

One measure that is likely to be in the package is an expansion of the lending to banks with a 12-month auction (currently the longest is six months). In addition, the package could include some form of quantitative easing. We believe that the ECB will prefer to buy corporate paper rather than government bonds. This will help to bring spreads between rates on corporate papers and government bonds down. We do not know how the ECB will decide what to buy. It will buy in the secondary market (to avoid claims of subsidising specific companies) and will probably prefer papers with a relatively short duration. It is likely that it will buy papers with a relatively low rating as this is where it can have the biggest market impact. On the other hand, we doubt that the ECB is keen to start buying junk bonds. The corporate debt markets vary significantly from country to country with the French market being the largest by far. How the ECB may take account of this will be interesting to see.

The ECB has indicated that it is not pleased with the quality of the collateral that it is receiving. It is possible that it will use this opportunity to modify the collateral requirements.

There is a risk that the ECB will announce the non-standard measures that it has ready to use, but that it will wait and see before it implements them. If hard data then improves, there is a risk that the tools will never get out of the toolbox.

Euribor-OIS spread has improved



Source: Ecwin

Recent comments from ECB members

Axel A. Weber (Germany), May 4

On the economy: “At the moment, I do not expect to see positive (GDP) growth rates in Germany before the second half of next year,” he said. “We should not assume that the rapid weakening of the business cycle will be followed by an equally powerful recovery”

Lucas Papademos (Vice President), May 4

On exit strategy: “We should do what is needed to support recovery, but also pursue credible exit strategy when conditions normalise”

Juergen Stark (Executive board), April 29

On interest rates and non-standard measures: “We will decide about the modest remaining room to manoeuvre in rate policy on May 7. At the same time we will decide on non-standard measures to employ once our interest rate lower limit is reached”

Lorenzo Bini Smaghi (Executive board), April 27

On non-standard measures: “When deciding on (non-standard measures), monetary policymakers have to think ahead and ask themselves: ‘We can get in, but how do we get out?’. They need to consider carefully the timing of their withdrawal of such monetary measures -- for there are risks in doing it too early, and there are risks in leaving too late”

Ewald Nowotny (Austria), April 27

On interest rates and non-standard measures: “We will keep the interest rate very low for as long a time as is required and stand ready to use unconventional measures of quantitative easing to assure European firms and consumers access to credit at appropriate conditions”

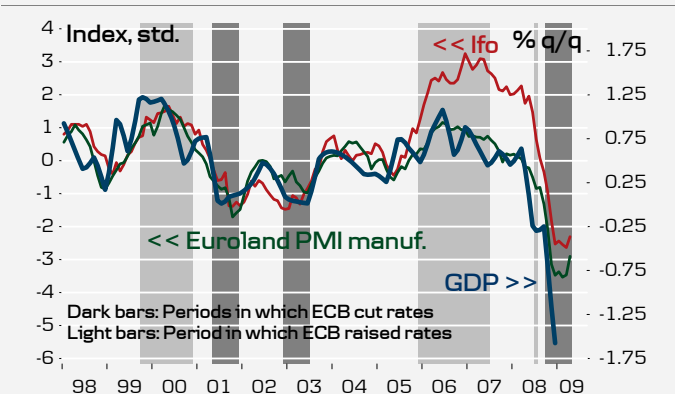
Axel A. Weber (Germany), April 22

On interest rates: “One of the lessons of the past has been that leaving rates too low for too long can contribute to macroeconomic and financial imbalances down the road”

Ewald Nowotny (Austria), April 20

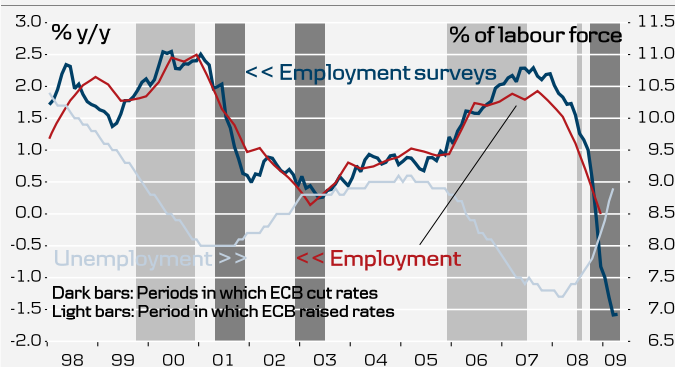
On interest rates “I myself am sceptical of zero rates. One has to look at the whole interest rate picture, not only at the ECB main rate. And here there is the 1 percent limit, one that, in my opinion, should not be crossed”

GDP in freefall, PMI recovering



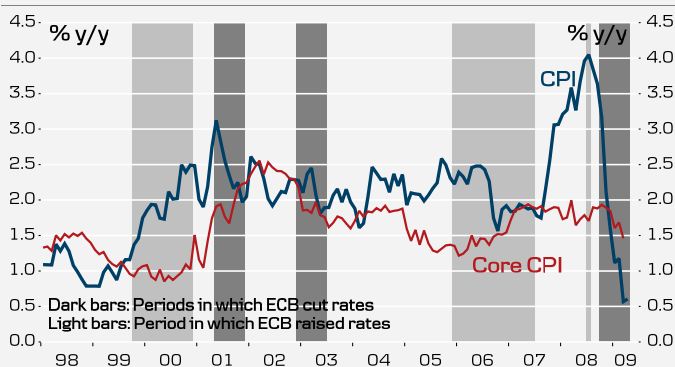
Source: Ecowin

Labour market deteriorating fast



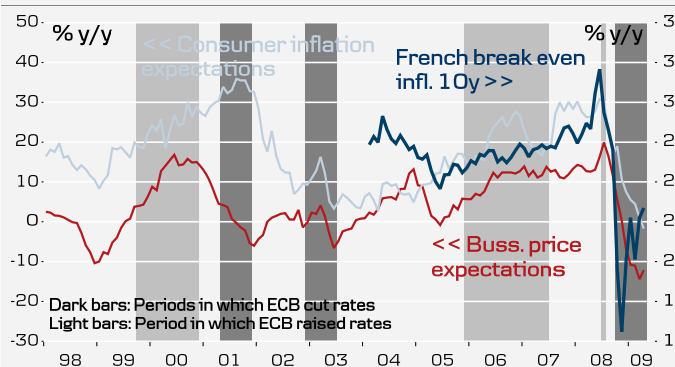
Source: Ecowin

Inflation falling sharply, but core fairly stable



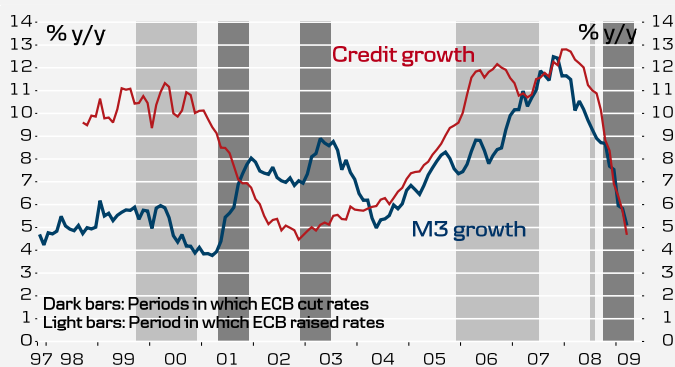
Source: Ecowin

Inflation expectations are low



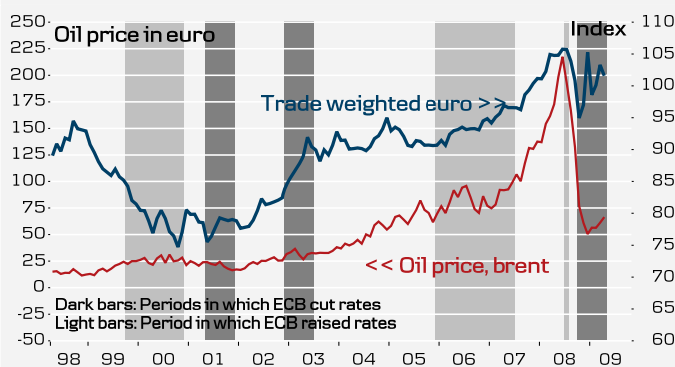
Source: Ecowin

Money and credit growth continues to ease



Source: Ecowin

Oil prices slightly up, EUR looking for direction



Source: Ecowin

Disclosure

This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority. The author of this report is Frank Øland Hansen, Senior Economist.

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish Securities Dealers Association.

Financial models and/or methodology used in this report

Calculations and presentations in this report are based on standard econometric tools and methodology. Documentation can be obtained from the above named authors upon request.

Risk warning

Major risks connected with recommendations or opinions in this report, including a sensitivity analysis of relevant assumptions, are stated throughout the text.

First date of publication

Please see the front page of this research report.

Disclaimer

This publication has been prepared by Danske Markets for information purposes only. It has been prepared independently, solely from publicly available information and does not take into account the views of Danske Bank's internal credit department. It is not an offer or solicitation of any offer to purchase or sell any financial instrument. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank, its affiliates or staff, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives), of any issuer mentioned herein. The Equity and Corporate Bonds analysts are not permitted to invest in securities under coverage in their research sector. This publication is not intended for retail customers in the UK or any person in the US. Danske Markets is a division of Danske Bank A/S. Danske Bank A/S is authorized by the Danish Financial Supervisory Authority and subject to limited regulation by the Financial Services Authority (UK). Details on the extent of our regulation by the Financial Services Authority are available from us on request. Copyright © Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.