For professional investors

BNP PARIBAS
INVESTMENT PARTNERS

No big steps from the ECB

Flash note | 2 August 2012

EUROZONE CRISIS DEEPENED ONCE AGAIN

Over the course of July, the eurozone fiscal crisis worsened once again. The Spanish government announced additional austerity measures, but the accompanying lower growth forecasts showed that the economy is not expected to grow out of recession before 2014. The recession is also taking its toll on the finances of Spanish regions, some of which were losing market access and had to apply for central government help. This does not matter for aggregated Spanish government debt or deficits, but it makes Spanish central government bonds riskier. To make matters worse, capital is fleeing the country. Finally, the Spanish government could in the end still be liable for the debt incurred to recapitalise banks. As a result, Spanish ten-year yields rose as high as 7.6% on 24 July and two-year yields to 6.6%. Yields in Italy also rose sharply. Spain in particular was on the brink of losing market access.

DRAGHI STEPPED ON THE BRAKES…

On 26 July, ECB president Mario Draghi appeared to be drawing a line in the sand. In an informal speech in London, he was unusually clear: "*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.*" Markets were left in the dark though, about which measures the ECB could take. Speculations ran from a policy rate cut or another LTRO (long-term loans to banks) to 'peripheral' bond purchases or giving the ESM (the eurozone's nascent permanent bailout fund) a banking license. Investors eagerly awaited Thursday's ECB news conference for more information.

ONLY TO TAKE HIS FOOT OFF AGAIN AND…

Today, Draghi, who looked nervous during the news conference, did not follow his outspoken words with big actions. He said he was surprised by the attention media and public opinion gave to giving the ESM, the fund which should become operational in September, a banking license. This would not be up to the ECB, but the ECB would decide whether it would be a legal counterparty. Draghi clearly ruled this out.

He was clearest about ECB bond purchases. "*The Governing Council, within its mandate to maintain price stability over the medium term and in observance of its independence in determining monetary policy, may undertake outright open market operations of a size adequate to reach its objective.*" This referred to the ECB's Security Markets Programme (SMP), under which the central bank can buy government bonds in the secondary market to drive down yields. It has been dormant since February. But there is a caveat: Draghi mentioned in the Q&A session that the SMP will be limited and, in contrast to earlier bond purchases, it would target short-maturity bonds. Apparently, the ECB is willing to help finance governments only for shorter terms and will try to keep the pressure on governments to cut fiscal deficits and implement structural reforms. Another drawback of the SMP is that ECB bond holdings are senior to private sector holdings. Thus, if debt is restructured, the private sector will suffer more if the ECB has large bond holdings. This was the case with the Greek debt restructuring. According to Draghi, concerns about seniority will be addressed, although he did not mentioned how.

Draghi referred to the bailout funds, saying, *"Governments must stand ready to activate the EFSF/ESM in the bond market when exceptional financial market circumstances and risks to financial stability exist – with strict and effective conditionality in line with the established guidelines."* Draghi appeared to hint at coordinated buying of bonds by the bailout funds and the ECB. He also said, *"The Governing Council may consider undertaking further non-standard monetary policy measures according to what is required to repair monetary policy transmission. Over the coming weeks, we will design the appropriate modalities for such policy measures."*

DISSAPOINT MARKETS

Draghi's promises clearly disappointed: European equities fell by more than 3.5% during the news conference; Italian and Spanish equities dropped by more than 5%; ten-year bond yields in Italy surged by more than 30bp to 6.2% and the 25bp increase in Spanish yields drove them to close to 7%. Since the SMP will from now on focus on bonds with shorter maturities, two-year yields in Spain and Italy fell. Thus, at least both countries should keep market access.

In our cautious stance on risky assets, including an underweight in equities, the negative market environment created by the eurozone fiscal problems is a dominant factor (although not the only one). We do not see Draghi's announcements as the game changer needed to make us more positive. The announcement of any further non-standard monetary policy measures to be designed over the coming weeks could be more significant, but we are sceptical. Many of the options (more long-term loans to banks, rate cuts, giving the ESM a banking license, coordinated bond-buying by the ECB and the bailout funds) will likely have an insignificant effect, lack consensus within the ECB (and the eurozone) or will take time to implement.

Joost van Leenders, CFA

Investment specialist - allocation & strategy

joost.vanleenders@bnpparibas.com

+31 20 527 5126

BNP PARIBAS
INVESTMENT PARTNERS

DISCLAIMER