July 2nd , 2011

Flash eco

ECB: exit strategy is under way but delayed by the sovereign crisis

On **10 May 2010**, the **European Central Bank announced a series of 3 measures** in order to address the European sovereign crisis including sovereign bond purchases, new refinancing operations (3-month maturity) and liquidity swap lines with the Federal Reserve.

New initiative	1. The Securities Market Programme (SMP) which consists in buying **private and public** debt "in the market segments which are dysfunctional" and the scope of which is yet to be determined by the Governing Council.
Re-instated initaitives (quantitative easing)	2. The next 2 three-month liquidity operations in the framework of the LTRO (Longer Term Refinancing Operations) will be done at **fixed rate** (26th of May and 30th of June, knowing that a LTRO amounting to € 442.2 bn is due on the 1st of July according to the ECB's tender operations).
	3. The 6-month liquidity operation will be done at the **minimum bid rate** of the Main Refinancing Operations (MRO) on the 12th of May
Re-established operation	**4. Liquidity Swap lines with the Federal Reserve** (the ones that ran during 2007 and 2008) are to be re-established, mainly to ease fears of dollar shortage however.

Purchase of sovereign bonds

The share of euro area government securities held outside repo operations is very low in the euro area (under 2 % in April 2010), which is a lot different from the situation in the United States (close to 90% before the crisis and 33% in end April - 90 % including MBS and Agency debt). However, the ECB **seeks to sterilize its purchases of public debt on the secondary market** through reverse repo operations. Those operations intend to offset the liquidity the ECB injects in the market by buying government bonds. The sterilization means that the ECB – unlike the Federal Reserve last year – has not entered a process in which it monetizes debt so that it is aimed to give confidence to investors and support to the euro exchange rate.

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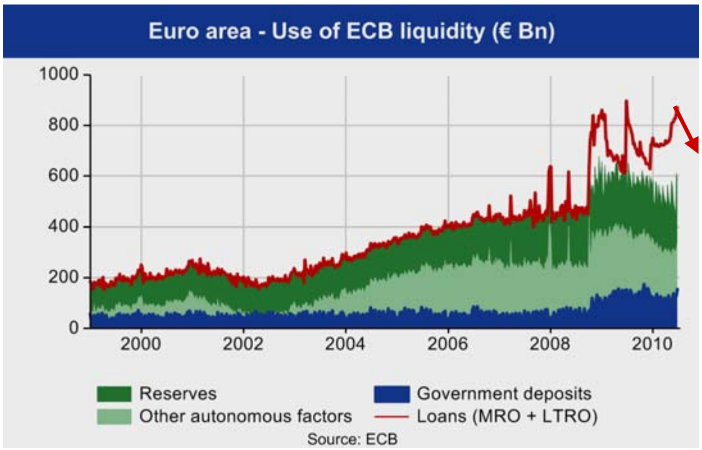
As of 28 June 2010, the size of the Securities Markets Programme reached an amount of € 55 bn (after € 51 bn the week before). However, on 29 June, the ECB managed to absorb only € 32 bn. It is the first time that the ECB does not manage to fulfil its commitment to fully sterilize the programme.

Refinancing operations

On **10 June 2010**, the Governing Council of the European Central Bank decided to adopt a **fixed rate tender procedure with full allotment** in the regular **three-month longer-term refinancing operations** to be allotted on **28 July**, **25 August** and **29 September** 2010. This decision was taken in order to address possible tensions in the money market during the 3rd quarter, due to the withdrawal of € 442 Bn on the 1st of July (12-month LTRO).

On 25 June 2010, the **excess reserves** – which can be proxied by the deposit facility outstanding – stand at around € 285 Bn. Given the different MRO (7 days), LTRO (3 months, 12 months) and OT (fine-tuning operations) that expired and were settled since the beginning of the week, the outstanding excess reserves could diminish down to around € 115 Bn. On 2 July 2010, the deposit facility has decreased to € 212 Bn.



		€ Bn
	Liquidity injections as of 25/06/2010 :	870.354
Settlement date	MRO 7j 30/06 -> 07/07	163
	OT 7j 30/06 -> 07/07	-32
	LTRO 3M 01/07 -> 30/09	132
	OT 6j 01/07 -> 07/07	111
Maturity date	MRO 7j 23/06 -> 30/06	151
	OT 7j 23/06 -> 30/06	-51
	LTRO 12M 25/06/09 -> 01/07	442
	LTRO 3M 01/04/10 -> 01/07	2
	Liquidity injections as of 02/07/2010 :	700.354

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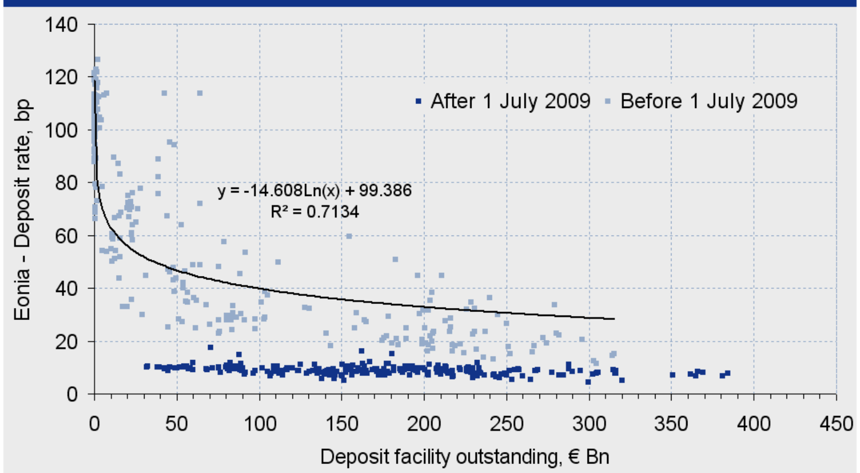
According to **SG Fixed Income Research**, the spread between Eonia and Deposit rate evolves differently depending on the duration of the liquidity injections.

- When the ECB decided to offer a 12-month refinancing operation on 1 July 2009, the spread has entered an inelastic regime and was globally unchanged (around 10 bp) whatever the amount of the deposit facility was;
- Before 1 July 2009, the regime was elastic that is to say that the spread was increasing if the amount of excess reserves was reduced.

Now that the 12 months LTRO expired on 1 July 2010, the outstanding ECB loans have a remaining shorter maturity so that **the probability is currently high that we switch back to the former regime of higher and more volatile EONIA fixings.**

2 regimes for Eonia
Source: SG Fixed Income Research



Deposit Facility Outstanding	EONIA-depo spread (bp)	EONIA (%)
€5bn	75.9	1.01
€10bn	65.7	0.91
€25bn	52.4	0.77
€50bn	42.2	0.67
€75bn	36.3	0.61
€100bn	32.1	0.57
€125bn	28.9	0.54
€150bn	26.2	0.51
€200bn	22.0	0.47

Source: SG Cross Asset Research

To conclude, excess reserves have started to diminish so that the exit strategy is under way. For the Eonia, the probability of switching to the old 'elastic' regime is very high. Provided that the ECB continues to exit from quantitative easing by draining excess reserves from the financial system, Eonia will tend to move closer to the refinancing rate (1%). However, given the sovereign crisis, the ECB is cautious and decided to add new refinancing operations until October so that the exit strategy is delayed.

These evolutions appear to be consistent with our macroeconomic scenario in which the ECB will not hike the refi rate until the end of 2011. Indeed, the ECB has first to remove excess liquidity from the financial system and regain control over the Eonia before hiking rates.

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