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TRENDMACRO LIVE!

On the November ECB Rate Decision

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Lorcan Roche Kelly

Draghi starts to unwind Trichet's errors, and keeps Europe's debt safety net in place.

In a very welcome move that surprised many market participants, Mario Draghi, in his first ECB monetary policy meeting as president, announced a 25 bp cut in key ECB interest rates. We had expected this rate cut (see "On ECB and BOE October Rate Decisions" October 6, 2011), and are glad to see that Draghi did not allow German sensitivities to stay his hand.

Further good news came at the press conference when Draghi did not signal an end to the Securities Markets Programme (SMP) under which the ECB purchases sovereign debt in the secondary market. He said the SMP is "temporary, limited and justified" in order to facilitate transmission of monetary policy." Until other support mechanisms such as the European Financial Stability Mechanism (EFSF) become fully operational, the SMP is the critical first responder in fighting flare-ups in the markets for Italian and Spanish debt (please see the chart below).

- Draghi is repeating the flimsy rationale for the dubiously lawful -- yet absolutely critical -- SMP that has been offered many times by his predecessor Jean-Claude Trichet.
- But in fact, it is clear to us that the financial crisis in the Euro area

Update to strategic view

ECB: Draghi's first meeting as ECB president produces a rate cut and reassures there will be no sudden shutdown of the SMP, which is now critical support for Italian and Spanish debt. This is a welcome reversal of Trichet's catastrophic hawkish errors, and may point toward a more dovish framework for the ECB going forward.

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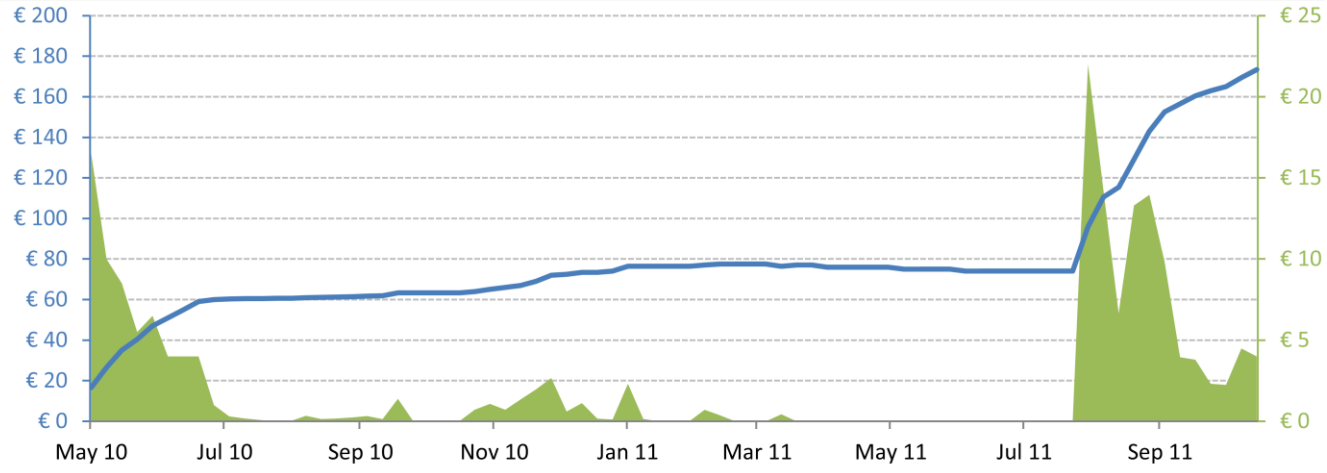
ECB Securities Market Programme purchases — **Cumulative** ■ **Weekly**
€ billions



Source: ECB

has indeed seriously impaired the effectiveness of the transmission channels for monetary policy. The ECB does play a monetary policy role, acting as a kind of quantitative easing, even though the purchases are putatively sterilized.

- So it legitimately remains up to the ECB to decide when those channels are again working properly. So it is solely up to the ECB to decide when it stops the SMP -- or when, as may be more likely, it transforms it into a more full-bodied QE. Draghi emphasized this point saying "We are not forced by anybody, we are independent," when pushed by journalists on the SMP.

After eight years of Trichet, we had become used to the coded signals he sent at monetary policy press conferences to point to future interest rate decisions. Draghi has yet to develop his own codebook. But he said that the risks were all to the downside, and that inflation would be on target in the medium term. It seems that Draghi feels he has room for further rate cuts in the near term.

- Completing next month the unwind of Trichet's catastrophically ill-advised rate hikes of April and July (see "EUicide" April 7, 2011) would be a large positive for Europe. Longer term, it may even be a welcome pointer toward a less dogmatically hawkish policy framework.

Today also saw the ECB release clarification on how the previously announced Covered Bond Purchase Programme (CBPP2) will work (again, see "On ECB and BOE October Rate Decisions"). The program will be €40 billon in size, there are two major differences between this CBPP and the original in 2009.

- First, the original CBPP accepted bonds rated AA by at least one of the major ratings agencies (Fitch, Moody's, S&P or DBRS). The new CBPP has a ratings threshold of BBB- from one of the ratings agency. So the CBPP2 will literally be buying junk.
- Second, there is a line in the CBPP2 release that was not in the original CBPP release:

> Furthermore, the Governing Council has decided to make its CBPP2 portfolio available for lending. This decision will be implemented by the Eurosystem. Lending will be voluntary and conducted through security lending facilities offered by central securities depositories, or via matched repo transactions with eligible counterparties.

- We've learned over the years what seem to be mere technical footnotes can in fact be quite significant, where the ECB is concerned. In this case, our antennae are detecting a possible mechanism through which the ECB could lend eligible collateral to banks that have otherwise run out of it. If that's right, then this would put yet another safety net in place to assure the funding of

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Europe's banks through emergencies that may arise as the ongoing debt crisis plays out.

Bottom line

Draghi's first meeting as ECB president produces a rate cut and reassures there will be no sudden shutdown of the SMP, which is now critical support for Italian and Spanish debt. This is a welcome reversal of Trichet's catastrophic hawkish errors, and may point toward a more dovish framework for the ECB going forward.