



3 August 2011

Data Flash (Euroland)

ECB: to intervene or not to intervene

The bond market seems to be stabilizing this morning in Italy and Spain, but the situation remains very fragile. We describe here what kind of contingency plans the European partners could come up with if market conditions deteriorate further. The ECB will be alone in its capacity to respond before EFSF 2.0 is enforceable, which is unlikely to occur before the end of September at best. We believe we could see a three-step approach by the central bank: first, verbal intervention ("ready to use any available instrument in our arsenal") tomorrow; if that is not enough, reinstatement of the one-year LTRO (long-term refinancing operation), with possibly some tweaking of the conditions; and then, as last resort, re-starting SMP (Securities Markets Programme).

1. *Stabilization as best case scenario for the coming few weeks*

It is now clear that the relief brought about by the Euroland leaders' new package announced on July 21st – which we still consider meaningful and well balanced – has been entirely lost after steep market action on the Italian and Spanish sovereigns on Monday and Tuesday. In a best-case scenario, market participants would not push further:

- a) the new valuations would probably attract some buying from domestic institutional investors;
- b) the more speculative participants would probably start to factor in their own decision-making process a higher probability of ECB intervention, engineering short squeezes;
- c) we expect the market pressure to elicit some response from the struggling countries, even in a limited way, potentially with more front-loading of fiscal austerity in Italy (see Marco Stringa's note on today's speech to parliament by Italian PM) and the announcement on 19 August of corrective measures to prevent slippage in the fiscal targets in Spain (the Spanish press mentioned acceleration in the collection of corporate tax and additional cuts in healthcare spending).

Then Italy would probably settle a little over 6% on a 10-year, Spain 20 to 30 bps higher, and the current state of affairs could persist until the end of September with the completion of the parliamentary process, when EFSF 2.0 is enforceable. With this new capacity to intervene in a more flexible manner, the risk premium on Spain and Italy could then start declining.

2. *What could derail this fairly benign scenario?*

First, the macro environment could continue to deteriorate. This morning's release of the services PMIs was a mixed bag: Italy came out better than expected at 48.6 (market consensus at 47.0) and improved from June (47.4). Even if that is below the expansion threshold for the second month in a row, the market apparently reacted positively. Conversely, the Spanish print was outright disappointing, below expectations at 46.5 (market consensus at 50.0), back to its lowest level since December 2010. A continuation of the series of bad macro news would probably raise market concerns about a self-reinforcing spiral jeopardizing long-term debt sustainability in the peripherals.

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Second, contagion can start affecting “core core” and particularly France, which is now displaying a spread (on a 10-year) just south of 80 bps. France being put under “negative watch” could be catalyst. We think the immediate risk is contained. The first crucial step for such a move from the rating agencies, in our view, depends on the outcome of the parliamentary process on the incorporation in the Constitution of a fiscal rule. The reform at this stage looks likely to fail, unless enough socialist MPs dissent from their party’s line.

More broadly, we think these two risks should not be overstated. First, we reiterate our view that it takes more than a few months of market action to jeopardize debt sustainability. For instance, the Italian sovereign will have to roll over EUR 202bn in bonds, only one-seventh of the outstanding amount in circulation, which means that the recent increase in interest rates would result in higher interest payments of only 0.15% of GDP in one year. Second, the fate of the French constitutional reform may not be known before October (the President still has not decided to summon a meeting of the “congress”, i.e. the reunion of the two houses of parliament). By that time, the EFSF 2.0 will be enforceable. In addition, France, which has so far opted for a fairly slow pace of fiscal consolidation, could react quite forcefully to prevent a negative watch from morphing into outright downgrade. However, we recognize that market dynamics have accelerated noticeably over the last few weeks, and that contingent planning is probably needed in the European institutions.

3. What are the ECB’s options?

The governments went as far as they could, technically and politically. From their point of view, the timeline is now incompressible (if only because the German parliament likely wants to await the Constitutional Court ruling – due around mid-September – before enacting any new legislation). Speeding up the implementation of EFSF 2.0 is therefore unlikely. This leaves the ECB alone in being able to respond to any further deterioration in market conditions.

Whatever happens, the ECB’s balance sheet will probably be put at further risk. Indeed, as a mechanical reaction to the increase in long-term sovereign rates, margin calls at LCH Clearenet will probably push Spanish and Italian banks back to the ECB refinancing, using local sovereign bonds as collateral (good carry).

The ECB would have three options, in our view:

- a) Doing nothing. By simply maintaining the current LTROs and MROs in their present conditions, the ECB allows for indirect financing of the governments (via banks). However, this cannot last forever: if interest rates continue to rise, the central banks will have to trigger margin calls, which at some point will significantly erode the profitability of the peripherals’ banks. The Greek, Irish and Portuguese experiences are not very encouraging from that point of view.
- b) Embrace indirect financing of governments by reinstating the 12-month LTRO. In Focus Europe eight months ago (“What is Plan B”, 3 December 2010) we proposed a way to make a one-year LTROP more powerful by targeting weakish sovereigns by accepting as collateral only non-AAA government bonds, which could be complemented by a “margin call holiday” protecting banks against further declines in the value of the collateral throughout the lifetime of the repo.
- c) Move to the “shock and awe” approach, re-start SMP and purchase bonds on the secondary market.

4. How to choose between one-year LTROs and SMP?

Assuming the ECB rules out inaction, how to choose between b and c?

The extreme version of the one-year LTRO (no margin call) is almost identical to SMP, as the risk brought about by gyrations in the price of collateral is ultimately borne by the central. However, two substantial differences remain:

First, by construction, reinstating one-year LTROs is transitory, as the collateral will go back to banks after one year, whereas with SMP the central bank can be stuck with large amounts

of government bonds indefinitely (it may never be “the right moment to sell”). The difference may be thin, but politically one-year LTROs may therefore be more “sellable” to the most conservative members of the Governing Council as the central bank could maintain the premise that it is not monetizing debt.

Second, playing in the opposite direction, would be convincing the conservative members of the Governing Councils to opt for SMP rather than for one-year LTRO, as with SMP the central bank can more easily control the size of its exposure to any particular sovereign, while in full allotment LTROs the ECB would have to take all the collateral its counterparts would choose to use, with no possibility to choose across signatures.

The ECB’s stance against SMP could be lifted by putting in place a guarantee of its interventions by the EFSF. There are three issues, however:

First, it is not in the Eurogroup’s statement of 21st July and would probably make another Euroland summit necessary. This, though, is only a technical problem that could easily be circumvented by a “flash meeting” or video conference.

Second, there would be a problem of time consistency for the ECB (intervention now but parliamentary endorsement of the new deal only later). However, given the gravity of the situation, the ECB could probably accept taking that risk, if the governments agreed to pledge such a guarantee, and in the case of Italy and Spain commit to additional efforts (for instance with Spain announcing that it would use EFSF support to recapitalise banks once the new system is in place). That would still require a significant coordination effort.

Third, the ECB’s capacity to turn the market around would be limited by the finite nature of the guarantee – but this will also apply to EFSF 2.0’s interventions.

5. *What is a possible timeline?*

First, the ECB could try “verbal intervention” without being specific. For instance, Jean-Claude Trichet tomorrow could repeat in his usual “read my lips” approach that the central bank is “always ready to use any instrument in our arsenal” to safeguard financial stability in the Euro area. This could apply to both SMP and one-year LTRO.

Second, if that is not enough, on balance we think that the ECB would probably prefer to go first for LTRO-type intervention (reinstatement of the 12-month), and could well shy away from going the whole way and decline to declare a margin call holiday. The prudence of the ECB could for instance be explained by its reluctance to embark into another form of non-conditional support – which could be seen as a moral hazard in the Italian case, given the difficulty in eliciting bold political responses there is a significant issue.

Third, if the first two approaches fail, the ECB may then have to opt for outright SMP (it would probably be too late to tweak the 12-month LTRO by declaring a margin call holiday) and could even have to do so in an emergency fashion, i.e. without explicit support from the EFSF.

In a nutshell, we think that technically it would probably be more fruitful to move to SMP directly, but the political realities may instead impose a series of gradual half-steps. Even after the relief triggered by today’s announcement, public debt prospects in Greece remain daunting, in our opinion. However, the combination of lower interest rates and – modest – debt reduction gives the Greek authorities a fighting chance to balance their public finances in the next few years.

Appendix 1

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