

Friday, 04 December 2009

# Flash Notes

## ECB

- **Keeps Interest Rates Unchanged**
- **Outlines its First Exit Strategy Steps**

The European Central Bank kept key interest rates unchanged, as widely expected – the refinancing rate at a record low of 1.00%, the marginal lending rate at 1.75% and the deposit rate at 0.25%. At the press conference, ECB President Jean-Claude Trichet highlighted that “the current rates are appropriate”.

The Bank has also decided to continue conducting its main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as is needed – and at least until the third maintenance period of 2010 ends on 13 April. This tender procedure will also continue to be used in the special-term refinancing operations with a maturity of one maintenance period, which will continue for at least the first three maintenance periods of 2010, according to the press release.

The Governing Council has also decided that the rate in the last 12-month longer-term refinancing operation, to be allotted on 16 December 2009, will be fixed at the average minimum bid rate of the MROs over the life of this operation. And with regards to longer-term refinancing operations in the first quarter of 2010, the Governing Council has decided to carry out the last six-month longer-term refinancing operation on 31 March 2010. This operation will be carried out using a full allotment fixed rate tender procedure, as will the regular monthly three-month longer-term refinancing operations already announced for the first quarter of 2010.

These announcements (which amount to an incipient exit strategy from the ECB’s unconventional policy measures due to the crisis) had been partially signaled by Trichet and other ECB officials in recent weeks. Yet, wires reported that some members of the ECB’s Governing Council were against indexing the rate, fearing it would add to market expectations of policy-tightening. Yesterday, Trichet indicated that the decision was not unanimous and was reached “by consensus”.

Markets had expected the ECB to leave the rate on its 12-month tender fixed at 1.0%. That would mean that any increase in the benchmark rate next year could prove less effective because banks would have had money at 1.0% through the end of next year. However, the move (of setting the rate on the loans to the average of the benchmark rate over the year) implies that future movements in interest rates will now be reflected in banks’ funding costs.

	End 4Q09	End 1Q10	End 2Q10	End 3Q10
ECB Refinancing Rate	1.00	1.00	1.00	1.50
EUR/USD	1.500	1.525	1.530	1.540
Source: UOB				

Trichet also released the ECB's new staff projections. Annual real GDP growth is expected to come in within the range of -4.1% and -3.9% for this year (previous -4.4% and -3.8%), while a range between +0.1% and +1.5% is expected for 2010 and a range of 0.2% and +2.2% is expected in 2011 (previous -0.5% and +0.9%). Meanwhile, annual HICP inflation is expected to come in at 0.3% for this year (previous 0.2% to 0.6%); between 0.9% and 1.7% in 2010 (previous range 0.8% and 1.6%) and between 0.8% and 2.0% in 2011.

Trichet's comments were a tad more hawkish and we get the sense that the ECB is withdrawing its unconventional policy measures at a slightly faster pace (than our expectations). That said, Trichet acknowledged that "the recovery process is likely to be uneven and that the outlook remains subject to high uncertainty".

Cautiously optimistic, we maintain our view that the ECB's initial focus will be upon unwinding some of these liquidity measures rather than setting the stage for rate hikes. Nonetheless, we look for the ECB to lead the G10 nations in the rate hike process some time in the middle of 2010. This should provide substantial support for the Euro, and should drive some dollar weakness, though our view is for the dollar's pace of decline to slow going forward. Our projection is for the EUR/USD to trade comfortably around the 1.530-level by the middle of next year.

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