Market Musings

TD Securities

May 10, 2010

Highlights

- European leaders reach headline agreement on €720bn package to alleviate sovereign risk.
- The ECB has also pledged extra liquidity provision measures, including renewal of USD swap lines and 3- and 6-month LTROs, as well as their first ever pledge to purchase any euro area public or private debt security that becomes "dysfunctional."
- There are still a number of details to be worked out in the coming days, in particular the pledges of €440bn in guarantees and the ECB pledge to purchase debt.
- Even if some portion of the financing package were slow to materialize, this does appear to provide sufficient liquidity to ensure the Eurozone members, excluding Greece, that have debt dynamics that are sustainable but not wonderful, can secure financing.

EUROPEAN UNION AGREES TO EMERGENCY FINANCING FACILITY

Shock and awe is alive and well as the European Union came to agreement over the weekend on an emergency financing facility. Much of the details with regards to modalities will still need to be worked out, and given the possibility of some disagreements to come to the fore in the coming days, we would take a somewhat cautious view to the overall package.

The package consists of three main fiscal financing measures which total €720bn, with an additional pledge for accelerated deficit reduction plans in at-risk economies, meant to reduce the chance the funding is needed. This includes:

- European Commission (EC) loans of €60bn
- Eurozone (and Sweden and Poland) debt guarantees of additional €440bn in EC issuance
- IMF financing of up to €220bn

The ECB will also provide indeterminate liquidity support through three main tools:

- Direct purchases of government and private sector debt which become "dysfunctional"
- Reintroducing the USD swap lines in coordination with other central banks
- 3-month fixed rate full allotment tenders and 6-month average minimum bid full allotment tenders

From these, we are left with three main questions.

- What will determine how and when government guarantees are triggered? There is political risk here given these generally require parliamentary approvals and there is no indication as to how easy these will be to tap.
- How willing will the ECB be to engage in direct debt purchases? The body is able, but is the Governing Council willing? This is not quantitative easing as purchases will be sterilized, meaning any cash used to buy debt securities will be offset with operations to remove cash elsewhere in the economy to leave net liquidity unchanged. The description is left as vague as possible so could be quite powerful, but this would be the one tool we will remain sceptical on until we hear more on how it will be implemented.
- Will further monetary easing be needed? Right now, European leaders and ECB are looking to ensure that they can make the market in sovereign debt issuance should the need arise. If implemented fully, this can alleviate the financing constraints and prevent contagion and second round effects. But there is now a risk that monetary easing may be needed if these measures are not fully effective or if European leaders become overzealous in supporting a strong euro.

Richard Kelly +44 020 7786 8448

Emergency Financing Facility for Europe

Overview

The European Union came to agreement over the weekend on an emergency financing facility that appears to go a long way towards allowing European leaders to put their money where their mouth is. Much of the details with regards to modalities will still need to be worked out, and given the possibility of some disagreements to come to the fore in the coming days, we would still take a somewhat cautious view to the package in its entirety.

But with the large size and various components, we generally feel that even if only a part of the package is able to be mobilized immediately, it would still represent a large step forward. The difference between the 2007/08 crisis and the current one is that as long as Eurozone members are able to raise the financing they need to meet their deficits, it is possible to avoid any second-round effects on the economy. This assumes member's debt dynamics are sustainable, which we do believe to be the case for all but Greece.

The package can be divided into fiscal measures coming from governments and liquidity provision measures provided by the ECB.

Fiscal Measures

The total amount of the financing package is currently estimated at €720bn. This is in addition to the €110bn joint EC-IMF package provided to Greece. This will be comprised by the following three financing components. In addition to these financing measures, there are also early pledges that we will hear details on accelerated deficit reduction plans from those members most at risk.

1. European Commission Loans - €60bn

The European Commission will expand its existing balance of payments facility from €50bn to €110bn, in which it will borrow in the market to provide financing to Eurozone members who present a financing need. There have been conflicting reports as to exactly how much of this is new money, but the overwhelming share does appear to be new.

2. Government Guarantees of EC Issuance - €440bn

The bulk of the financing package comes in the form of national government guarantees of debt that will still be raised in the market by the European Commission. In effect, this is the EC taking the first big step towards a "Euro-ization" of national government debt that we called for last week (https://www.tdsresearch.com/currency-rates/viewFile.action?fileKey=J29MY5WX816TED973MHXTTCVN). If a member state now finds the market unwilling to finance their borrowing, they can effectively remove the target from their debt by issuing under the umbrella of the European Commission. If implemented, this can effectively fill the financing need of any member. At present, these guarantees will be provided by Eurozone members, as well as Sweden and Poland, which have voluntarily pledged to provide assistance. The UK was quite adamant that it not be forced to provide funding, so while it will help contribute to the €60bn in direct EC loans, it would not provide any government guarantees or be held liable for any Eurozone member's debt obligations.

3. IMF Financing – Up to €220bn

The remainder of the pledged financing would come from the IMF. It is odd to have the IMF promising some level of up-front financing without any particular country being named as the beneficiary. As in Greece, the IMF would likely be brought in to create the technical expertise and benchmarks on fiscal and structural adjustments and provide the minority share of the financing.

Liquidity Provision Measures

In addition to the fiscal support provided from governments, the ECB has pledged to provide the liquidity support needed to "address the severe tensions in certain market segments which are hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy oriented towards price stability in the medium term." None of these measures can have any effect on the overall need for fiscal adjustment, but are meant to ensure financing constraints and a drying up of liquidity do not lead to second-round effects of broader national and global crises and a contractionary impact on the economy.

1. Securities Market Program (Debt Purchases)

The ECB has now moved from not having discussed the direct purchase of member's debt in Thursday's Governing Council meeting to implementing it as of today, also consistent with our previous belief that this step was only a matter of time. The details are very vague with regards to this new tool. The scope of eligible securities has been defined very broadly to include all euro area public and private debt securities markets. The ultimate size is left up to the Governing Council, though, and the trigger will be to "ensure depth and liquidity in those market segments which are dysfunctional." There is no indication that this is a tool the ECB intends to use immediately.

But the ECB is not back-stepping at all when it comes to the stance of monetary policy. These debt purchases do not usher in the era of quantitative easing for the Eurozone. While the ECB could now purchase member governments' debts in the secondary market, these purchases will be sterilized. This means the ECB is not interested in injecting new cash into the economy. Rather any cash they use to purchase debt securities will be taken out of cash markets elsewhere. The use of this facility is not to ease monetary policy and overall liquidity but to move a part of aggregate liquidity into a market (government debt) that private markets are seen to be neglecting.

It is not clear yet what tool the ECB plans to use in order to actually withdraw cash from the economy. This would typically be done in shorter-term cash markets, meaning reverse repos or bill issuance, rather than actually selling bonds, but the ECB has no past experience with sterilization to draw on. Reverse repos would likely have the undue impact of pushing up EONIA rates and impacting borrowing for all banks while ECB bill issuance would likely put upward pressure on German short-term rates as the ECB bills would become the risk-free short-term asset.

2. USD Swap Lines Reopened

The ECB, in cooperation with other central banks, is reintroducing the temporary 7- and 84-day USD swap lines. The first fixed rate full allotment auction will take place this Tuesday, May 11th, with an initial indication these will run through January 2011. This should be sufficient to nip in the bud any of the fledgling USD funding issues that emerged last week.

3. Broadening LTRO tenders

To also help address any near-term financing constraints in the domestic banking sectors, the ECB will hold fixed rate full allotment 3-month LTROs on May 26th and June 30th and a 6-month tender at full allotment but at the average minimum bid rate over the next six months, to be held this Wednesday, May 12th.

The 1-month and 1-week full allotment tenders remain in place through September and interest rates were unlikely to rise over that period so this is more an easy step to take than one that provides significant new liquidity. As with the swap lines, this provides direct liquidity support to the private sector without directly financing any debt issuance. It also failed to force the ECB's hand on future monetary policy. With a fixed-rate 3-month auction on June 30th implies limited chance of an interest rate change through September while leaving the 6-month auction at the average minimum bid rate, the ECB can still leave the possibility of an interest rate hike in the market before year end. We feel there is still a vocal hawkish contingent in the ECB that is intent on removing liquidity, not expanding it.

Remaining Concerns

The broad provision of liquidity and direct fiscal support is impressive. Even if part of it becomes held up due to implementation delays or lack of parliamentary approval, it does seem to provide more than enough financing take any future member out of the market that should happen to find themselves short of market financing. Our initial concerns and areas we look for further clarification are as follows:

1. **What will determine how and when the government guarantees are triggered?** Must the member show they have no market willingness to finance their deficits or is there a level of interest rates that is considered too usurious? The guarantees would generally require parliamentary approval in order to go forward, which raises the usual political risk, as well. Showing that German Chancellor Angela Merkel's domestic political concerns were founded, Sunday's exit polls showed the opposition had won in the North Rhine-Westphalia elections. This means Merkel's coalition has lost its majority in the Bundesrat, the upper house of the German Parliament and could increase the domestic intransigence among German politicians to contribute.
2. **How willing with the ECB be to engage in debt purchases in the secondary market?** At the press conference last week, Trichet said the Governing Council had not even discussed the option of debt purchases. This weekend's announcement provides no guidelines as to the amount of debt that will be purchased nor again the triggers to start it. It is worded in a vague fashion to effectively cover any public or private debt instrument that is deemed "dysfunctional." This is the area we think could hold the most disappointment. In the heat of the credit crunch, the ECB did everything it could to avoid the direct purchases of debt. Even though this money is being sterilized, there is broad distaste among many ECB and Eurozone leaders for anything that blends monetary and fiscal policy.
3. **Nothing on monetary easing yet, but it could happen.** We still hold a base case for an economic recovery that is accelerating into mid-year. Nevertheless, while there was almost no chance for further easing of monetary policy from the ECB, we must now acknowledge that there is a non-negligible risk that either lower interest rates or unsterilized debt purchases may be needed by year end. This could particularly

be the case if European leaders place too much attention on keeping the euro strong. The Eurozone needs a weaker currency and we think anything in the 1.30-1.35 range keeps the ECB at risk of having to lower interest rates in three to six months due to a weak economy that has too little external demand to offset the accelerated fiscal adjustment.