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The ECB's Exit Strategy Needs to Remain Flexible

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Recent comments suggest that the ECB is keen to push ahead with its exit strategy. But the environment is still very fluid and any reversal of the recent flow of positive news could lead to a rapid deterioration in financing conditions for Europe's governments and their banks.

Although it warned against complacency at its latest press conference, the European Central Bank (ECB) is clearly satisfied with recent developments. The latest economic data have been unambiguously positive, the sovereign debt crisis has faded—at least for now—and the ECB has been able to wind down its controversial bond-purchase program. If the economic and financial backdrop remains benign, the ECB is likely to continue exiting from its unconventional policy measures.

It has already made significant progress. Since the expiry of the huge €442 billion 12-month refinancing operation at the beginning of July, the euro-area banking system has dramatically reduced its reliance on central-bank funding. There are several ways of illustrating this. For example, the outstanding amount of refinancing operations has fallen to €597 billion from an average €842 billion in June. Excess reserves, as measured by the amount of cash on overnight deposit at the ECB, have also fallen sharply. Adjusting for normal fluctuations associated with the

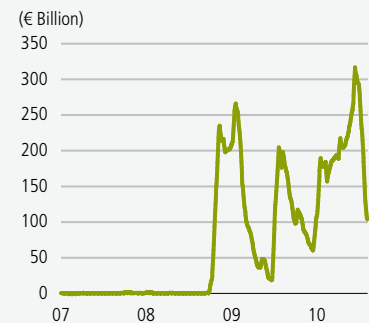
monthly reserve-maintenance period, we estimate that excess liquidity now stands at about €100 billion compared with a peak of around €300 billion (**Display 1**).

This reduction in liquidity, combined with the ECB's earlier move to phase out six- and 12-month refinancing operations, has pushed money-market rates higher. The impact on overnight rates has been modest. Since the beginning of July, the overnight rate has averaged 0.46%, 10 basis points higher than the average during the first half of the year but still well below the refinancing rate (1.0%). The impact on longer-term rates has been more noteworthy, with the three-month interbank rate having risen by over 20 basis points to 0.90% (**Display 2**).

Throughout the financial crisis, the ECB has drawn a clear distinction between liquidity support and monetary policy. The recent increase in money-market rates fits into the former category. Indeed, it is important to remember that the reduction in excess reserves has been driven by lower

Display 1
Excess Liquidity Starts to Fall

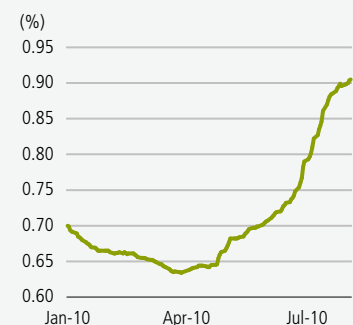
Use of ECB Deposit Facility (28-Day Moving Average)



Source: ECB and AllianceBernstein

Display 2
Term Interbank Rates Start to Rise

Three-Month Money-Market Interest Rate



Source: Bloomberg and AllianceBernstein

demand from the banks, rather than an ECB-induced contraction in supply. (Even so, the resulting increase in money-market rates will eventually feed through into higher bank lending rates.)

At this week's press conference, President Trichet took a relaxed view of the increase in money-market interest rates, describing it as part of the progressive normalization of the interbank market. In light of these comments, it is reasonable to conclude that the ECB will soon seek to phase out the rest of its unconventional liquidity-support measures. Foremost amongst these is its guarantee to satisfy all bids in full at upcoming refinancing operations (until the middle of October for the main refinancing operation and at the next two longer-term refinancing operations in August and September).

Once the ECB starts rationing funds at its refinancing operations, the interbank rate is likely to gradually reattach itself to the refinancing rate. Importantly, this would restore the effectiveness of the refinancing rate, preparing the way for an eventual tightening of monetary policy.

This is still a distant prospect. Once there is clear evidence that the euro-area economy is on a sustainable recovery path, we have little doubt that the ECB will be quick to raise interest rates. But even though the manufacturing sector is currently firing on all cylinders, the recovery in the broader economy is still in its infancy and faces a number of important hurdles.

One of these hurdles is the sovereign debt crisis itself. Although the news from the periphery has been good and financing conditions have improved, the situation is still fluid and sentiment remains fragile. Any reversal of the recent flow of positive news could lead to a rapid deterioration in sentiment towards Europe's governments and their banks. The ECB's desire to pursue its exit strategy and restore normal money-market conditions is understandable. But it needs to remain flexible.

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