

European Central Bank, Bank of England Meetings Previews and Currency Implications

The European Central Bank and Bank of England regular monetary policy meetings will take centre stage in Europe this week and while overall, we expect no change in rates or on the QE front from neither, we would argue that **if anything, the risk remains tilted towards fresh monetary easing measures** (non-conventional). Indeed, whether it is at the European Central Bank or at the Bank of England, **exit strategy remains a distant prospect** and we remain at a stage of the post crisis cycle at which the case for additional monetary policy measures **is reasonable, but not overwhelming**. On the other hand, talking exit strategy is premature considering the contracting economic environment still prevailing in the UK and the euro zone.

The European Central Bank:

Policy Options:

i) Rates on hold (marginal lending at 1.75%, main refinancing at 1% and deposit facility rate at 0.25%) and no new non-conventional monetary policy measure is announced. The ECB recent policy language does not suggest that cutting rates further is a contemplated option. It should also be noted that the discount rate (which is the most relevant rate in the current post-crisis context) currently stands at a low 0.25% so there is not much room for maneuver from here. Following on to the Eur60bn covered bonds purchase programme announced a couple of months ago and after the substantial liquidity injection through the recent first 12-month refinancing operation, the monetary authorities may be in the mood to wait and see how the various measures are feeding through the economy at this stage. A mildly bullish scenario for the euro, allowing some to conclude that the ECB is now done on the QE/easing front, even if exit strategy remains a distant prospect.

ii) Rates on hold but the ECB introduces new non-conventional policy measures: there has been some speculation suggesting that the ECB is considering additional non-conventional measures such as the purchase of commercial paper or corporate bonds. The case for stepping up non-conventional policy measures has been boosted by the June M3 data which showed that loans to households and companies grew at their slowest pace on record (at 1.5% y/y), capturing a still precarious economic environment and/or a monetary transmission mechanism that is still not working efficiently. Such a scenario be a surprise and indicate that not only is exit strategy a distant prospect, but also that the ECB remains in an easing mentality. An unlikely scenario, but it would be a bearish scenario for the euro.

iii) Rate cut and new non-conventional policy measures announced: such a scenario would capture surprising activism from the ECB and a central bank obviously still very concerned about the current economic environment. Such a scenario would also come as a major surprise as the ECB recent policy language failed to hint at any imminent change in policy orientation. A highly unlikely scenario, but a scenario that would be very bearish for the euro.

What we think and what it means for the euro:

Considering the recent policy language from the monetary authorities and the marginally more upbeat bias emerging from a majority of recent euro zone indicators, we would expect the ECB to opt for **option i)** at this week's meeting. The case for implementing fresh non-conventional measures cannot be totally dismissed (especially considering the latest M3 data), but it would be much more in the ECB's style to wait and see at this stage. Option i) is expected in the market so the overall euro impact would be limited, with ECB President Trichet likely to stick to a neutral tone at the press conference (and keep all options open). That would allow market bulls to conclude that QE is yesterday's story and that exit strategy is next on the menu, even if not imminent. A mildly bullish scenario for the euro.

The Bank of England:

Policy Options:

i) Rates on hold (at 0.5%), no further announcement made regarding QE. This would imply that the MPC has decided not to use the extra £25bn worth of QE available without Treasury consultation at this stage. It would capture a likely more optimistic growth assessment (hence higher inflation forecast) in the BoE August Inflation Report, due next week. At this point, the MPC could also choose to keep all options open by not specifying whether it has ended its QE programme. A bullish scenario for the pound.

ii) Rates on hold (at 0.5%), the MPC announces that it will use the extra £25bn available but it also indicates that it will finish its QE programme at £150bn. Here, the end of the QE programme is in sight and exit strategy talks and eventually rate hike talks would come back to the forefront. That would capture a cautiously optimistic central bank, likely to be matched by upward revisions to both the inflation and growth forecasts in next week's Inflation Report. A mildly bullish scenario for sterling.

iii) Rates on hold (at 0.5%), the MPC uses the extra £25bn available, completing the £150bn available programme but does not commit to anything beyond, keeping all options open. That would capture a central bank that remains uncertain about the near to medium term economic and inflation outlook. Next week's August Inflation Report would most likely show a slightly worse profile as what was seen in May. Recent exit strategy/rate hike talks would become obsolete, uncertainty would return and sterling would be a loser under such a scenario.

iv) Rates on hold (at 0.5%), the MPC uses the £25bn still available and announces that it will ask the Treasury for extra funds to extent the QE programme above £150bn. This would capture a central bank clearly not comfortable with the current growth prospects which would most likely be matched by fresh downward revisions to the growth (and inflation) forecast in next week's August Inflation Report. A very unlikely scenario and a scenario which would unequivocally be bearish for sterling.

What we think and what it means for sterling:

Considering recent economic and market developments and bearing in mind the Bank of England MPC members' recent policy statements, we would see policy **option i)** as most likely to be implemented. Using the extra £25bn available may not be seen warranted at this stage, but because the environment remains uncertain, all options should be kept open. As the market has adjusted to a more upbeat sentiment of late, such a scenario would be seen as a signal that the BoE is done on the QE front, exit strategy talks/rate hike talks would resurface and that could theoretically add on to the more bullish sterling sentiment of the past few sessions.

Audrey Childe-Freeman
Senior Currency Strategist

August 3rd 2009