
Snapshot

Draghi's speech spurred the euro rally

European central bank (ECB) president Mario Draghi gave one of the strongest pro-Euro speeches in London today. He said that "the ECB is ready to do whatever it takes for the Euro" and "believe me, it will be enough" also adding that "the euro area is much stronger than people acknowledge" and that they should not "underestimate the political capital in the euro zone". ECB is the only institution capable to provide the boost to the single currency area's economy and to lower sovereign bond yields at least in the short-run. Thus, Draghi's comments started the euro rally.

We believe that the next step the leaders in the euro zone should undertake is to give the European Stability Mechanism (ESM) the banking license. In this way ESM could use sovereign bonds of euro periphery countries as collateral to borrow from the ECB and to leverage its financial power. More powerful ESM with the new pan-European bank supervisor could be a much needed anchor for the single currency area. Nevertheless, there would still be a need for deeper political integration of the euro zone in the medium-run.

ECB chief's comments had an immediate effect on the euro today. The single currency appreciated by 1.3 per cent against the US dollar in a time span of just one hour. However, we do not expect a more pronounced euro rally at least before the ECB policy making meeting next Thursday.

Next week will be packed with central bank meetings (Bank of England and the FED also meet next week) and there are market rumors about possibility of coordinated actions undertaken by these monetary authorities. Actions could include punishing commercial banks for parking money with their central bank or allowing them to use credit-backed securities as collateral for borrowing from the lenders of last resort. Bank of England has already started a similar program. This should incentivize lending to the real economy and put downward pressure on the long-term interest rates.

Spanish 10 year bond yields have decreased from 7.6 to 7 per cent today while German 10 year bond (regarded as risk free) yields increased from 1.2 to 1.3 per cent. Current news might create a more risk loving environment and this could lead to cheaper assets that are regarded as less risky. These include gold, high quality sovereign bonds, safe-heaven currencies. It is worth noting that we witnessed pronounced rallies in less liquid European currencies like Polish zloty and Hungarian forint.

Nevertheless, we believe that today's speech by the president Draghi is just the introduction to the next week's decisions. Market is hyped about the ECB taking a more active role in the euro zone crisis and Draghi should better deliver on these expectations next week.

Best regards,

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