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MACROCOSM

The ECB's Real Agenda

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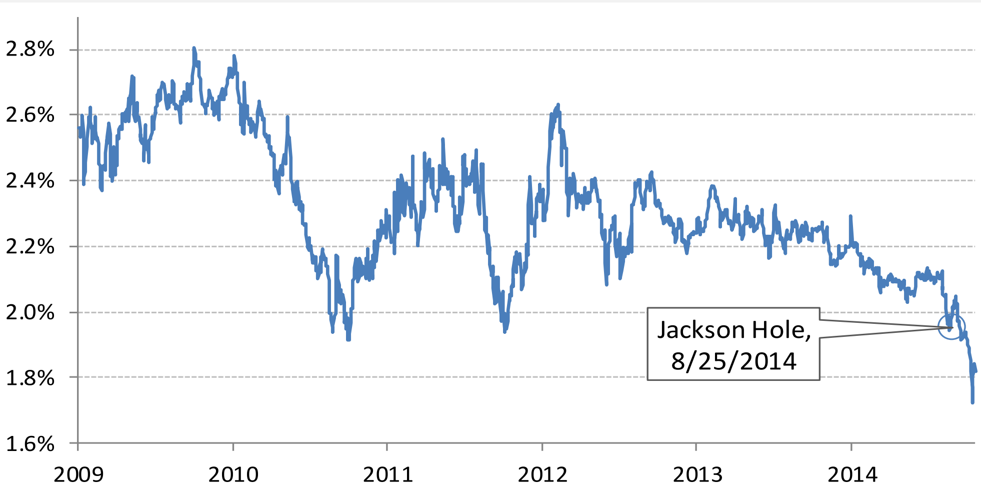
Donald Luskin with research input from **Lorcan Roche Kelly**

Draghi's policies are aimed at supporting reform, not fighting phony emergencies.

European Central Bank President Mario Draghi has a problem. He did it to himself -- and its consequences have spilled over into the global economy, becoming a key theme in the pessimistic narrative that has run through this last month of severe market volatility.

- Draghi boldly went off-script at the Federal Reserve's Jackson Hole conclave and declared a deflation emergency in the euro area (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014). He deliberately created a demand effect that would gave him the political power to push through his long-sought asset-backed securities purchase program at the following Governing Council meeting (see "On the ECB August Policy Decision" September 4, 2014).
- Now with two months gone by, as we warned (see "No Way ECB QE" October 1, 2014), the ECB has yet to buy its first ABS, and from what he hear won't do so until December.
- At the same time, the Targeted Longer-Term Repurchase Operations (TLTRO) introduced at the June Governing Council meeting has been a disappointed, as we also warned (see "On the ECB June Policy Decision" June 5, 2014).

Euro swap-implied 5-year inflation expectations, 5 years forward



Source: Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE MACRO: The euro area deflation scare Draghi cooked up at Jackson Hole gave him the leverage to get his ABS purchase program approved. But that program is not the grand gesture markets feel is appropriate to an emergency, and implementing it will be slow going. But there really isn't an emergency -- and Draghi's policies are cleverly aimed at what the euro area actually needs: the facilitation of ongoing reform of labor and product markets now that the pressure of the crisis years has subsided. We don't believe the euro area is headed for a triple-dip recession, and we counsel patience while Draghi's programs get put in place and build scale.

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- About the only thing the ECB has been able to accomplish has been the weakening of the euro, possibly thanks to the imposition of negative deposit rates also at the June meeting -- but just as likely the lucky by-product of the dollar's strength over the same period against all major floating currencies.
- Meanwhile, reported inflation in the euro area continues to fall, and eager rumors circulate about some bold new action the ECB will take to halt it. Yesterday's rumor *du jour* was a new program to purchase corporate bonds.
- *So having excited urgent fears of a deflation emergency, and yet having put into practice no commensurably bold new policy measures to fight it, Draghi has created the impression that the euro area faces a great unchecked danger. Since his Jackson Hole warning, inflation expectations have only worsened* (please see the chart on the previous page).
- *The logical inference from this impression is that the euro area will lapse now into a triple-dip recession.*

We don't believe that the euro area really faces a deflation emergency -- we think low reported inflation is to a large extent the result of wrenching but pro-growth labor cost adjustments in peripheral Europe (see "Attack of the 15 Basis Point Deflation Monster" September 2, 2014) and the ongoing decline in global crude oil prices (see "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014).

- We think Draghi would like inflation to be higher, to be sure.
- *But his real aim is to increase the supply of lending to the non-bank, non-government sector -- especially in Europe's periphery, and especially to small and medium-sized enterprises. If that has the spillover effect of increasing inflation back toward the ECB's target -- as it probably would -- then so much the better.*
- But inflation here is only a dependent variable -- what Draghi has in mind is to increase lending. But since the ECB's single mandate is price stability, any goal Draghi might have must be framed within that objective.

Success or failure of Draghi's programs to increase lending will not be easy to judge in the short term. Markets will be looking first to see if Draghi can fulfill his stated aim to "steer, significantly steer, the size of our balance sheet towards the dimensions it used to have at the beginning of 2012." Right now, it's all going the wrong direction. The ECB balance sheet is presently shrinking through two channels.

- The early repayment of 3-year LTRO borrowing
- The maturing of asset purchases made under the Securities Markets Programme of emergency sovereign bond purchases (SMP) and the first and second Covered Bond Purchase Programs

Since the June ECB meeting at which TLTRO was announced, these repayments and maturities have averaged just over €10 billion per week -- €9 billion from repayments and €1 billion from maturities.

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- There is still €363 billion outstanding from the 3-year LTROs, all of which will need to be repaid by next February 26 at the latest -- only 19 weeks away. If, say, half of this does not roll into other LTROs, then the €9 billion per week pace would continue.
- The SMP and first two CBPPs are likely to continue to decrease by €1 billion per week on average over the same period.

Against this tide of balance sheet shrinkage, the ECB currently has TLTROs and the third Covered Bond Purchase program (CBPP3). The latter started its purchases in the market on Monday. The ECB will update the total amount of these purchases weekly. Then at some point -- again, we hear it will be December -- the ABS purchases will start.

- Will the ECB buy corporate bonds or sovereigns?
- While we would never say never when the wily Mr. Draghi is concerned, we would ignore the constant rumors about new asset purchase programs for the time being. The ECB already has three irons in the fire, it will not add another until it is sure it is necessary -- that is, unfortunately, until it is sure the other operations have failed.
- Failure is too strong a word for it, but TLTRO got off to a bad start in September. When the next operation comes around in December, banks will have gotten past the ECB's Asset Quality Review and could be more likely to take advantage of the operation. We think uptake could be as large as €150 to €200 billion -- but then again the Bank of England's similar Funding for Lending program never really got off the ground.
- We will get an idea of the size of the CBPP3 operation over the coming weeks. Unlike the first two CBPP operations, this one does not have a target size. CBPP1 was targeted and completed at €60 billion; CBPP2 was targeted at €40 billion, but was suspended after only €16 billion of purchases for lack of available securities. The CBPP3 has a broader pool of covered bonds it can purchase, including retained covered bonds.
- The run rate of the CBPP1 was just over €1 billion per week. For the CBPP2 it was a mere €400 million per week. The CBPP3 will have to be a significantly larger if it is to do more than just cover the maturities on the first two CBPPs and the SMP.
- The ABS purchase program remains a completely unknown quantity. We have been a fan of the idea, believing it can bring supply in line with palpably growing demand for small and medium-sized enterprise borrowing. But because the euro area's ABS market is opaque and non-standard -- so the securities will be difficult to value and price (indeed, the ECB is struggling to build its institutional capacity to deal with these issues) -- we simply can't say whether this program will be of sufficient size to really boost the ECBs balance sheet sufficiently to achieve its goals.

For all that, we emphasize that the shrinkage of the ECB's balance sheet is most definitely not evidence that the ECB has been deliberately tightening policy. The great bulk of the shrinkage has come from entirely voluntary *returns of central bank liquidity by the banks who had been borrowing it -- it was the banks' decision, not the ECB's. That simply means the liquidity crisis of recent years has passed -- which is all to the good. Now the ECB is striving mightily to ease -- but in a particular way tailored to the post-crisis euro area.*

- Why does the ECB not just hold its nose and bend the rules a little bit a do true quantitative easing -- that is, buying sovereign bonds?
- *The political and legal strictures are not trivial. But more fundamentally, this isn't what Draghi wants to do.*
- Draghi is a reformer who very much believes in the restructuring of labor and product markets in the euro area that has painfully and haltingly begun under the lash of the crises of the last several years. In a speech this month, he inverted one of Keynes' *bon mots* to say, "Without reform, there can be no recovery."
- True QE cuts against this theme by propping up profligate and bloated governments, by subsidizing their excessive debt.
- TLTRO and ABS purchases, on the other hand, are aimed at allowing the grass roots of the private economy to take advantage of the hard-won reforms that have been put in place, and create demand for more.

Reform is terribly difficult -- anytime, anywhere -- but especially in the sclerotic euro area. The crisis years enabled reform to occur because the alternative was annihilation. Now that the real crisis has passed, Draghi has no choice but to manufacture crises -- like his deflation emergency -- to get the ECB to take the steps necessary to support ongoing reform. *The cost of this charade is to excite market expectations for extraordinary emergency measures that simply will not materialize.*

- *Thus the euro area triple-dip scare we're currently digesting.*
- *We think the euro area does not, in fact, face a deflationary emergency, nor is it likely to lapse into recession again. To be sure it is caught in the backwash of the Ukraine crisis -- but that said, it faces a windfall from falling crude oil prices* (see "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014).
- *Draghi's programs, unspectacular and slow-footed as they may be, are the right moves for realities of a post-crisis euro area struggling to keep reform on track.*

Bottom line

The euro area deflation scare Draghi cooked up at Jackson Hole gave him the leverage to get his ABS purchase program approved. But that program is not the grand gesture markets feel is appropriate to an emergency, and implementing it will be slow going. But there really isn't an emergency -- and Draghi's policies are cleverly aimed at what the euro area actually needs: the facilitation of ongoing reform of labor and product markets now that the pressure of the crisis years has subsided. We don't believe the euro area is headed for a triple-dip recession, and we counsel patience while Draghi's programs get put in place and build scale.