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TRENDMACRO LIVE!

On Draghi in London

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Lorcan Roche Kelly

The ECB chief responds to our critique -- but this is crisis response, not true easing.

Yesterday we criticized European Central Bank President Mario Draghi for both for too-tight policy and for his lack of response to the crisis that was starting to overtake Spain and Italy (see "Mario Canute" July 25, 2012). Draghi seemed to have ruled out ECB bond purchases -- which could both ease monetary conditions and respond to the crisis. This morning in London, Draghi made comments that directly address our concerns, and raise the possibility of bond purchases -- this is a very positive development,

- Also, he said if high yields hamper the monetary policy transmission mechanism of the ECB, they would come within the ECB's mandate.
- The ECBs mandate is a single price stability one, so the ECB is tied to only take actions that lead to price stability outcomes. This morning Mario Draghi directly tied sovereign yields to that mandate, saying that the ECB was "ready to do whatever it takes" within its mandate to preserve the single currency, adding "believe me, it will be enough."
- In our note we expressed sympathy with Mariano Rajoy in Spain and Mario Monti in Italy, as their countries yields seem to have disconnected from the reality in those economies. Draghi agreed this morning, saying "To the extent that these premia have to do not with factors inherent to my counter party, they come into our mandate, they come within our remit."

Markets have already reacted positively to these comments, and rightly so. We had identified the problem yesterday, it seems Draghi has agreed and offered the solution that the markets needed. He did not specify how the ECB would react, just that it would. The least he will do is turn the Securities Market Programme back on, and may go further -- perhaps direct purchases -- if he feels it is necessary.

In a larger sense, this welcome act of pulling back from the brink doesn't alter the strategic reality that European institutions require a crisis in order to do the right thing, usually at the last possible moment. For the ECB, the kind of outright QE that every other central bank has already done remains off the table because of the strictures imposed by the ECB's unique

Update to strategic view

ECB, EUROPE BONDS, EUROPE FINANCIAL STOCKS: Draghi said this morning that sovereign bond yields can form part of the ECB's mandate if they are damaging the price control ability of the bank. This is a very clear signal that the ECB will intervene in the sovereign market again, either via the Securities Markets Programme, or direct bond purchases. This is very positive for peripheral yields, which feeds through to peripheral banks**.**

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supranational position. So QE comes not as monetary policy, but rather as a response to a crisis that presents itself as a "market failure" requiring central bank intervention.

Better to pull back from the brink than not, but better still to not have to constantly confront brinks. For now, Draghi has made clear that sovereign yields can be the ECB's job. And that is not something to take the other side of.

Bottom line

Draghi said this morning that sovereign bond yields can form part of the ECB's mandate if they are damaging the price control ability of the bank. This is a very clear signal that the ECB will intervene in the sovereign market again, either via the Securities Markets Programme, or direct bond purchases. This is very positive for peripheral yields, which feeds through to peripheral banks.