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MACROCOSM

Draghi: Off the Reservation

Friday, August 3, 2012

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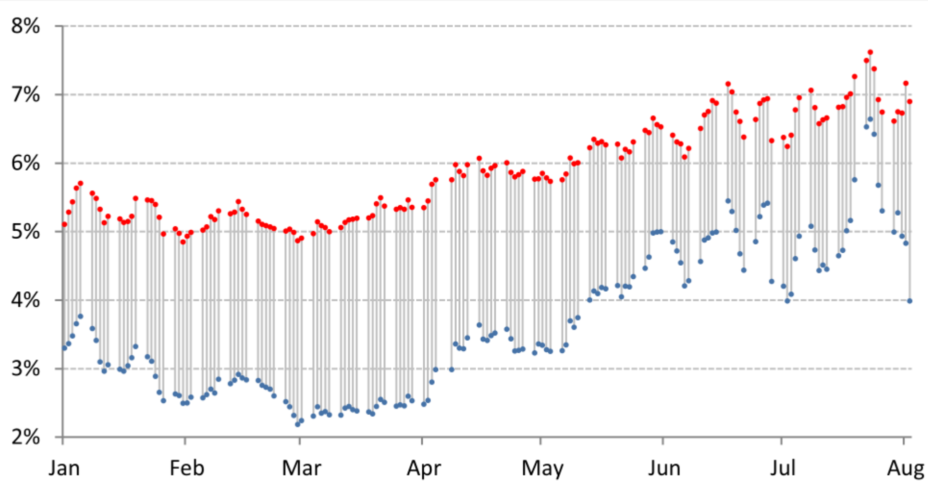
All is not lost: what little the ECB did yesterday was enough to make the Bundesbank dissent.

Markets -- rightly -- had high expectations for yesterday's ECB monetary policy meeting, after President Mario Draghi's assurances of relief for distressed bond markets last week in London (see "On Draghi in London" July 26, 2012). At first blush, yesterday's Frankfurt Draghi seems to have forgotten all about last week's London Draghi. The ECB disappointed.

- He offered no immediate relief for peripheral bonds.
- Draghi opened the door to the revolutionary development of unsterilized bond purchases, focused on the short end of the curve. But his statement and his response to questions lacked much-needed clarity as to the path toward this or other future actions.
- Reaction to the disappointment was rapid, with the euro giving up all the gains against the dollar that had been achieved since Draghi's London speech, the Spanish IBEX Index giving up half the gains, and yields on long-term peripheral debt moving sharply higher.
- Today in Europe, though, the initial shock is being moderated. Spanish and Italian long-term yields falling, and yields at the short end are falling sharply. This has dramatically widened the yield curve in Spain, restoring it from the recessionary narrowness seen last week (please see the chart below).

Spanish sovereign yield curve ● 10-year ● 2-year Source: Bloomberg



Source: TrendMacro calculations

Update to strategic view

ECB, EUROPE BONDS, EUROPE MACRO: Draghi disappointed the market with vague, confusing and conditional policy assurances. That said, he opened the door to the revolutionary step of unsterilized bond purchases -- in the face of the Bundesbank's objections. That and the August hiatus in Spanish and Italian bond auctions should buy him the few weeks he needs to fill in the details. But his next move has to be more than words. Without action soon, the ECB's credibility will be beyond repair, and that could force Spain and/or Italy into seeking bail-outs. It's possible that this is what Draghi wants, a *force majeure* event that would liberate the ECB to do QE, and force Europe's politicians into an accelerated agenda of political and fiscal integration.

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- What relief was offered was, in an unclear way, linked to the co-participation of the EFSF and ESM bail-out mechanisms and the willingness of countries like Italy and Spain to take the dangerous step of calling upon their aid.
- Beyond this highly conditional commitment, Draghi offered only the hint that the ECB "may consider undertaking further non-standard monetary policy measures."
- It is becoming easier to dismiss Draghi as being all talk and no action. Yet his putting unsterilized bond purchases on the table -- however unclearly -- was enough to make the Bundesbank so uncomfortable as to effectively dissent from the decision.
- While we take comfort in the Bundesbank's discomfort, Draghi is testing both the patience of investors, and, more important, the limits of the ECB's credibility.

Awful as the market response was, it is amazing that the sell-off wasn't much, much worse -- and that is has moderated so much so far today. If Draghi had truly giving markets nothing, then we should be all the way back to where we were last week before Draghi's London speech (see "Mario Canute" July 25, 2012).

So he must have given something. But *what*?

We think the one significant element here -- and probably the only thing holding off a rout at the moment -- is that whatever new directions the ECB is in fact planning to take now are repugnant enough to the Bundesbank that its president, Jens Weidmann, felt the need to not vote in favor of them.

- Draghi said that the ECB's decisions were basically unanimous, with one "reservation" -- what the FOMC would call a "dissent." It is clear he means Weidmann.
- Proceeding in the face of Weidmann's objections means that the ECB under Draghi is willing to take decisions without the backing of the Bundesbank.
- And we note that Jörg Asmussen, Germany's appointee to the ECB Governing Council, did *not* dissent. Thus Germany itself, like the ECB, is willing to stand against the Bundesbank.
- This does not mean that the ECB is going to stray too far from the Bundesbank's preferred policy position. But yesterday Draghi was willing to stray far enough to put unsterilized bond buying on the table -- in other words, quantitative easing.
- For the ECB -- by far the tightest major central bank in the world -- QE is the obvious next step when it is stuck at the zero-bound. Unfortunately QE is the one thing the ECB cannot do -- or, at least, it has been prohibited from doing until now.
- Draghi is trying to break that prohibition -- or rather chip away slightly at the edge of it. But even that is enough to make the Bundesbank uncomfortable. The significant thing is that Draghi seems determined to carry on regardless.

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This is not to say that the ECB is set to launch a massive QE program that will save the euro area and lead to a huge risk-on rally.

- Details are very sketchy. In fact, there are no details at all. Sadly, this is typical for European political developments. Even the ones that turn out in retrospect to be quite important are often first announced in the vaguest possible terms.
- We have to wait for the ECB's Monetary Policy Committee, the Market Operations Committee and the Risk Management Committee to decide exactly what policy tools are needed and how they should be implemented.
- All that the ECB has given those committees is guidance, but that guidance includes looking at unsterilized bond purchases.
- Draghi said in the press conference that the committees would report back to him in the coming weeks.

Timing, as ever, is critical. Yesterday morning -- *before* the ECB decision -- Spain issued its last bonds in the market until early September. Italy's next bond auction is August 30. With both of these countries out of the bond market -- they do have short term bill auctions in the interim which are unlikely to be problematic -- there is some time before the market is really tested again.

Draghi said "weeks" for the details of new measures to be worked out, so we should think of Spain's and Italy's next primary bond auctions as establishing the deadline.

- Under normal circumstances, the ECB has two governing council meetings each month. However, this being August in Europe, there is only one this month. So, it is unclear how any policy change can be made in time for the Spanish and Italian auctions.

Which leads us to the biggest problem the ECB may face following yesterday's meeting: by Draghi's not giving the market what he had allowed the market to expect, he has damaged the institution's reputation. He is much less likely to get away with merely promising actions ahead of the Spanish and Italian auctions. The market will have to see the color of his money.

If the market is unwilling to buy Spanish and Italian debt in a world where the ECB's intentions are still unclear, then Spain and Italy may be put in a position where they have to look at becoming "program countries" -- that is, asking for a bailout.

- Perhaps we are mistaking Draghi was his fellow countryman Machiavelli -- and in doing so, giving Draghi too much credit. But forcing Spain or Italy into bail-outs may be his tactical intent. If the precondition for getting help from the ECB is that the country being helped asks for a bail-out, then since the ESM does not exist yet, the EFSF is the only bail-out mechanism available. The EFSF is running very low on fire-power after the Spanish bank bailout (see

"No Senior Discount for Spain" July 2, 2012), so a request for aid from Spain or Italy -- or both -- would have to have ECB participation.

- In such a *force majeure* situation, the controversial step of unsterilized bond purchases would be seen as a necessity, not a choice -- liberating the ECB to do QE. And Europe's politicians would be forced into a sharply accelerated program of political and fiscal integration.
- Such ideas would seem to be well developed in Draghi's mind. After all, he said yesterday that "In this context, the concerns of private investors about seniority will be addressed." This would seem to be front-running the objection that ECB bond purchases would necessarily subordinate other holders, as they effectively did in the case of the ECB's purchases of Greek bonds.

So for the future, bond purchases -- maybe. For now, what Draghi may have bought is a little time. But even if he is not spending euros now, he is spending credibility by building up the market's hopes, and then dashing them. And credibility is one thing no central bank can print more of.

Bottom line

Draghi disappointed the market with vague, confusing and conditional policy assurances. That said, he opened the door to the revolutionary step of unsterilized bond purchases -- in the face of the Bundesbank's objections. That and the August hiatus in Spanish and Italian bond auctions should buy him the few weeks he needs to fill in the details. But his next move has to be more than words. Without action soon, the ECB's credibility will be beyond repair, and that could force Spain and/or Italy into seeking bail-outs. It's possible that this is what Draghi wants, a *force majeure* event that would liberate the ECB to do QE, and force Europe's politicians into an accelerated agenda of political and fiscal integration.