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MACROCOSM

Draghi's Troika of Troubles

Wednesday, April 3, 2013

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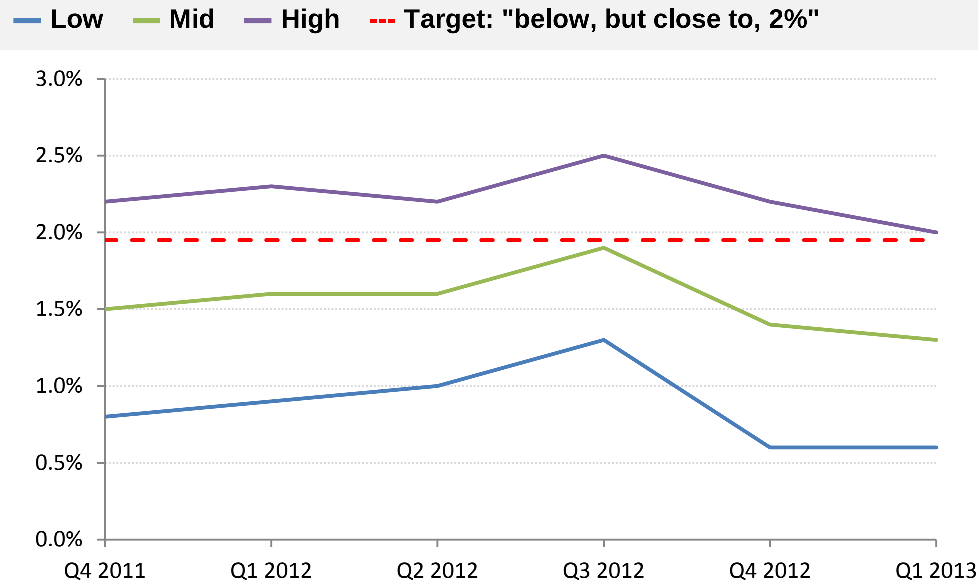
"Structural Operations" could fix disinflation, too-slow money growth, and fragmentation.

This morning's euro area flash inflation estimate came in at 1.7%, down from a recent peak of 3.0% in November 2011. The ECB's mandate is to control inflation in the euro area, with the target being "below, but close to, 2%." Today's estimate is certainly below 2%, but is starting to stretch credibility on "close to." More worrying for ECB president Mario Draghi, the ECB's own quarterly staff projections have reduced their forecast for full year 2013 inflation in each of the last three quarterly projections, with the Q1-13 median expectation a low 1.3% (please see chart below).

ECB forecast for 2013 euro area annual inflation



Source: ECB, TrendMacro calculations

- The ECB's own reasoning for keeping inflation close to 2% -- and not close to 0% -- is that it provides an adequate margin to avoid the risks of deflation. Further, the ECB says,

> Having such a safety margin against deflation is important because nominal interest rates cannot fall below zero. In a deflationary environment monetary policy may thus not be able to sufficiently stimulate aggregate demand by using its

Update to strategic view

ECB, EUROPE MACRO: Mario Draghi faces a troika of monetary problems ahead of tomorrow's ECB meeting: below-target inflation, below-mean M3 growth, and financial fragmentation across the euro area. But he does have a modality available to address these issues -- Structural Operations -- and we think it is only a matter of time before it is deployed. He should know better than to lower interest rates at tomorrow's policy meeting. We will listen carefully to the press conference for any hints of something more substantial.

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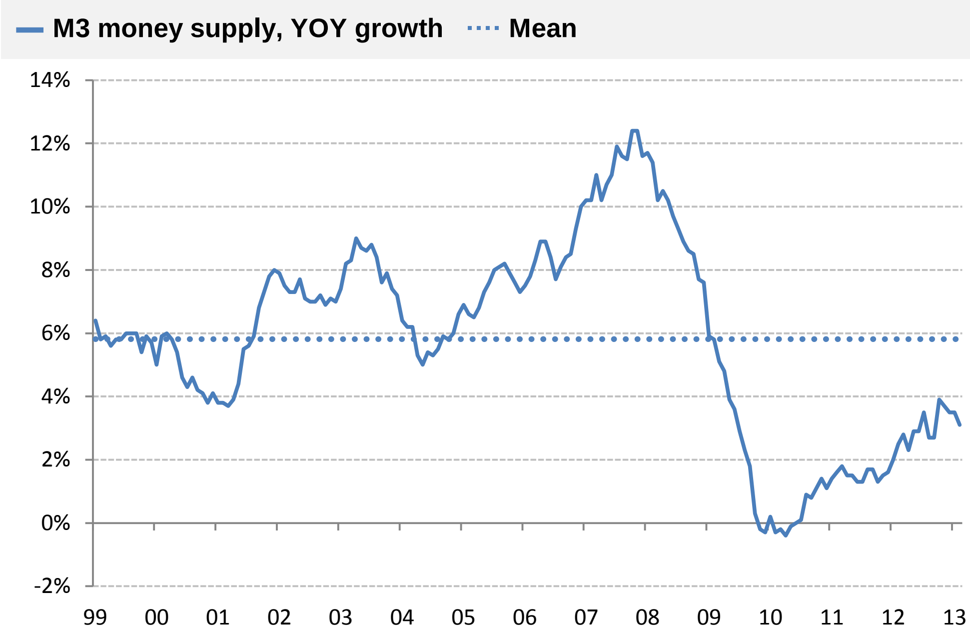
interest rate instrument. This makes it more difficult for monetary policy to fight deflation than to fight inflation.

Mario Draghi seems to be entering that more difficult phase. To add to his woes, there are two other areas of significant underperformance that he has to be worrying about ahead of tomorrow's policy meeting.

The pace of broad money growth in the euro area has stagnated at very low levels. The mean M3 growth rate since January 1999 has been 5.8% -- which the euro area has been consistently below now for four years (please see chart below).



Source: ECB, TrendMacro calculations

- If the pace of M3 growth remains subdued, there is little chance of the ECB getting inflation higher. Disinflation expectations mean people are less likely to invest -- investment that would show up in M3 -- leading to a vicious cycle of further disinflation.

Another area of concern for Draghi is the ongoing *de facto* reversal of financial integration across the euro area. Though the ECB is setting a single interest rate for the entire euro area, borrowers in different nations within the euro area face different costs of borrowing (please see chart on following page).

- This fragmentation means that the interest rate channel can no longer work effectively for the ECB when it comes to setting inflation expectations across the euro area. This is probably the greatest threat to the euro area's "one size fits all" monetary policy.

So disinflation, slow broad money growth, and fragmentation within the euro area are Draghi's troika of troubles. There is a solution for all three,

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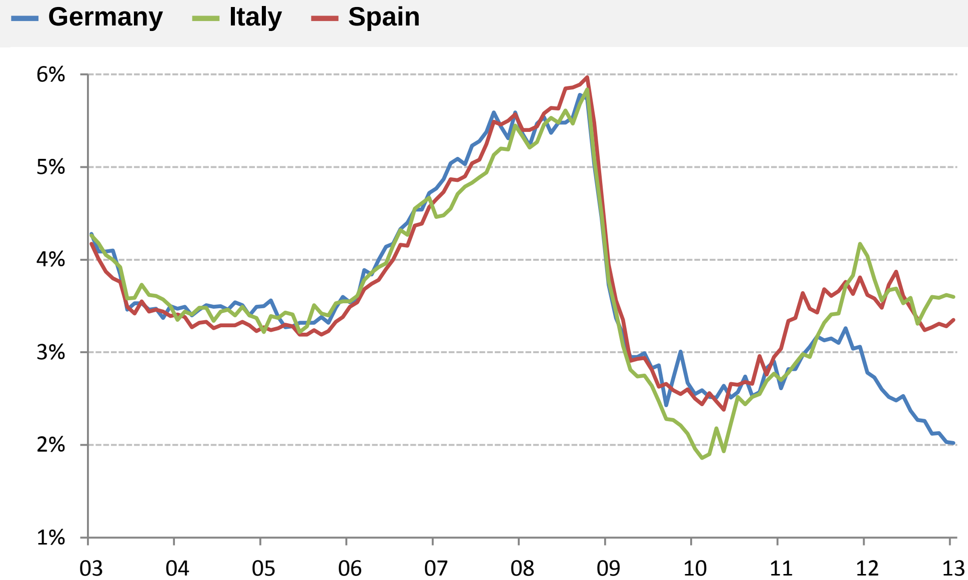
Borrowing rates for non-financial corporates



Source: ECB, TrendMacro calculations

and it is already available to Draghi within existing ECB statutes. All that is needed from Draghi is the will to implement it -- and a little imagination.

Under the ECB guidelines on monetary policy instruments and procedures -- effective from January 1 2012 -- beyond the normal weekly Main Refinancing Operations (MRO) and the now-famous Longer-Term Refinancing Operations (LTRO), the ECB can engage in a procedure called "Structural Operations," which can include outright purchases similar to the Fed's quantitative easing.

- According to the guidelines, Structural Operations can be "executed whenever the ECB wishes to adjust the structural position of the Eurosystem vis-à-vis the financial sector."
- Structural Operations can take the form of outright transactions by national central banks (NCBs), or in exceptional circumstances, by the ECB itself.
- In conducting Structural Operations, an NCB can engage in the outright purchase of any marketable asset. Unlike MRO and LTRO, outright transactions cannot deal with non-market instruments.
- Most interesting, the outright transactions can be executed by NCBs through bilateral procedures, rather than through an open market operation like MRO and LTRO, allowing the NCB to pick exactly where it intervenes.
- Page 30 of the guidelines outlines the two ways an NCB can engage in bilateral operations. It can either have direct contact with counterparties -- that is, purchase assets outright from a bank directly -- or can act through stock exchanges or market agents.
- Further, these operations do not have to be announced in advance, nor do the outcomes of the operations have to be made public. However, we feel that if the ECB did decide to make use of these

operations, there would be a clear benefit in telling the market that they were happening.
- Currently, the ECB's Covered Bond Purchase Program (CBPP2), which is an outright transaction -- that is, covered bonds purchased are held to maturity -- , is reported weekly by the ECB. This operation is limited to a total of €40 billion though, and since inception in November 2011 has only purchased €16 billion of covered bonds. So, at least the ECB has shown itself to be willing to engage in outright transactions, even if not in a meaningful way.

The use of Structural Operations to make outright purchases of marketable instruments from euro area banks would go some way towards solving the troika of problems facing Draghi. New money injected into the system via Structural Operations would expand the ECB's balance sheet and feed through to M3 growth. If this new money leads in turn to an increase in lending, then that would go some way towards repairing the monetary policy transmission mechanism, and thereby inflation expectations

- To address the third issue of fragmentation, Draghi could go a step further and allow the NCBs to use Structural Operations to purchase non-marketable instruments.
- Non-marketable instruments include credit claims on non-financial corporations (NFCs). If Draghi were to allow these to be purchased -- especially by the peripheral NCBs -- it would free banks in the periphery to increase lending, and allow them to do so at a lower rate to NFCs -- the real drivers of any return to euro area growth.

To be sure, fixing the monetary problems the euro area faces will be difficult, but the ECB does have the instruments available to do it. It is only a matter of time before they are forced to put them into action. We would welcome an announcement tomorrow along these lines, though so far there is no hint of it coming. The biggest mistake the ECB can make would be to lower interest rates -- that is not a solution to any of the problems it faces.

Bottom line

Mario Draghi faces a troika of monetary problems ahead of tomorrow's ECB meeting: below-target inflation, below-mean M3 growth, and financial fragmentation across the euro area. But he does have a modality available to address these issues -- Structural Operations -- and we think it is only a matter of time before it is deployed. He should know better than to lower interest rates at tomorrow's policy meeting. We will listen carefully to the press conference for any hints of something more substantial.