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TRENDMACRO LIVE!

On the November ECB Policy Decision

Thursday, November 7, 2013

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

With QE ruled out, the ECB has pretty much fired all its bullets. The euro area is on its own.

The European Central Bank cut rates today -- lowering the main refinancing rate to 0.25% and the marginal rate to 0.75%, and leaving the deposit rate at 0%.

- In this morning's press conference ECB President Mario Draghi left the door open to negative rates in the future. But absent that fairly radical step, the ECB is at or near the zero bound.
- Today the ECB extended its commitment to fixed-rate full-allocation operations to July 2015, taking out any cliff risk to the maturity of existing Longer Term Refinancing Operations (LTROs).

Here, virtually at the zero bound on rates, the ECB finds itself very much out of bullets, to an extent that the US Federal Reserve is not. That's because the ECB operates within policy constraints not operative for the Fed.

- When the ECB cannot manipulate rates any lower, its remaining policy tools are passive, not active -- that is, demand-led by the euro area banks, not supply-led by the ECB.
- Refinancing operations such as the LTROs are demand-led in that their amount is determined by the banks who choose to accept the liquidity or not when it is tendered, and then to keep it or not afterward. Already, much of the liquidity accepted by the banks in 2012's two massive LTROs has been returned -- voluntarily, through no act of the ECB (please see the chart on the following page).
- The ECB has always forbade to itself the policy option of quantitative easing -- that is, buying government securities on its own account, in amounts of its choosing.
- The purchases of peripheral sovereigns in the Securities Market Programme was demand-led too, in the sense that it was done only in response to a systemic emergency, not as an act of monetary policy *per se*.
- The Outright Monetary Transactions program -- the ECB's standby commitment to buy bonds of countries like Spain or Italy that may come under systemic stress in the future -- is similarly demand-led

Update to strategic view

ECB, EUROPE MACRO: With today's small rate cut, the ECB is very nearly out of bullets. Unlike the Fed's QE, in which the Fed determines the amount of liquidity to force into the banking system, the ECB's operations are all demand-led. Banks determine how much liquidity to take -- and they've been actively returning liquidity to the ECB all year, while already low business lending and inflation has been falling. Unless the ECB changes its basic operating toolkit and engages in Fed-type QE, the euro area is on its own. We believe it's wishful thinking to imagine that ECB QE would make any difference, anyway -- the euro area will continue to move toward recovery thanks to structural reforms, and the background of an improving global economy.

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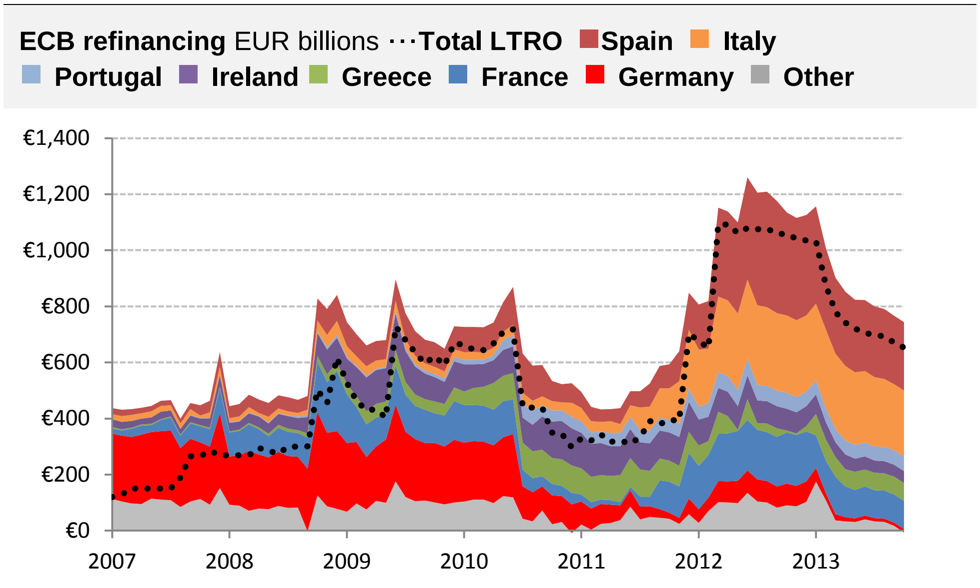

Source: ECB, TrendMacro calculations

in that the governments involved would have to request it, and would do so only under dire conditions.

Facing falling inflation and no lending growth (see "Data Insights: Euro Area Recovery Monitor" November 7, 2013), the ECB would presumably be doing more here, if only it had the same toolkit as the Fed.

- The ECB's interventions so far have been brilliantly effective in stemming systemic risk over the last several crisis years, just as the Fed's have.
- But we are not convinced there is any strong reason to believe that now, with the systemic crisis over, the ECB would be any more successful at economic "stimulus" than the Fed has been (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).
- So whether or not the ECB finds some way to expand its policy toolkit in the future, the euro area is effectively on its own. If monetary fine-tuning is impotent, it really doesn't matter if the ECB or any other central bank engages in it. So the euro area will have to rely on supply-side reforms, and on an improving global economy.
- The consensus may be disappointed that the ECB can't do more here -- that's what's behind today's little risk-off spasm in global markets. But we remain confident that the euro area's structural reforms are already becoming effective, and will continue to be so (see "Europe's Ghosts of Stress Tests Past" October 22, 2013).

Bottom line

With today's small rate cut, the ECB is very nearly out of bullets. Unlike the Fed's QE, in which the Fed determines the amount of liquidity to force into the banking system, the ECB's operations are all demand-led. Banks

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