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MACROCOSM

"Whatever It Takes" Comes to Jackson Hole

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

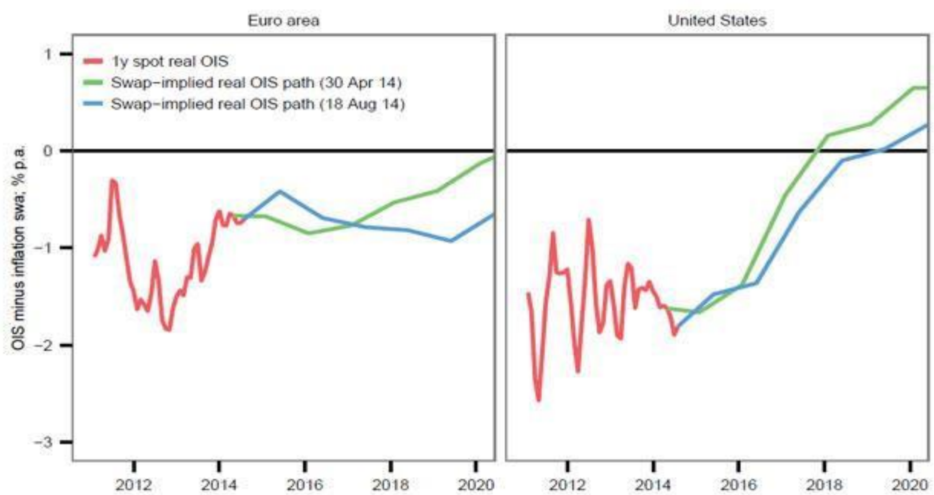
Off-script again -- Draghi drops a QE bombshell at the Fed's conference.

This morning's euro FX weakness, and the general tone of risk-on, arises from improvised changes in ECB President Mario Draghi's speech at the Federal Reserve's Jackson Hole conference on Friday.

In the originally published text of the speech, Draghi was meant to say:

> Inflation has been on a downward path from around 2.5% in the summer of 2012 to 0.4% most recently. Acknowledging this, the Governing Council would use also unconventional instruments to safeguard the firm anchoring of inflation expectations over the medium- to long-term.

But when he got as far as this chart in his slide deck…



…he significantly broke from the prepared script. Draghi actually said (emphasis ours):

> Inflation has been on a downward path from around 2.5% in the summer of 2012 to 0.4% most recently. I comment on these movements about once a month in the press conference and I have given several reasons for this downward path in inflation, saying it

Update to strategic view

ECB, EUROPE MACRO: Draghi improvised at Jackson Hole the new judgment that too-low inflation in the euro area is becoming embedded in long-term expectations, and requires response from the ECB. We expect at the very least the strongest hints yet for quantitative easing -- probably broad-based ABS purchases -- at next week's policy meeting, perhaps even a launch date.

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is because of food and energy price declines; because after mid-2012 it is mostly exchange rate appreciation that has impacted on price movements; more recently we have had the Russia-Ukraine geopolitical risks which will also exert a negative impact on the euro area economy; and of course we had the relative price adjustment that had to happen in the stressed countries as well as high unemployment.

> I have said in principle most of these effects should in the end wash out because most of them are temporary in nature -- though not all of them. **But I also said if this period of low inflation were to last for a prolonged period of time the risk to price stability would increase.**
>
> **Over the month of August financial markets have indicated that inflation expectations exhibited significant declines at all horizons.** The 5year/5year swap rate declined by 15 basis points to just below 2% - this is the metric that we usually use for defining medium term inflation.
>
> But if we go to shorter and medium-term horizons the revisions have been even more significant. The real rates on the short and medium term have gone up, on the long term they haven't gone up because we are witnessing a decline in long term nominal rates, not only in the euro area but everywhere really. **The Governing Council will acknowledge these developments and within its mandate will use all the available instruments needed to ensure price stability over the medium term.**

The change in emphasis in the final sentence concerning the Governing Council response is important. In the original version, Draghi was meant to talk about a hypothetical response -- "the Governing Council would use also unconventional instruments." Instead he is now seemingly pre-committing the Governing Council to a response: "The Governing Council…within its mandate will use all the available instruments."

- If you think we are reading too much into Draghi's off-the-cuff comments, you must remember that remarks like those at Jackson Hole -- off the cuff while on the road -- is a tactic that Draghi has used before to spectacular effect. His "whatever it takes" speech in London in July 2012 was unscripted. His remarks then were the single most significant factor in changing investor sentiment towards the euro area (see "Whatever It Takes Turns Two" July 25, 2014). The monetary policy meeting the week after those remarks saw the first announcement of Outright Monetary Operations (OMT) by the ECB.
- *The ECB is a single-mandate central bank, focused exclusively on price stability. Draghi's judgment that long-term inflation expectations are becoming unanchored amounts to declaring a state of emergency, which arrogates unto himself the power to take steps not ordinarily permitted.*

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The ECB's next monetary policy meeting is on September 4th. Following the Jackson Hole speech, we now expect two things -- barring a miraculous recovery in inflation in next Friday's data.

- Draghi will not blame transitory factors for continued low inflation.
- He will assert that inflation expectations are no longer anchored in the medium to long-term.
- At minimum he will give the strongest hints yet for quantitative easing -- probably broad-based purchases of asset-backed securities. At maximum, he will announce a launch date.

Bottom line

Draghi improvised at Jackson Hole the new judgment that too-low inflation in the euro area is becoming embedded in long-term expectations, and requires response from the ECB. We expect at the very least the strongest hints yet for quantitative easing -- probably broad-based ABS purchases -- at next week's policy meeting, perhaps even a launch date.