

TRENDMACRO LIVE!

On the ECB November Policy Decision

Thursday, November 6, 2014

Donald Luskin with research input from Lorcan Roche Kelly

Preparations for new easing measures -- while Draghi eases concern about his authority.

The European Central Bank announced no new policy measures at today's Governing Council meeting -- at least none to be immediately implemented. This should be no surprise, since President Mario Draghi does not wish to distract from the debut of his Asset Backed Securities Purchase Programme (ABSPP), to finally begin in the coming weeks. *In some sense this is, itself, a surprise -- the ECB has fallen into very public bickering and sniping on the Governing Council, threatening to undermine Draghi's authority and the ECB's political credibility. By beginning this morning's press conference with a recitation of familiar plans to continue buying covered bonds, initiate the ABSPP, get the ECB's balance sheet back up to peak levels -- and the statement of the unanimity of the Council on the will to use further unconventional means should they become necessary -- Draghi started right out by representing that he is still entirely able to govern, and that his policy preferences are still on track.*

- *Specifically, a new sentence in the opening statement states that the "Governing Council has tasked ECB staff and the relevant Eurosystem committees with ensuring the timely preparation of further measures to be implemented, if needed." And in response to the first question in this morning's press conference, Draghi was clear -- perhaps to the point of being somewhat uncharacteristically defensive -- that this was approved unanimously by the Council.*

The credibility of Draghi as a leader and the ECB as a political institution -- perhaps the euro area's only true federal institution -- is key to Europe's chances of continuing its painful restructuring and recovery, and not slipping back into crisis. After all, it was the ECB's credibility that saved the euro in 2012 -- a credibility consolidated in one heroic moment for Draghi, when he gave his famous ["whatever it takes" speech](#) in London (see ["On Draghi in London"](#) July 26, 2012).

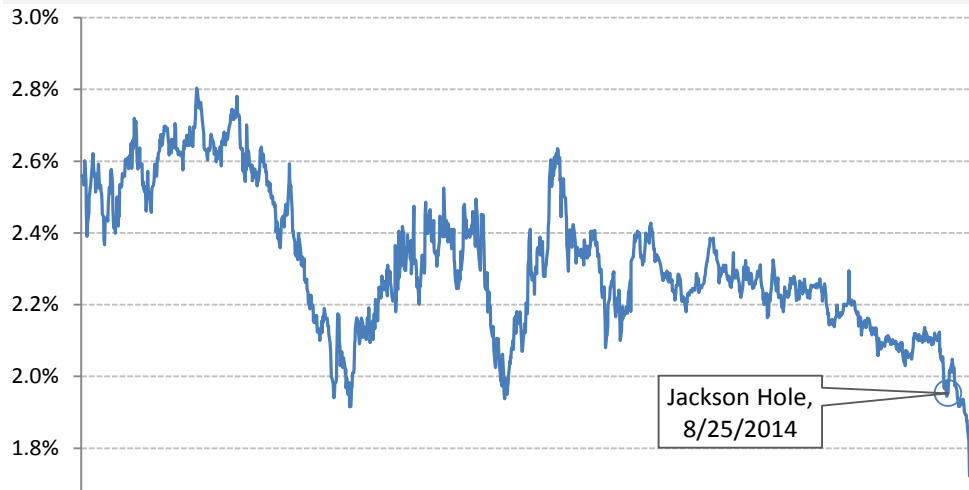
- The problem now, more than two years on, is that Draghi has enflamed market expectations at the same time as he has irritated his colleagues by doing again what he did in London -- making unilateral policy decisions in public forums, presenting the Governing Council with a *fait accomplis*.
- When Draghi improvised a deflation emergency in [his speech](#) at the Fed's Jackson Hole conference (see ["Whatever It Takes"](#)

Update to strategic view

ECB, EUROPE MACRO: No new immediate policy initiatives -- but the ECB said this morning that its committees have been tasked with developing new initiatives to be ready if needed. Draghi emphasized that his is being done with unanimous consent of the Governing Council, clearly seeking to calm markets about the public bickering and sniping in recent weeks, which threatens to undermine not only the easing measure currently being undertaken, but also Draghi's personal authority and the ECB's political effectiveness. Draghi personally -- and the ECB institutionally -- saved the euro of 2012. Continued credibility is key to the euro area's ongoing reform and recovery. We see much evidence this morning that Draghi understands the risks here, and is taking steps to ameliorate them.

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— Swap-implied 5-year inflation expectations, five years forward



Source: Bloomberg, TrendMacro calculations

[Comes to Jackson Hole](#)" August 25, 2014), he created a demand effect in markets for remedial action.

- Now each passing day with no action -- while the market-implied forward inflation expectations Draghi highlighted in his speech have moved lower (please see the chart above) erodes Draghi's credibility.
- At the same time, he used that demand effect as a club to coerce the conservative Germans to go along with his ABS scheme. *But the ECB's languid progress toward implementing that scheme renders false the supposed emergency that justified it to begin with. The Germans have used that incongruity -- and all that time -- to push back against Draghi's attempt at coercion, which they understandably resent.*
- So we can only cringe as we imagine what might have been said at the dinner last night in Frankfurt for Governing Council members. It should have been a celebration of Draghi's third anniversary as president, but it may well have been overshadowed by suspicion and strained relationships.
- Indeed, in this morning's press conference, Draghi seem to think it was necessary to mention that the dinner was the scene of the "best discussion we've ever had," which included an exploration of the importance of the independence of Governing Council members. Later, he said the dinner went "better than expected." Surely this means Draghi is painfully aware that the ECB's parental squabbling has upset the children, and is seeking to reassure them.
- That the policy priorities of the congenitally conservative Bundesbank and the more expansive ECB are frequently divergent is not new. In fact, we have often used Bundesbank disapproval of an ECB measure as a litmus test for its efficacy, Bundesbank President Jens Weidmann's dissent over Outright Monetary Transactions (OMT) being a prime example (see "[Draghi: Off the Reservation](#)" August 3, 2012). But that Draghi and Weidmann are personally at odds is something new and dangerous -- with the

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[German press reporting](#) "that Draghi finds cooperating with Weidmann has become 'almost impossible' and that he no longer divulges his plans to him beforehand."

- With the normal conduits of collegial communication and decision-making impaired, in the past few weeks leaks from the normally secretive ECB have been coming thick and fast. The [French Banque de France under Governor Christian Noyer](#) let it be known how much French noses are out of joint over the design of the ABSPP, apparently relying too little on French expertise. Ultimately [four firms were selected](#) (including one French one) to run the program. And the [New York Times](#) got its hands on selected portions of ECB meeting minutes in a leak that seemed to be designed to embarrass the former head of the Central Bank of Cyprus, Panicos Demetriades.
- Then yesterday, we got a [Reuters story](#) playing up the discontent on the board, citing anonymous sources suggesting that as many as ten board members are against quantitative easing using sovereign bonds. That's not even seriously on the table at this point (see "[No Way ECB QE](#)" October 1, 2014) -- yet the story's sources took the opportunity to complain about Draghi's secrecy, particularly his failure to distribute policy papers ahead of meetings, for fear that they would be leaked to the press.

Perhaps a way of summing up what is shaping up on the ECB would be to say that the Germans and the French have called Mario Draghi's bluff. In the heat of the euro crisis in 2012, the stakes were too high to risk anything but compliance with Draghi's unilateral policy decisions. Yes, Weidmann dissented as a formality, but he did nothing to undermine Draghi's authority in the matter. After all, faith in Draghi's authority was what saved the euro.

- But now there's no actual crisis -- nothing but the deflation scare that Draghi overhyped at Jackson Hole (see "[The ECB's Real Agenda](#)" October 22, 2014). The stakes are lower. So for Germany -- and the other leakers who seem to be opposing Draghi on the Governing Council -- there is really not that much risk in drawing the line on how much they will allow themselves to be cowed.
- *The dark thought: it if was Draghi's authority that saved the euro from crisis, then undermining that authority could put the euro right back into crisis.*
- We think the ECB has the luxury of a little time here, during which it hopefully will mend the relationships that are so important for any central bank's functioning. But the runway is not infinitely long.
- *Draghi has unleashed fears of malignantly too-low inflation. If he's not seen as "doing something," then he's not only the boy who cried "wolf" but also the boy who was used his cry to get a gun, and then didn't shoot the wolf. In that sense, he is his authority's own worst enemy.*
- It is possible that Draghi's authority might once again be as important as it was in 2012. We don't mean to be alarmist, but economically significant political risk is starting to boil again in the periphery of the euro area. Greece faces [elections in early 2015](#) -- the risk of the leftist party SYRIZA coming to power doesn't directly

threaten the currency union, but surely Greek debt would come under intense pressure as reform and restructuring are halted or reversed. There will be elections in Spain next year too, where the periphery's most successful pro-growth reformer, President Mariano Rajoy, will face [stiff opposition](#) from the far-left party Podemos, as he labors under continuing [corruption scandals](#).

We have always said that, for Europe, crisis would drive difficult reforms -- then those reforms would alleviate the crisis, take the pressure off, and that would slow the reforms, which then would bring on further crisis. It's a process of two steps forward and one step back, but one fraught with potential tipping points and could potentially crash the system. A collapse of credibility in a key institution could be such a tipping point. The bad news is that this has become a risk. The good news is that Draghi seems, based on today's statements, to be quite aware of that risk, and has begun to take steps to alleviate it -- indeed, perhaps like a marriage that has been through a rough patch, the relationship is now stronger than ever for having been tested. In the end, that may be more important than any new easing measures being prepared by staff.

Bottom line

No new immediate policy initiatives -- but the ECB said this morning that its committees have been tasked with developing new initiatives to be ready if needed. Draghi emphasized that his is being done with unanimous consent of the Governing Council, clearly seeking to calm markets about the public bickering and sniping in recent weeks, which threatens to undermine not only the easing measure currently being undertaken, but also Draghi's personal authority and the ECB's political effectiveness. Draghi personally -- and the ECB institutionally -- saved the euro of 2012. Continued credibility is key to the euro area's ongoing reform and recovery. We see much evidence this morning that Draghi understands the risks here, and is taking steps to ameliorate them. ▶