Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Michael Warren, Energy Strategist
Lorcan Roche Kelly, Europe Research Affiliate

TRENDMACRO LIVE!

On the January ECB Policy Meeting

Thursday, January 22, 2015

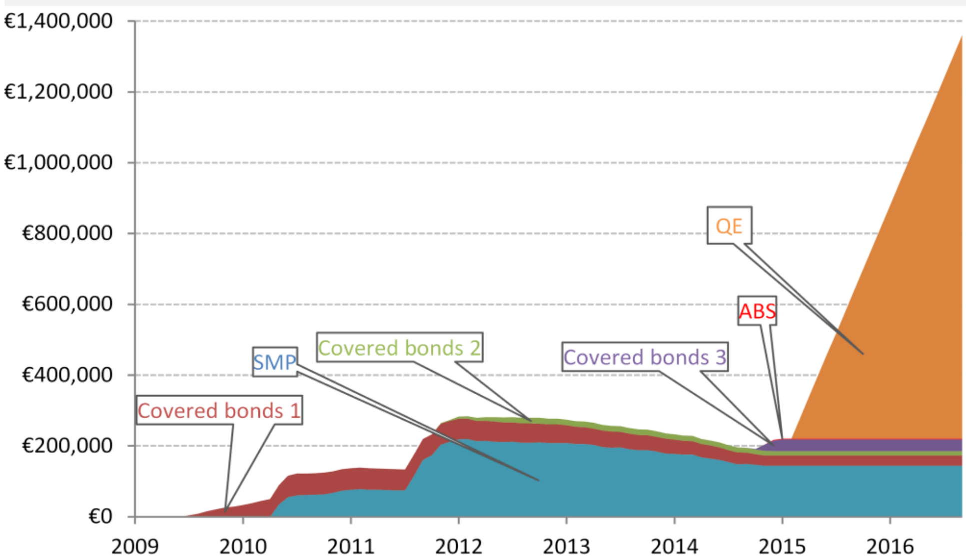
Donald Luskin with research input from **Lorcan Roche Kelly**

With national central banks buying their countries' own debt, the Germans can't screw it up.

At last it has happened. QE with sovereign bonds has come to the euro area. *As a quick-take, after an initial knee-jerk reaction and some random turbulence, we would ultimately expect euro area bond yields, priced to perfection, to rise -- as yields did in the US whenever the Fed announced a purchase program. The already weak euro should strengthen.*

- In what is likely an engineered "beat" versus leaks yesterday from Frankfurt, this morning the European Central Bank announced it will increase its existing asset purchase programs to €60 billion per month through September 2016, and include euro area sovereign bonds of 2 to 30 years maturity -- which will surely dominate the purchase mix. This would more than sextuple the value of the EBC's purchased assets (please see the chart below).
- Member states' bonds will be held in proportion to their respective "capital keys" -- that is, their financial commitments to the ECB. The plan ostensibly calls for buying investment grade bonds. But "additional eligibility criteria will be applied," allowing inclusion of

ECB purchased assets, projected to January 2016 € millions, non-QE constant



Source: ECB, TrendMacro calculations

Update to strategic view

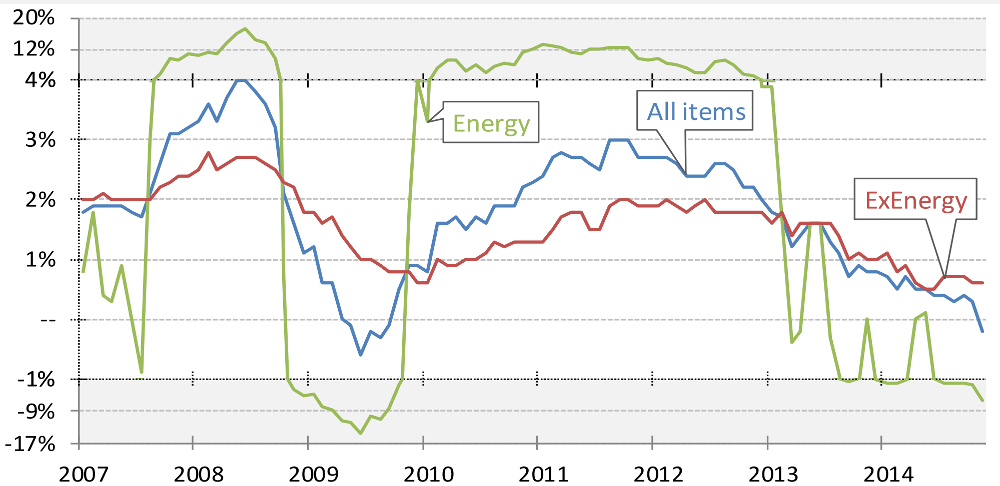
ECB, EUROPE MACRO, EUROPE BONDS, FX: QE with sovereign bonds comes to the euro area. We are agnostic as to whether it stimulates the euro area to faster growth or higher inflation. We don't see how it promotes what the euro area needs -- for banks to lend to small to medium-sized enterprises, precisely what Draghi's failed ABS program could have done. It was sunk by German obstructionism, but with QE being executed by each member state's own national central bank, the German bureaucrats can't interfere. There is precedent for this form of distributed monetary policy in the euro area -- the use of ELA by the Central Bank of Ireland, backed by sovereign debt. That operation created euros that are still in circulation throughout the Eurosystem, despite an intensely local origin. With euro area sovereigns priced for perfection, we think this announcement will ultimately drive yields higher, just as QE did every time in US, and strengthen the already weakened euro.

[Strategy Dashboard home]

bail-out countries.

- When complete, this will leave the ECB holding about 15% of outstanding sovereign debt in the euro area (the Fed, the Bank of England, and the BOJ, by comparison, hold 20% or more of their states' respective debts).
- *We don't want to play the game of speculating whether this is "too little," "too much" or "enough." We'd be more interested in doing that if we knew "for what?"*
- *We have never been convinced that the ECB really needs to do QE anyway, at least not for any objective policy reason. At this point the best reason for doing it is because the market so clearly demands it -- and never mind that this demand is possibly entirely non-rational.*
- We don't buy the idea that there is really a deflation emergency in the euro area that would necessitate QE -- which ECB President Mario Draghi cooked up this summer at Jackson Hole (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014). Despite the current negative reading on headline inflation, when energy is taken out of the calculation euro area inflation is low, but positive and rising (please see the chart below, "Data Insights: Euro Area Recovery Monitor" January 22, 2015, and "The Deflation Hoax" January 8, 2015).

Euro area consumer price index Year-over-year change



Source: Eurostat TrendMacro calculations

- *Sure, maybe doing QE can raise inflation because people think it will. But we don't think that's an urgent mission, or much of a monetary theory.*
- Even *ex-post* evidence won't really decide the matter. Whether the euro area struggles or flourishes from here, wherever inflation goes, whatever the euro exchange rate does, and whichever direction euro area bond yields go, there's no way to draw strong conclusions about cause and effect with respect to QE.
- *We know from the US experience that it seems every time the Fed started a Large Scale Asset Purchase (LSAP) program to lower long-term yields, instead yields went up. Whenever they ended an*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Michael Warren
Houston TX
862 812-7374
mike@trendmacro.com

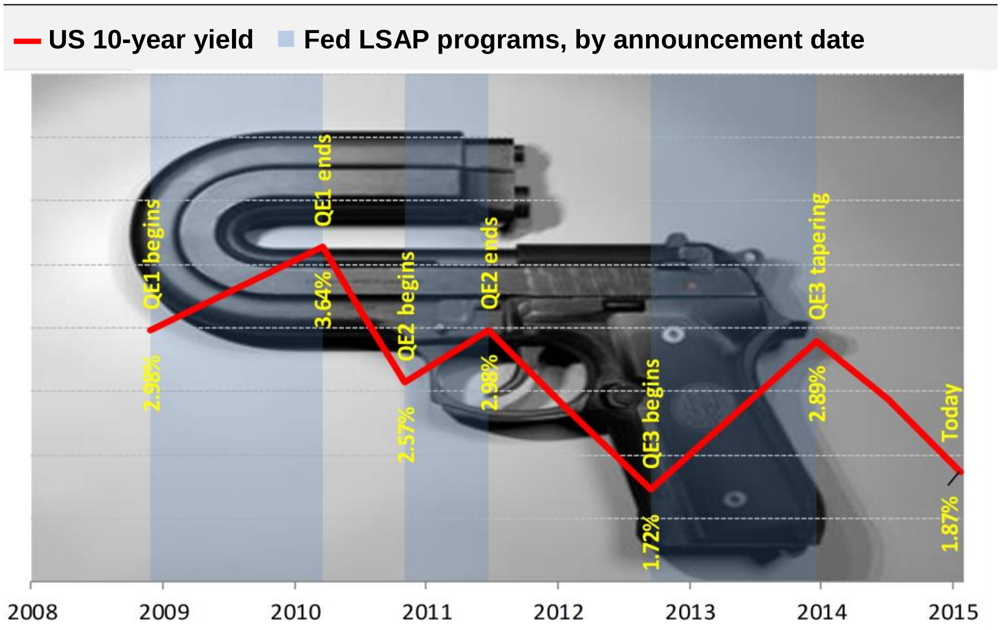
Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

Recommended Reading

Holder limits seized-asset sharing process that split billions with local, state police
Robert O'Harrow Jr., Sari Horwitz and Steven Rich
Washington Post
January 16, 20152, 2015

[Reading home]



Source: Bloomberg, Federal Reserve, TrendMacro calculations

LSAP, yields went down (please see the chart above, and "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). *As a best guess, and all else equal, we continue to expect the same thing to happen in the euro area* (see "2015: Oil Change for the Global Economy, Non-US Edition" December 31, 2014).

- And yet the market seems to cling to the narrative -- possibly true -- that QE was a great success in the US and the UK, and that the euro area's poor recovery is simply because the ECB hasn't done the same thing. Never mind that the German economy has done quite well *without* QE -- and surely Greece wouldn't have done any better *with* QE.

Setting all that aside, let's look at the devilish details.

- The ECB's sovereign bond purchases won't be made by the ECB itself. They will be executed by, and 80% of the principle risk will be borne by, each member state's national central bank (NCB).
- This seems to minimize risk-sharing across member states, and is on the face of it a concession to German demands. But it is probably more a sop to German dignity. The Germans had no choice but to bow to the markets' demand for QE, but this decentralization of risk at least allows them to set the terms of their surrender (see "Here Come Greek Elections -- and QE from the ECB" December 30, 2014).
- Indeed, Draghi said in response to a question at today's post-meeting press conference that the new purchase program was not approved by a "large majority" of Governing Council members -- that is, not unanimously, and that is, not with German acquiescence.
- In one sense this is all somewhat disturbing. As one Italian newspaper put it, "It's not a small matter, it's a question of

European solidarity." That could be a *big* matter -- as European solidarity is essential to euro area financial stability. Indeed it was the real force behind Draghi's "whatever it takes" promise in 2012 (see "On Draghi in London" July 26, 2012).

- We have said many times that the euro currency is a political institution, not a monetary institution. Draghi himself wrote recently, "Monetary union is possible only because of the substantial integration already achieved among European Union countries -- and sharing a single currency deepens that integration."
- *That said, distributing the execution and risk of sovereign QE among euro area nations may actually be the best way to assure the operational success of an asset purchase program that is at risk of being yet another ECB flop*.
- The sad reality is that every new program begun in 2014 by the ECB has been a major disappointment (see "Failure to Launch at the ECB" December 3, 2014). The ECB can't control the run-off of assets on its balance sheet when euro area banks return financing obtained through Longer-Term Refinancing Operations (LTROs), so it has been especially disappointing that it can't build its balance sheet through 2014's new purchase programs in which it is, ostensibly, entirely in control of the outcome. The value of purchased assets today is about €50 billion below the level of three years ago (again please see the chart on the first page).
- An especially vexatious disappointment has been the Asset-Backed Securities Purchase Programme (ABSPP), which after four months of operation has accumulated holdings of a puny €2.1 billion. This was Draghi's pet project -- one designed specifically to help capital-constrained peripheral euro area banks (see "The ECB's Real Agenda" October 22, 2014). Its failure reflects personally on Draghi.
- *We think the Germans helped it to fail. Executed centrally from the ECB's headquarters in Frankfurt, we hear that the program has been deliberately hobbled by unnecessary bureaucratic frictions imposed by the Germans, such as a 100-page form that must be completed by the counterparty bank for each and every transaction, no matter how small.*
- *Now, putting sovereign QE out of reach of the German obstructionists -- and directly in the hands of national central banks who favor it, such as the Banca d'Italia -- is the best way to assure it will get off the ground and stay aloft. Further, from today, ABS purchases will be delegated to NCBs too, breathing new life into that important but now-moribund program.*
- NCBs bearing most of the risk of their own sovereign's debt does not truly end risk-sharing, nor in the end does it thwart European solidarity. *When a NCB purchases anything outright, it creates euros. Those euros are a Eurosystem liability. That's a fundamental part of both risk-sharing and European solidarity.*
- And don't forget, we've seen this movie before, or at least an indie version of it. We are thinking of the Central Bank of Ireland's unwind of its emergency liquidity assistance (ELA) that had been extended to the now-defunct Anglo Irish Bank (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). It was a

beautiful bit of monetary Three Card Monte -- it fooled 'em then, and it could fool 'em again now.

- Anglo Irish was a nationalized bank that was completely insolvent after the bursting of the Irish property bubble. In order to keep the zombie animated -- in order to avoid a disorderly default -- the Irish Central Bank of Ireland provided over €40 billion of funding via ELA. This was backed by an instrument called a "promissory note" issued by the Irish government. The promissory note would be paid off over about 10 years, paying €3.06bn annually to the Central Bank of Ireland. For all practical purposes, the promissory note was a form of sovereign debt, sitting on balance sheet of the Central Bank of Ireland -- because it was the collateral backing ELA which Anglo had no possibility of ever repaying.
- In February 2013, the Irish government decided to wind up Anglo (by this time it was called IBRC), so the Central Bank of Ireland's ELA counterparty no longer existed. To resolve the ELA, the Irish government gave sovereign bonds to the Central Bank of Ireland.
- Given that nationalized Anglo was an arm of the Irish state, we can simplify and retell that story like this: (1) the Central Bank of Ireland accepts a promise from an arm of the Irish state in return for newly created euros; (2) that arm of the Irish state defaults; so (3) the Central Bank of Ireland accepts another promise from the Irish state in lieu of repayment of the created euros.
- *The Anglo precedent means that even if a euro member state defaults (as Anglo effectively did), then the NCB can replace the defaulted debt on its balance sheet with new debt from the same sovereign. The important consequence is that all the euros created in exchange for the original purchase of debt remain in circulation.*
- This maneuver most likely only arises when an NCB is the holder of the debt in question. If the ECB is the holder, then it would surely -- as Greece knows well -- insist on full repayment in euros, not in new bonds.
- If your goal is to design a form of ECB sovereign QE that insulated the money supply from default shocks, then you'd want NCBs to buy the sovereign debt.

Bottom line

QE with sovereign bonds comes to the euro area. We are agnostic as to whether it stimulates the euro area to faster growth or higher inflation. We don’t see how it promotes what the euro area needs -- for banks to lend to small to medium-sized enterprises, precisely what Draghi's failed ABS program could have done. It was sunk by German obstructionism, but with QE being executed by each member state's own national central bank, the German bureaucrats can't interfere. There is precedent for this form of distributed monetary policy in the euro area -- the use of ELA by the Central Bank of Ireland, backed by sovereign debt. That operation created euros that are still in circulation throughout the Eurosystem, despite an intensely local origin. With euro area sovereigns priced for perfection, we think this announcement will ultimately drive yields higher, just as QE did every time in US, and strengthen the already weakened euro.