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TRENDMACRO LIVE!

On the September ECB Policy Decision

Thursday, September 6, 2012

Lorcan Roche Kelly

Draghi delivers.

ECB President Mario Draghi today delivered on hints in late July (see "On Draghi in London" July 26, 2012) that turned into promises in early August (see "Draghi: Off the Reservation" August 3, 2012). Initial market reaction has been very positive.

This is all in line with our expectations (see "Exceptional Measures" August 29, 2012).Taking the elements of today's announcement one by one, we can see how much the ECB has delivered.

- The ECB's new bond purchase program will be an improvement on the old Securities Markets Programme.
- The new mechanism -- called Outright Monetary Transactions (OMT) -- will work in conjunction with the EFSF and ESM. Once those institutions are involved in primary market purchases -- i.e., buying when the country is issuing new debt into the market -- the OMT will purchase in the secondary market to control yields.
- Critically, the OMT will rank *pari passu* with other holders of the sovereign's debt. This does not change the status of historic SMP purchases, which became *de facto* senior after the Greek Public Sector Involvement agreement. This change should provide confidence to market participants that they do not risk subordination in the future, as it was feared investors in Spanish debt would as a consequence of the bank bailout (see "No Senior Discount for Spain" July 2, 2012).
- There will be much more clarity with the OMT. Draghi said that the ECB will publish weekly the size, market value, name of issuer and duration of all OMT purchases. This is a huge improvement on the old SMP which lacked any clarity as to what it was trying to achieve, or what it was actually doing in the market.
- The OMT purchases would only be at the short end. Draghi defined the short end of being up to three years.
- Conditionality will not be imposed by the ECB, but by the EFSF or ESM.
- Draghi emphasized conditionality many times during his speech. The OMT will only act when there is an EFSF or ESM program in place for the country requiring the OMT. The program can either be

Update to strategic view

ECB, EUROPE MACRO, EUROPE BONDS: Mario Draghi today delivered what he promised -- "whatever it takes." The new Outright Monetary Transactions (OMT) will replace the SMP, but with changes that will make it much more effective. Most important, OMT purchases will not take seniority, so countries under EFSF or ESM programs in the future will be able to maintain market access. While the requirement for sterilization is a disappointment, it seems unlikely to curtail the size of the OMT, which Draghi said would be unlimited. And sterilization or no sterilization, this is effectively QE.

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a full bailout -- as we have seen in Ireland, Portugal and Greece -- or an EFSF/ESM precautionary program.

- The key requirement is that the program provide for EFSF or ESM purchases in the primary market. Once that is in place, the ECB will engage the OMT in the secondary market.
- Involvement of the IMF will also be sought, but only for the design of country-specific conditionality and monitoring, not as a lender. This distinction is important because if the IMF were coming in as a lender, then seniority would again be an issue.

We have some disappointment that Draghi specified that the OMT bond purchases would be sterilized.

- We had hoped that OMT purchases would be straight QE -- no sterilization. But Draghi said today that any OMT purchases would be sterilized.
- He gave no hint as to how that sterilization would take place, but our assumption is that it will be in the same way that the SMP is currently sterilized -- through a weekly reverse operation.
- Draghi said that there would be no *ex ante* limit placed on the size of the OMT, so he clearly isn't worried about the ECBs ability to sterilize.
- Evidence at the moment suggests that he is right not to be worried. The latest SMP sterilization operation attracted €460 billion of bids for a €209 billion operation that yielded 0.01%.
- Any OMT purchases would increase the size of the ECBs balance sheet, so it would create its own market for the sterilization operation. That is, the funds created by the ECB to buy the bonds would be available in the market for redeployment in sterilization.
- The sterilization is the only disappointment today, but it is not a huge one. Sterilization is a slippery concept in monetary economics, among many that have no clear definition. Notably, the Fed's various QE operations have not been sterilized *formally*, yet the proceeds from them have nevertheless ended up on the Fed's balance sheet in the form of excess reserves.
- The key concept here is that the OMT will, in effect, be limitless. And by absorbing risky sovereigns from private hands and replacing them with riskless ECB deposits in one form or another, it will have significantly eased credit conditions -- and will be, effectively, QE.

What the ECB has again done is provide the gift of time to struggling countries to continue to implement the structural reforms that are necessary create future growth (see "Mario Canute" July 25, 2012). For these countries it amounts to a new and benign form of bailout, very different in structure than those we have previously seen in Ireland, Portugal and Greece. Any new program country would maintain market access throughout the reform process. The EFSF or ESM would act in the primary market, the OMT in the secondary market in tandem with market participants.

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One more important detail -- the ECB has also announced further collateral easing measures.

- Minimum credit ratings thresholds on bonds issued or guaranteed by countries under EU-IMF programs, or by countries eligible for OMTs, are to be suspended.
- Further, the ECB will accept as eligible collateral marketable debt instruments denominated in US dollar, pound sterling and Japanese yen that are issued and held in the euro area.
- These changes further ease the collateral rules of the ECB, but also should reduce bank worries -- especially in Spain and Italy -- over any sovereign downgrade attached to entry into an EFSF or ESM program.
- It is as yet unclear what effect the acceptance of foreign currency euro area issued debt will have. The demand for the weekly US dollar liquidity operation at the ECB has generally been fairly low.

Taken as a whole, what the ECB announced today is a strong backstop to sovereign yields in the euro area periphery. Countries will have to pay with fiscal sovereignty to access the OMT, but when they do, there will always be enough firepower there to meet their needs -- the ECB's resources are effectively limitless. The removal of seniority worries also means that bond investors will have more certainty about the nature of risks they are taking.

- We now have to wait to see which country -- most likely Spain -- will access the program first.

The only possible glitch on the horizon is next Wednesday's German constitutional court decision on the ESM. Our call is that we will have a re-run of last September's EFSF decision (see "On the German Court EFSF Decision" September 7, 2011) -- which will amount to a "yes, but" with the "but" being Bundestag oversight. If this is the outcome, then our attention can turn back to political space in the coming months as we wait for progress on the euro banking union and fiscal union.

Bottom line

Mario Draghi today delivered what he promised -- "whatever it takes." The new Outright Monetary Transactions (OMT) will replace the SMP, but with changes that will make it much more effective. Most important, OMT purchases will not take seniority, so countries under EFSF or ESM programs in the future will be able to maintain market access. While the requirement for sterilization is a disappointment, it seems unlikely to curtail the size of the OMT, which Draghi said would be unlimited. And sterilization or no sterilization, this is effectively QE.