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MACROCOSM

Going Negative?

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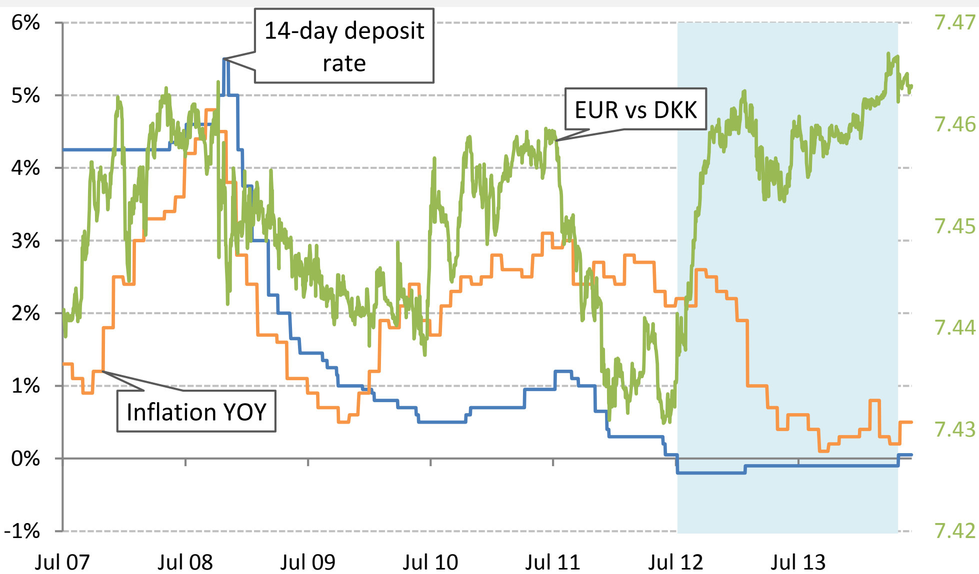
Donald Luskin with research input from **Lorcan Roche Kelly**

In the ECB's quixotic quest for inflation, ABS purchases are more likely than negative rates.

It's practically unanimous: 44 out of 50 economists surveyed expect the European Central Bank at its policy meeting tomorrow to move to negative interest rates. President Mario Draghi committed himself last month to do *something* to combat too-low inflation in the euro area (now running at just 0.5% year-on-year). *We're alone on this, but we continue to think Draghi is more likely to announce asset purchases, probably asset-backed securities* (see "Draghi Commits to QE" May 9, 2014).

- Since the May policy meeting, Draghi has said nothing to support that idea that he will move to negative rates on funds deposited with the ECB.
- *And there is the considerable problem that negative interest rates are largely an untried policy tool* -- the Fed has always thought it was too risky to the long-term functioning of the money market.
- *And in the two cases in which negative rates have been tried -- both in Europe -- the results have not been inspiring.*
- In Denmark (please see the chart below), the Danmarks

Denmark's experience with negative policy rates



Source: Danmarks Nationalbank, Eurostat, Bloomberg, TrendMacro calculations

Update to strategic view

ECB, EUROPE BONDS, EUROPE STOCKS: The consensus expects the ECB to go to a negative deposit rate at tomorrow's policy meeting. We disagree, expecting instead the announcement of an asset-backed securities purchase program. The Swedish and Danish experiences with negative deposit rates are not encouraging -- inflation fell in both cases during the period of negative rates. And in a speech last week Draghi seemed to lay out a case of ABS purchases, to specifically target the credit shortage he feels is behind the euro area's too-low inflation. By de-risking banks, ABS purchases could stimulate business credit and accelerate growth -- good for euro area equities. But the euro area doesn't need higher inflation -- so ECB easing will not help euro area bonds, which are now priced for perfection.

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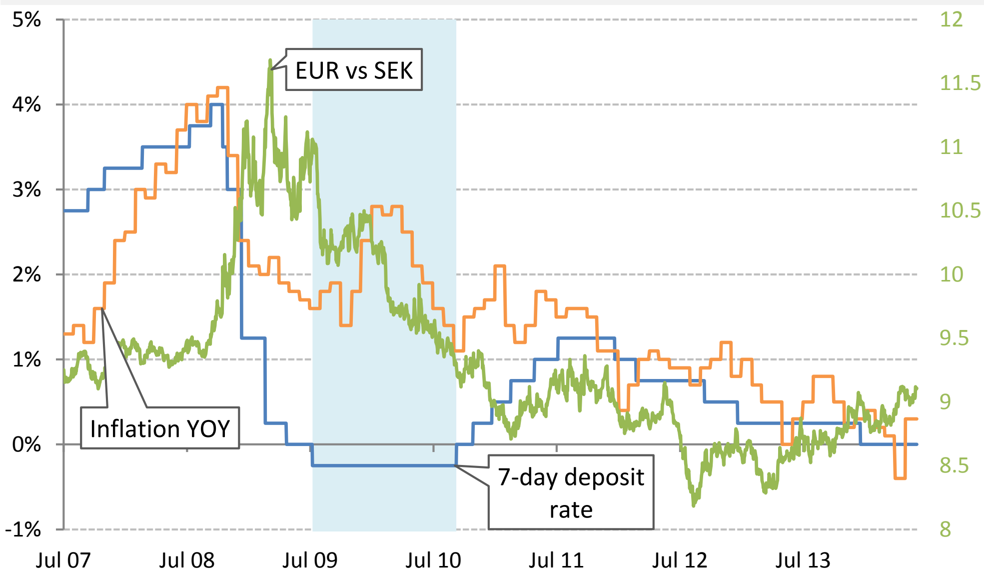
Nationalbank kept its 14-day deposit rate negative for almost 22 months, from July 2012 to April 2014. The purpose was to defend the Danish krone currency against a very weak euro -- and to that limited extent the policy was a success: the krone weakened considerably. This might encourage Draghi -- he would like to see the euro weaker. But he will not be encouraged by the Danes' experience with inflation -- it fell from over 2% to near zero during the period of negative rates.

- In Sweden (please see the chart below), the Sveriges Riksbank kept its 7-day deposit rate negative for 14 months, from July 2009 to September 2010. The purpose was not a currency intervention, but general stimulus -- but Draghi will find little to admire here. Over Sweden's period of negative rates, inflation first rose but then ultimately fell. And the Swedish krona *strengthened*.

Sweden's experience with negative policy rates



Source: Sveriges Riksbank, Eurostat, Bloomberg, TrendMacro calculations

In a major policy speech last week, Draghi had every opportunity to foreshadow negative rates if that was where he were headed. *But no*.

- Instead, he focused on too-low inflation being primarily the consequence of "credit supply constraints." These could be eased by "Term-funding of loans, be it on-balance sheet -- that is, through refinancing operations -- or off-balance sheet -- that is, through purchases of asset-backed securities."
- *Refinancing operations? Been there, done that (*see "On The First LTRO Payback" January 25, 2013).
- *That leaves purchases of asset-backed securities.*
- In Draghi's perfect world, that would mean the ECB buying securities that package loans for small and medium-sized enterprises. Draghi has spoken about this over the last year (see "Not a Big Bang, But It Could Work" May 29, 2013). But it would require the creation of a virtually brand new market in Europe. A new paper issued jointly by the ECB and the Bank of England tout

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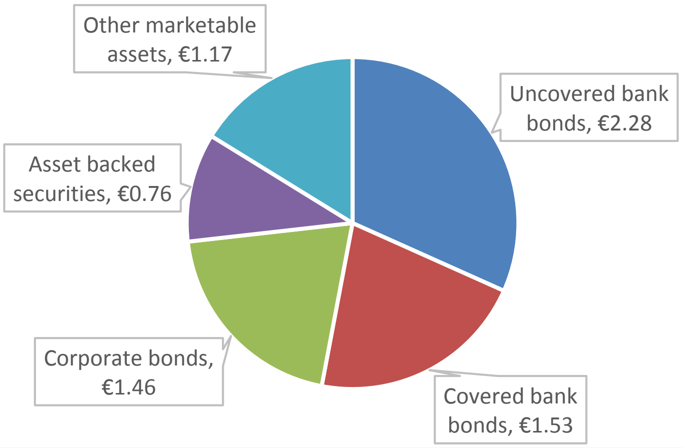
it as a big idea, but it doesn't exist now.

- So for now, the ECB would have to operate within the existing framework of securities which, by the ECB's calculations, total €7.2 trillion of assets including €760 billion of ABS (please see the chart below).

Assets eligible for purchase by the ECB EUR trillions



Source: ECB, TrendMacro calculations

Let's grant for the moment that the ECB does in fact undertake ABS purchases tomorrow. Will it help to solve the problem of too-low inflation?

- Draghi's argument is that ECB ABS purchases de-risk bank balance sheets -- and, perhaps not incidentally, bolster capital ratios ahead of the ECB's Asset Quality Review -- by taking risky assets away.
- That's good for bank stability -- and when banks are more stable they are able to originate more credit. That would be good for the euro area's nascent recovery.
- Will it accelerate inflation?
- Possibly. But we're not so sure low inflation is even actually a problem -- despite modern central bank dogma that 2% inflation is ideal. With unit labor costs low across the euro area (see "Euro Area Recovery Monitor" May 14, 2014), the traditional argument for higher inflation as a mechanism for creating wage elasticity is moot. And with no serious probability that the ECB would have to tighten monetary conditions, the traditional argument for higher inflation as a policy buffer against deflation is moot, too.
- *Indeed, the major risk faced by the euro area is the ongoing need for savers to keep confidence in the real value of the bonds of heavily indebted sovereigns.*
- *ECB asset purchases help by de-risking banks, and potentially accelerating growth through expanded business credit.*
- *But to the extent that inflation rises, how does it help to erode the value of much-needed savings?*
- With all these cross-currents in mind, we continue to think any easing measures here from the ECB will be good for euro area equities (which are only beginning to recover), and bad for euro

area bonds (which are priced for perfection).

Bottom line

The consensus expects the ECB to go to a negative deposit rate at tomorrow's policy meeting. We disagree, expecting instead the announcement of an asset-backed securities purchase program. The Swedish and Danish experiences with negative deposit rates are not encouraging -- inflation fell in both cases during the period of negative rates. And in a speech last week Draghi seemed to lay out a case of ABS purchases, to specifically target the credit shortage he feels is behind the euro area's too-low inflation. By de-risking banks, ABS purchases could stimulate business credit and accelerate growth -- good for euro area equities. But the euro area doesn't need higher inflation -- so ECB easing will not help euro area bonds, which are now priced for perfection.