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On the ECB June Policy Decision

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

Draghi begs the question: how many pea-shooters does it take to make one bazooka?

The European Central Bank conceded to strong market expectations by announcing it will cut its deposit rate from zero to negative 10 bp, and its main refinancing rate from 25 bp to 15 bp. And it tried to go further, by announcing a panoply of other measures including Targeted Longer-Term Refinancing Operations (TLTRO, pronounced *tell-tro*). But there is no immediately actionable asset-backed securities purchase program like we had anticipated (see "Going Negative?" June 4, 2014), and indeed which President Mario Draghi had foreshadowed just last week.

The initial market reaction was positive -- but hours later, as of this writing, the glow seems to have mostly worn off. Even the euro exchange rate, after a sharp drop initially, is now stronger on the day. This is not what you'd expect from a surprisingly aggressive program designed to lift too-low inflation. But it makes perfect sense to us. At first it all may have seemed like a major intervention employing a broad portfolio of policy tools. But no matter how fancy the tool-kit, if none of the tools in it is particularly effective, they are unlikely to be effective in combination.

- We know from the Swedish and Danish experiences that negative rates don't do what Draghi says he most wants to do -- that is, lift too-low inflation. In Sweden and Denmark inflation declined markedly during the period of negative rates (again, see "Going Negative?").
- The TLTROs won't start until September, and Draghi says that about €400 billion of collateral would be eligible at that time. But why would banks that have been returning funding from past LTROs want funding now from a TLTRO? And the idea of supplying funding specifically for new non-financial non-housing private sector loans sounds a lot like the Bank of England's "Funding for Lending" program. Since it began in July 2012, the program has attracted only £43 billion in loans -- an unknown portion of which would surely have happened anyway.
- The closest the ECB came to ABS purchases was to promise to "intensify preparatory work" and to "consider purchasing simple and transparent asset-backed securities" -- and to "work with other relevant institutions" to effect "desirable changes in the regulatory environment." So rather than do something here and now that could de-risk bank balance sheets and make room for more

Update to strategic view

ECB, EUROPE MACRO: The seemingly aggressive package of policy measures announced by the ECB this morning is actually a set of trivial, shopworn and likely ineffective strategies that have been tried elsewhere, and failed. The ECB failed to undertake the one thing that might have made a difference to growth -- outright purchases of asset-backed securities, which we had expected and that Draghi had foreshadowed. Nothing here will lift the euro area's too-low inflation -- which is a good thing, because inflation's not actually too low. There is no virtue in adding higher inflation to the other challenges faced by the euro area as it comes out of crisis and recession.

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lending, Draghi is only riding a favorite hobby-horse -- the development of an entirely new ABS market for Europe (see "Not a Big Bang, But It Could Work" May 29, 2013).

- The other measures announced today are equally trivial. There's no surprise that fixed rate full allocation funding auctions will be continued -- obviously the ECB will be the guarantor of easy funding for the euro area's fragile banks. And ceasing to sterilize the Securities Markets Programme -- under which the ECB had bought bonds of distressed sovereigns -- is meaningless. It was always a mere fig-leaf, with deposits in that operation deemed qualified collateral, and any sterilization auctions this year have failed anyway.

Our skepticism on the ECB's program shouldn't be mistaken for lack of enthusiasm for the euro area's recovery and growth prospects. It doesn't scare us that the policies announced today are unlikely to help lift too-low inflation -- because we don't think it's a virtue for the euro area to have higher inflation. In an important sense it's a great relief to us that Draghi didn't announce anything that might actually work.

Bottom line

The seemingly aggressive package of policy measures announced by the ECB this morning is actually a set of trivial, shopworn and likely ineffective strategies that have been tried elsewhere, and failed. The ECB failed to undertake the one thing that might have made a difference to growth -- outright purchases of asset-backed securities, which we had expected and that Draghi had foreshadowed. Nothing here will lift the euro area's too-low inflation -- which is a good thing, because inflation's not actually too low. There is no virtue in adding higher inflation to the other challenges faced by the euro area as it comes out of crisis and recession.

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