

MACROCOSM

## No Way ECB QE

Wednesday, October 1, 2014

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

All that's preventing sovereign buys are feasibility, timing, politics and Draghi's wishes.

[Yesterday's euro area flash inflation report](#), showing headline inflation falling to a five year low of 0.3% year-over-year (please see the chart below), [prompted further euro weakness against the dollar](#). That's not a textbook reaction -- normally falling inflation causes a currency to appreciate, not depreciate. *But the reaction in foreign exchange markets is driven by expectations, not realities -- in particular, expectations that the European Central Bank will start a true quantitative easing program, that is, large-scale purchase of euro area sovereign debt. Such a program, presumably, would be on top of the asset-backed securities purchase program the ECB already announced last month (see "[On the ECB August Policy Decision](#)" September 4, 2014). Markets will be disappointed -- that's not going to happen.*

In the US, true QE -- large-scale long-term sovereign bond purchases -- began with [the Fed's November 2010 announcement](#) of the program misnamed "QE2" (the asset purchase programs announced in [November 2008](#) and [March 2009](#) were not true QE -- they were emergency purchases of distressed mortgage assets, and the replenishment of the

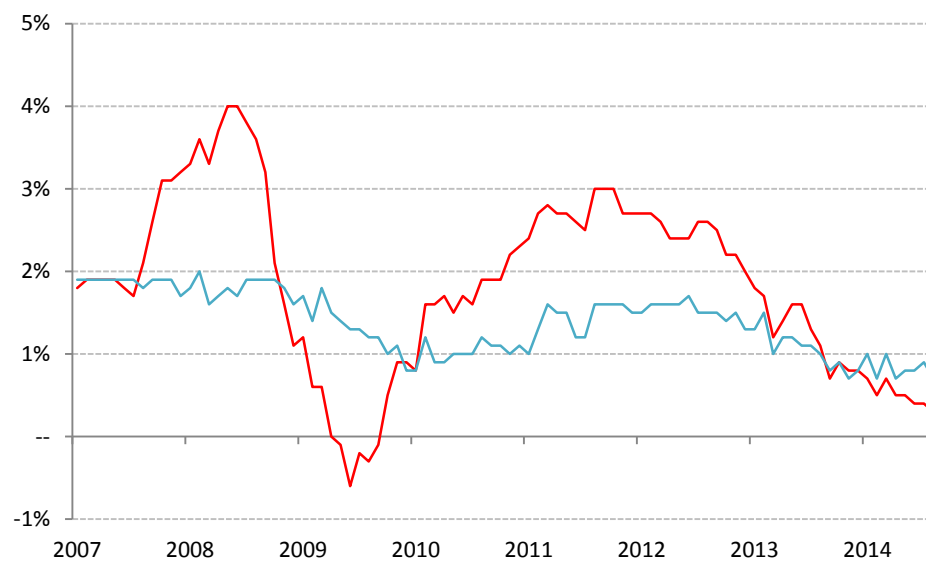
### Update to strategic view

#### ECB, FX, EUROPE

**BONDS:** The euro has over-reacted to rumors and expectations that the ECB will announce true quantitative easing -- that is, large-scale purchase of sovereign bonds. That's not what Draghi wants to do, it isn't politically achievable, and it probably wouldn't work given the euro area's underdeveloped non-sovereign fixed income markets. For tomorrow's meeting, we expect Draghi to continue to sound as dovish as possible, to give a strong defense of TLTRO, and provide the first details of a gradual program of ABS purchases.

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Euro area consumer inflation, YOY — All items — Core



Source: Eurostat, TrendMacro calculations

Fed's depleted portfolio of short-term Treasuries). Then-Chair Ben Bernanke [explained in 2010](#) how QE operates: "securities purchases work by affecting the yields on the acquired securities and, via substitution effects in investors' portfolios, on a wider range of assets."

- Presuming such a portfolio effect would happen in the euro area if the ECB bought sovereign bonds, what assets would investors then buy to substitute for them?
- The euro area still does not have a corporate bond market on anything like the scale of the US, and has yet to see a revival of its ABS market. So for fixed income investors, it is very likely that the "wider range of assets" they would purchase through any substitution effect would largely be assets outside of the euro area.
- *Therefore, any ECB QE would be very leaky, as the yields ultimately moved by such a policy would be yields on assets outside the euro area.*

Previous ECB sovereign purchase programs -- both [the Securities Markets Programme and Outright Monetary Transactions](#) -- were prudential responses to severe market turmoil, much as the Fed's was in 2008. No substitution effects were required -- the idea was simply to alleviate extremely wide risk premia that were manifesting the risk of sovereign default in the euro area or a breakup of the monetary union. These were very effective interventions. It only takes a moment's glance at any euro area sovereign bond yield to see neither of these risks are particularly high in investors' minds at the moment.

*Today, the challenge is entirely different -- it is to unclog the bank lending channel of monetary policy. [The ECB's preferred tools will be different, too. Draghi has made his preferences for these different tools perfectly clear.](#)*

- The Targeted Longer-Term Repurchase Operations (TLTRO) and the announced ABS purchase program have two significant advantages over QE. They target the channel through which most non-financial corporation funding happens in the euro area, and so should lead to increased investment which would feed through to improving levels of inflation. In targeting operations within the euro area they are much less likely to be leaky.

Can it succeed? To be sure, the first TLTRO was a disappointment to the market. We never had very high expectations for it (see ["On the ECB June Policy Decision"](#) June 5, 2014). But it's still early days.

- TLTRO operations continue quarterly to June 2016, and the circumstances surrounding the first operation -- uncertainty surrounding the upcoming Asset Quality Review and ABS purchases -- were unique to that operation.
- In an environment in which ABS purchases open up room on bank balance sheets for more lending, TLTROs make that lending all the more appealing, so they may yet get some substantial up-take.

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## Recommended Reading

### [Why and how we care about inequality](#)

John Cochrane  
*The Grumpy Economist*  
September 29, 2014

### [Government Debt Management at the Zero Lower Bound](#)

Robin Greenwood,  
Samuel G. Hanson,  
Joshua S. Rudolph and  
Lawrence H. Summers  
Hutchins Center Working  
Paper  
September 30, 2014

### [Deleveraging, What Deleveraging?](#)

[\[full report\]](#)

[\[VoxEU summary\]](#)

Luigi Buttiglione, Philip  
Lane, Lucrezia Reichlin,  
and Vincent Reinhart  
CEPR  
September 29 2014

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We will get further details of the ABS purchase program tomorrow, after this month's ECB Governing Council meeting.

- It is very unlikely that the ECB will announce a specific program size tomorrow. Expectations should be for an ABS program that will lead to a steady increase in the size of the ECB's balance sheet, rather than a front-loaded big bang.
- Both the TLTRO and ABS purchases should steadily increase the ECB's balance sheet. This would fall perfectly in line with ECB President Mario Draghi's [stated aim](#) to "steer, significantly steer, the size of our balance sheet towards the dimensions it used to have at the beginning of 2012."

Returning to the possibility of QE, remember that TLTROs and particularly ABS purchases have been policies that Draghi himself has championed at the ECB. He is very unlikely to abandon them in favor of true QE just as he has finally managed to launch them. Adding another program to the policy mix at the moment would likely diminish the effectiveness of the ABS purchases and TLTROs.

Finally, as always with the ECB, politics cannot be ignored.

- Draghi has used a lot of his own personal political capital to get ABS purchases agreed by the Governing Council (see "[Whatever It Takes' Comes to Jackson Hole](#)" August 25, 2014). He would face strong opposition both from within the ECB and among some member states to a true QE program. We don't think he could get through that fight without damaging himself, or the ECB's reputation.
- Any QE program would have to face challenges brought to the [German constitutional court](#) by the usual [hard-money fanatics](#). That process would delay and degrade any implementation of QE.
- Finally, starting next January next, the ECB governing council will start a [rotating vote system](#) on the Governing Council, in which some euro area member central bank governors will be excluded from each vote. A policy as controversial as QE would be best decided at a meeting in which every member had a vote, and there are only two left this year after tomorrow's meeting -- that just doesn't leave enough time to build consensus for QE, even if Draghi wanted to, and even if he could.

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### Bottom line

The euro has over-reacted to rumors and expectations that the ECB will announce true quantitative easing -- that is, large-scale purchase of sovereign bonds. That's not what Draghi wants to do, it isn't politically achievable, and it probably wouldn't work given the euro area's underdeveloped non-sovereign fixed income markets. For tomorrow's meeting, we expect Draghi to continue to sound as dovish as possible, to give a strong defense of TLTRO, and provide the first details of a gradual program of ABS purchases. ▶