

MACROCOSM

## Failure to Launch at the ECB

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Donald Luskin with research input from Lorcan Roche Kelly

### Six months in the making, Draghi's pet ABS purchase program is an embarrassing flop.

Ahead of tomorrow's policy meeting of the European Central Bank Governing Council the only questions that matter are: *will President Mario Draghi announce further easing, and, if so, will it include sovereign bond purchases?*

- No, Draghi will not announce a sovereign quantitative easing program this week. Despite continuing low inflation -- and continued lack of the promised expansion of the ECB's balance sheet -- the ECB has not reached the point where the blockers on the Governing Council will be won over to the very controversial idea of sovereign bond purchases.
- But this does not preclude announcement of new easing programs by other means. We can easily see an expansion of the Asset Backed Securities Purchase Programme (ABSPP) to include corporate bonds as a likely route for that further easing.
- Also, there may be some liberalization of the conditions attached to the Targeted Longer Term Refinancing Operation (TLTRO) in order to further incentivize banks to take advantage of that operation. The second TLTRO is due to be allotted on December 11, so there is still time for some late changes.

The Governing Council comes into this meeting facing a problem of its own making. In September, Draghi first announced an ambitious growth target for the ECB's balance sheet -- about €1 trillion (see "[On the ECB August Policy Decision](#)" September 4, 2014). In the three months since that target was announced, the expansion has totaled a paltry €15 billion.

- At the same time, it's now been 22 months since the ECB has been able to deliver on its 2% inflation target (see "[Whatever It Takes Comes to Jackson Hole](#)" August 25, 2014).
- Surely the Council is wondering how long investors will regard the ECB as a credible institution.

The failure of the ECB to make any real progress towards its balance sheet target can be explained -- at least computationally -- by the continued drain caused by early repayments of the 3-year LTROs. But the target was announced with full cognizance that this drain was a possibility

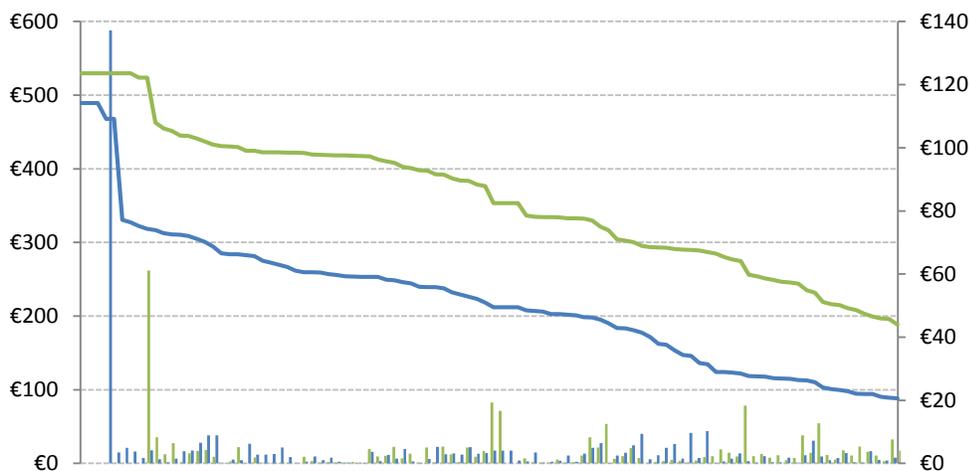
#### Update to strategic view

##### ECB, EUROPE BONDS:

At just €368 million, the ECB's first week of ABS purchases is an embarrassing washout. This is a pet project of Draghi's, six months in preparation and aided by four outside managers. This seeming failure of leadership imperils the ECB's credibility, and puts pressure on the Governing Council to possibly announce corporate bond purchases tomorrow. We still think sovereign buys are unlikely -- but we're no longer ruling them out entirely. The ECB needs to be seen as actually accomplishing something, and at least buying sovereign bonds is something it knows it can do.

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**Longer Term Refinancing Operations** — LTRO 1 — LTRO 2 € billions  
 Left scale: Outstanding balance Right scale: Weekly repayments



Source: Bloomberg, TrendMacro calculations

-- indeed, it has been an ongoing long-term trend (please see the chart above). It reflects the simple reality that the ECB is largely a demand-driven institution. There is nothing it can do to force the banking sector to accept any particular amount of central bank funding beyond the amount demanded.

The ECB's new easing programs put in place this year were designed to plug the drain, or compensate for it.

- So the failure of the first TLTRO to add much to the balance sheet is slightly worrisome -- although we never expected much from it (see "[On the ECB June Policy Decision](#)" June 5, 2014). Banks were still facing a major stress test at the time, so perhaps we can understand if they were unwilling to pile on new loans, or were just distracted (see "[Stop Stressing. Start Lending](#)" October 24, 2014). The true test of the LTRO program comes next week with the second tender operation.
- *Much more worrying is the embarrassing disaster that is the most inauspicious debut of the ABSPP.* This program, long championed by Draghi himself, and announced in September following "the intensification of preparatory work on this matter, as decided by the Governing Council in June," managed in its first full week of operations to purchase a mere €368 million of asset-backed securities.
  - That's not a typo. Million, not billion.
  - Or to put it another way, 0.037% of the total promised balance sheet expansion.
  - *Or to put it yet another way, zero.*
  - *We had expected it to be €10 billion. With a "b"* (see "[Buy More Stuff](#)" November 21, 2014).
  - From talking to market participants during the week, we think that as the ECB made its first ABS purchases, it spent a lot of energy

**Contact  
TrendMacro**

On the web at  
[trendmacro.com](http://trendmacro.com)

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[twitter.com/TweetMacro](https://twitter.com/TweetMacro)

Donald Luskin  
Chicago IL  
312 273 6766  
[don@trendmacro.com](mailto:don@trendmacro.com)

Thomas Demas  
Charlotte NC  
704 552 3625  
[tdemas@trendmacro.com](mailto:tdemas@trendmacro.com)

Lorcan Roche Kelly  
Agenda Research  
Sixmilebridge Ireland  
617 600 6969  
[lorcan@trendmacro.com](mailto:lorcan@trendmacro.com)

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**Recommended  
Reading**

[Schumer's ObamaCare  
Mea Culpa](#)  
*Wall Street Journal*  
November 25, 2014

[Measured, Unmeasured,  
Mismeasured, and  
Unjustified Pessimism:  
A Review Essay of  
Thomas Piketty's Capital  
in the Twentieth Century](#)  
Deirdre Nansen  
McCloskey  
*Erasmus Journal of  
Philosophy and  
Economics* (forthcoming)  
November 21, 2014

[The 153-Year-Old Oil  
Well That's Still Going in  
Boom and Bust](#)  
Lynn Doan  
*Bloomberg*  
November 21, 2014

[The economic effects of  
the Obama immigration  
order](#)  
Cardiff Garcia  
*FT Alphaville*  
November 21, 2014

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on price clarity, often choosing not to buy at all in order to minimize recriminations in the event it paid too much.

- We'd think that after six months of preparing for an ABS purchase program and hiring four outside firms to help, the ECB could have managed a more encouraging debut.
- Draghi's motive for sponsoring the ABS program has been to start a virtuous cycle that both deleverages euro area banks at the same time as it creates additional lending -- by helping to create a broader more transparent market for ABS in Europe (see "[The ECB's Real Agenda](#)" October 22, 2014). That the worker bees at the ECB have not gotten the memo on this is worrying. Buying on a small scale and in a very risk-averse way sends exactly the wrong signal -- it discourages the very market that Draghi is trying to encourage.
- Lack of competence? Or leadership? Or both? The Governing Council must know the market is wondering which as it prepares for tomorrow's meeting.

This puts pressure on the ECB to do something it can actually do.

- It's perhaps strange, but what we know the ECB can actually do is something it can't legally do -- buy sovereign bonds. Legal or not, it has done it twice before in the two waves of the Securities Markets Programme, once under Draghi and before that under his predecessor Jean-Claude Trichet.
- *So we are changing our long-standing view that the ECB will not do sovereign QE* (see "[No Way ECB QE](#)" October 1, 2014).
- *Our view now is that sovereign QE is merely unlikely, no longer something we utterly rule out.*
- This is not based on a change in our view as to the effectiveness of sovereign QE versus ABS purchases -- nor our perception of Draghi's view of their relative effectiveness. We, like Draghi, prefer ABS purchases.
- But if the ECB *can't* execute on ABS purchases, and it *can* execute on sovereign bond purchases, then at some point push will come to shove and the ECB will do sovereign bond purchases.
- It doesn't have to be expected to be effective. It just has to be expected to be something that will rescue the ECB's credibility.

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### Bottom line

At just €368 million, the ECB's first week of ABS purchases is an embarrassing washout. This is a pet project of Draghi's, six months in preparation and aided by four outside managers. This seeming failure of leadership imperils the ECB's credibility, and puts pressure on the Governing Council to possibly announce corporate bond purchases tomorrow. We still think sovereign buys are unlikely -- but we're no longer ruling them out entirely. The ECB needs to be seen as actually accomplishing something, and at least buying sovereign bonds is something it knows it can do. ▶