ECB preview: ushering in QE

Policy on hold

- I expect the Governing Council to leave all policy instruments unchanged when it meets this week. I also think the Council is contemplating quantitative easing (QE) as its next step, however, and that President Draghi will address the bank's reaction function to the gradual de-anchoring of medium and long-term inflation expectations.
- Draghi's comments at Jackson Hole open the door for the ECB to change its message hitherto that long-term inflation expectations are firmly anchored.
- While long-term inflation expectations are gradually drifting below 2%, medium and short-term expectations derived from inflation swaps are all well below the ECB's definition of price stability over the policy relevant horizon. Persistently low realized inflation risks entrenching these expectations at longer time horizons.
- It is probably too early for a significant majority on the Governing Council to favour implementing QE at this point. After the Council eased policy in June, I thought it would want to observe the impact of targeted long-term refinancing operations (TLTROs) in the third and fourth quarters of this year before considering whether additional measures would be necessary in 2015.

Liquidity trap

- While that view still holds, the challenge to it, however, is that inflation continues to undershoot and the intensification of geopolitical risks threatens to derail the fragile recovery before the first two TLTROs will be implemented, causing the eurozone to sink deeper into a liquidity trap and raising the possibility of additional stimulus later this year.
- The flow of total credit to the private sector – from loans, bonds and equities – contracted by €142 billion in the first half of 2014. While deleveraging shows signs of slowing down and may soon come to a standstill, credit is a slow-moving variable that will require many months before returning to a sustainable expansion pattern.
- The conflict in Ukraine is a significant event not only for the loss of lives incurred there but for the economic fallout associated with it. For the eurozone, the economic fallout so far is limited to a modest decline in business confidence and exports and the potential for lower food prices as sanctioned exports destined for Russia are redirected back to the domestic market.
- Investment thrives on certainty. War creates uncertainty. Second-round impacts associated with the conflict are notorious to quantify ex ante, yet common sense suggests the threat of further sanctions and counter-sanctions, on the eurozone automobile industry for example, bode ill for growth.
- I would expect the Governing Council to look through potential increases of inflation owing to oil and gas supply shortages since aggregate demand would also suffer in such a scenario.

Ushering in QE

- If the ECB contemplates further stimulus I think it will take the form of QE.
- "*I would say that for all the practical purposes, we have reached the lower bound*" – such was President Draghi's message in June after cutting interest rates and announcing TLTROs.

- ECB policy actions have followed a clear reaction function outlined by President Draghi in Amsterdam earlier this year. In that speech he said the ECB would respond to "*a broad-based weakening of aggregate demand that derails our baseline scenario of a moderate recovery*" with a "*broad-based asset purchase programme*.[1]" Persistently low inflation and high unemployment, weak credit growth, below 2% inflation break-evens for the next five years and growth-negative trade sanctions suggest a broad-based weakening of aggregate demand is unfolding.
- To be effective, a QE programme would need to be about €500-€1,000 billion in size. About two-thirds of purchases would likely be central government securities with the balance comprising covered bonds, asset backed securities and European agencies and supra-nationals. The ECB's capital key would provide a rough guide for the geographical distribution of purchases and I think they would center on securities with three to ten year maturities.
- By compressing interest rate term premia and lowering the external value of the euro such a programme ought to help arrest the decline in growth and inflation. But returning to a sustainable growth trajectory will also require contributions from the fiscal agents, not just through structural reforms and but in how budget policy is distributed over time and geography and, ultimately, how the eurozone's fiscal governance structure will be constructed.

Andrew Bosomworth

Managing Director, PIMCO

"*A third contingency would be a worsening of the medium-term outlook for inflation. One cause for this could be by a broad-based weakening of aggregate demand that derails our baseline scenario of a moderate recovery. Another cause could be a substantial positive supply shock that, given the current low level of inflation, loosens the anchoring of medium-term inflation expectations. Unlike the other contingencies, the objective here would not be to defend the current stance, but rather to increase meaningfully the degree of monetary accommodation. Hence, the limited margin for manoeuvre that remains over short-term interest rates would not be sufficient. This would be the context for a more broad-based asset purchase programme*." Mario Draghi, Amsterdam, 24 April 2014.

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