Europe-X-Press

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ECB Delivers On Quantitative Easing

Event

European Central Bank (ECB) President, Mario Draghi, announced that the governing council decided to expand the ECB's asset-purchase program to €60 billion per month, which will start on March 1st, 2015 and run through at least September 2016 — totaling upwards of €1.1 trillion of investment-grade assets. In addition to the existing covered bonds and asset-backed securities purchases, the new buying program will be broadened to include sovereign bonds, debt securities issued by European institutions and private-sector bonds. The ECB also lowered the interest rate on its six remaining Targeted Long-Term Refinancing Operations (TLTRO) by 10 basis points (bps).

Significance

This landmark decision highlights the ECB's significant concerns regarding the euro area's lackluster economic recovery and deflationary dynamics. The ECB left the door open for unlimited quantitative easing (QE) as long as inflation is not in line with its price stability mandate. The program was also designed to limit the ECB's exposure to potential losses, while cutting Greece out of program for at least six months until policy uncertainty can be resolved.

Market Tone & Reaction

The ECB's larger-than-expected asset purchase program was well received by market participants. The euro (EUR) has experienced broad-based weakness against the four major currencies, such as the US dollar (USD), the British pound (GBP), the Japanese Yen (JPY), and the Swiss franc (CHF). Equity indices on both sides of the Atlantic have rallied, while yields on 10-years sovereign bonds in the euro zone have fallen to new record lows. Yields on 10-year Greek government bonds also edged down roughly 60 bps to 8.4%.

Analysis & Outlook

With prevailing monetary policy proving insufficient in boosting the ECB's balance sheet and addressing the heightened risk of too prolonged a period of low inflation, full-blown QE was the only weapon left in the ECB arsenal. However, the latest decision out of the ECB contained some surprises.

While a timeframe for the expanded asset purchasing program was specified, the ECB ultimately announced an open-ended QE program by tying its duration to the sustained improvement in inflation consistent with its price stability mandate of close to, but below 2%. The ECB has also tied its bond-buying program to good behavior by including additional eligibility criteria for members under an EU/IMF adjustment program, which is currently only applicable for Greece. However, Draghi suggested that if Greece meets the conditions of its bailout plan, the ECB could be purchasing the country's bonds by summer — offering an encouraging push for the new government to strike a compromise with EU institutions. Furthermore, the ECB plans to buy assets with maturities ranging from 2-30 years, including bonds with negative yields, and will try to limit price distortions by purchasing no more than 33% of an issuer's debt or 25% of an issue. In terms of risk sharing, the ECB chose to limit its exposure to potential losses by placing most of the burden on National Central Banks. Indeed, this could be viewed as disappointing and as fragmentation in the management of monetary policy. But overall Draghi delivered.

The economic outlook in the euro area remains subdued. The sharp decline in oil prices has sent euro zone HCPI inflation to a five-year low of -0.2% y/y in December. Deflationary pressures are forecast to persist through most of 2015 and present adverse second-round effects on future wage and price expectations. Meanwhile, the region's recovery remains constrained by weak domestic demand, elevated unemployment, insufficient structural reforms, and subdued monetary and credit dynamics.

Significant monetary accommodation by the ECB will maintain the depreciatory bias on the EUR. In turn, this should support medium-term price stability by increasing import costs and economic growth on the back of greater export competitiveness. However, it is no cure all. Some euro zone lawmakers' inaction and/or inability to implement necessary structural reforms in product and labour markets continue to undermine confidence and growth in investment and productivity. More accommodative fiscal policy — in accordance with the Stability and Growth Pact — would also be helpful at the national level to support long-term growth and job creation.

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