ECB Measures Highlight Draghi's Determination

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The reduction in eurozone interest rates announced on September 4 by European Central Bank (ECB) President Mario Draghi came as a bit of a surprise to some market players. But David Zahn, Head of European Fixed Income and portfolio manager, believes that this move, along with the confirmation of the commencement of the bank's asset-backed securities purchase program, is very much in line with its previous action and suggests a central bank president who is in control and determined to get the eurozone's economy back on track.

The latest measures unveiled by European Central Bank President Mario Draghi follow on nicely from the measures announced in June. In fact, it's not really a new package; I see it more as a continuation of the old package with elements that very much dovetail with one another.

Draghi has long insisted the bank would continue to take what it feels is appropriate action to get the eurozone economy on track, and he reinforced that message most recently in August at the Federal Reserve Bank of Kansas City-sponsored economic conference in Jackson Hole, Wyoming. He'd already taken a step in that direction back in June when he announced the last rate cut and first revealed the bank's asset-backed securities purchasing program and Targeted Longer-Term Refinancing Operations (TLTROs), but now he's reinforced that message with more measures. This consistency of message and action is quite a powerful statement and suggests to me this is a central bank president that's in control and knows what he wants to do. Whether it all works as he expects is a different question, but at least he knows what he wants to do.

European government bonds have reacted quite favorably to the latest announcements, specifically in the peripheral markets: Italy and Spain in particular have done quite well.

I thought it was interesting that on September 5 – the day after the announcement – two-year government bonds in Germany, Denmark, Belgium, Netherlands, Finland, France, Austria and Ireland all had negative yields. This is likely going to push foreign buyers further up the curve looking for yield, I believe.

I do think, however, that these newly announced measures indicate that inflation (or lack thereof) continues to give the ECB cause for worry.

The ECB forecast for eurozone growth was lowered to 0.9% for 2014, compared with a previous forecast back in June of 1%, but its inflation forecast for 2016 is still sitting at 1.4%. That's still quite a bit below its target and is based on its own numbers, which have tended to be optimistic in the past. The five-year forward forecast for inflation also falls shy of the target of close to, but just below, 2%.

A Path of Easy Monetary Policy

Cutting the interest rate by 10 basis points to 0.05% and dropping the deposit rate to minus 0.2%, in my view, shows the ECB has done everything it can on interest rates. But it also suggests to me that we're likely to continue to have easy monetary policy for some time to come in the eurozone, and building on what the ECB has already done, and I'd also expect it to do more in the future.

The ECB seems to remain focused on getting liquidity into European banks and encouraging them to do something with that money. By dropping a negative deposit rate even lower, it is effectively saying: "You can't give that money back to us because we'll charge you."

The Asset-Backed Securities (ABS) purchase program that Draghi has now confirmed will start in October, and will see the ECB making outright purchases of certain asset-backed securities. The full details of the size and exactly how the ABS program will work will be made public in due course. Draghi said the program would be open to asset owners including institutional investors, but in general, in Europe, it is banks that hold those assets, and they are the ones that will get the liquidity. The TLTROs are also intended to inject more liquidity into banks.

It’s also interesting that in response to a question about the size of the ABS program, Draghi said he wanted to move the ECB balance sheet back to its 2012 dimensions – about €3.1trn – that’s quite a bit away from where we are now – just over €2trn at the beginning of September.

For the last two years, the balance sheet has been contracting, while the economy has not been doing well. I think it’s significant that Draghi is predicting the ECB balance sheet will now start to expand again.

Meanwhile, for the first time, Draghi has acknowledged that Quantitative Easing (QE) had been discussed by ECB board members. I believe that the bank is likely to introduce QE somewhere down the line, but this acknowledgement brings it more to the forefront: they’ve discussed it and have now openly said they’ve discussed it. So I think that actually brings the prospect of QE further forward.

At the same time, it seems to me the weakening of the euro versus other European currencies and also against the US dollar that we’ve seen in response to these latest announcements could very well be the beginning of an ongoing trend. I believe euro weakness is likely to have an inflationary effect for Europe, which is part of the reason the ECB wanted to weaken it, but it should also help exports to a moderate degree. That, in turn should help growth potential.

With these latest announcements, Draghi has brought more of his tools out of the toolkit but not all of them: he still has the QE option should he need it.

Lastly, Draghi also seems to be saying that the onus cannot only be on him and his ECB colleagues. He has increased the level of his rhetoric on the fiscal approach across the eurozone, implying that maybe the drivers of economic improvement shouldn’t all be through monetary policy. To me, Draghi seems to be hinting that there needs to be some fiscal loosening and perhaps some regulatory change. I think he's laying the groundwork to suggest that the finance ministers of individual countries need to work with him to get the eurozone going in the right direction.

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