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GLOBAL ECONOMIC & MARKET OUTLOOK
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FOCUS NOTES

The ECB is expected to announce purchases of sovereign debt in Q1 2015

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- Amidst falling inflation expectations, anaemic growth prospects and mounting pressure to act, we expect the ECB to embark on sovereign quantitative easing (QE) in the first quarter of 2015.
- Although resistance to sovereign debt purchases by the ECB is high, monetary action seems more palatable to opponents than political action, such as some form of fiscal risk sharing.
- In our view, both the size and the synthesis of the ECB's QE matters. The size of QE matters mainly in terms of ring-fencing the ECB's credibility as price stability defender and in terms of currency depreciation.
- The ECB should also broaden its purchases of private assets in order to target more effectively lending to SMEs, which are highly dependent on bank lending and continue facing fragmented financial conditions.

In the last meeting of the Governing Council, President Draghi stopped short of announcing new monetary measures. However, a linguistic change was duly noted as he stated that the ECB's balance sheet is intended- as opposed to expected- to rise by about €1tn. Interestingly enough, he mentioned that the Governing Council pondered on the purchase of all assets apart from gold and, all the more interesting, that sovereign quantitative easing does not have to be based on a unanimous decision, an allusion to German opposition.

The Governing Council refrained from taking additional measures in Q4 2014, as it opted for allowing time to assess the impact of the measures already in place. However, purchases of ABS and covered bonds have so far been telling of their restricted clout to increase the ECB's balance sheet. The lackluster take-up at the two TLTROs has also illustrated that abundant liquidity provision is not the most appropriate course of action in the current circumstances. Insufficient monetary policy on a backdrop of lingering economic weakness and mounting political risk is fueling markets' worries about price dynamics, as is evident by a continued drop of long-term inflation expectations (Figure 1).

Amidst growing pressure to act, we believe the ECB is ready to embark on full blown quantitative easing. We expect it to announce government bond purchases either at the meeting of January or March next year. Most likely, the ECB will announce sovereign QE in January and spell out the details in March. By that time, the European Court of Justice Advocate will have published his opinion on the OMT program (January 14). Although not binding, his decision is allegedly not expected to be a hindrance on public debt purchases by the central bank. Meanwhile, state elections in Hamburg on 15 February, imply that the ECB may choose the March meeting to launch sovereign bond purchases in order to meet less resistance from Germany.

Further to the timing of the decision, from January 2015, following Lithuania's accession to the euro, the voting system of the ECB's Governing Council will switch to a rotational scheme. The German central bank governor, Mr. Weidmann, will not participate in the April meeting. Launching QE in April is deemed unlikely, as it would most probably convey a negative political signal. This corroborates our view that QE should be decided at either the January or March meeting.

Figure 1
Long-term inflation expectations on a declining trend

Source: Bloomberg

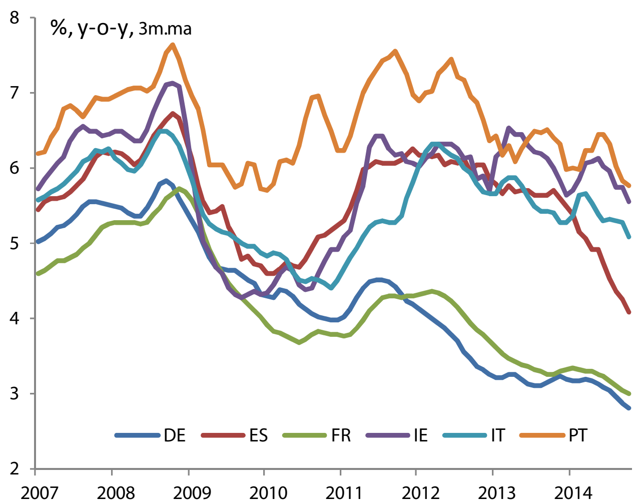
We acknowledge that the German opposition to sovereign debt purchases by the ECB remains high. Trepidation over the possibility of higher than desired inflation due to money printing may have subsided, as oil prices have plummeted and the German economy is affected by the euro area weakness and drawbacks elsewhere in the world. However, concerns over breaching the rules about debt monetization and the moral hazard induced by QE with respect to reform undertaking remain elevated.

During the sovereign debt crisis, the ECB has repeatedly stepped in to save the day, as politicians took very hesitant steps towards fiscal risk sharing, or towards adopting a more balanced policy mix, i.e. one involving both structural reforms and demand promoting initiatives. Juncker's recently announced European Fund for Strategic Investment plan constitutes a step in the right direction. However, its ability to motivate private funds fifteen times as much as the public money involved is deemed as a tall order. For such a leverage to materialize, an independent project selection committee to pick truly strategic projects is required. Moreover, of the €21bn of public funds the plan is endowed, €8bn is not new money but it comes from other growth programs of the EU. It remains open to question whether funds will be funneled more efficiently under the new initiative in order to reinvigorate growth and employment. Therefore, the effectiveness of the initiative to resuscitate the economy may prove contained. Given the risk from the looming economic weakness in France and Italy, we believe Germany will likely opt for ECB action as more palatable compared to other forms of assistance, such as taking steps towards debt mutualization or a generous injection of public money to shore up demand in the euro area.

The class of sovereign bonds offers a vast pool of assets that can be purchased (the eligible securities amount to €6.6tn, as of Q3 2014). Including this asset class in its QE, it will enable the ECB to expand its balance sheet sizably, as intended. The signal conveyed of the ECB being a credible guardian of price stability will be strong. Sovereign QE will also work through the exchange rate channel, leading to a sustained depreciation of the currency. Although the exchange rate does not constitute a target of the ECB, improved terms of trade offer great service to debt-afflicted members, which are trying to rebalance towards exportable sectors. To amplify the impact of sovereign QE, a peace-meal approach should be avoided. Once launched, the ECB should proceed with large-scale bond purchases and stand pat, despite likely contending voices.

While focus is clearly on sovereign bonds and their impact on the size of the QE, in our view, the ECB should also modify the components of its basket of asset purchases in order to target SMEs. SMEs continue facing harsh credit conditions in a financially fragmented euro area (Figure 2). What is more, they are the category of firms most dependent on bank credit, as their access to capital markets is limited. This implies that the potential of sovereign QE to work through the portfolio rebalancing channel for the benefit of SMEs is limited. To spur credit extension to SMEs, the ECB could add targeted asset purchases, such as mezzanine tranches of ABS without guarantees or corporate bonds of lower credit rating. Such an action could propel issuance of these assets and allow banks to offload credit risk from their balance sheets, stimulating lending to SMEs.

Figure 2
Financial fragmentation persists



Note: Rates refer to new business loans up to €1mn and with maturity over 1 year, typical features of loans to SMEs
Source: ECB

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