May 20, 2014

What can the ECB do to act on the EU's growth?

Yes or no to European QE? ECB President Mario Draghi poised to act as soon as June 2014. But is it not the exchange rate the main problem?

Key Points:

- The ECB will most certainly announce a concrete action on its next June 5 meeting
- The exchange rate is becoming a matter of greater concern
- The strength of the euro is mainly due to the very positive current accounts
- The Purchasing Power Parity suggests a EUR/USD at 1.13
- The ECB is in a similar situation to that of the SNB in 2011 – can it pursue a similar monetary policy?
- ECB intervention on key interest rates will be insufficient to weaken the single currency
- An asset purchasing program (European QE) could have an impact on long-term rates, inflation and real interest rates
- The ECB is expected to announce favorable measures for the fixed-income and equity market

ECB is ready to take action at its next meeting in June 2014

During the last meeting of the European Central Bank (ECB), President Mario Draghi said the ECB is ready to take a new concrete action next month to boost the euro zone economy.

The latter actually announced that the ECB was ready to adopt further measures to support growth in Europe, given that recent data showed new striking signs of weakness.

Financial markets reacted favorably to what appears to be synonym of a probable interest rate cut.

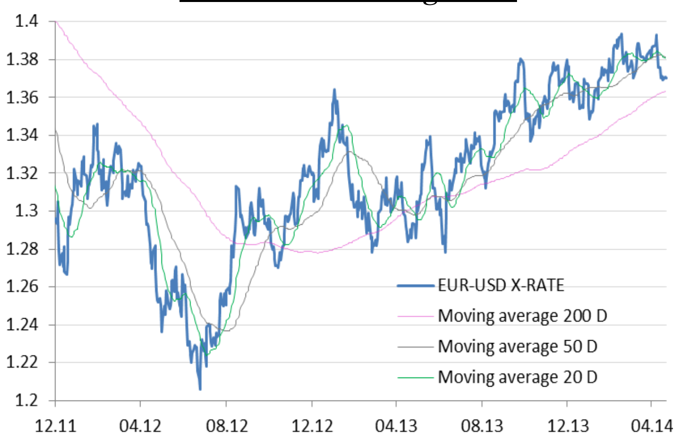
The ECB could certainly announce in June at least a 10-15 basis point reduction in key interest rates, refinancing rates and deposit facilities.

Even if Mr Draghi has indicated a probable date, he did not specify what policy action the ECB could take beyond. At the risk of jeopardizing his credibility otherwise, there will eventually be a concrete announcement in June that should reassure markets after the disappointments caused by the recent release of European GDP and national EU member countries growth figures. Especially, since there seems to be a broad consensus for a specific new action in the Governing Council of the ECB. Such action is based on the unsatisfactory trend of inflation in the euro area.

The exchange rate at the center of EU concerns

Without clearly indicating what measures could be considered, the question of the exchange rate has long been discussed as one of the possible brakes to the European economic recovery.

<u>EUR/USD Exchange Rate</u>



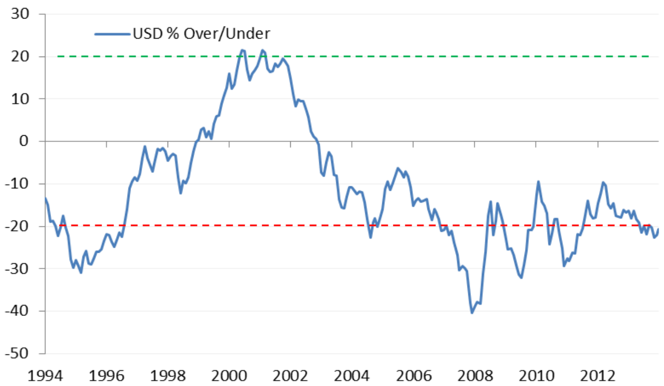
Sources: Bloomberg, BBGI Group SA

Since 2012, the exchange rate Euro/U.S. dollar actually bounced by 16%, a very penalizing appreciation for euro zone exports.

According to the Purchasing Power Parity (PPP), which suggests the exchange rate theoretical value at 1.13, the euro is overvalued by about 21% against the U.S. dollar.

But the figure calculated by the OECD is less extreme and appears to be only 6%, similar to the Purchasing parity level of the Big Mac index (5.07%).

PPP EUR/USD (1994-2014)



Sources: Bloomberg, BBGI Group SA

Just a few days ago, two Governing Council officials also mentioned that the ECB is considering a package of possible measures rather than relying uniquely on interest rate cuts. Such an action being insufficient to trigger all expected effects.

Even if the exchange rate is not one of the ECB's monetary policy objectives in the strict sense, Mario Draghi still recalled its importance for the control of prices, inflation and growth.

He stated that «…the exchange rate is the cause of persistent low inflation…» he clearly indicated that the strengthening exchange rate was « …cause for serious concern… ».

When the SNB had confessed its concern of a very strong Swiss franc, it consequently announced back in September 6, 2011 that it would adopt a new policy of a minimum exchange rate of CHF 1.20 per euro. Two and a half years later, its policy remains unchanged and the Swiss franc is permanently stabilized above the 1.20 threshold. At the height of the financial crisis in Europe, the Swiss franc had appreciated and almost reached parity against the euro. In the wake of such events, the exchange rate jumped from 1.0073 to 1.15 in only four days, before falling back to 1.10 and then finally depreciating by 10% on September 6, with the announcement of an aggressive exchange rate policy.

The SNB initially shocked the Forex market but it was in 2012 that it doubled the size of its foreign exchange reserves. The latter were below $200 billion during the summer of 2011 but literally exploded above $400 billion twelve months later.

The ECB could announce an action whose effects could be similar and largely reinforced by the differential growth expected in the coming quarters and the interest rate differential between the United States and the euro zone?

Can the ECB unilaterally implement a low euro?

The ECB has clearly changed its tone at its press conference on May 8, specifically, by pointing to the exchange rate as one of the main factors behind an anemic economic activity.

But so far, did it have the means to act unilaterally?

The current account surplus registered by the euro zone and Germany in particular largely explains the current single currency strength. Today, the interest rate differential plays a role in the yield spread between U.S. and German rates.

In our view, the announcement of the ECB'S action at its policy meeting on June 5 initiated a process of a sustainable correction of the value of the euro, which could intensify in the coming weeks.

Low interest rates are now likely but limited given the already very low rates. Thus, a 10 to 15 basis point decrease should not have a major effect on the exchange rate.

The ECB could use other levers and move into unchartered territory by setting a negative rate on bank deposits which benefit from the privilege of parking their money at the ECB.

Such an initiative could encourage banks to sell their surplus in euros and buy other currencies to benefit from a positive interest rate. However, this strategy would include a currency risk, which would be acceptable if the likely consequence were, for instance, to lower the value of the euro against the U.S. dollar.

Several members of the Governing Council of the ECB have recently expressed the view that a negative deposit rate would certainly be more effective to tackle the single currency's appreciation rather than cutting interest rates.

The idea is to rather avoid a unilateral decision on the key interest rate but rather, act on several interest rates to reach a more substantial effect.

Still, it remains difficult to foresee a concrete action which could only target the exchange rate, even if the ECB is aware that the exchange rate is at the center of its concerns, it is also aware of the fact that it is not a key monetary policy objective.

Are we looking at a EU version of the US QE program?

Mario Draghi has already hinted that in a context of an overvaluation of the euro and a weaker than expected inflation, the ECB is readying the possibility of buying asset backed securities in order to ease its monetary policy.

The lack of wiggle room on short-term interest rates in order to stimulate growth, along with low inflation, are conditions which force to adopt a more deterministic approach.

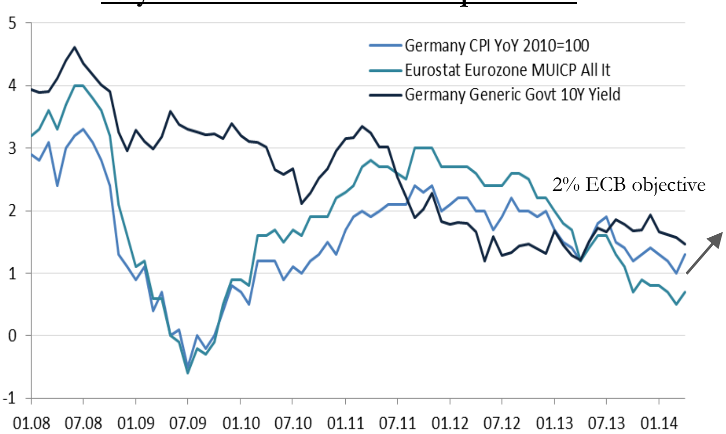
Is a broad-based quantitative easing program being considered?

The evolution of inflation is an important parameter in the implementation of such a strategy. The ever more marked decline in prices in Europe since the beginning of the year would further support this vision.

Manufacturing PMI data continue to suggest a recovery in the sector, but the released growth figures show no clear sign of such expectations.

On the other hand, despite the decline in long-term rates in Europe and a return to the April 2013 levels, 10-year government rates are still higher compared to current inflation. Despite a decline in long-term rates, the fall of inflation from 3% in 2011 to the more recent 0.7% in 2014 caused a rise in real interest rates in Europe, which is synonym of monetary tightening.

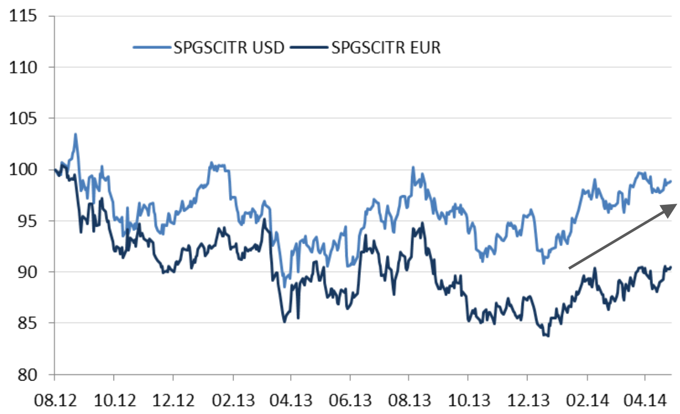
10-year Interest Rates – European CPI



Sources: Bloomberg, BBGI Group SA

Therefore, a recovery in demand does not always have a significant effect and lower commodity prices (expressed in euros), which continue to weigh on inflation data. We do not believe that the risk of a downward spiral for commodities could occur and create an additional risk of deflation in Europe. Instead, the economic recovery in the United States has already begun to support the price of certain commodities, since the beginning of the year. The outlook for the prices of oil, gas and industrial metals is in our view bullish for 2014.

Commodity Prices in USD and EUR



Sources: Bloomberg, BBGI Group SA

But the evolution of inflation will quickly be determined by a possible upcoming fall in the euro or by a rise in commodity prices.

We believe that these two causes will materialize in the coming months and inflation will go back to the ECB's long-term objective of 2%.

Could an asset purchasing program accelerate inflation, lower real interest rates and push the euro to weaker levels?

At first, a lower interest rate and deposit facilities could have a downward effect on the euro and an indirectly induced bullish effect on inflationary expectations. But, it is especially through a further decline in long-term rates that an easing of liquidity (QE program) could also help lower nominal interest rates and encourage a rapid decline in real interest rates.

The **purchase of sovereign debt** could be considered, provided that they are widespread and affect all public debt issued by EU member states. It would then be possible to proceed in the same way as for purchases of covered bonds based on the proportions of the single EU member central banks investments in the ECB's capital.

Alternatively, there is the option of embarking on a mass **purchase of government bonds**. Experts recommend the ECB should spend 35 billion euros a month. This amount would be divided into approximately 15 billion euros for private corporate bonds and 8 billion euros in asset back securities (ABS) and 12 billion in debt issued by agencies (EFSF/ESM/EU/EIB bonds). Quantitative easing could then be extended to redemptions of bank debts with the goal of reducing the yield spreads, improving margins and thus promoting the conditions for financing and give loans to businesses and households. The estimates show an impact of around 1% of inflation a year.

An influential think-tank in Brussels engineered that the total pool of bond purchases would amount to approximately 420 billion euros.

It has unveiled a « shopping list » of potentially eligible purchases of about 14,000 billion securities, which may be overestimated and lead to a scaling-down of the monthly targets. Thus, even if the ECB might consider launching a QE program, the amounts involved should certainly be significantly lower than the envisaged 35 billion euros per month.

Another thing which could be considered could joint action on the government and "corporate" debt, which could still occur at these levels and have the ECB's desired effect.

On June 5, the ECB will probably announce concrete action which will affect the interest rate corridor and perhaps already hint at the implementation of a European QE whose details are still to be defined. This might be sufficient to create new expectations and trigger a new wave of interest rate decline in the euro zone and a depreciation of the single currency.

Conclusion

The ECB will soon announce a change to its monetary policy.

The key interest rate will probably be cut by 10-15 basis points, while excess deposits rates could end up being negative.

This decision should be followed by new declarations favorable to a depreciation of the euro.

The announcement of a European QE which is still to be defined could, already create enough momentum to revive a low of long-term rates.

The European bond and equity markets should benefit from this new positive economic environment.

BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva -Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch