Draghi Pushes ECB Closer to QE as Deflation Risks Rise

By Simon Kennedy and Alessandro Speciale - Aug 24, 2014

Mario Draghi just pushed the European Central Bank closer to quantitative easing.

With euro-area data this week poised to show the weakest inflation since 2009, the ECB president used the high-profile central banking conference in Jackson Hole, Wyoming, to warn that investor bets on prices have “exhibited significant declines.”

The comments will fan speculation that to ward off Japanese-style deflation the ECB is finally heading for a form of monetary stimulus it has long avoided. Draghi has previously said that a worsening of the medium-term inflation outlook would provide a reason for broad-based asset purchases.

“He clearly signaled strong interest to do what it takes,” said Glenn Hubbard, dean of Columbia Business School and a former adviser to President George W. Bush. Hubbard attended the Aug. 22 speech and said he expects Draghi to conduct QE.

Euro-area inflation slowed to 0.3 percent this month, a fraction of the ECB’s goal of just under 2 percent, according to the median forecast in a Bloomberg News survey ahead of an Aug. 29 report. Other releases this week are predicted to show unemployment sticking close to a record high and economic confidence falling. Gross domestic product in the 18-nation currency bloc stagnated in the second quarter.

‘Stand Ready’

Draghi showed his concern in his Jackson Hole speech by singling out his preferred gauge of inflation expectations. The 5-year, 5-year inflation swap rate fell below 2 percent this month for the first time since October 2011, according to data compiled by Bloomberg.

“The Governing Council will acknowledge these developments and within its mandate will use all the available instruments needed to ensure price stability over the medium term,” Draghi said at the Federal Reserve Bank of Kansas City’s annual economic symposium.

The remarks on inflation expectations were ad-libbed by Draghi after being omitted from the original text of his speech. In the scripted text, he also said “we stand ready to adjust our policy stance further.”

Draghi’s fear is that if inflation expectations keep falling, they’ll affect actual inflation as investors, consumers and companies pull back spending in anticipation of even weaker prices. That could tip Europe into a deflationary spiral that would be hard to reverse.
Policy Debate

Citigroup Inc. economists last week predicted that the ECB will unveil a QE program in December valued at 1 trillion euros ($1.3 trillion), split between public and private assets and aimed at reducing borrowing costs and increasing liquidity. JPMorgan Chase & Co. said the ECB may enhance existing measures before buying bonds.

The speech “prepares the ground for a debate that may result in more action,” said Greg Fuzesi, an economist at JPMorgan in London. “It will be crucial to see both how the data evolve in the coming weeks and how policy makers more broadly respond to Draghi’s speech.”

The ECB’s Governing Council next meets to set monetary policy and issue fresh economic forecasts on Sept. 4 in Frankfurt. It has so far avoided QE amid political, legal and logistical concerns over how such a program would be carried out and questions over whether it would achieve much given that bond yields in many euro-area countries have dropped to record lows.

German Weakness

It still may not come. Draghi didn’t mention QE directly in his speech and said he is “confident” that unprecedented measures announced in June will work.

The ECB reduced the benchmark interest rate to a record-low 0.15 percent and became the first major central bank to use a negative deposit rate. Policy makers will lend banks as much as 400 billion euros next month in the first stage of a funding program tied to real-economy loans. Officials are also “fast moving forward” with a program for buying asset-backed securities, and the euro area should benefit from a weaker currency, Draghi said.

The euro last week slid to an 11-month low against the U.S. currency at $1.3221.

Even so, the bloc’s economic weakness is looking increasingly broad. Unemployment (UMRTEMU) probably held at 11.5 percent in July, near the record of 12 percent set last year and almost twice as high as the U.S. rate. Germany, the region’s powerhouse, saw GDP drop last quarter and a report today is forecast to show business confidence in the country declining. Escalating sanctions against Russia because of its support for separatists in Ukraine add to the risks.

Fiscal Help

Draghi intensified pressure on European governments to play their part, saying “it would be helpful” if those with room to ease fiscal policy did so.

“We need action on both sides of the economy: aggregate demand policies have to be accompanied by national structural policies,” he said. “We should not forget that the stakes for our monetary union are high.”

Quantitative easing would burnish Draghi’s reputation as a central banker of action two years after he pledged to do “whatever it takes” to save the single currency amid a festering sovereign debt crisis. It
also would reinforce the Jackson Hole conference’s status as a source of news given then-Fed Chairman Ben S. Bernanke used it in 2010 and 2012 to signal new rounds of quantitative easing in the U.S.

The Fed is now slowing its own QE program and Draghi’s policy stance increasingly runs counter to that of Chair Janet Yellen. She told the symposium that the U.S. labor market has made “considerable progress” and that officials are debating when they can begin “dialing back our extraordinary accommodation.”

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