Draghi Sees Almost $1 Trillion Stimulus With No QE Fight

By Simon Kennedy - Sep 4, 2014

Mario Draghi signaled at least 700 billion euros ($906 billion) of fresh aid for his moribund economy and left a fight with Germany over sovereign-bond purchases for another day.

Pledging to “significantly steer” the European Central Bank’s balance sheet back toward the 2.7 trillion euros of early 2012 from 2 trillion euros now, the ECB president yesterday announced a final round of interest-rate cuts and a plan to buy privately owned securities. His mission: to revive inflation in the 18-nation euro area.

Fully-fledged quantitative easing as deployed in the U.S. and Japan wasn’t enacted amid a split on the 24-member Governing Council, with Bundesbank President Jens Weidmann opposing the new stimulus and others seeking more. The latest round of measures pushed the euro below $1.30 for the first time since July 2013 and sent European bond yields negative.

The steps “probably reflect that President Draghi does not have unanimity, or a large enough majority for quantitative easing,” said Andrew Bosomworth, a Munich-based portfolio manager at Pacific Investment Management Co. and a former ECB economist. “The ECB is ready to do more if more is needed.”

Encouraging Consumers

With euro-area inflation languishing at 0.3 percent last month, a fraction of the ECB’s 2 percent goal, and Draghi saying price expectations are worsening, policy makers unexpectedly cut interest rates. The benchmark and deposit rates fell by 10 basis points to 0.05 percent and minus 0.2 percent, respectively.

That may help encourage companies and households to spend rather than save. It could also attract greater participation in a targeted lending program for banks that was unveiled in June and starts this month. Banks can borrow from the ECB for as much as four years at a small premium to the benchmark rate.

The rate cuts mark the bottom line for conventional monetary policy. Declaring that the ECB can now reduce them no more, Draghi committed to buying so-called asset-backed securities and covered bonds in the hope that will funnel cash into an economy which stalled in the second quarter and where lending has been shrinking for more than two years.

ABS are packaged securities backed by underlying instruments such as mortgages or credit-card debt,
containing slices with different risk profiles. The covered-bond purchases will revive a measure that the ECB ended in 2012.

**Less Risky**

Draghi gave few details on the size or nature of the ABS plan, saying the “modalities” of the program will be announced in October. The ECB will initially target the less-risky segment of the market, which collapsed in the wake of the financial crisis after being criticized by politicians and regulators for being opaque. The ECB may consider buying more-risky versions if governments provide a guarantee.

“We want to make sure that these ABS are being used to extend credit to the real economy,” Draghi said. The measures “are predominantly oriented to credit easing.”

Weidmann, who has clashed with Draghi before over the need for stimulus, opposed the policy measures, according to two euro-region central bank officials. A Bundesbank spokesman declined to comment. In July, the German central-bank head called ABS purchases “problematic” and warned against supporting bank profits while socializing the losses.

**Asset Bubbles**

Draghi, who has shown a repeated willingness to act aggressively since taking the helm of the ECB in 2011, said he secured a “comfortable majority” in favor of action.

The dissent from Weidmann highlights how tricky it may be to win approval for quantitative easing. Germany has been the biggest proponent of the view that large-scale sovereign-bond purchases could constitute monetary financing of governments, which is banned under European Union law.

Weidmann and German politicians have also argued that QE risks inflating asset bubbles. European bond prices rose and yields fell to record lows yesterday, with two-year notes below zero in eight countries.

Spain sold 10-year bonds at an average yield of 2.272 percent. The equivalent government debt in the U.S., where the Federal Reserve is tapering its QE program and debating when to raise interest rates, yields 2.44 percent.

**Falling Expectations**

Even so, the ECB’s concern is that a prolonged period of low inflation will cut predictions of future price growth and tip the euro area into a deflationary spiral. Reiterating comments made last month at a symposium of central bankers in Jackson Hole, Wyoming, Draghi said inflation expectations have fallen “across all maturities.” He also dropped his standard line that inflation risks are “limited and broadly balanced.”

The ECB lowered its macroeconomic forecasts for this year and next from its previous assessment in June, when it last cut interest rates. Gross domestic product is now predicted to expand by 0.9 percent this year and 1.6 percent in 2015, instead of the previous 1 percent and 1.7 percent. Inflation is seen at...
0.6 percent this year instead of 0.7 percent previously. The inflation outlook for 2015 is unchanged at 1.1 percent.

Draghi repeated that monetary easing must be combined with structural reforms, indicating a desire for Europe to pursue an all-fronts approach to boosting its economy as practiced in Japan by Prime Minister Shinzo Abe.

Members of German Chancellor Angela Merkel’s party yesterday criticized the ECB’s decision, saying it eases the need for France and Italy to follow through on economic reforms. Those nations are among countries that have pushed for greater flexibility within EU fiscal rules.

Commerzbank AG economist Joerg Kraemer said there is still a 60 percent probability the ECB will eventually buy government bonds should its forecasts deteriorate.

The “decisions show the ECB reacts sensitively to disappointing economic expectations,” he said. “Major disappointments are still looming.”

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