Traders are showing confidence in Mario Draghi’s ability to weaken the euro and stave off deflation, even as the initial results of a key part of the European Central Bank president’s plan fell below estimates.

Draghi has signaled he wants to boost the central bank’s balance sheet to as much as 3 trillion euros ($3.8 trillion) of assets from 2 trillion euros, expanding the supply of euros in the process. Yet, when the ECB went to lend cash to banks under its first targeted longer-term refinancing operation, they borrowed just 82.6 billion euros.

Traders pushed the euro to an almost two-year low of $1.2697 today, even though the loans take-up was below the 100 billion euros to 300 billion euros predicted in a Bloomberg survey. Companies from UBS Wealth Management AG to Morgan Stanley say they aren’t discouraged, and the 18-nation currency is poised to depreciate further as more euros make their way into circulation.

“Draghi’s main message is clear,” Thomas Flury, the head of foreign-exchange research at the Swiss money manager, said Sept. 23 in a phone interview from Zurich. “The ECB wants to have a big balance sheet, and there’s a problem with deflation expectations, and therefore they will do more.”

‘Consistently Decline’

The euro will tumble about 6 percent to $1.20 in the next year, according to Flury, whose company oversees about $2 trillion. The currency has weakened 9 percent from a 2 1/2-year high of $1.3993 in May to trade at $1.2723 as of 7:05 a.m. in New York.

“The ECB’s balance-sheet expansion is very significant for the euro,” Sireen Harajli, a strategist at Mizuho Bank Ltd. in New York, said in a Sept. 23 phone interview. “This is why the market is now expecting the euro to consistently decline.”

A weaker currency suits Draghi. It makes euro-region exports more competitive, while stoking inflation by making imports more expensive. At 0.4 percent in August, annual inflation remains a fraction of the ECB’s target of just under 2 percent. Growth in manufacturing and services has slowed to the weakest this year, and business confidence in Germany is at a 17-month low, reports showed this week.

ECB policy makers have stepped up efforts to boost the Frankfurt-based central bank’s balance sheet after lowering their three key interest rates and announcing the targeted longer-term refinancing
operations, or TLTROs, in June. They cut borrowing costs again this month and announced plans to buy asset-backed bonds.

‘Ambitious’ Plan

The success of the plan isn’t assured. BlackRock Inc., the world’s biggest money manager, said this week the plan to pump another 1 trillion euros into the economy is “ambitious.”

The median of 70 forecasts in a Bloomberg survey puts the euro at $1.29 by year-end. While that’s down from a prediction of $1.32 as recently as Aug. 15, it still implies a gain of about 1 percent by the end of December. The surveys predict a decline in the currency to $1.26 by the middle of 2015.

Hedge funds and other large speculators are more confident about which way the euro is headed. They pushed net bets on a decline in the common currency to 161,423 contracts in the week through Sept. 2, the most since July 2012, before paring them to 137,149 last week, data from the Commodity Futures Trading Commission in Washington show. Investors were betting the euro would strengthen as recently as May.

Quantitative Easing

The ECB’s four-year TLTRO loans are intended to spur lending to the real economy, with the offers of cheap cash tied to the size of banks’ loan books. Eight portions of funding will be offered through 2016, with the next round of loans scheduled for December.

Policy makers have said they may need to resort to government-bond purchases like the Federal Reserve and Bank of Japan, a policy known as quantitative easing.

“If it continues to be a low take-up in the December TLTRO, then the market is going to increase its expectations that the ECB will have to do something else,” Ian Stannard, the London-based head of European foreign-exchange strategy at Morgan Stanley, said by phone on Sept. 23. “That can put the euro under further pressure.”

Stannard predicts the euro will weaken next year to $1.15, the lowest since November 2003.

The impact of ECB easing on the shared currency may be all the greater because the Fed is on course to end its bond-purchase program next month. In an interview with Europe 1 radio, published yesterday on the ECB’s website, Draghi acknowledged that the euro’s decline reflects the divergence in global monetary policies.

Bank of Tokyo-Mitsubishi UFJ Ltd. sees the euro trading at $1.27 by year-end, before slipping to $1.22 by mid-2015.

“It’s perhaps unwise, at this moment in time, to bet against the ECB,” Derek Halpenny, the head of global-markets research at Bank of Tokyo-Mitsubishi in London, said Sept. 22 by phone. “Draghi has said that the ECB will expand the balance sheet, and they do have the means to do it.”
(An earlier version of this story corrected Bank of Tokyo-Mitsubishi’s euro forecasts.)

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