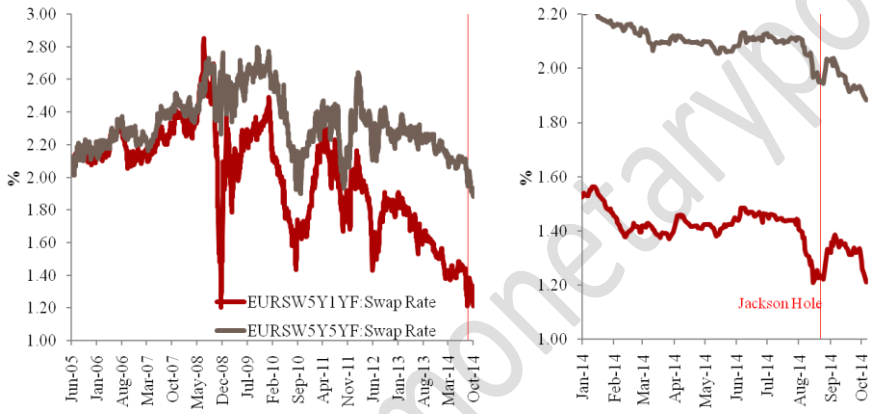
Monetary policy conditions, actions and prospects in the € area.

Conditions

Inflation

I have made the point that inflation is getting dis-anchored in a post 7 months ago[1] and Draghi has belatedly recognised it. This is not only because of the 0.3% of current inflation but mostly because the hope that inflation may get back to close to 2.0% extends over such a long horizon that the projection error is so wide that the prospect is hardly reassuring.

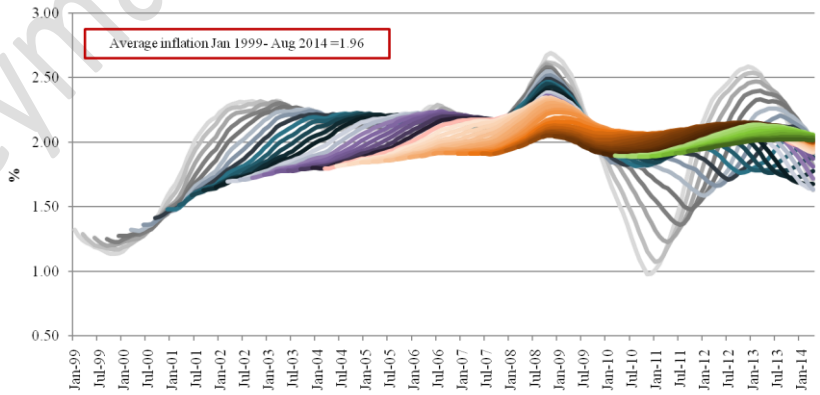
Chart 1. Break-even inflation rates



Source: Barclays Live

It should be recognized, however, that the ECB has so far preserved price stability only in the long rather than in the medium run. In Chart 2 it is shown that only when the moving average over which inflation is calculated moves to 6 or 7 years can one say that deviations from the 2.00% per cent objective are limited and thus inflation control is sufficiently precise.

Chart 2. Extending moving averages of the rate of inflation from 8 to 64 quarters



Source: ECB

[1] From firmly to weakly anchored, or the importance of an adverb!

Growth

Another very important background condition, as seen in table 1, is that growth is anaemic in aggregate and recession prevails in some non-core countries.

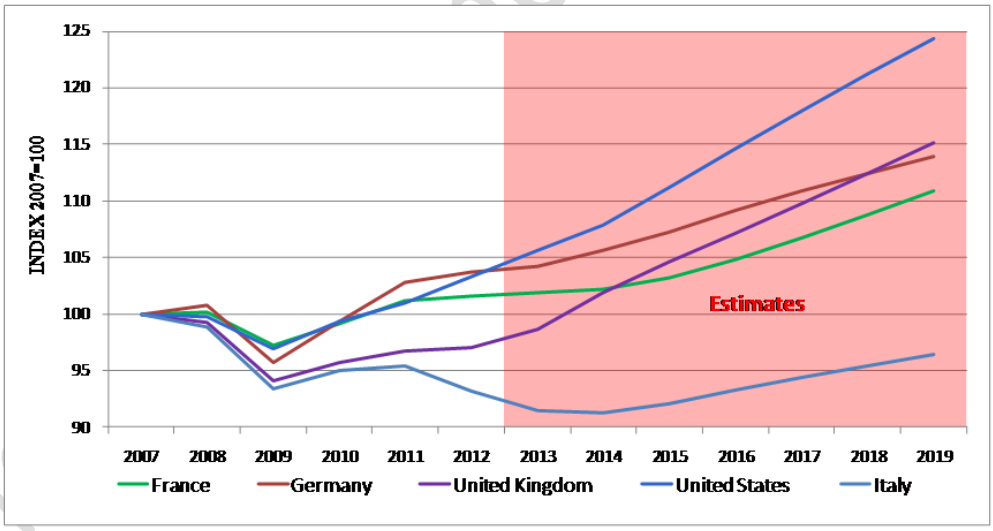
Table 1. Rates of growth in selected €-area countries.

COUNTRY	EURO AREA	GERMANY	FRANCE	ITALY	SPAIN	IRELAND	PORTUGAL	GREECE
2013	-0.43	0.53	0.29	-1.85	-1.22	0.17	-1.41	-3.86
2014	0.83	1.39	0.37	-0.17	1.31	3.62	0.99	0.60
2015	1.35	1.45	0.95	0.85	1.69	3.05	1.55	2.87
2016	1.70	1.81	1.55	1.30	1.79	2.54	1.74	3.71
2017	1.71	1.61	1.82	1.25	1.85	2.65	1.84	3.53
2018	1.64	1.39	1.92	1.05	1.90	2.54	1.84	3.28
2019	1.63	1.28	1.93	1.05	2.03	2.54	1.84	3.62

Source: ECB

The evidence of anaemic growth going forward is more worrying taking into account that income losses on a cumulated basis since the beginning of the crisis are unprecedented, in particular in Italy not to mention Greece (see Chart 3).

Chart 3. GDP levels in some selected €-area countries and the US (2007=100)



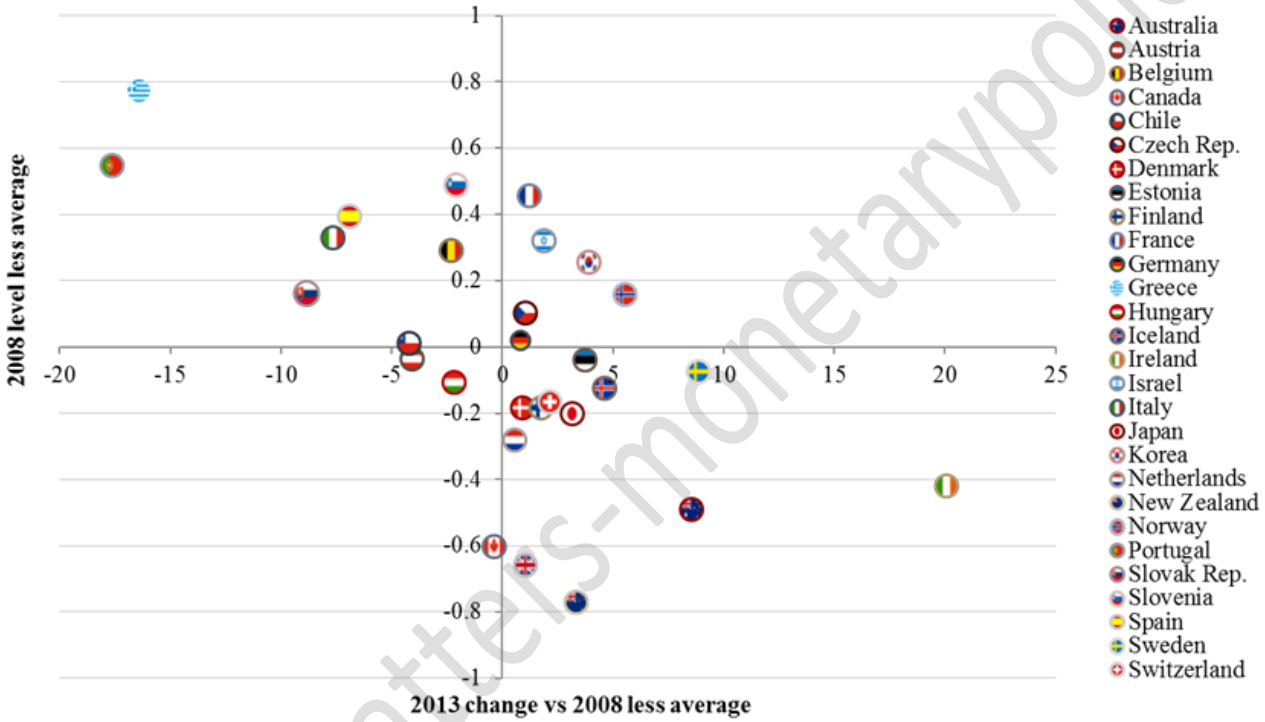
Source: IMF WEO

The prospects of fiscal policy helping with the demand component of the problem in the €-area do not look favourable: while Draghi has called for exploiting the **margins of manoeuvre** afforded by the Growth and Stability Pact in the countries that do have them (Germany), the only countries wanting to do something on the fiscal front are those that do not have significant margins (Italy and France) and should instead comply with all the EU fiscal rules.

Structural measures

Non-troika/non-core countries (read Italy and particularly France) are hesitant or, at least, uncertain. Chart 4, drawn from a previous post[2] gives the level (vertical axis) and the change (horizontal axis) of a composite measure of product and labour market flexibility for OECD countries, derived from OECD measures. In the upper left quadrant, where are located the countries that still had a high level of rigidity in 2008 but have moved towards flexibility between that year and 2013, one finds all Troika countries (except Ireland, that traditionally had flexible markets). One also finds, albeit in a non-advanced position, Italy but not France. Two additional interesting general patterns emerge from the chart: countries characterized by much rigidity significantly moved towards flexibility, but are still rigid. Countries which are very flexible somewhat moved towards more "protection". Overall the clustering of countries around the North-East/South-West diagonal shows a degree of convergence towards the "mean flexibility" among OECD countries.

Chart 4. Level and changes of product and labour market rigidity for a number of OECD countries.



Source:OECD

Overall, there is a big political **co-ordination problem** in €-area between the "three arrows" that in the €-area, very much like in Japan, would be needed to revive growth: *monetary policy is still somewhat hesitating, fiscal policy looks lopsided and structural measures insufficient.*

Geopolitical risks

These derive, in my view, more from Ukraine than the Middle East, even it is difficult to exaggerate the political importance of what is happening in Siria and Irak. A very simple exercise seems to validate this assessment. In table 2 a selection of Ukraine and Middle East related events is reported together with their impact on the €-area and US stock markets. The average negative impact on stock exchanges, and thus presumably on the economy, of Ukraine related events is much higher than for events related to the Middle East.

[2] Titus Maccius Plautus and the EU Troika

Table 2 Stock exchange impact of Middle East and Ukraine related events

Date	EurSTOXX change	SPX change	Event Middle East
9-Jun-14	0.33	0.09	ISIS overrun parts of the Iraq's second largest city, Mosul
2-Jul-14	-0.20	0.07	Abu Bakr al-Baghdadi, the self-proclaimed leader of the 'Islamic State' stretching across Iraq and Syria, has vowed to lead the conquest of Rome.
28-Jul-14	-0.11	0.03	The release of mass executions video by ISIL
5-Aug-14	0.06	-0.97	UN declares humanitarian tragedy in Sinjar where 30000-50000 civilians flee into the mountains
7-Aug-14	-1.23	-0.56	US President Obama authorized targeted airstrikes in Iraq against ISIL. The UK offered the US assistance with surveillance and refueling, and planned humanitarian airdrops to Iraqi refugees
19-Aug-14	0.57	0.50	American journalist was beheaded by ISIL which led to Obama to publically condemn the organization
29-Aug-14	0.26	0.33	UK PM David Cameron raised the UK's terror level to "severe" and committed to fight radical Islam "at home and abroad"
1-Sep-14	0.08	0.00	German government's Cabinet decision to arm the Kurdish Peshmerga was ratified in the Bundestag
2-Sep-14	0.17	-0.05	ISIL released a video showing the beheading of a second American journalist
4-Sep-14	1.81	-0.15	ISIL issue threats to Russian President Vladimir Putin
Average	**0.17**	**-0.07**	

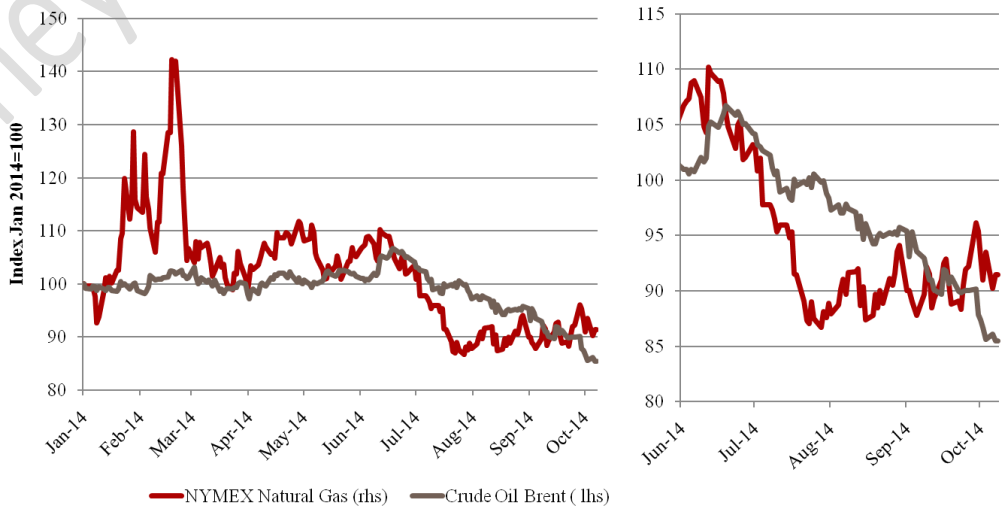
Date	EuroSTOXX change	SPX change	Ukraine event
11-Mar-14	-0.01	-0.51	Crimean parliament declared Crimea independent from Ukraine; To hold referendum for joining Russia.
13-Mar-14	-1.50	-1.17	Pro- Kyiv vs Pro- Moscow protestors in Donetsk results in injuries and one death
24-Mar-14	-1.41	-0.49	Intensified protests over the weekend; Russia Expelled from G8, with G7 threatening Additional Sanctions
7-Apr-14	-1.37	-1.08	People's Republic of Donetsk: In Donetsk pro-Russian activists demanded regional government to vote to authorize a referendum on allowing the "Donetsk Republic" to join Russia
23-Apr-14	-0.74	-0.22	President Turchynov renewed the offensive against separatists (whose activity is seen like an act of terrorism);
2-May-14	-0.65	-0.13	Between 30 and 45 pro-Russian activists died in Odessa. Reported as the deadliest day in Ukraine since the protests started
10-Jul-14	-1.64	-0.41	EU Diplomat confirmed that new economic sanctions are imminent for 11 new individuals involved in the Ukrainian Crisis. Following this the US enforced the new sanctions as well.
17-Jul-14	-1.41	-1.18	Malaysian Airlines Flight Shot Down in Eastern Ukraine
30-Jul-14	-0.67	0.01	The EU and US announce new sanctions against Russia with focus on oil sector, defense equipment and sensitive technologies.
22-Aug-14	-0.83	-0.20	A convoy of more than 100 Russian lorries enters Ukraine without permission, carrying what Russia says is humanitarian aid for the besieged city of Luhansk.
Average	**-1.02**	**-0.54**	

Source: Bloomberg, Media

Energy prices

The lower energy prices (see Chart 5) are helping, as they act as something of a homeostatic (but weak) mechanism, imparting an impact specular to that leading to stagflation in the 1970s.

Chart 5. Oil and gas prices (Jan 2014=100)



Source: Bloomberg

Actions

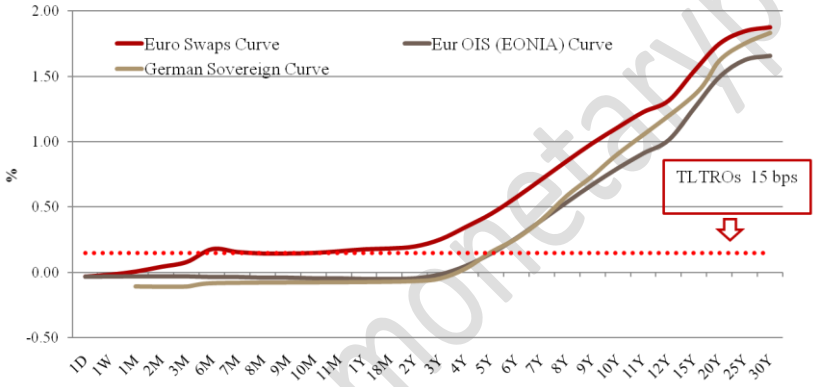
Comprehensive balance sheet assessment

This measure is potentially very important and could have a cathartic effect. Of all the measures in the pipeline this is, in my view, the one with the biggest potential effect. Two results are, plausibly, hoped: 1. Banks will objectively be better able to intermediate funds because of repaired balance sheets; 2. The opacity and uncertainty over the entire €-area banking system will be lifted. This should deal with credit supply problems. However it will not, of course, deal with credit demand issues.

TLTRO

The TLTRO is generous in cost terms (15 bp cost for 4 years, Chart 6 – see post[3]) taking the euro swap curve as the best approximation to the cost of market funding for banks, but the first instalment has been modest in gross terms and even smaller in net terms (because of the repayment of 3 year LTRO). The second instalment will likely be bigger, but the maturity of 3y LTRO will imply a substantial withdrawal of liquidity (300 still outstanding).

Chart 6: Cost of TLTRO compared with other money market rates.



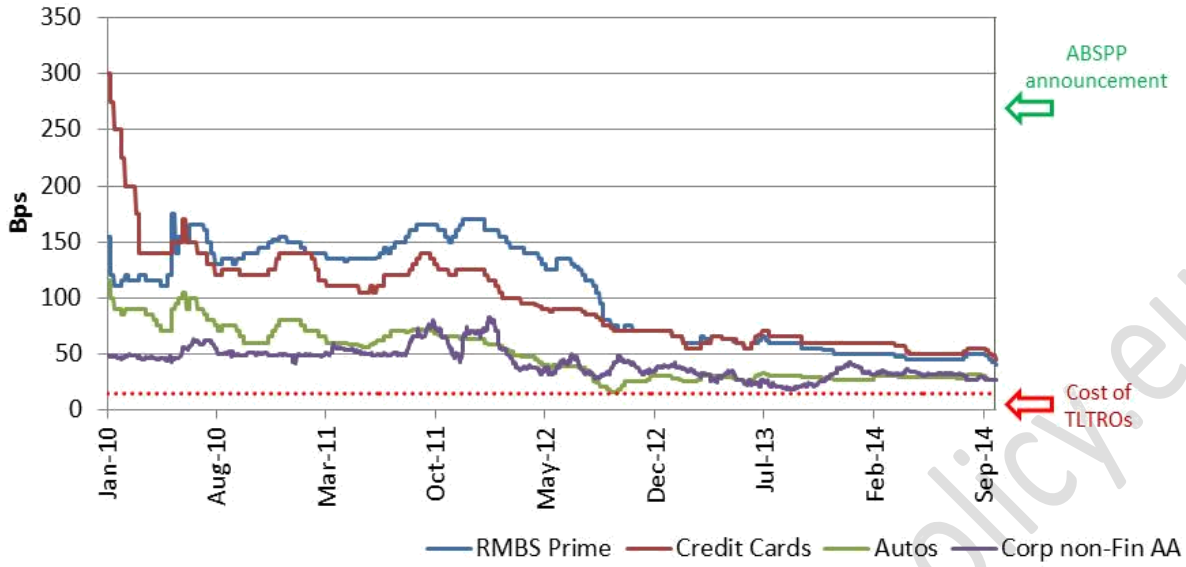
Source: Bloomberg

ABS purchase program

The ABSPPwill succeed only if the "Moribund" market is resurrected[4]. ABS have difficulty in competing with TLTRO in terms of cost of funding (see Chart 7) but they could help in terms of portfolio effect pushing towards riskier assets, including mezzanine, thus giving a capital relief, in particular taking into account the long duration of the program. The latter aspect reinforces the idea that we are not looking at something with a quick effect but at something that could have long-term positive effects. In addition, the regulation changes for LCR and solvency II that the EU Commission announced are definitely positive for the ABS market. However, there was nothing concrete in the ECB statement on guarantees for mezzanine purchases and the part on "qualifying securitizations" was skimpy. Overall, the long-term prospect of the ABSPP is open, with both a successful and an unsuccessful outcome about equally possible. We are not, however, in any case looking at something whose effects on macroeconomic conditions, and in particular on inflation prospects, will be felt in the next one or two quarters.

[3] An enticing Very Long Term Refinancing Operation from the ECB
[4] The ECB Asset Backed Securities Purchase Program

Chart 7. Yields on different types of ABS (spread to swap rate).



Source: BofA

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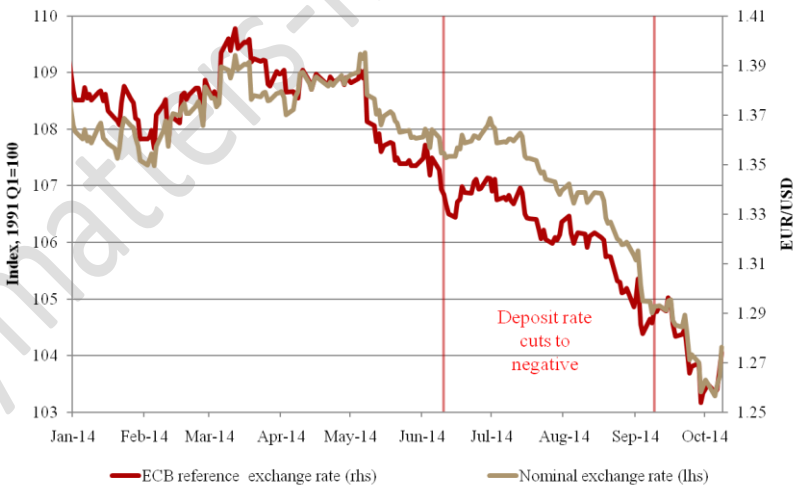
Covered bond purchase program

Although this has just recently been started, it does not look more than a side dish.

Negative rates

The negative ECB deposit facility rate did what one could think they would do: contribute to € weakening (5% in effective terms, see Chart 8).

Chart 8. Effective and $ exchange rate of the € (1991 Q1=100)



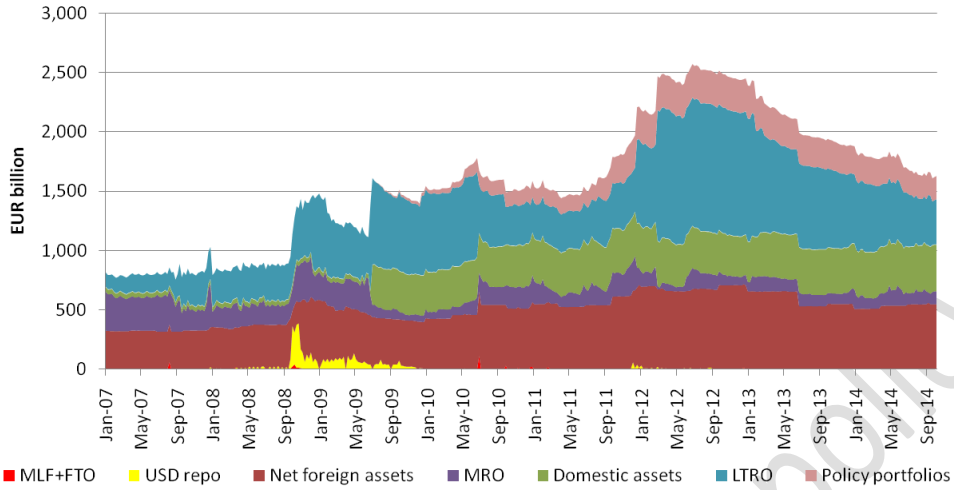
Source: ECB

Prospects

ECB balance sheet

The prospect of bringing the balance sheet to the level of the first quarter of 2012 (see chart 9) seems to me very hard to reach with the current measures, whatever the precise definition of it (650 to 1000 billion increase) and whatever its time horizon, also taking into account that a reduction of around 300 billion will be brought about by the maturity of the 3y LTROs.

Chart 9. ECB balance sheet (asset side)



Source: ECB

In my view, more generally, the TLTRO and the ABS purchase program on the monetary policy side and the comprehensive balance sheet assessment on the supervision side should **surprise dramatically on the upside** over the next couple of quarters to stop and invert the dis-anchoring of inflationary expectations.

A **weaker exchange rate** could help, but given the elasticity mentioned some time ago by Draghi between the exchange rate and inflation (0.04/0.05), a weakening of 25-30% per cent would be needed to move from the current 0.7% core inflation towards the objective of 2.0%. €/$ should move towards parity! Is this desirable? And would our partners accept it?

Unless dramatic surprises do indeed take place and inflation prospects improve over the next couple of quarters, the mantra that "**The Governing Council is unanimous that other unconventional measures should be taken in case of need**" must mean, to maintain ECB´s credibility, that indeed the ECB does more. With inflation remaining well below the target for a period extending beyond any sensible definition of "medium term", how can one deny the need for further unconventional measures?

And if, against logic, a limited number of hawks would still deny that the need has arrived, the Governing Council seems to be resigned to act on the basis of majorities, not to be blocked by the need of unanimity in the pursuit of its statutory objective of price stability.

Unless the ECB has up on its sleeve some new idea on what these unconventional measures could be, only QE seems to be available. So, the probability of QE sometime in the first half of 2015 is in my view quite high: 40% if the inflationary prospects do not improve but do not worsen either, 75% if there is a worsening of inflationary prospects. Only in case inflation prospects would improve, even if not dramatically, would the probability of QE go down to zero.