Draghi's Uppers

The 'high' of Mario Draghi's initial stimulus measures has fallen flat again but there is clearly a thirst for more. Following the introduction of a negative deposit rate, the targeted long-term refinancing operation (TLTRO) and the asset-backed securities (ABS)/covered bond purchase programme, it is now time for the mother of all stimulants: spending self-printed money worth EUR 1140 billion to buy up bonds, i.e. Quantitative Easing (QE). What will be the impact of this liquidity bomb?

The flow of information from the ECB on QE was briefly interrupted in February by a poker game with Greece, but now in March QE is once again in the news. Investors and governments are holding their breath about the impact on the markets. To give an idea: if *all* German bonds from 2-31 years were bought up, the amount would not be enough to come to that figure of EUR 1140 billion. Meanwhile investors have already made allowances for the consequences of this.

What's already been said

Scheduled to continue until September 2016, on 9th March the ECB launched its bond-buying programme which aims to spend EUR 60 billion a month on bond purchases. If necessary the period may be extended, if there are still sellers in the market. However, this amount includes the previously announced purchases of ABS/covered bonds. An anticipated EUR 45 billion a month will be spent on government bonds (and agencies). The minimum amount spent on buying government bonds will come to EUR 855 billion, in a total market of EUR 4600 billion.

To maintain market neutrality, the ECB will buy the bonds on the secondary market rather than directly from member states. National central banks (NCBs) will recognise 80% of the securities on their balance sheets. This avoids dividing the specific country risk between too many different member states, maintains each country's incentive to repay and ensures that they continue to meet the 'Maastricht Conditions' on a maximum budget deficit of 3%.

To qualify for purchase, bonds must have a term between 2 and 31 years and a rating of at least BBB-. With a negative yield at 60% of German government bonds, the ECB cannot avoid buying up bonds with a negative yield. However, the ECB has set a lower boundary: no bonds with a yield below the ECB deposit rate (-0.20%) will be bought. This ensures no accounting losses arise.

Matters which ought to be mentioned

Who are the sellers?

Figure 1 shows the types of investors (i.e. prospective sellers) of Eurozone government bonds, amounting to EUR 4600 billion. The group comprising non-EU banks and asset managers (12%) is especially envisaged as the prospective seller.

Many parties need a base stock of high-quality security (collateral). Especially for banks (25%)are government bonds, the oil for the financial system's engine. This group will therefore be reticent in the sale, regardless of the price. Moreover, this group has to comply with the ever more stringent liquidity requirements and capital buffers under Basel 3. Insurers and pension funds (20%) have few alternatives owing to Solvency II regulations. In addition, reinvestment options are limited by the enormous influx of liquid assets, simply because the alternative yields -0.20% in money (see also 'Draghi's dream' in KAS Selections, June 2014). Meanwhile, the search for yield has led parties to take increasingly greater risks, which means that the risk reward ratio is no longer in balance.

How will market liquidity be guaranteed?

Market forces will be severely disrupted if the ECB is the only bond buyer in the market; at some point there simply won't be any other sellers left. The ECB's solution to this is the securities lending programme, whereby the NCBs will lend out the purchased securities. The problem is that they will probably not be lent out again in return for cash but in return for high-quality securities collateral, which is scarce. Operationally, this will also be a considerable task for the NCBs, owing to the lack of experience with securities lending and because the bonds are kept by various custodians.

Who will bear the potential losses?

When the government bonds are not redeemed, a construction has been conceived in which the NCBs will bear the greatest losses. However, the question is whether the losses are equivalent to the other creditors or whether the ECB has an advantage.

Has it all been factored in already by the markets?

To a considerable extent it has. This can be seen in the 10-year German interest rate which is currently traded at the same level as the Japanese rate (figure 2). Of more concern is the fact that the 10-year/30-year swap rate in Europe is 50 base points below that of Japan. This implies that Japan's inflation/growth rate will be higher than Europe's in 10 years.

What does the ECB aim to achieve?

Draghi's 'high'

Pumping more money into the financial system will increase investment and spending in Europe. Inflation will then move towards the ECB's target of 2% and countries such as Italy will gradually attain lower national debts. This will avoid the path to lower growth. However, without significant efforts by governments, QE

Figure 1: Holders of government bonds per type of investor (%) – Source: ECB, IMF

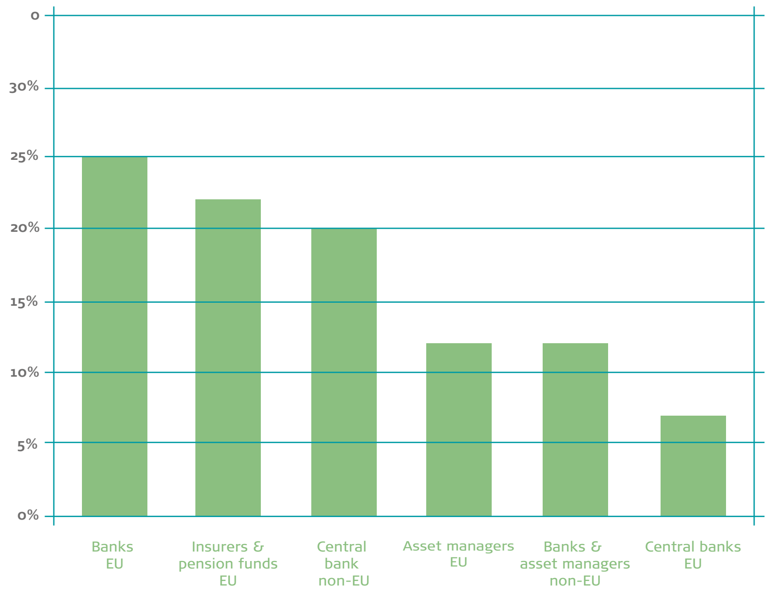
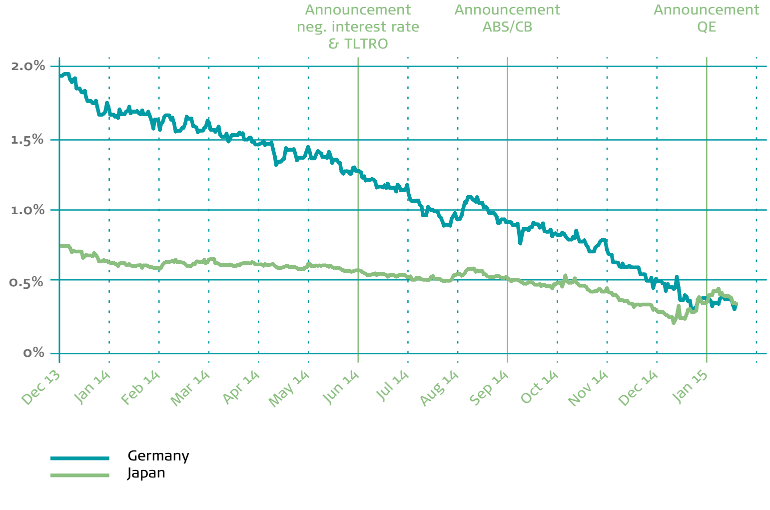


Figure 2: 10-year interest rate Germany and Japan – Source: Bloomberg



will not make much difference, a point Draghi repeats in practically all of his speeches.

Borrowing costs will be extremely low and stable for problem countries, which will enable them to create extra time to implement reforms. Take for example Portugal's 10-year interest rate, which was higher than 14% in early 2012 but has since fallen to below that of the United States. They will also be less affected by short-term interest rate fluctuations.

Draghi's 'low'

Problem countries will put off difficult reforms because there is no immediate need to act. They will lay low in exchange for more popularity among voters. As in 2008, when all European countries paid the same interest rate, we're now seeing the same thing happening again. Consequently, signals from the market as a result of rising interest rates in problem countries will be absent.

Everyone is talking about a stock market bubble but an enormous bubble is growing in the bond market too. We see minimal compensation for extra risks because the ECB is severely disrupting the balance between supply and demand. There is a similarity here too with 2008, when high-risk packaged mortgages (ABS) were traded without any additional cost of credit. This could lead to the same correction as then, which will bring us right back to where we started.

The ECB is bordering on politics with QE, which involves new hazards. Firstly, increasing resistance to ECB policy is threatening support for Europe as a whole. QE is feeding the flame of anti-European parties. Even members of the ECB's board disagree with each other. Shortly after the QE announcement, Klaas Knot, president of the Dutch regulator, De Nederlandsche Bank (DNB), dubbed QE a "coarse remedy with uncertain consequences". Moreover, the risk of a member state exiting the euro zone is becoming increasingly likely. After all, the majority opinion will always have to be respected in a democracy.

Conclusion

Over the coming months the markets will float on Draghi's 'high'. Unfortunately, this high will not be the result of successes but the result of uppers. As Klaas Knot remarked: "QE is a coarse remedy". It might give you pleasant dreams but you are left with a hangover when you wake up. As with any addiction, it's naive to think that the world will look like a better place after the high and that all your problems will disappear instantly. The same applies to QE.

Unrestrained expansion of liquidity alone will never lead to European growth. The bond market will be disrupted for a long time and a shortage of sellers will only lead to further contraction of the spreads. We can only hope that the ECB, and thereby the European Union, steers clear of the path of short-term 'highs' and quickly takes the path to structural growth.

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