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If it looks like a duck, walks like a duck, and quacks like a duck, it must be a duck. Yet the European Central Bank says it is not a duck. Perhaps it is a platypus.

At its most basic level, quantitative easing refers to central banks using tools other than interest rates to make monetary conditions more accommodative. The ECB has expanded its balance sheet from €1157.53 billion in the summer of 2007 to €2088.87 billion at the start of this year. It has provided unlimited funding to its banks for six months with liberal collateral rules. Last week, it announced it will expand the duration of unlimited funding to twelve months. It also indicated then that there was an agreement in principle to buy €60 billion euros of covered bonds.

ECB President Trichet is clear. It is not quantitative easing, he says. But this is an assertion not an argument. Just because he says so doesn't make it so. Why isn't it quantitative easing? The emperor says he is wearing clothes, but is he?

Different Strokes for Different Folks

Quantitative easing is taking place in different countries in different ways and for different purposes. The Bank of England is very clear. Its initial intent to purchase £75 billion in gilts, and was increased by £50 billion last week. These purchases are explicitly aimed at boosting inflation toward BOE's medium term target of 2%. The quarterly inflation report released on May 13th projected even with the £125 billion purchases of UK bonds that inflation would still be below its target in two years time.

This makes it likely that the BOE will draw on the remaining £25 billion that the Chancellor of the Exchequer Darling approved. Indeed it seems increasingly likely that BOE Governor King will have to request from a reluctant Darling authority purchase even more bonds later this year.

The Federal Reserve's quantitative easing is not intended to boost inflation. It is not targeting government bond yields. The goal is to stimulate private lending and provide liquidity to re-open segments of the capital markets. Some of the facilities that it was initiated to do that are winding down on their own accord. These include the commercial paper facility, the money market facility and the swap lines with foreign central banks. As the efforts produced the desired results, they are to a real extent self-liquidating.

On March 18th, the Federal Reserve QE took a quantum jump when it announced it would purchase \$300 billion of Treasuries in the next six months and increase its purchases of mortgage-related securities from \$600 billion to \$1.45 trillion. From a purely monetary point of view, it matters little whether the Fed purchases Treasuries or mortgage-related securities.

The Fed has been upfront about the assets and amounts it will buy, but it has been decidedly less clear on precisely how it will finance its purchases. How it purchases those assets, through crediting bank's reserve accounts (creating money in the vernacular) or in effect by swapping assets (Treasury holdings for other assets) or some combination thereof, is key to assessing the extent of the Fed's quantitative easing. Although it has not been discussed much, recall that at the joint Treasury-Fed press conference on March 19th, officials indicated that authority would be sought from Congress for the Federal Reserve to issue its own bills.

Enigmatic Central Bank

Whereas the Federal Reserve and the Bank of England try to be more transparent, the ECB seems to relish in its opaqueness. Six months ago, in December 2008, the ECB recognized that the "smooth functioning" of the covered bond market was "important from a financial stability perspective."

But it sat on its hands until early May as the covered bond market remained largely paralyzed. Issuance of benchmark “jumbo” bonds was halved last year and issuance in the first four months of the year was roughly a third of what was seen in the same year ago period, according to reports citing Dealogic data. Finally on May 7th it announced that it had reached a unanimous decision in principle to purchase €60 billion worth of covered bonds. Yet details, including how it would decide which covered bonds to buy, how it would finance the purchases and on what time frame, would not be announced until the next meeting on June 4th.

This casts a pall over the covered bond market. Press reports celebrated Banco Santander announcement that it first covered bond sale in almost a year within days of the ECB announcement. Yet the offering was planned before the ECB's unexpected decision and so the bank's saving of some 30 basis points according to some industry estimates, was more a function of (good) luck than financial prowess. And while some spreads have narrowed relative to the sovereign benchmarks, spreads between bid and offers have reportedly widened. Other market participants report that liquidity in the secondary market remains challenging.

What is the Agenda?

Many, if not most observers appear to be taking Trichet's claim that the ECB is not engaged in quantitative easing and the reasons for the measures at face value. Since covered bonds are issued mostly by banks, the ECB's purchases seem perfectly consistent with official efforts to help revive bank lending. Moreover, they seem to be exceptionally safe insofar as there does not appear to have a single default of covered bonds in their more than 200-year history.

The €60 billion worth of covered bonds the ECB intends to purchase appears to have been arrived at after much debate is a small, dare one say token effort. In last December's report, the ECB estimated that there were 2 trillion euros of covered bonds outstanding in Europe at the end of 2007, of which 75% were denominated in euros.

The ECB indicated it will only buy the euro denominated issues and its €60 billion is roughly 4% of that market. Although we have been left with the impression that the ECB's purchases will be stretched out over time, the €60 billion are more than the total issuance of European covered bonds in the first four months of 2009.

Consequences

To get our hands around the potential consequence of the ECB policy course we must add to the mix what the Bundesbank President Weber suggested was even more significant that the covered bond purchases (even though Germany accounts for about 57% of the European covered bond market) was the extension of the period that banks can borrow unlimited funds from the ECB to 12-months.

What are banks going to do with that liquidity? Given the depth of the economic contraction, private sector demand is likely to remain poor for some time. It seems reasonable to suspect that a good part of that liquidity that the ECB is offering for 12-months will be used to purchase government bonds as balance sheets are rebuilt. But which government bonds?

Sovereign bond spreads in Europe have mostly widened since the ECB's decision. Finland is the only euro member whose bonds have kept pace with the 8 basis points decline in 10-year German bund yields. Outside of the eurozone, Norway and Denmark have kept pace with Germany. The UK has been the best performer, with the 10-year gilt yield falling some 20 basis points over the five sessions through May 14th, owing largely to country-specific developments.

Bonds of countries in southern Europe have dramatically under-performed bunds. Greek bond yields have risen 11 basis points, Italy 9, Ireland 8 and Portugal 4 basis points. Spain is the exception, with its 10-year bond yield falling 4 basis points. Of note that after Germany and France, Spain's covered bond market is the third largest in Europe.

The Screws Tighten

If over time banks take advantage of the ECB's liquidity provisions to buy bonds from the periphery of the eurozone, then the ECB's actions may be seen as a subtle form of fiscal support for those countries that have been squeezed the hardest during the crisis. But they were also, for the most part, the countries which failed to introduce

significant fiscal and institutional reform during the good years. They also were losing competitiveness through increases in unit labor costs far greater than Germany.

Yet if the banks do not buy the peripheral bonds, then the pressure within the eurozone can only intensify as spreads widen. Moreover, on May 14th, Hungary revealed that the ECB formally rejected the request by a number of central European countries which accept their sovereign local currency bonds for collateral.

Intended or not, if the ECB does not proceed carefully here, it risks aggravating the divergence within Europe and precipitating a deeper and more profound crisis. Ten months ago, the ECB hiked rates. It cannot afford a blunder of similar proportions now. It needs to embrace its quantitative easing and get on with it. The ECB needs to commit itself, like the BOE and Fed, to do whatever is necessary to overcome the financial crisis. Yet amid the great experiment of monetary union without political union, the ECB may feel institutionally trapped and may really be more platypus than duck.

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