ECONOMIC OUTLOOK
REGIONS
September 2014

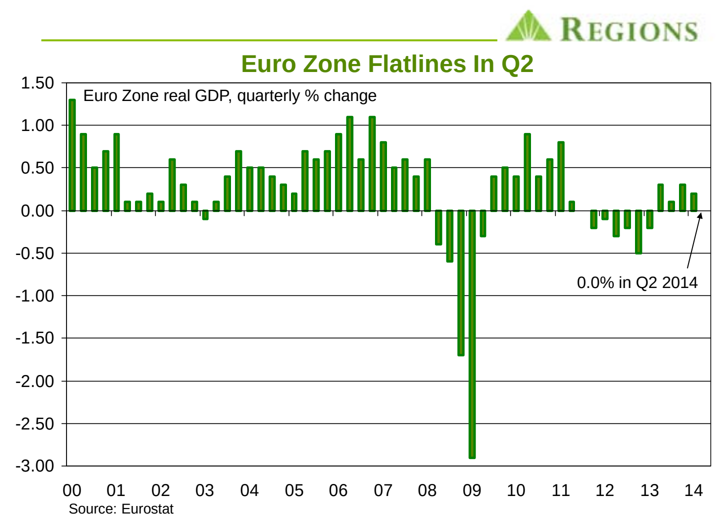
ECB Comes To The Party As Fed and B of E Head For The Exit

In the summer of 2012, amidst another bout of sovereign debt drama and a faltering Euro Zone economy, European Central Bank (ECB) President Mario Draghi famously pledged to do "whatever it takes" to preserve the euro. As if by magic, what had been a bruised and battered euro began to strengthen against other major currencies and yields on sovereign debt issued by individual Euro Zone nations began to fall, thanks to little more than those three little words. Indeed, the lack of any meaningful structural reforms, a lack of progress in cleaning up the balance sheets of European banks, and extraordinarily high unemployment rates across the Euro Zone left us quite skeptical that Dr. Draghi's pledge would be more than a passing diversion from the underlying ills of the Euro Zone economy.

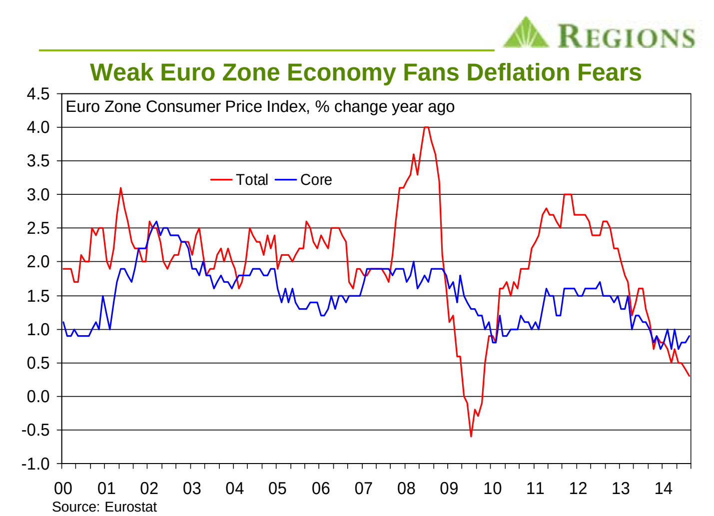
To this point, our February 2013 *Economic Outlook* led off by asking "will 'whatever it takes' be enough?" and discussed how, and why, we thought analysts and investors had in the wake of Dr. Draghi's pledge become far too complacent over the ample list of downside risks that still confronted the Euro Zone. As such, we thought it only a matter of time until the ECB saying it would do whatever it takes would have to give way to the ECB actually doing whatever it takes to stabilize the euro and help revive the Euro Zone economy.

As 2013 progressed, however, it began to look as though that time would not actually come as the Euro Zone economy began to emerge from the 2011 recession that saw real GDP in the Euro Zone contract in six consecutive quarters. Again, though, even as many became increasingly confident about the outlook, we remained skeptical as what was at best a feeble recovery did little to cure the deep economic and financial imbalances that continued to weigh on growth across the Euro Zone and risks remained skewed to the downside. One sign of concern was, or at least should have been, a persistent deceleration in inflation – after peaking at 3.0 percent in late 2011, headline Euro Zone inflation began to slow and continued to do so even as real GDP began to expand, however modestly.

Even as the U.S. economy lost its footing in 2014's first quarter, as an unusually harsh winter contributed to a contraction in real GDP, the Euro Zone managed to post modest growth, though inflation continued to slow. During Q2, however, while the U.S. economy was playing catch-up and posting annualized real GDP growth in excess of 4.0 percent, the Euro Zone economy was stalling. What had been a tepid rate of growth left little margin for error, particularly with fiscal policy out of play given the wave of austerity that had swept across the Euro Zone over recent years. Thus, when Russia embarked on its foray into Ukraine, leading to dueling sanctions between the West and Russia and triggering a sharp decline in business and investor confidence across Europe, the Euro Zone economy came to a stall in Q2. Real GDP contracted in both Germany and Italy in Q2 while remaining flat in France – the "Big 3" of the Euro Zone – while growth elsewhere, including Spain, kept topline real GDP for the Euro Zone as a whole flat.



There are those who see the Euro Zone's shaky Q2 performance as a one-off occurrence that is largely a function of elevated tensions with Russia – a major trading partner for the Euro Zone. We're not so sure, however, that it's as straightforward as all the Euro Zone economy needs to right itself is for Mr. Putin to play nice with the rest of the world. Once again, we would argue the ongoing deceleration in inflation is telling a story of more fundamental issues weighing on the Euro Zone economy.



Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com

As of August, headline Euro Zone inflation stood at just 0.3 percent – yes that is year-over-year, not month-to-month. To be sure, lower energy prices are helping hold down headline inflation, as some analysts are quick to point out. Even allowing for this, however, core inflation in the Euro Zone isn't exactly providing much reassurance, coming in at 0.9 percent in August. Moreover, if energy prices are weak due to, or at least due in part to, weak demand stemming from a soft economy, then the core inflation numbers provide even less reassurance. Even more telling is that inflation expectations in the Euro Zone seem to have come unmoored and continue to drift lower.

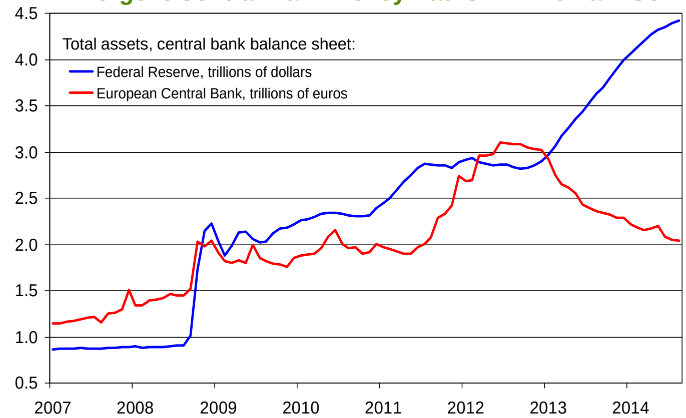
It was this latter point that many feel was the catalyst for Dr. Draghi's headline grabbing speech at the annual Jackson Hole conference at which Fed Chairwoman Yellen also spoke. That inflation expectations are drifting lower at a time when actual inflation is running as low as it now is in the Euro Zone paves the way for outright deflation if there truly is more to the recent weakness in the economy than elevated tensions with Russia.

While central bankers worry about inflation for obvious reasons, it sometimes seems counterintuitive that they also worry about deflation. After all, what could be bad about falling prices, right? Wrong. The short version is deflation makes it more burdensome for debtors to repay loans, leads to delayed business and consumer spending (why buy today when you can do so in the future for a lower price), and leads to falling wages, none of which are particularly good things for an economy let alone all of them – ask Japan if you don't want to take our word for it.

One means of a central bank stemming the tide of fading inflation expectations is to engage in monetary expansion, think of Milton Friedman's famous "helicopter drop" example (yes, it was his idea but it was Ben Bernanke who ended up with the cool "Helicopter Ben" moniker). The preferred alternative in recent years (as flying around in helicopters throwing out cash is apparently considered unseemly for central bankers) has been the more indirect method of "quantitative easing" through which central banks purchase assets and in the process add reserves to the banking system, which in theory will help combat deflationary trends and hold down the long end of the yield curve (of course, how QE works in practice is open for debate).

While central banks in Canada, Japan, the U.K., and the U.S., among others, have engaged in quantitative easing over recent years, the ECB has been notably absent from the QE party, though Dr. Draghi's Jackson Hole speech was largely seen as an announcement that the ECB is on the way. Sure, by time the ECB gets to the party, assuming they do get there, there won't be much company, save for the Bank of Japan, as other central banks either have left or, as in the case of the Fed, are heading for the exit. As seen in the following chart, in a time when other central banks were actively expanding their balance sheets, the ECB's balance sheet has actually been shrinking. In a sense, this made Dr. Draghi's "whatever it takes" performance all the more remarkable, in that the ECB got the effects desired by other central banks, i.e., lower long-term interest rates, without having to actually do anything. Except speak. To illustrate this point, the following chart shows the path of total assets on the balance sheets of the Federal Reserve and the ECB over the past several years.

Divergent Central Bank Policy Paths Will Remain So



Source: Federal Reserve Board; European Central Bank; Regions Economics Division

Now, however, the tables are starting to turn. As the Fed nears the end of its large-scale asset purchases and engages in internal debate as to the proper timing and means of monetary policy normalization, the ECB at its September meeting unveiled plans to purchase private sector debt, in the form of asset backed securities and covered bonds, and also announced cuts to key policy interest rates. It was Dr. Draghi's Jackson Hole speech in which he pointed to the dangers of fading inflation expectations that laid out the path for the ECB to engage in asset purchases. In the immediate aftermath of his speech, it was widely expected the ECB would announce plans to purchase government debt along the lines of other central banks before it.

The ECB did not go that far at their September meeting, and this month was not a realistic possibility for them to have done so, but many see the asset purchase plan the ECB did announce as an interim step to "full blown" QE. Expectations for ABS purchases are low, and rightfully so. Contrary to the U.S., the ABS market is simply not very large in Europe and, moreover, a relatively small share of that market is in the form of bonds backed by loans to small/mid-sized companies, which would be the ECB's likely desired target.

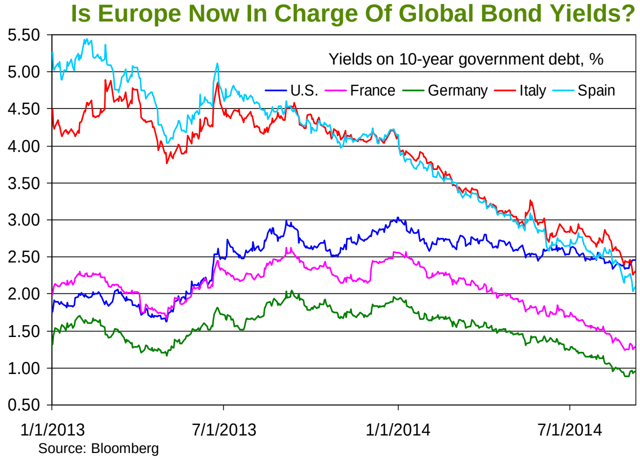
So, in that sense, the ABS plan is more symbolic than substantive. It at least paves the way for the ECB to go all in on QE and purchase government debt. Such a plan is widely seen as being inevitable, with the December ECB meeting as a possible time for QE – ECB Style to be announced. One reason for a December launch is the ECB has yet to see how the Targeted Long-Term Refinancing Operations – announced in June but by now seemingly an afterthought – will perform. As this plan is yet another means by which the ECB aims to make credit more available to firms it is not yet clear how this and the recently announced asset purchases will interact and whether they will, individually or collectively, be impactful enough so that the ECB will not need to engage in a version of QE entailing purchases of government. Again, though, expectations are the ECB will, ultimately, do just that.

Still, regardless of how they do it, the ECB finally seems committed to actively expanding its balance sheet. The obvious question may be "well, what took you so long?" but to ask this is to ignore the obvious institutional constraints the ECB operates under that its global counterparts do not. Most notably, the ECB is not the central bank of an individual nation but of a group of 18 nations, so instead of answering to one master it answers to 18 and one, Germany, pulls more weight than the others. Thus far, Germany has been steadfast in its opposition to the ECB purchasing government debt – with opposition coming from both the Bundesbank and the central government in Berlin – and has even raised the possibility of legal challenges to any such plan. Indeed, Germany was not at all smitten with Dr. Draghi's Jackson Hole speech, nor with the asset purchase plans unveiled at the September ECB meeting, and it remains to be seen whether German opposition to government debt purchases will ease or, if it does not, whether the ECB will nonetheless go down that path.

Will They, And If They Do Will It Matter?

We are not sure whether or not the ECB will actually follow through with a form of QE that includes purchases of government debt, mainly because we see it as highly unlikely them doing so would have a meaningful effect on the Euro Zone economy. For starters, the price of credit is clearly not the constraint holding down the Euro Zone economy, although interest rates have nonetheless fallen further in the wake of Dr. Draghi's Jackson Hole speech and the ECB's September meeting, though of course part of this decline could be based on the anticipation of the ECB launching full scale QE in the near future. Indeed, while yields on 10-year government debt issued by France and Germany have been below those on 10-year U.S. Treasury notes for some time, the same is now true for yields on 10-year government debt issued by Italy and Spain. Take a minute to re-read the previous sentence and let it sink in.

Is Europe Now In Charge Of Global Bond Yields?



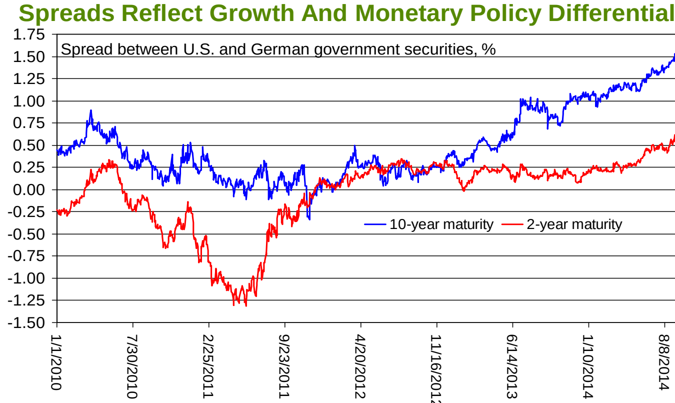
Source: Bloomberg

While the ECB embarking on full scale QE could drive rates lower, we think it unlikely that would be the driver of faster growth in the Euro Zone economy. Lower interest rates are simply no match for the litany of woes still confronting the Euro Zone, including weak demographics and structural and regulatory constraints that will continue to act as material drags on growth. In a sluggish growth environment with low levels of consumer and business confidence, demand for credit is not likely to improve regardless of how low interest rates ultimately go. Additionally, the banking system across the Euro Zone is still on shaky ground and with the release of the results of the ECB's stress tests not due until at least next month, the capacity of banks to extend additional credit is not entirely clear. And, though resistance to fiscal austerity is growing, including Dr. Draghi's spirited remarks along these lines, there has yet to be meaningful reversal of restrictive fiscal policy across the Euro Zone, meaning fiscal policy will remain a drag on growth.

There are those who argue that even should the ECB's efforts to expand its balance sheet not have a material impact on economic growth, they will nonetheless help buck up inflation expectations and head off a potential deflationary spiral. We're not sure, but we think the people making this argument are the same ones who began warning of the imminent inflation crisis that would be unleashed on the U.S. economy with the advent of QE – and they were at it starting with QE-1. As we have seen, though, excess reserves piling up in the banking system are not in and of themselves inflationary. If the ECB does embark on full-fledged QE and there is not a meaningful and sustained increase in the demand for credit, there is likely to be little effect on inflation expectations in the Euro Zone.

This is not to say an ECB version of QE would not have any impact, but it is an open question as to which economy would get more of a benefit -- the Euro Zone economy or the U.S. economy. To some extent, the U.S. economy is benefitting from the ECB's actions, and expectations of additional (QE) action down the road. One of the confounding elements of the U.S. economy this year has been the behavior of long-term interest rates, with yields on 10-year U.S. Treasury notes much lower than most of us foolish to forecast interest rates expected would be the case this far into the year. Still, even though lower than expected, rates in the U.S. remain above those elsewhere, on both the short end and the long end of the yield curve. While the focus tends to be on longer-term rates, short-term rates are telling an interesting story, as they tend to better reflect expectations over monetary policy moves. Thus, while short-term rates in the U.S. are drifting higher, in many Euro Zone nations short-term rates are negative. As seen in the chart below, spreads between rates on U.S. and German government debt are rising and are above where they historically have been.

Spreads Reflect Growth And Monetary Policy Differentials



Source: Bloomberg; Regions Economics Division

Of late, the combination of heightened geopolitical tensions and ECB policy moves (and expectations of future moves) has fueled a flight of capital into the U.S. as investors seek out the safety and higher yields offered by dollar denominated assets. To the extent this continues, a stronger U.S. dollar and downward pressure on long-term U.S. interest rates could have implications for the Fed as they consider their policy course. A stronger U.S. dollar will put downward pressure on global commodity prices (at least for those traded globally and priced in dollars) and will mitigate price pressures on imports into the U.S., thus helping hold down U.S. inflation. This would give the Fed more latitude to be more deliberate in their management of the Fed funds rate (or any other rates used in the process of normalizing monetary policy) and, to the extent the funds rate is pushed higher, a steady flow of capital into the U.S. would act as a weight on long-term interest rates and thus cushion the impact on the broader economy of any Fed tightening.

It is worth noting an additional channel through which the ECB is attempting to prop up the Euro Zone economy. With further cuts to ECB policy interest rates and the ECB's asset purchase plans making euro denominated assets less desirable, what is an already weakening euro will weaken further, which could help support growth in Euro Zone exports, though Germany figures to be the prime beneficiary of any such effect. By the same token of course a stronger U.S. dollar could hurt growth of U.S. exports, but this is really a function of the dollar's relative strength against currencies other than the euro. For instance, the top three destinations for U.S. exports are Canada, Mexico, and China, which together account for over 40 percent of U.S. exports of goods while Germany, the top Euro Zone destination for U.S. exports of goods, accounts for just over 3 percent. So, a stronger U.S. dollar relative to the euro will have relatively little impact on U.S. export growth, the key will be how the dollar fares against other currencies.

One caution, however, is banking on capital flows and exchange rate differentials is not necessarily a winning strategy, for central banks or investors. The problem of course is capital flows and exchange rates go in both directions, and can change course quickly and without advance notice. So, one potential risk for the ECB is any signs of improvement in underlying conditions could trigger an appreciation of the euro, and one potential risk for the U.S. is that capital flows could reverse and there could be a sharp and sudden increase in long-term U.S. interest rates. This is not to say either of these is likely, but simply to note the vulnerability to shifting investor expectations/sentiment.

Whither Fiscal Policy?

One factor that leaves the Euro Zone, and to a lesser extent the U.S., vulnerable to reversals of financial flows is the absence of effective fiscal policy. Fiscal policy makers seem to have ceded the field to monetary policy and, as a result, the demands and expectations placed on central banks have greatly expanded over recent years, such that monetary policy is now being counted on to achieve goals traditionally thought to be beyond its scope.

During his speech at Jackson Hole, Dr. Draghi laid out what he sees as the main factors behind, nearly six years out from the financial crisis, what remains a plodding Euro Zone economy marked by chronically high unemployment. While noting several factors that have contributed to persistent unemployment, including skills mismatches (which will sound familiar to those here in the U.S. who have been following the domestic version of this discussion), Dr. Draghi set his sights on fiscal austerity as a primary culprit behind the Euro Zone's current woes.

Recall in the early stages of the sovereign debt crisis (circa 2010) growing concern amongst investors that nations such as Greece would be unable to repay their debts led to sharp increases in interest rates on government debt, to varying degrees, across the Euro Zone. With the lack of a common fiscal backstop, then, it was up to each nation to adopt more restrictive fiscal policies, most of which focused on reducing government spending. So, despite the Euro Zone still being mired in recession, fiscal policy became less supportive of economic growth.

There are those, including Dr. Draghi in the one point of his Jackson Hole speech with which we take issue, who advance the argument "front loaded" fiscal austerity was necessary, even in economies still reeling from the financial crisis, to restore investor confidence, which is evident in subsequent declines in yields on government debt across the Euro Zone. The problem with this argument is that it is simply not correct. True, yields on government debt did recede somewhat in mid-2011, but this was after the ECB stepped in and offered liquidity to banks that enabled them to purchase government bonds, which led to the decline in yields. This decline, however, proved short-lived and by year-end 2011 yields on government debt across the Euro Zone were again heading higher. They remained so until Dr. Draghi's now famous pledge that in essence set the ECB up as a fiscal backstop – similar in principal if not operationally to the role played by central banks in the U.S., the U.K., and Japan. It was then and only then yields on government debt across the Euro Zone began to decline in a meaningful and sustained way.

We are by no means arguing fiscal austerity is not desirable, or that it is not necessary. We are, however, arguing that the timing stinks. Fiscal policy in the U.S. was needlessly tighter in 2013 and remains inexplicably restrictive in the Euro Zone. Credible plans to pare down fiscal deficits over time need not be incompatible with present day efforts to support aggregate demand, whether on the tax side or the spending side of the ledger. Instead, fiscal policy makers seem to have declared victory and left the field, opting instead to play arm chair quarterback, or in this case arm chair central banker – critiquing monetary policy now burdened with being the sole source of policy support. There is ample room, in both the Euro Zone and here in the U.S., for tax reform and entitlement reform, but no action on either in either venue. Indeed, it seems that here in the U.S. the best we can hope for from our fiscal policy makers is they do no (more) harm, such as shutting down the government and engaging in meaningless theatrics over issues – such as the debt ceiling – that don't really matter. Across the Euro Zone, punitive tax rates (and seemingly mindless regulations) are waiting to be addressed, but don't hold your breath waiting for that to happen. At least in the U.S. the underlying fundamentals are more supportive for economic growth. But, in both cases the absence of responsible fiscal policy has raised the bar for monetary policy and needlessly acted as a drag on growth.

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Q1 '14 (a)	Q2 '14 (a)	Q3 '14 (f)	Q4 '14 (f)	Q1 '15 (f)	Q2 '15 (f)	Q3 '15 (f)	Q4 '15 (f)		2012 (a)	2013 (a)	2014 (f)	2015 (f)
-2.1	4.2	3.2	3.5	3.1	3.3	3.2	3.0	Real GDP[1]	2.3	2.2	2.2	3.3
1.2	2.5	2.8	3.5	3.5	3.6	3.2	3.2	Real Personal Consumption[1]	1.8	2.4	2.4	3.3
								Business Fixed Investment:				
1.2	8.2	9.3	9.1	8.2	7.5	7.7	7.5	Equipment, Software, & IP[1]	5.6	4.1	5.9	8.3
2.9	9.5	4.7	4.4	5.4	6.2	5.7	5.7	Structures[1]	13.1	-0.5	7.5	5.6
-5.3	7.2	9.1	14.0	12.5	10.9	10.2	10.5	Residential Fixed Investment[1]	13.5	11.9	2.6	11.3
-0.8	1.4	-0.2	-1.6	-1.6	-1.0	-0.9	-1.3	Government Expenditures[1]	-1.4	-2.0	-0.8	-1.0
-447.2	-463.5	-466.2	-474.6	-484.7	-489.8	-492.3	-492.8	Net Exports[2]	-452.5	-420.5	-462.9	-489.9
0.925	0.997	1.036	1.062	1.072	1.081	1.090	1.118	Housing Starts, millions of units[3]	0.784	0.930	1.005	1.090
15.7	16.5	16.8	17.0	16.9	17.0	16.7	16.7	Vehicle Sales, millions of units[3]	14.4	15.5	16.5	16.8
6.7	6.2	6.1	5.9	5.8	5.6	5.5	5.4	Unemployment Rate, %[4]	8.1	7.4	6.2	5.6
1.7	1.8	1.9	1.9	2.1	2.0	2.1	2.1	Non-Farm Employment[5]	1.7	1.7	1.8	2.1
1.4	1.6	1.6	2.0	2.2	2.2	2.3	2.2	GDP Price Index[5]	1.8	1.5	1.6	2.2
1.1	1.6	1.6	1.9	2.1	2.0	2.1	2.1	PCE Deflator[5]	1.8	1.2	1.6	2.1
1.4	2.1	2.0	2.4	2.5	2.4	2.4	2.4	Consumer Price Index[5]	2.1	1.5	2.0	2.4
1.2	1.5	1.6	1.8	2.0	2.0	2.0	2.0	Core PCE Deflator[5]	1.8	1.3	1.5	2.0
1.6	1.9	2.0	2.1	2.3	2.3	2.3	2.3	Core Consumer Price Index[5]	2.1	1.8	1.9	2.3
0.13	0.13	0.13	0.13	0.13	0.13	0.25	0.47	Fed Funds Target Rate, %[4]	0.13	0.13	0.13	0.24
2.76	2.62	2.40	2.55	2.70	3.00	3.10	3.20	10-Year Treasury Note Yield, %[4]	1.80	2.35	2.58	3.00
4.36	4.23	4.02	4.05	4.17	4.40	4.53	4.62	30-Year Fixed Mortgage, %[4]	3.66	3.98	4.17	4.43
-2.6	-2.6	-2.4	-2.3	-2.3	-2.2	-2.3	-2.3	Current Account, % of GDP	-2.8	-2.4	-2.5	-2.3

a = actual; f = forecast;

Notes:
1 - annualized percentage change
2 - chained 2009 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203

Richard F. Moody — Chief Economist — richard.moody@regions.com

Constantine Soras — Senior Economist — constantine.soras@regions.com

Greg McAtee — Economist — gregory.mcatee@regions.com