TD Economics

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Data Release: European Central Bank steps fully into QE with a sovereign bond-buying program

- As widely anticipated, the ECB finally decided to undertake a sovereign bond-buying program at its meeting today. It will now purchase €60bn of assets per month, which will include sovereign bonds, as well as the previously announced ABS and covered bond purchases. These purchases will begin in March 2015, be carried out until at least the end of September 2016, and will cover instruments with a maturity between two and thirty years. The purchases will continue until the ECB has seen a "sustained adjustment in the path of inflation, consistent with [the] aim of achieving inflation rates below, but close to, 2% over the medium term." In the press conference afterwards, Mario Draghi appeared to leave the meaning of a "sustained adjustment" purposefully vague.
- The purchases will be investment-grade euro area government, agency and EU institution securities, with additional elibility for countries under an EU/IMF adjustment program. As Greece is currently under such a program, its sovereign debt will likely be included. Mario Draghi stated that the purchases will also be undertaken on bonds with current negative yields.
- The purchases will be based on the share of each countries capital key at the ECB. The shares are based on the proportion of a country's population and economy within the area.
- Of the purchases, 8% will be held by the ECB, with the remainder held by the national central banks of each member country. The ECB stated that 20% of the total purchases will be subject to risk-sharing in the case of hypothetical losses, with the rest of the purchases not subject to risk-sharing.
- The ECB left its deposit rate and main refinancing rate unchanged at -20bps and 5bps, respectively.
- The ECB also tweaked its six remaining targeted long-term refinancing operations, whereby the interest rate charged to banks will be equal to its main refinancing rate, removing the 10bp spread which applied to the first two operations.
- The ECB stated that the motivation for today's decisions was due to two developments. First, the measures announced in June and September had been insufficient to prevent the risks of too long a period of low inflation. Second, there is the heightened risk that the fall in oil prices further depresses inflation expectations and causes negative second-round effects on wage and price-setting.

Key Implications

- Today, the ECB finally decided to undertake what it long put off: full-blown QE including sovereign bonds. Anything less would have disappointed market expectations. Inflation was already low as a result of tepid euro zone economic growth, and tumbling oil prices pushed euro zone price growth into negative territory. Moreover, with inflation expectations also falling, the ECB's credibility in achieving its inflation mandate was at serious risk. As a result, the ECB had little choice but to act, in order to prevent any deflationary mindset from taking hold across the euro area.
- With all the leaks in the lead-up to the ECB meeting, markets were anticipating a €50bn/month program for at least a year. In this respect, the size of the package announced is above expectations, and remains somewhat open-ended with the mention of "at least September." Government bond yields fell further across the euro zone, while the euro tumbled 1% vs the USD in the aftermath of the decision, after having already fallen almost 8% since early December.
- Overall, with interest rates already so low (partly in anticipation of QE), the impact of this program will be primarily to help raise and anchor inflation expectations, as well as lower the euro even more over time. Sovereign-bond purchases are unlikely to be a panacea for the euro area's economy, however. We see inflation remaining negative over the first half of the year and only slowly rising over the second half. Economic growth should also marginally improve through 2015-16, as the worst of fiscal austerity is behind, lower oil prices feed into higher real incomes, and a lower euro supports exports.

- The fact that only 20% of the total purchases will be subject to risk-sharing may reduce some of the impact of the program, as markets worry about the implications in the case of a member country default. Total risk-sharing would have been the ideal outcome for markets.
- Greek bonds rallied in the wake of the decision. Market attention will now turn to the upcoming election on Sunday. We think in the case of an opposition victory, volatility will remain elevated, but ultimately an agreement with the Troika is the most likely outcome. See our report for more on this issue.

Andrew Labelle, Economist
416-982-2556