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Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

AUGUST 25, 2014

DRAGHI GOES DOVE?

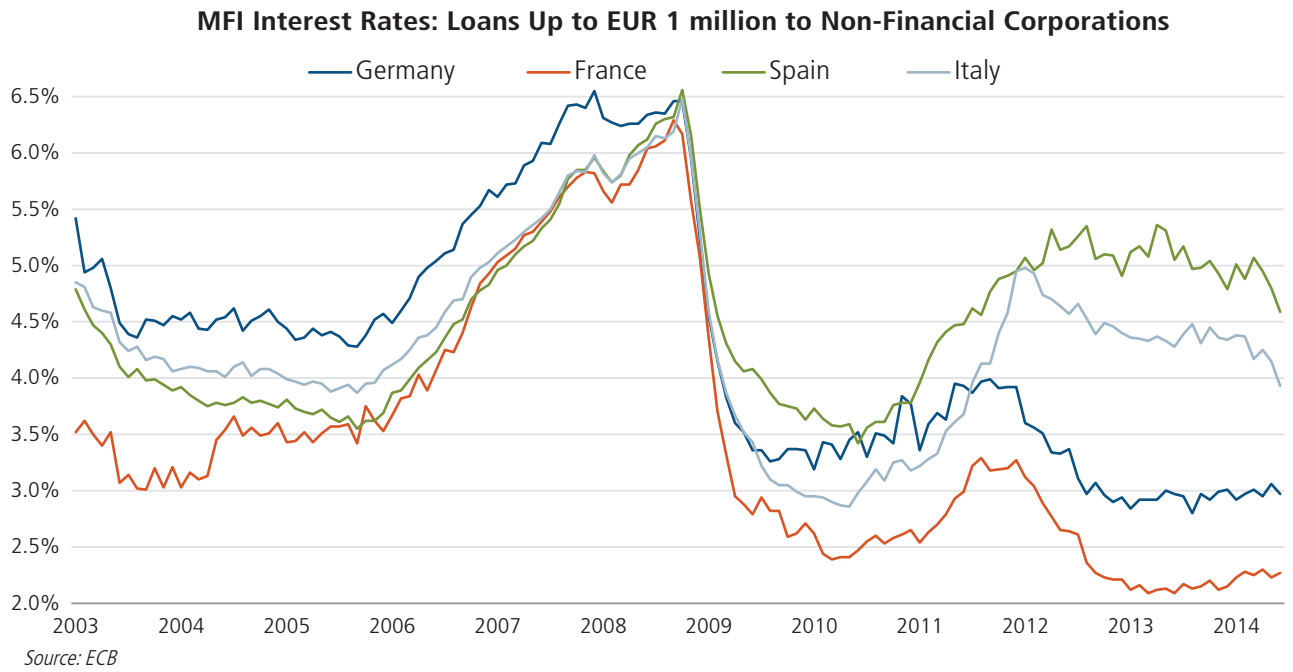
After calls that the European Central Bank (ECB) was "behind the curve," a massive roll-out of negative interest rates and conditional balance sheet expansion in June 2014 seemed to placate investors. But only for a time. Since the ECB announced its pseudo-QE in June, data have showed flat second quarter growth, dismal inflation, and labor markets only slowly healing. In a speech given last week, Mario Draghi addressed the persistent weakness in the euro area economy and hinted that further ECB action could come if inflation expectations continue to fall.

At the Kansas City Federal Reserve's annual Jackson Hole meeting, Mario Draghi gave a speech entitled, "Unemployment in the Euro Area." The speech was a meditation on the extraordinary levels of joblessness across peripheral countries in the monetary union. If the double digit levels of unemployment in Spain (24.5%), Greece (27.1%), Portugal (13.9%) and Ireland (12.0%) weren't bad enough, Draghi lamented that a full 6% of the total euro area labor force had been unemployed for one year or longer. In the United States, that number stands at only 2%. Despite the ECB's best efforts, labor market health has scarcely improved.

Draghi also cited low government bond yields and the prospect of declining inflation expectations as causes for concern. Highlighting the difficulty of coordinating fiscal and monetary policy across an 18 country group, Draghi referenced "ECB staff estimates of the 'credit gap' for stressed countries–the difference between the actual and normal volumes of credit in the absence of crisis effects–[which] suggest that that credit supply conditions are exerting a significant drag on economic activity." As we have suggested before, the ECB has struggled to fix the "transmission mechanism" of monetary policy—ensuring that lower policy rates affect all countries in the euro area. Thus far, the ECB's efforts have been in vain, as borrowing costs for small and medium sized businesses in the hardest hit countries remain elevated (see chart below).

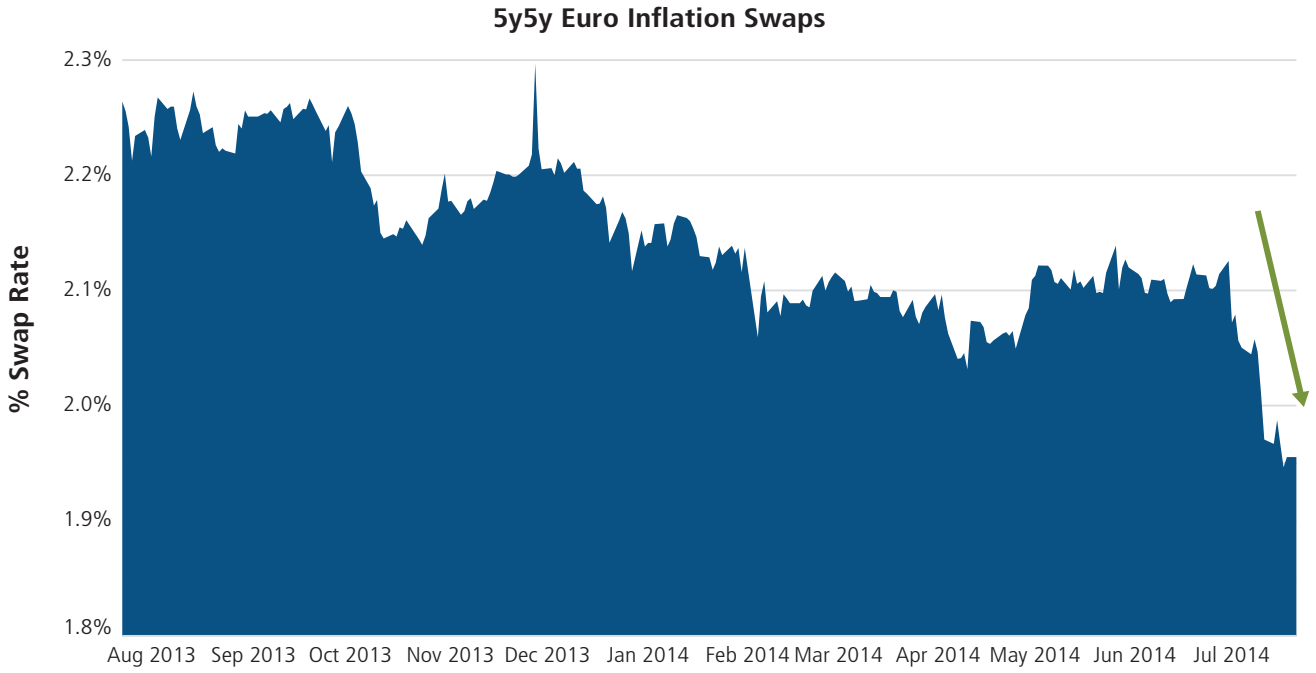
As a result of the low growth, high unemployment, and uneven credit creation, little surprise should come from falling inflation expectations. In particular, Draghi worried explicitly about the market pricing in Japan-like deflation: "the 5year/5year swap rate declined by 15 basis points to just below 2%–this is the metric that we usually use for defining medium term inflation" (see chart on next page). Falling prices in stagnating economies is not a pleasant sight for a central bank which just introduced its newest easing program.

THE TRANSMISSION OF CREDIT REMAINS BROKEN IN THE EURO AREA, THIS IS THE ECB'S REAL PROBLEM–RATE CUTS HAVEN'T FILTERED THROUGH TO THOSE BORROWERS WHO NEED IT MOST



If current inflation (running below 0.5% year-over-year) and inflation expectations continue to fall, we expect further action from the ECB. Whether in the form of open-ended asset purchases or targeted lending programs meant to ameliorate small business credit, the central bank still has options for easing monetary policy further. However, previous policy initiatives have yet to stimulate credit creation, inflation, or growth. While we hope for the best for the future of the euro area economy, a slow and jerky recovery may prove the unfortunate outcome.

INFLATION EXPECTATIONS IN THE EURO AREA HAVE HIT HISTORIC LOWS –THE MARKET NOW EXPECTS SUB-2% INFLATION OVER THE MEDIUM TERM



Source: Bloomberg

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