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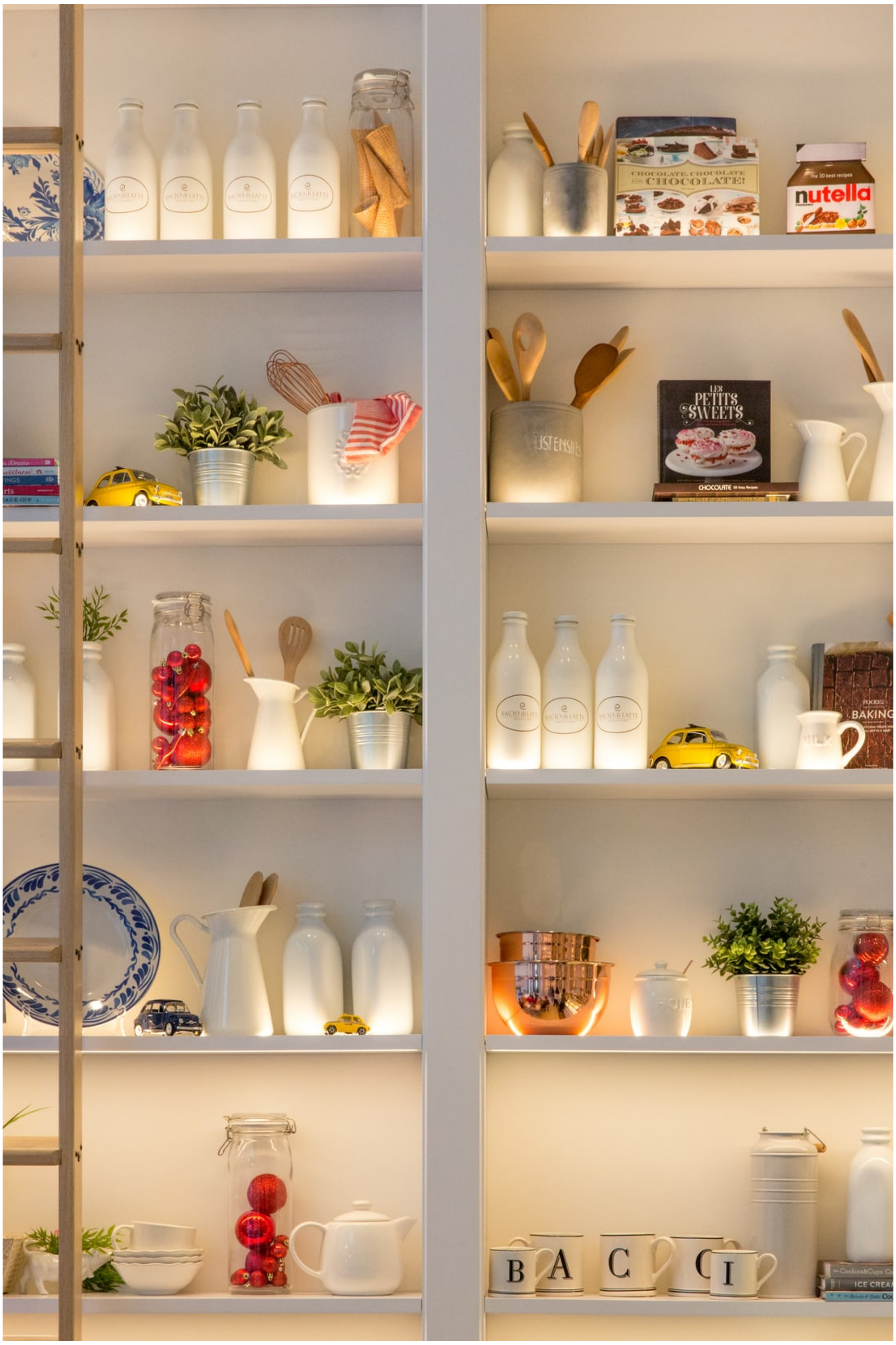
Are the ECB's cupboards bare?



This topic calls to mind the renowned English nursery rhyme about an old lady - Mother Hubbard - who goes to her cupboard, but when she gets there, the cupboard is bare. So ubiquitous is the rhyme, that 'Old Mother Hubbard' has become a standard turn of phrase, to indicate that you are all out of something. With the European Central Bank (ECB) looking poised to embark on a fresh round of monetary stimulus, Mario Draghi has been busy trying to reassure markets that its not a case of Old Mother Hubbard when it comes to the ECB's toolbox.

With
inflation expectations at all-time lows and with declining global trade volumes taking their toll on the eurozone, the ECB looks poised to re-assert itself in order to support the economy. But with its policy jar looking a little bare, commentators are asking, what shape a fresh round of monetary stimulus could take.

We believe
that a new asset purchase program (APP)
is becoming increasingly probable before year-end. The outgoing President, Mario Draghi, said in June that the ECB had 'considerable headroom' with regard to an APP, but, it faces quite a few dilemmas in designing this. The first is that before long, it will likely run out of bonds to buy. This is largely due to its self-imposed 33% issuer limit, put in place to avoid the ECB having the power to block a vote on the restructuring of ECB-held debt of a euro-area country (not blocking such a restructuring could be interpreted as financing of a member state). Of course, the ECB could lift this constraint, but that would require some soul searching as to whether this essentially equates to bailing out governments. If the limits were kept, it is estimated that the ECB would hit the 33% share limit on Germany within one year.

Changing
the 33% would let them buy more German bunds but that's probably not the most effective stimulus, given that investors are already piling into this asset class. Alas, it may also wish to change capital key rules to avoid this, but this would result in more purchases of Italian, French, and Spanish debt, inciting moral hazard.

Increasing
the importance of corporate bond purchases in a new program may be an idea, but again this carries its own problems, mainly in that bank bonds would probably have to be excluded in order to avoid a conflict of interest whereby the ECB is simultaneously the regulator and an investor.

Another

possibility that Draghi has hinted at is rate cuts, leading the market to price a 10 basis point cut to the deposit facility rate (to -0.5%) by September. However, negative yields are deeply problematic for banks and insurers. ECB board members, Coeuré and Praet, have indicated that further cuts would need an assessment of deposit-tiering to alleviate pressure on banks.

So, the ECB's cupboard doesn't seem to be bare just yet, but selecting the appropriate tool is not going to be straightforward. Whatever it decides, the market is hoping for decision to be taken at its July 25th meeting, even if the implementation comes later, potentially under the leadership of Christine Lagarde, who is expected to bring 'more of the same' dovishness. In the meantime, Draghi has encouraged Governments to reach into their own cupboards and pull out some fiscal policy saying: "*monetary policy can always achieve its objective alone, but especially in Europe where public sectors are large, it can do so faster and with less side effects if fiscal policies are aligned with it*".

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