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Ground Zero

Will the raft of measures announced by the ECB be enough to restore growth in the euro area? The answer will depend on the following three factors:

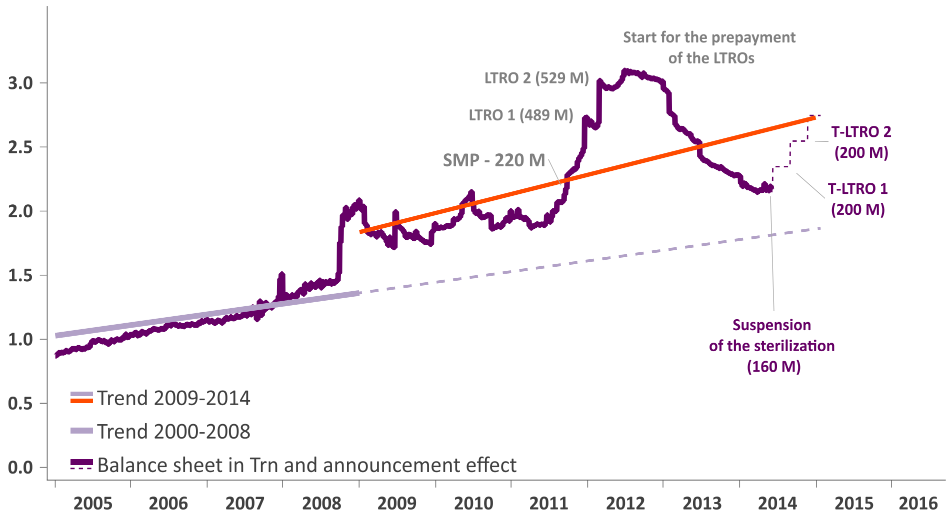
- The effective size of the package,

- The ability of demand for credit to be stimulated,

- The return of a more favorable international economic context, which provides an outlet for improved competitiveness that has been at the origin of deflationary risk.

The markets have been circumspect with regard to these measures because none of these factors are guaranteed to materialize at this point.

ECB Consolidated Balance Sheet and The Announcement Effect of June 05



Sources: RichesFlores Research, Macrobond

Beyond the shock effect, the total amount of measures unveiled yesterday is currently being estimated at €560bn, including:

- €160bn from the suspension of sterilizing what remains of the €219bn in securities the ECB bought as part of its SMP program in 2011; this amount will decline as these securities reach maturity; stocks have already shrunk by €30bn in 2013.
- €400bn, two targeted longer-term refinancing operations (T-LTROs) scheduled for September and December.

The outright ABS purchase program remains to be hashed out. Therefore, only the above-mentioned measures can be estimated. At this point, the package is relatively small in scale, and much less ambitious than what was previously attempted in 2011 and 2012 with the SMP program and the two LTROs, which were twice as big. What will be the total amount of the ABS program? It is difficult to say, but it will have to double the size of the overall package if it is going to be on par with past initiatives or one year of the Fed's QE3…

Pending further news, the announcements this week cannot be considered to be a radical departure for the bank, whose balance sheet with these measures factored in (based on the assumption of two T-LTROs for €200bn each) would make up for about half of what it has lost since the vLTROs started to be repaid early. Given stable interest rate expectations for the euro area and the United States, these measures would be just enough to stabilize the euro-dollar exchange rate at present levels, but would not help it depreciate.

If these efforts have no marked effect on the exchange rate, then they will have to stimulate demand for credit in order to be effective.

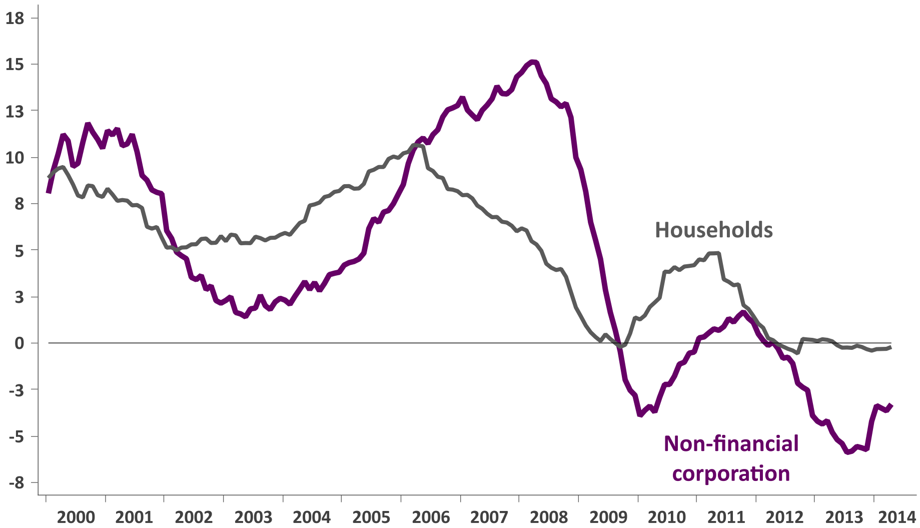
Ability to stimulate demand for credit: a litmus test for deflation

The drop in key rates is unlikely to have much material effect on the cost of credit.
Under the highly-unlikely scenario that the banks use their deposit facility with the central bank, credit could become more expensive if the deposit rate were to pass into negative territory. Consequently, the measures taken by the ECB are not intended to stimulate credit but aim to enhance supply-side fluidity. It remains to be seen, given that funding sources are awash in liquidity, if the following will materialize:

1- measures will be enough to get banks to lend more,

2- demand will follow suit.

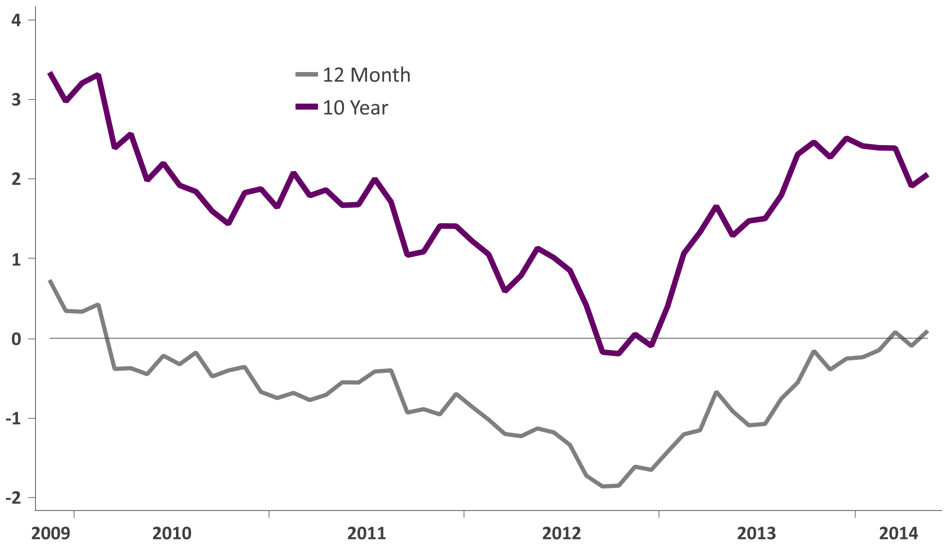
Annual Growth Rate of Credit in Private Sector



Sources: RichesFlores Research, Macrobond

The answer to this two-pronged question will come from the evolution of the economic situation and, first and foremost, the intensity of deflationary pressure felt by economic agents. Deflation and credit expansion are largely contradictory. Not only because deflation has a negative effect on consumer demand and investment but also because it makes the cost of debt more expensive by increasing real interest rates.

Interest Rate in Euro Area, in %



Sources: RichesFlores Research, Macrobond

The change in demand for credit will therefore be the biggest test of just how mired eurozone economies are in deflation, from the weakest ones to the strongest.

Stimulation from the rest of the world

The current situation does not provide much justification that domestic resources on their own will continue to drive the current improvement in economic conditions. Domestic resources are being hit by structural adjustments that are poised to last for the foreseeable future. The end of austerity policies gave economies in the euro area's south some breathing room, but their structural factors driving growth are still convalescing. Moreover, in the euro area core, the situation for France is more worrisome than ever, while fiscal restrictions are not likely to end anytime soon. The euro area will be unable to get back on the growth track without external support and without German growth trickling down.

European leaders have made this strategy their anti-crisis mantra in recent weeks and find themselves in a precarious position: either the global environment picks up and Mario Draghi's efforts will end up paying off, or the global spark fails to materialize and ECB efforts will fail.

The recovery from this crisis will have to come from beyond the euro area's border. Markets seem to have understood this and are reacting sharply to news from the rest of the world, which hasn't disappointed Mr. Draghi, U.S. job growth and Chinese PMI apparently have more of an impact on investors than his own policies.

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