Economy

Industrial accident at the ECB

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Mario Draghi is not infallible. The ECB did indeed ease its monetary policy yesterday as expected and the measures announced –rate cut and extension of QE – would, not such a long time ago, have been deemed considerable. But the markets, whipped up for weeks into expecting more by the ECB's communication, reacted very badly. The euro, whose depreciation was seen as inexorable by many, experienced one of the largest surges in its history. Here, we are drawing a number of conclusions from this major communication blunder.

A bazooka? No, a water pistol

If Mario Draghi was a footballer, we would say that he scored a number of goals yesterday… against his own team. The new package of easing measures *should have* exerted downward pressure on the euro and interest rates while providing the equity markets with support. Instead, the euro rose by around 4% against the dollar, long rates bounced back and the European stock markets collapsed. The markets' reaction is commensurate with the magnitude of the disappointed expectations that the ECB's president and several of his colleagues had allowed to form in recent weeks. Let us try to learn some lessons from this historic day.

- **On communication and managing the market's expectations** – The ECB's error in communication was not committed yesterday. It had been thoroughly (but inadvertently) prepared for around two months. Over this period, barely a day went by without Mario Draghi or one of the influential Board members (Messrs Constancio, Coeuré and Praet) telling the markets: "You will see what happens in December." At the end of the day, the ECB did indeed deliver a fairly substantial package of measures: it cut rates, extended QE and widened the pool of eligible assets. But since the market was expecting much more[1], the disappointment was great. This has done nothing for the ECB's credibility, to put it mildly. We can also see that the marginal effectiveness of QE announcements is on a rapid decline.
- **On the economic analysis** – In our view, since the summer the ECB's analysis has been biased, almost hemiplegic, highlighting the negative (low inflation, external risks to growth) and ignoring the positive (the business climate, employment, credit). All told, the ECB staff's economic forecasts are not so very different in December than they were in September. It is hazardous for a central bank to distort the economic reality in order to justify its policy.
- **On the euro exchange rate** - The euro/dollar exchange rate yesterday registered its second-highest intraday increase of all time (with the record being March 2009 after the Fed announced QE). The violence of the correction reflects massive short positions which had to be cut immediately. This reaction should remind us that the decline in the euro is not as predetermined as some would have us believe. The disconnection between the Fed's and ECB's monetary policies is clearly a key factor exerting downward pressure on the euro/dollar rate, but this has been known and accepted for months. We do not see this as an absolute argument to predict the return of the euro to parity or under parity.
- **On the Fed** - The communication blunder committed by the ECB yesterday should serve as a reminder to other central banks that even after laying the groundwork for a decision, the markets' reaction can be a) extreme and b) against expectations. Volatility is exacerbated since the monetary policy currently in place is essentially in uncharted territory. No-one can predict with any certainty all the effects of the QE policies, not to mention those of negative rates policies. The Fed is preparing to launch a cycle of monetary normalisation in mid-December. The watchword (fairly vague it should be said) is: gradual. The normalization cycle will be gradual. This is clearly the Fed's intention, although it remains to be seen whether the markets' reaction will be also.

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[1] *On this topic, we published a (half-serious) note on Monday which listed 25 possible easing measures, some very radical, knowing that most of them would not even be considered. See our Economic Note of 30 November: "25 ways to ease the ECB's policy".*

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