ECB sows the seeds for better eurozone growth

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EXECUTIVE SUMMARY

The European Central Bank (ECB) finally delivered its bazooka. Worth a total size of around €1.1 trillion, the expansion to its quantitative easing (QE) programme was much more aggressive than markets anticipated. Although the programme itself will not solve the eurozone's entrenched problems, we believe the stage is now set for the 19-nation bloc to defy the gloomy consensus forecasts and improve in the second half of this year.

In this Price Points, T Rowe Price's portfolio manager for European Fixed Income, Ken Orchard, provides his latest thoughts on the ECB's announcement and the outlook for the eurozone economy.

Defying the gloomy consensus on eurozone growth

With moribund growth and headline inflation in negative territory, the ECB finally pulled the trigger and launched a full QE programme at its January 22 monetary policy meeting. From March, the central bank will expand its asset purchases to include bonds of eurozone governments, agencies and European institutions.

We believe there are some potential positive effects from the ECB's asset purchases programme that could boost the eurozone economy in the second half of 2015. Firstly, the euro is substantially weaker against almost all currencies this year. This should help boost eurozone exports as a weaker currency makes them cheaper abroad.

Another potential impact from the ECB's action is that it could take a lot of sovereign debt off banks' balance sheets. Consequently, in order to maintain their profit margins, banks would be forced to increase lending to the private sector. Such a development could boost investment.

At the margin, we believe the ECB's programme could encourage investors to take on riskier assets. This could be supportive for corporate investment as companies take advantage of the increased interest to sell bonds.

Therefore, set against a backdrop of slightly looser fiscal policy from some governments, the signs are encouraging for the eurozone economy for the second half of this year. This makes us more optimistic than consensus about the outlook for the region's growth. That said we are not expecting a dramatic turnaround. Economic growth is still likely to be low, especially when compared to peers. In addition,

there's likely to be significant divergence between members. Countries with the strongest budget positions, low-debt levels and competitive economies are expected to grow above the average rate. We include Germany and Austria in that group. In contrast, countries that have structural problems, such as France and Italy are likely to see growth rates that are close to zero this year.

Thoughts on the ECB's bazooka move

The ECB's package exceeded expectations on several fronts. Totaling €1.1 trillion overall, the size is much larger than what consensus anticipated. In a further surprise, the ECB indicated that the programme could be extended if necessary. The purchases are "intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term," ECB President Mario Draghi said.

Looking at the pace of buying, the ECB's purchase plan is broadly in-line with the last programme launched by the US Federal Reserve. However, the aggregate budget deficit of eurozone government's is around half of what the US government's deficit was when it last launched QE. Therefore bond supply is likely to be less. We estimate that the ECB will buy around €425 billion of sovereign bonds this year, which is about 220% of net issuance. From that perspective, we believe the ECB's impact on the eurozone government bond market is likely to be greater than the Fed had on US Treasuries.

Potential market implications

The ECB's announcement came as no surprise to the markets. In the weeks and months leading up to the announcement, investors had been selling the euro and buying eurozone government bonds. These moves have been extended post announcement with the euro tumbling to its weakest level in over 11 years against the dollar, while yields on eurozone government bonds reached new record lows and the Stoxx Europe 600 index rallied to seven-year highs.

Overall, we expect the ECB's action to continue to be supportive for riskier assets in Europe as government bond yields are likely to remain at low levels. As a result, investors in search of higher yielding assets could head further down the credit-quality curve in bond markets. Alternatively, they could decide to invest more of their money in stock markets, thus driving up European share prices.

On the currency front, we expect the euro to remain weak and potentially even depreciate further, particularly in the short-term with political risks in Greece rising. The anti-austerity Syriza party won Greece's general elections at the weekend, raising concerns about the impact that this could have on its financial aid package. Developments could weigh on the euro and serve to increase volatility in Greek bonds. However, we see the contagion to broader eurozone government bonds being limited.

The ECB's latest move helps lay the groundwork for the eurozone economy to start recovering. However, as ECB President Mario Draghi pointed out, for the programme to be "optimal," it needs to be accompanied by structural reforms. Notably, two of the region's largest members–France and Italy–remain uncompetitive, and their economies are expected to continue to struggle and lag peers unless structural reforms are undertaken.

ECB – The details

Here are the main details from the ECB's January 22 announcement:

- Total asset purchases will amount to €60 billion per month.[1]
- The programme will run until at least September 2016.
- Sovereign purchases will be done in proportion to how much a country contributes to the ECB's capital; the higher the country's so called 'capital key', the more government debt that will be purchased.
- Bonds with maturities from two to 30 years can be bought.
- There will be "additional eligibility criteria" applied to countries under EU/IMF programmes such as Greece and Cyprus.
- Risk sharing: the ECB will shoulder 20% of potential losses, while national central banks will bear the remaining 80%.

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[1] Includes buying asset backed securities and covered bonds

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