European Economics and Strategy

Game over

The deterioration in liquidity and pricing in euro area government bond markets means an aggressive policy response is urgently needed. Liquidity needs to be restored by the time government issuance ramps up in early 2012.

Such liquidity can only come from the ECB in our view and could be provided by a large-scale asset purchase programme of quantitative easing. We think conditions will increasingly justify the ECB embarking on it early next year.

A large-scale asset purchase programme of quantitative easing, buying euro area government bonds in the secondary market, would be justifiable under the Treaty if it was undertaken for monetary policy purposes. That may mean the ECB needs to take rates down to a “zero-bound.” It would also mean that the ECB would need to buy either a representative basket of euro area government bonds or, perhaps, EFSF bonds. For such a programme to be similar in scale to that seen in the US or UK would imply around €1trn of asset purchases.

That requires that the ECB does something it has hitherto denied it would, but not doing it will be increasingly grave for the euro area economy and, quite possibly, the euro itself.

In our view, a ECB QE programme would reduce the safe haven premium in bunds. Thus, we expect a bold move from the ECB to result in higher German yields and core curve steepening. Large scale QE would also imply policy rates remaining low for a prolonged period. Hence we would expect reds/greens flattening in the front end. In terms of the periphery, the main beneficiaries are countries with relatively lower debt-to-GDP ratios. We expect Spain to outperform versus Italy and Belgium.

Exhibit 1: Orthodoxy Hurts, sometimes

10 year government bond yields

Source: Credit Suisse, Thomson Reuters Datastream
Game over

**Euro area bond markets are now frozen.** Even Germany is not insulated. It failed to get bids for 35% of its 10-year bond auction and this follows on the heels of its 2-year auction also remaining uncovered only one week earlier.

**There is now an urgent need for firm policy action.** Euro area politicians have dithered too long and the gap between decision-taking and implementation has been too protracted and too uncertain. The latter has led to increased market stress, as evident in the liquidity flowing back into the ECB, which is not far off the peak it reached at the start of the sovereign debt crisis last year. Uncertainty is also manifest in the sharp fall of business confidence, which has led the euro area back into recession.

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**Exhibit 2: Funding stress**

![Graph showing ECB deposit facility](Source: Thomson Reuters Datastream, Credit Suisse)

**Exhibit 3: Into recession**

![Graph showing Euro area composite PMI and GDP](Source: Thomson Reuters Datastream, Credit Suisse)

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**What will it look like?** With the EFSF on the verge of having beensumitted to extremes, Germany, the paymaster, will have to choose between two – in the German mind, ‘evils’: Activating the ECB printing press more decisively or Eurobonds. The latter requires a fiscal union, which in turn requires changes to the Treaty, a process that given the parliamentary approvals and ratifications required, could take years. This leaves the onus on the ECB.

**Plenty has been written about why the ECB won’t activate the printing press more fully.** But it has always been viewed from the angle of the ECB funding sovereign debt, which indeed counters Article 123 of the Treaty prohibiting the direct lending by central banks to governments.

More details on different clauses on Treaty can be found in *European Strategy and Trades – Of Treaties and auctions*, 24-Nov-11

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**Article 123**

1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as “national central banks”) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.

2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.
The term quantitative easing is not found in the treaty and so far, the sovereign debt crisis has been a sequence of rearguard actions and capitulations. Although the Treaty contains a no bail-out clause and Greece was supposed to be an exception. Portugal and Ireland then also received credit programmes invoking Article 122, which states that under certain conditions, financial assistance to member states can be provided. The promise that no orderly default was in store was given up with the Greek PSI and the ECB gave up its aim to keep fiscal and monetary policy separated when it started buying periphery bonds in May 2010.

Periphery bond purchases did not counter Article 123 because they were justified in response to exceptional circumstances in financial markets. As the ECB argued, these hamper the monetary policy transmission mechanism and thus the effective conduct of monetary policy orientated towards price stability in the medium term.

Indeed, the Treaty gives latitude to the ECB to buy assets if needed, for example, if it was necessary for its price stability target to be met. Article 18 of the ECB Statute states that: "In order to achieve the objectives of the ESCB and to carry out its tasks, the ECB and the national central banks may operate in the financial markets by buying and selling outright".

To a certain extent, the ECB's bond buying programme contributed to the loss of market confidence that we are seeing. First, because from the start the ECB reiterated that the bond purchases would be temporary and not unlimited and has repeatedly kept reminding the market of this fact. Second, because the ECB used the purchases to put pressure on governments to comply with delivering fiscal austerity and structural reform measures.

But not moving before a government does becomes a dangerous game as the dearth of liquidity in the market shows. And with the risk that the liquidity crisis turns into a full blown solvency crisis and thus potentially the end of the euro, the game of chicken is nearly up unless politicians deliver a Christmas miracle on 9 December. Since miracles are rather uncommon, our view is that the ECB will need to step in more decisively early in the New Year. In the first quarter alone, the euro area sees EUR143 bn of bonds maturing with Italy accounting for EUR 64 bn of those.

Assuming politicians fail to restore market confidence by the start of next year, what are the options for the ECB? For many, the ECB announcing that it would buy unlimited amounts of sovereigns embarked on an austerity course would do the trick. In our view, such an announcement could easily be challenged from a Treaty point of view. It would also blur the boundaries between monetary and fiscal policy further and on top bring up questions of democratic legitimacy.

It would be far easier to announce large scale asset purchases along the lines of QE as long as it is announced as a monetary policy tool. This would not be against the treaty since under the latter, the ECB has a clear price stability objective of below but close to 2%. The backdrop is given to use QE as a monetary policy tool. The euro area is sliding back into recession, which will be accompanied by a mounting risk of deflation exacerbated by the fact that the periphery has embarked on large scale fiscal adjustment and has started to restore competitiveness through relative price declines. The risk that in the medium term, inflation undershoots the price stability objective, is thus not negligible. Even the German orthodoxy, which likes to take its cues from money supply can rest assured that the risk for price stability objective is on the downside rather than on the upside.
In order to use QE as a monetary policy tool, interest rates need to have reached the zero bound. The euro area composite PMI signals that the ECB's key policy rate should fall well below 1% and the zero bound should be reached at a repo rate level of 0.75% or perhaps even 0.5%. Our forecast currently has the ECB cutting rates to 0.75% by early next year. We do not expect the deposit rate to fall below 0.25%, which means that the bands around the repo rate would narrow from the current +/- 75 bp for marginal lending and deposit rate, respectively. In the past, the bands have varied between +/- 50 up to +/- 100 bp.

The Bank of England set the precedent of using large scale purchases of government bonds as a monetary policy tool in early 2009. The Bank argued that, having taken policy rates down to 0.5%, further monetary stimulus was required to prevent inflation from falling significantly below its 2% target. It argued that large scale asset purchases financed by the creation of central bank reserves (so unsterilized) would boost the UK money supply and stimulate economic activity. Given the scale of the programme (in March 2009, the Bank decided to buy £75bn of assets, but eventually ended up buying £200bn), the Bank decided it was appropriate to buy government bonds as it was a large and deep enough market to conduct those purchases, as well as avoiding favouring specific sectors or firms, as would have been the case in the purchase of other assets.
When it comes to quantity, a further leaf could be taken out of the Fed and BoE book. The first Fed QE programme amounted to USD 600bn - just over 4% of US GDP, to start with but this was quickly boosted to USD 1.75trn equivalent to 12% of GDP. An amount equivalent to 10% of GDP was the first QE announced by the Bank of England. An equivalent amount could see the ECB purchasing bonds to the tune of nearly EUR 1trn. The risk is that the ECB is not as bold to start with, but as we have learned with the Fed and BoE, the initial amount gets increased.

Using the ECB’s capital key would be the most neutral stance when it comes to allocating purchased shares. Merely purchasing periphery bonds would lay the ECB open to deficit financing and thus go against the treaty. Instead, the capital key would ensure that the largest purchases are done in core markets with purchases of Italian bonds ranking only third after German and French sovereign bond purchases. We take a closer look at the breakdown of buying per country and the countries which would benefit the most from the ECB embarking on QE in the strategy section in the following pages.

The question remains how possible future losses would be underwritten. Bonds bought by the Fed or BoE are issued by their own treasuries and thus have no credit risk attached. For the euro area, a union of 17 national sovereign states, this is different. But the credit risk for the ECB could be circumvented if the euro area as a whole would underwrite these bonds. Euro area member states might acquiesce once there is no other option.

Key for the ECB, once it embarks on QE, is how to keep pressure on politicians to continue pursuing not only structural reforms but also steps towards a fiscal union, which eventually would make ECB bond buying unnecessary. It is valid to fear that once the ECB embarks on QE, sovereign states would feel less pressure and this partly explains why the ECB continues resisting large scale bond purchases. But QE as a monetary policy tool means that the time frame in which it is conducted is not unlimited and is closely linked to the economic outlook. Once economic activity stabilizes and starts to recover, QE should cease. Member states would be well advised to use the window of opportunity to continue putting their house in order.
Strategy: market impact of QE

If the ECB does announce a large scale asset purchase program, we expect the first market reaction to be an immediate rally in risky assets and a corresponding sell-off in core markets. Although a €1trn asset purchase program using ECB capital weights would result in larger purchases of German and French bonds, an ECB QE program would reduce the near-term safe haven premium in German bunds.

Thus, we expect a bold move from the ECB to result in higher German yields and German curve steepening. Large scale asset purchases would also imply policy rates remaining low for a prolonged period of time. Hence we would expect reds/greens flattening in the money market curve.

It makes intuitive sense that the main beneficiaries of QE are countries with low debt-to-GDP ratios. €1trn of purchases, distributed by ECB capital weight, would result in purchases of 10% of Italian debt outstanding versus 20% of Spanish debt. We, therefore, expect Spain to outperform Italy and Belgium.

Experience in the UK and US

The UK started QE in March 2009 and in the first instance began with £50bn in gilt purchases. The program reached £200bn by the end of 2009, which was over 10% of UK GDP. In October this year, the program was further expanded by £75bn. We also expect the BoE to increase QE by a further £75bn next year, which would take the program to 23% of GDP.

The immediate market reaction in the UK to the first announcement of QE was richening in swap spreads and gilt curve steepening into the announcement. Another clear impact of QE and monetary easing in the UK and US was more aggressive market pricing for the “lower for longer” theme. Exhibit 8 shows the money market slope, proxied by the red/greens slope for the US and UK. Both the US and UK money market curves have flattened as market expectations for rates remaining lower for longer have increased. In the event of large-scale QE in Europe, we would expect policy rates to have reached their minimum. In such a scenario, we expect the money market curve to flatten in line with the US and UK curves.

Distribution of asset purchases

As discussed above, the most likely scenario, in our view, is for the ECB to use the capital subscription key in order to weight bond purchases. In the table below, we outline the total debt stock per EA17 country, the adjusted ECB capital contribution key and assuming €1 trn in QE purchases, we also suggest the total maximum amount that could be bought per country.
Exhibit 9: Possible distribution of ECB bond purchases assuming ECB capital weights

<table>
<thead>
<tr>
<th>Country</th>
<th>General Government Gross Debt 2010 (in bn)</th>
<th>GDP 2010 (Eur, bns)</th>
<th>Gross Debt 2010 (% GDP)</th>
<th>ECB Capital Subscription (%)</th>
<th>Re-scaled ECB weights (%)</th>
<th>Expected maximum amount bought under QE (EUR, bns)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>205.2</td>
<td>284.4</td>
<td>72.2</td>
<td>1.9</td>
<td>2.8</td>
<td>27.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>340.8</td>
<td>352.5</td>
<td>96.7</td>
<td>2.4</td>
<td>3.5</td>
<td>34.7</td>
</tr>
<tr>
<td>Cyprus</td>
<td>10.6</td>
<td>17.5</td>
<td>60.8</td>
<td>0.1</td>
<td>0.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>0.8</td>
<td>14.5</td>
<td>5.8</td>
<td>0.2</td>
<td>0.3</td>
<td>0.8</td>
</tr>
<tr>
<td>Finland</td>
<td>87.2</td>
<td>180.3</td>
<td>48.4</td>
<td>1.3</td>
<td>1.8</td>
<td>17.9</td>
</tr>
<tr>
<td>France</td>
<td>1,591.2</td>
<td>1,931.4</td>
<td>82.4</td>
<td>14.2</td>
<td>20.3</td>
<td>203.2</td>
</tr>
<tr>
<td>Germany</td>
<td>2,079.6</td>
<td>2,476.8</td>
<td>84.0</td>
<td>18.9</td>
<td>27.1</td>
<td>270.6</td>
</tr>
<tr>
<td>Greece</td>
<td>328.6</td>
<td>230.2</td>
<td>142.8</td>
<td>2.0</td>
<td>2.8</td>
<td>28.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>148.1</td>
<td>156.0</td>
<td>94.9</td>
<td>1.1</td>
<td>1.6</td>
<td>15.9</td>
</tr>
<tr>
<td>Italy</td>
<td>1,843.0</td>
<td>1,548.8</td>
<td>119.0</td>
<td>12.5</td>
<td>17.9</td>
<td>178.6</td>
</tr>
<tr>
<td>Luxemburg</td>
<td>7.7</td>
<td>41.6</td>
<td>18.4</td>
<td>0.2</td>
<td>0.2</td>
<td>2.5</td>
</tr>
<tr>
<td>Malta</td>
<td>4.2</td>
<td>6.2</td>
<td>68.2</td>
<td>0.1</td>
<td>0.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>374.6</td>
<td>588.3</td>
<td>63.7</td>
<td>4.0</td>
<td>5.7</td>
<td>57.0</td>
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<tr>
<td>Portugal</td>
<td>160.5</td>
<td>172.7</td>
<td>92.9</td>
<td>1.8</td>
<td>2.5</td>
<td>25.0</td>
</tr>
<tr>
<td>Slovakia</td>
<td>27.0</td>
<td>65.9</td>
<td>41.0</td>
<td>0.7</td>
<td>1.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Slovenia</td>
<td>13.4</td>
<td>36.0</td>
<td>37.3</td>
<td>0.3</td>
<td>0.5</td>
<td>4.7</td>
</tr>
<tr>
<td>Spain</td>
<td>638.8</td>
<td>1,062.6</td>
<td>60.1</td>
<td>8.3</td>
<td>11.9</td>
<td>118.7</td>
</tr>
<tr>
<td>Total</td>
<td>69.97</td>
<td>100.00</td>
<td>1,000.0</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Credit Suisse

One of the questions regarding QE implementation concerns which country experiences the largest marginal benefits. Intuitively, the first reaction to a limited sized program is that countries with low debt-to-GDP ratios would generally benefit. This can be more clearly shown in Exhibit 10, which shows the proportion of outstanding government debt that could be absorbed under a ECB capital-weighted QE program.

Exhibit 10: % of outstanding debt bought under QE program

Exhibit 11: Marginal returns for high debt stock countries lower

\[ y = 0.8812x - 12.66 \]
\[ R^2 = 0.9487 \]

Source: Credit Suisse

As shown in Exhibit 10, Italy, Belgium and Greece would likely see the lowest proportion of debt absorbed under QE and Spain and Finland would be the larger beneficiaries of such a program. This can also be seen in Exhibit 11, which plots absolute debt stock outstanding versus GDP, a proxy for the ECB capital weights.
Market implications of ECB QE  The main impact of €1trn in purchases is that net issuance in Europe as a whole would be negative. Our European Government Bond strategist estimates gross bond issuance of €798bn for the main Euro-area issuers (Euro sovereign supply outlook 2012, 21-Nov-11). Thus net issuance, after accounting for ECB QE, would be negative €202bn.

Exhibit 12 compares the amount of gross issuance that could be absorbed by the ECB, under the scenario detailed in Exhibit 9. As shown, Italy and Belgium would still have positive net issuance whereas Germany would have negative issuance of €80bn. Once again, this shows that Italy and Belgium see a smaller proportion of issuance absorbed under a QE program.

Sectors  We expect that if the ECB embarks on large-scale QE, it would most likely adhere closely to the Securities Market Program (SMP) where it buys mostly in the 2-10y sector, and mostly off-the-run issues. In both the UK and US QE programs, the central bank announced the issues being bought and the distribution of purchases across the curve. In Europe thus far, the ECB has not disclosed the breakdown per country or by maturity buckets for the SMP. We do not expect the ECB to state these guidelines at the start of a full scale QE program, which makes discerning relative-value opportunities due to QE less clear.

The immediate reaction following the ECB extension of the SMP to Spain and Italy in August is an indication of the expected market reaction to a QE announcement. In the event of a QE large-scale asset purchase program from the ECB, we would expect peripheral sovereign curves to re-steepen, as the near-term default risks are reduced. Exhibit 14 shows that peripheral curves have substantial room to steepen.

Exhibit 12: Net issuance, adjusted for QE

<table>
<thead>
<tr>
<th>Country</th>
<th>Maximum amount bought under QE</th>
<th>2012 expected bond issuance</th>
<th>Net issuance (adjusted for QE)</th>
<th>Ratio of QE amount versus 2012 issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>179</td>
<td>225</td>
<td>46</td>
<td>0.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>35</td>
<td>41</td>
<td>6</td>
<td>0.8</td>
</tr>
<tr>
<td>France</td>
<td>203</td>
<td>179</td>
<td>-24</td>
<td>1.1</td>
</tr>
<tr>
<td>Netherlands</td>
<td>57</td>
<td>46</td>
<td>-11</td>
<td>1.2</td>
</tr>
<tr>
<td>Austria</td>
<td>28</td>
<td>22</td>
<td>-6</td>
<td>1.3</td>
</tr>
<tr>
<td>Spain</td>
<td>119</td>
<td>90</td>
<td>-29</td>
<td>1.3</td>
</tr>
<tr>
<td>Finland</td>
<td>18</td>
<td>13</td>
<td>-5</td>
<td>1.4</td>
</tr>
<tr>
<td>Germany</td>
<td>271</td>
<td>182</td>
<td>-89</td>
<td>1.5</td>
</tr>
</tbody>
</table>

Source: Credit Suisse

Exhibit 13: Immediate reaction in Spain and Italy when ECB started buying these bonds under the SMP

Event date: 04-Aug-11

Source: Credit Suisse Locus

Exhibit 14: Recently, sovereign curves have started to flatten

Source: Credit Suisse
The impact of ECB QE on Germany is less clear. On the one hand, more than 100% of 2012 bond issuance could be bought under QE, thus net issuance over the year would be negative. On the other hand, the ECB support for Europe removes some of the systemic risk priced into bunds. In our view, the over-riding impact is the latter. Hence, we expect German bunds to sell off.

**Pros and cons of QE**

The obvious benefits of large scale QE would be to stem contagion in the short term, and provide a clear signal of the commitment from the EU authorities to the Euro. We see QE as providing a “bridge” stability tool for the market, in order to buy politicians time to implement fiscal reforms.

Unfortunately, QE does not solve the structural issues in Europe. It is merely a tool to buy time and another way to transfer sovereign debt to the official sector. In the extremis, if the ECB is forced to extend QE, but fiscal reforms are not successfully implemented, we could end up in a situation where certain countries are still forced to restructure debt. In such a scenario, the perverse outcome is that larger haircuts may have to be imposed on private bond holders, as the official sector (ECB) is unlikely to participate in a restructuring.

Large scale QE would also bring the question of moral hazard back to the fore. One could argue that such bold ECB action reduces the need for political and structural reform. Another negative is that the market may question the independence of the ECB and whether its price-stability mandate is being compromised. To this end, the other main risk to unsterilized asset purchases is inflation. As seen in the UK, inflation has been stubbornly above target during the last two years. We see this risk as less likely in the short term, primarily as expectations for growth in Europe have deteriorated significantly.
Disclosure Appendix

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