Macro Market Insights

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Out of Options

As the euro makes its way towards parity, we are witnessing the sole desired outcome of the policy initiative of the European Central Bank and their member governments. It prompts the question whether this policy approach will render what Mario Draghi and his team of central bankers are attempting to achieve by following the actions of like institutions and endeavouring on a journey of quantitative easing. But as the European Union is governed by a number of sovereign governments that have autonomy over their own domestic policy, the lack of coordination narrows the scope of what targeted bond purchases will accomplish when compared to other monetary experiments like in the US or Japan.

For starters, when the Federal Reserve embarked on their quantitative easing policy, and purchasing government debt with newly printed US dollars, the US government was running a deficit close to 10 per cent of their GDP. They were in essence supplying bonds to the market, which helped to make the Fed successful. One of the greatest over exaggerations in the market was around why the Fed began their taper process and scaled back their monthly asset purchases. The misperception was routed in the fact that US Federal government was shrinking their deficit and issuing fewer bonds. A diminishing net supply was inevitably seeing the US Federal Reserve as less accommodative.

The constraint on the fiscal side is what is more than anything prompting negative yields or interest rates in European countries. And this isn't to suggest that governments are exercising a modicum of responsibility or restraint; moreover, with a limited supply of sovereign debt to the market and the demand for higher rated bonds, prices are being driven higher and yields lower. The financial institutions alone in Europe require a certain level of higher rated liquid assets, and it's exactly the reason when the ECB attempts to purchase German Bunds they'll be in a bidding war with other institutional buyers.

The other factor that questions the policy approach breeds from the criticism a policy like quantitative easing has received. The cost is the imperfect wealth effect created by an overvalued stock market because asset prices are distorted by abnormally low policy rates. Particularly in the US where QE saw those invested benefit, but the average American that didn't trust a market that recently shed half its price got left behind. And where corporations have the opportunity to invest in new projects and workers, they also benefited from the opportunity to take on new financing at extremely attractive low rates and simply return cash to shareholders through buy backs and increased dividends.

The European Central Bank has one transmission for policy and that is weakening the euro. The continent has disinflationary if not deflationary pressures currently. Growth is stagnant. Their fiscal authorities look hapless. The ECB can weaken the euro further so that foreign demand boosts their domestic economy. The US Federal Reserve and Bank of Japan have crossed the line in terms of coordinating fiscal and monetary policy. The ECB cannot. But now they remain engaged, like other central banks, in a race to the bottom, beggar thy neighbour policy.