

Research

Euroland: Credit easing vs quantitative easing

- The ECB is about to embark on credit easing. Jean-Claude Trichet emphasised that the ECB will not be embarking on quantitative easing. We look at differences/similarities and the implications of this.
- Credit easing aims at affecting the risk spread across assets, whereas quantitative easing aims at affecting the general level of the longer-term interest rate.
- The ECB move should be enough to positively affect the market for euro-denominated covered bonds while the effect on the overall bond market is likely to be muted.
- In the current situation of financial distress, credit easing appears as the appropriate response. We believe that the ECB will cautiously go down the road of credit easing, but not take a single step along the path of quantitative easing.
- Credit easing is not necessarily sterilised. EUR60bn, however, only amounts to about 4% of the Eurosystem's current balance sheet. The ECB appears to consider sterilisation important for medium- and long-term credibility.
- Trichet also announced that the EIB will get access to central bank liquidity. This move will help to increase investment in vulnerable sectors and regions. It is not targeted at alleviating government budgets and will do little in this respect.

Not embarking on quantitative easing

Trichet announced after the Governing Council meeting that it had decided in principle that the Eurosystem (ECB and the European central banks) will purchase euro-denominated covered bonds issued in the euro area. Trichet emphasised that the ECB does not see this as quantitative easing: "We are not at all embarking on quantitative easing". Instead he said that this according to the ECB vocabulary is part of the "enhanced credit support" and could be called "credit easing".

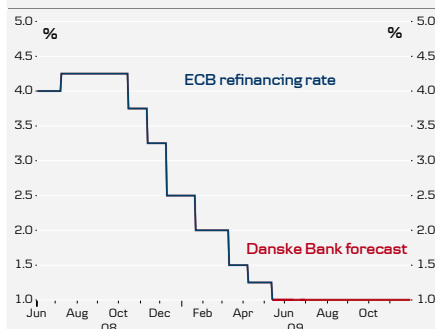
So what is the difference between quantitative easing and credit easing? In a [speech](#) given by Bini Smaghi, Member of the Executive Board of the ECB, on 28 April 2009, we find the following definitions:

Quantitative easing aims at affecting the level of the longer-term interest rate of financial assets across the board, independently of risk. Such type of policy would operate mainly by affecting the market for risk free assets, typically longer-term government bonds.

Credit easing aims at affecting the risk spread across assets between those whose markets are particularly impaired and those that are more functioning.

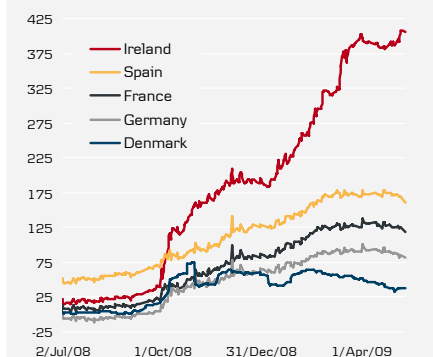
The argument given by Trichet for buying covered bonds is that this is one of the segments of private securities that have been most affected by the financial turmoil. The targeting of this impaired market is indeed credit easing and not quantitative easing according to the definitions given above. Trichet noted that EUR60bn looks like an appropriate level for what the ECB is trying to achieve. This should be enough to affect the market for euro-denominated covered bonds, which is worth about EUR1,500bn and had new issues amounting to about EUR270bn in 2007 – an activity that has contracted much since then (we estimate that new issuance of euro-denominated covered bonds could amount to just EUR100bn in 2009). But EUR60bn is by no means a bold move. The credit easing undertaken by both the Federal Reserve and the Bank of England is much more aggressive. So far the ECB announcement has resulted in a narrowing of covered bond spreads by 10-15 basis points in Germany and France and more in

The end of the rate-cutting cycle – time to move on to credit easing



Source: Reuters Ecowin and Danske Markets

Covered bond spreads are almost unaffected by the ECB announcement



Source: Bloomberg and Danske Markets

Senior Economist
Frank Øland Hansen
+45 45 12 85 26
franh@danskebank.dk

periphery countries. It has also had a positive impact on trading activity.

The effect of the ECB's EUR60bn credit easing on the overall Euroland bond market, which is worth more than EUR6,000bn is likely to be muted. If a general reduction in longer term interest rates was what the ECB was trying to achieve it could have embarked on some kind of quantitative easing too.

So why will the ECB not embark on quantitative easing? Well, it seems that it is sceptical that it would work in the current situation of bank distress. Quantitative easing has traditionally focused on buying longer-term government bonds from banks, but if banks do not find themselves in a position to pass on the additional liquidity to the non-financial sector the impact on non-government bond yields and private investments could be very limited. In addition, the ECB wants to avoid being on collision course with the Treaty's prohibition of monetary financing. This could in theory be circumvented by trading in the secondary market, but the ECB could easily end up finding itself in a questionable grey zone, which is something it certainly doesn't want to. Finally the ECB would find it difficult to decide on a key for allocating government bond purchases across countries without affecting cross-country spreads in yields and thus differentiating financial conditions for governments, which again is in conflict with the Treaty.

In the current situation of financial distress credit easing appears as more appropriate than quantitative easing. Credit easing also entails the risk of allocative distortions in terms of company size, sectors and regions, but it is not conflicting with the Treaty, and it can directly target the most distressed markets. We believe that the ECB will cautiously go down the road of credit easing, but that it will not take a single step on the path of quantitative easing.

Sterilisation and technicalities

Credit easing is not necessarily sterilised. Both credit and quantitative easing aim at increasing the size of the central bank's balance sheet and therefore expand its monetary liabilities. EUR60bn, however, only amount to about 4% of the Eurosystem's current balance sheet (EUR1,510bn at end-April). It is also a relatively modest amount relative to the EUR600bn that the Eurosystem's balance sheet has already been expanded by since the financial turmoil broke out in July 2007.

In the press conference's Q&A session Trichet said that the Governing Council considers sterilisation and the exit strategy absolutely essential to maintain the maximum amount of credibility in the medium- and long-term. This is not the same as saying that the credit easing will be fully sterilised, but it seems fair to conclude that the ECB has a preference for sterilised credit easing.

The credit easing is not to be implemented immediately. The ECB is due to inform about the technicalities at the next meeting on June 4 and probably would stand ready to embark on credit easing shortly after. We will look for further information on what mechanism it is likely to apply, the key for allocating covered bond purchases, how quickly it will buy and what exit strategy it has.

Covered bonds are more widely used in Germany than in most other member states, and it will be particularly interesting to see how the ECB chooses to deal with this. The German Pfandbrief market amounts to a third of the total Euroland covered bond market while Spain accounts for almost 30% and France almost 15%.

Endogenous credit easing

Just to complicate the vocabulary further the ECB is also talking about endogenous (or indirect) credit easing. This is lending to banks at longer maturities, against collateral that includes assets whose markets are temporarily impaired. The liquidity-providing longer-term refinancing operations with a maturity of 12 months, which Trichet announced at the press meeting, is thus endogenous credit easing. The idea is to affect the yield curve over the horizon at which the policy operations are conducted. This can be done effectively by conducting the operations as fixed rate tender procedures with full allotment – and this is indeed what the ECB now does. The ECB already embarked on endogenous credit easing with a widened collateral framework and full allotment for the three and six month's supplementary refinancing operations from October 2008.

EIB access to central bank liquidity

At the ECB press conference Trichet also announced that the European Investment Bank (EIB) will become an eligible counterparty in the Eurosystem's monetary policy operations with effect from 8 July 2009.

The EIB [says](#) that access to central bank liquidity will facilitate it to accommodate the additional demand for its lending programme. The increased lending is targeting priority and/or particularly vulnerable sectors and regions, additional support for SMEs and a comprehensive package for energy and climate change. They may alleviate government and/or regional budgets by co-funding public investment programmes (e.g. infrastructure), but the budget impact of this will be modest and the impact on the need for government bond issuance almost negligible.

The additional demand for EIB lending is estimated at EUR10bn in 2009 and this will bring the total EIB loan signatures up to EUR70bn in 2009. The EIB is co-funding projects and therefore the additional lending should generate investment of more than just the EUR10bn. It is estimated by the EIB that the additional financing could generate additional investment value up to EUR40bn this year.

The increased lending is part of the EU recovery package approved by the ECOFIN council in December 2008.

Disclosure

This report has been prepared by Danske Research, which is part of Danske Markets, a division of Danske Bank. Danske Bank is under supervision by the Danish Financial Supervisory Authority, by Frank Øland Hansen, Senior Economist.

Danske Bank has established procedures to prevent conflicts of interest and to ensure the provision of high quality research based on research objectivity and independence. These procedures are documented in the Danske Bank Research Policy. Employees within the Danske Bank Research Departments have been instructed that any request that might impair the objectivity and independence of research shall be referred to Research Management and to the Compliance Officer. Danske Bank Research departments are organised independently from and do not report to other Danske Bank business areas. Research analysts are remunerated in part based on the over-all profitability of Danske Bank, which includes investment banking revenues, but do not receive bonuses or other remuneration linked to specific corporate finance or debt capital transactions.

Danske Bank research reports are prepared in accordance with the Danish Society of Investment Professionals' Ethical rules and the Recommendations of the Danish Securities Dealers Associations.

Financial models and/or methodology used in this report

Calculations and presentations in this report are based on standard econometric tools and methodology. Documentation can be obtained from the above named authors upon request.

Disclaimer

This publication has been prepared by Danske Markets for information purposes only. It has been prepared independently, solely from publicly available information and does not take into account the views of Danske Bank's internal credit department. It is not an offer or solicitation of any offer to purchase or sell any financial instrument. Whilst reasonable care has been taken to ensure that its contents are not untrue or misleading, no representation is made as to its accuracy or completeness and no liability is accepted for any loss arising from reliance on it. Danske Bank, its affiliates or staff, may perform services for, solicit business from, hold long or short positions in, or otherwise be interested in the investments (including derivatives), of any issuer mentioned herein. The Equity and Corporate Bonds analysts are not permitted to invest in securities under coverage in their research sector. This publication is not intended for retail customers in the UK or any person in the US. Danske Markets is a division of Danske Bank A/S. Danske Bank A/S is authorized by the Danish Financial Supervisory Authority and subject to limited regulation by the Financial Services Authority (UK). Details on the extent of our regulation by the Financial Services Authority are available from us on request. Copyright (C) Danske Bank A/S. All rights reserved. This publication is protected by copyright and may not be reproduced in whole or in part without permission.