IS IT TIME TO TAKE THE EURO OUT OF EUROPE?

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On September 4, the European Central Bank (ECB) took further accommodation to support the economic growth environment in Europe.[1] As a result, the euro collapsed about 1% immediately after the news, while European stocks rose on prospects for more monetary policy easing. This reaction mirrors what we saw in Japan in 2013, and it strengthens the case for taking the euro out of Europe. Why? **Lower Interest Rates** At last month's meeting, ECB president Mario Draghi stated that, for practical purposes, interest rates had reached a lower bound, barring some technical adjustments. Yet at this meeting, the ECB lowered rates further by 10basis points across all its key policy rates. Hence, the ECB is effectively charging banks 20 basis points annually to keep excess cash parked at its deposit facility. This then incentivizes banks to extend loans that will jump-start the lackluster Euro system credit cycle. The newly announced rates are: • The main refinancing operations of the Eurosystem was lowered to 0.05%. • The marginal lending facility was lowered to 0.30%. • The deposit facility was lowered to -0.20%. **Credit Easing with Expanding Balance Sheet** Draghi also announced that the ECB would start purchasing nonfinancial private sector assets. The goal of these actions is to easecredit conditions for the banks, as they extend 80% of all lending activity in the euro area, according to Draghi's testimony. This is from the ECB release: *"The Eurosystem will purchase a broad portfolio of simple and transparent asset-backed securities (ABSs)with underlying assets consisting of claims against the euro area non-financial private sector under an **ABS purchase programme** (ABSPP). This reflects the role of the ABS market in facilitating new credit flows to the economy and follows the intensification of preparatory work on this matter, as decided by the Governing Council in June. In parallel, the Eurosystem will also purchase a broad portfolio of euro-denominated covered bonds issued by MFIs domiciled in the euro area under a new **covered bond purchase programme** (CBPP3). Interventions under these programmes will start in October 2014. … The newly decided measures, together with the targeted longer-term refinancing operations, which will be conducted in two weeks, will have a sizeable impact on our balance sheet."* During the press conference, Draghi gave an indication of how he would like the ECB's balance sheet to grow. He stated that it would be desirable for the balance sheet to reach its 2012 levels, which would imply an expansion of more than €1 trillion. To provide some perspective, the peak of the ECB's balance sheet size stood at €3.1 trillion in June 2012, where else the balance sheet size today stands at only €2.0 trillion[2]. An expanding balance sheet has traditionally led to a weaker local currency, in this case the euro. Draghi has previously talked about the euro's strength as it approached the 1.40 level in May this year. We discussed his comments in a previous blog. His rhetoric about a rising euro potentially creating deflationary pressures was quite effective as the currency depreciated from 1.40[3] to just about 1.30 following this latest news. But now Draghi is backing up his words with concrete actions to expand the ECB balance sheet—measures that have been associated with currency weakness.The weakness in the euro does not mean the case for investing in Europe should be weakened. Stocks reacted quite positively to the news of these additional measures. The weakness in the euro just highlights the need to adopt currency-hedged equity strategies in obtaining exposure to European stocks. [1]Mario Draghi, "Introductory statement to the press conference," European Central Bank, 9/4/14.[2]Sources: ECB, Bloomberg as of August 2014.[3]1.40: refers to the spot exchange rate of the eur currency vs. the usd.

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Basis point : 1/100th of 1 percent.

Marginal Lending Facility Rate : The rate at which banks obtain overnight liquidity from the central ban.

Deposit Rate : The rate parties receive for deposits at the central bank.

Credit conditions : The markets perception of the willingness of lenders to extend credit to risky borrowers.

Targeted longer-term refinancing operations (TLTRO II) : a periodic open market operation executed via tender offers which mature in June 2020.

Deflation : The opposite of inflation, characterized by falling price levels.