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ECB's Mario Draghi has run out of magic as deflation closes in

The German press has savaged ECB chief Mario Draghi, unfairly accusing him of debauching the euro CREDIT: HANDELSBLATT

By Ambrose Evans-Pritchard
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Large parts of the eurozone are slipping deeper into a deflationary trap despite negative interest rates and one trillion euros of quantitative easing by the European Central Bank, leaving the currency bloc with no safety buffer when the next global recession hits.

The ECB is close to exhausting its ammunition and appears increasingly powerless to do more under the legal constraints of its mandate. It has downgraded its growth forecast for the next two years, citing the uncertainties of Brexit, and admitted that it has little chance of meeting its 2pc inflation target this decade, insisting that it is now up to governments to break out of the vicious circle.

Mario Draghi, the ECB's president, said there are limits to monetary policy and called on the rest of the eurozone to act "much more decisively" to lift growth, with targeted spending on infrastructure. "It is abundantly clear that Draghi is played out and we're in theterminal phase of QE. The eurozone needs a quantum leap in the nature of policy and it has to come from fiscal policy," said sovereign bond strategist Nicholas Spiro.

Mr Draghi dashed hopes for an expansion of the ECB's monthly €80bn (£60bn) programme of bond purchases, and offered no guidance on whether the scheme would be extended after it expires in March 2017. There was not a discussion on the subject.

"The bar to further ECB action is higher than widely assumed," said Ben May from Oxford Economics.

The March deadline threatens to become a neuralgic issue for markets given the experience of the US Federal Reserve, which suggests that an abrupt stop in QE stimulus amounts to monetary tightening and can be highly disruptive.

The ECB has pulled out all the stops to reflate the economy yet core inflation has been stuck at or below 1pc for three years. Officials are even more worried about the underlying trends. Data collected by Marchel Alexandrovich at Jefferies shows that the percentage of goods and services in the inflation basket currently rising at less than 1pc has crept up to 58pc.

Mario Draghi CREDIT: REUTERS

This is a classic precursor to deflation and suggests that the eurozone is acutely vulnerable to any external shock. The figure has spiked to 67pc in Italy, and is now significantly higher that it was when the ECB launched QE last year.

The eurozone should have reached economic “escape velocity” by now after a potent brew of stimulus starting last year: cheap energy, a cheaper euro, €80bn a month of QE, and the end of fiscal austerity.

Yet all the eurozone has achieved is growth of 0.3pc a quarter. France and Italy have both slowed to a standstill.

The euro’s trade-weighted exchange rate has crept up by 7pc since QE began, and it has continued to rise even since the ECB cut interest rates to minus 0.4pc.

“The euro is far stronger than they want, and stronger than the economy deserves, but they don’t know how to weaken it. This is exactly what happened to the Japanese,” said Hans Redeker, currency chief at Morgan Stanley.

Mr Redeker said the eurozone’s current account surplus – now running at €350bn, or 3.3pc of GDP – is feeding the deflationary dynamic. Since European banks are shrinking their balance sheets and repatriating money to meet capital rules, they cannot recycle the eurozone surplus abroad. This is creating a chronic bias towards a stronger currency.

Work by the International Monetary Fund shows that “lowflation” – even short of deflation - causes to a host of debilitating pathologies. It holds down nominal GDP and makes it even harder to work off high-debt ratios.

In theory, Mr Draghi could resort to even more radical measures but the scope is limited and he is walking through a political minefield. Public trust in the ECB has collapsed in several countries and the mood in Germany has turned toxic. The German banking and insurance lobbies have accused the ECB of destroying their business models with negative rates.

Deutsche Bank’s chief economist David Folkerts-Landau said the ECB had gone beyond the point of diminishing returns and was now itself a threat to the eurozone. “Central bankers can lose the plot. When they do, their mistakes can be catastrophic. After seven years of ever-looser monetary policy there is increasing evidence that following the current dogma risks the long-term stability of the eurozone,” he said.

This is unfair to Mr Draghi. The great macroeconomic errors were made long ago from 2010 to 2012 when drastic austerity and premature rate rises pushed the region into a double-dip recession.

Yet ECB officials confess that they may be close to the “economic lower bound”, where any gains to be eked out from more stimulus are outweighed by poisonous side effects.

The ECB network is running out of assets to buy since it can purchase only in proportion to the size of each national economy, a precaution against backdoor bail-outs of insolvent states.

The eurozone no longer seems to have an activist policy. It is treading water and at the mercy of external forces. The danger is that the next global downturn will strike before the currency bloc has escaped its current malaise and before it has built up any defences against a deflationary shock. Mr Draghi will not be able to rescue them a second time.