



Fourth, the crucially, market-based inflation expectations have declined in the last couple of weeks. The SPF survey-based indicator showed the first increase in the 5-year ahead inflation expectations balance for about 2 years, despite drops in nearer term expectations. But the rise was tiny (1.86% from 1.84%).

The current crop of ECB Executive Board members seems keen to take a steer on medium-term expectations from market breakeven rates. These have weakened in the last couple of weeks. Draghi referred to this in unprepared comments in his speech at Jackson Hole on Friday. He said B/Es point to "significant declines at all horizons". The 5Y5Y inflation swap he singled out as falling 15bp to below 2%. This is the third time the 5Y5Y has fallen below 2% since the start of the credit crisis. Draghi said "this is the metric that we usually use for defining medium-term inflation".

Draghi said the Governing Council "will acknowledge" these developments with inflation expectations and within its mandate "will" use all available instruments needed to ensure price stability over the medium term. There is a definitiveness to the message. Having questioned the stability of inflation expectations, it would be very difficult for the ECB to credibly claim on 4 September that inflation expectations "remain firmly anchored", at least not without announcing a new policy to better anchor those expectations.

On balance, we think the data and Draghi's comment puts pressure on the ECB to accelerate the next phase of monetary easing. We believe the ECB will accelerate the announcement of a private QE (ABS purchasing) to 4 September. Draghi has some history of deviating off-script at a conference and subsequently convincing the Council to act. For example, his "whatever it takes" precursor to OMT in mid 2012.

The risk is the Council plays for more time, arguing that Q2 GDP was distorted, inflation is close to its trough, that once inflation starts rising after the trough it could help stabilise inflation expectations, that the TLTRO benefits are still to be seen, the EUR exchange rate is declining, etc. But one way or another, it feels to us like ABS purchasing begins before December.

Our view is the ECB announces a "private" QE, that is, not sovereign bond purchasing and not a mixed package of private and public purchases. We don't expect sovereign bond purchasing to be ruled out, but it faces political, legal and technical questions in a way that private QE does not. Government bond purchases will remain in reserve for a more outright deflationary episode.

How effective is ABS purchasing? The objective will be to incentivise banks to lend. The incentive depends on exactly which ABS the ECB purchases and in what scale. The TLTRO is implemented in a way to not directly incentivise mortgage lending, but in July Draghi intimated that the set of assets the ECB would consider for ABS purchasing includes RMBS. This raises the set of existing ABS by 10 fold to about E500bn. Draghi talks about incentivising a new market for ABS, implying the ECB focus may be more on primary (new ABS) rather than secondary (existing ABS). Still, the ECB can play the portfolio reallocation channel for QE by purchasing existing ABS.

The ECB has talked of a twin track effort on ABS -- regulatory easing as well as a commitment to ABS purchasing, if it proves necessary. At last month's press conference, Draghi implied that the purchasing decision is not conditional on achieving regulatory easing. Proposals have been published for an easing of the Solvency II capital charges on ABS, but no action has been taken yet. Beyond changing the capital charges to incentivise banks to lend and create ABS, the best way for the ECB to do so is by buying the mezzanine tranches of ABS. It is not obvious that the ECB has the risk appetite for this.