QNB Economics
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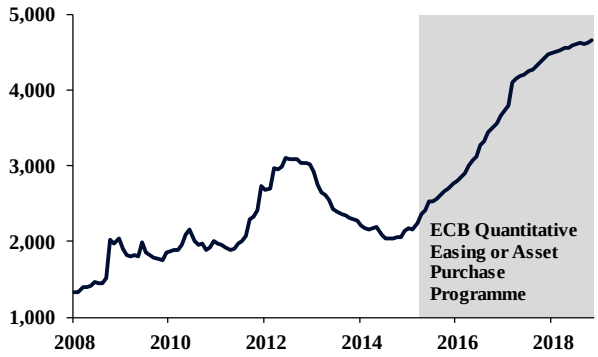
# ECB presses ahead with policy normalization

Despite a weaker Euro area recovery and mounting headwinds associated with softer global growth and higher policy uncertainty, the European Central Bank (ECB) has decided to end the net purchases of assets under its quantitative easing (QE) program earlier than previously planned. Our analysis delves into the nature of the ECB QE program and describes the reasoning behind the recent decision to move ahead with QE taper plans.

QE programs are unconventional monetary policy tools that are waged after financial crisis and deep recessions. In such cases, a prolonged period of deleveraging is often unleashed and policy rates tend to quickly reach nominal levels at or close to zero. Operationally, QE is the extraordinary process through which central banks intentionally expand their balance sheets beyond normal levels. This requires central banks to systematically acquire selected securities from the secondary market against bank reserves. The aim is to remove "duration" from the market and thus put downward pressure on long-term interest rates, further easing financial conditions. Initially experienced by the Bank of Japan in the early 2000s, QE programs became a tool for central banks in the aftermath of the great financial crisis of 2007-08.

The ECB officially started its QE or large-scale expanded asset purchase program (APP) in March 2015. Back then, disinflationary pressures were creating material deflationary risks on the back of new bouts of economic weakness following the European debt crisis. The APP was implemented just after a series of other non-standard monetary measures such as the negative deposit facility rate and a facility extended by the ECB to provide longer-term funding to banks for new loans. The APP expanded the unconventional toolkit by extending four programs targeting the acquisition of different types of assets, including public sector bonds, corporate sector bonds, asset-backed securities and covered bonds. Over the last three years, the APP turned into the primary instrument for calibrating the monetary policy stance in the Euro area. In fact, net purchases of assets by the ECB varied, peaking at EUR 80 billion per month in 2016-17. Overall, the APP has added EUR 2.3 trillion in assets for the ECB, which contributed to create EUR 1.9 trillion in excess reserves.

**ECB's total assets**
(million EUR)




Sources: Bloomberg, QNB Economics analysis

In 2017, the ECB announced its intention to start tapering or gradually scaling back its net asset purchases. Recently, the ECB confirmed that it will stop net purchases after December 2018. While more details of the tapering plan are still to be communicated, the ECB will continue to reinvest proceeds from maturing bonds for an extended period of time.

Four reasons explain the ECB's decision to press on with policy normalization.

First, the unconventional monetary policy has partially achieved its main goals. Lower term and risk premia had provided accommodative financial conditions, boosting economic activity. Unemployment and industrial spare capacity are at or close to ten year lows at respectively 8.1% and 16.1%. The risks of deflation were fully eliminated for the time being.

Second, further purchases of public sector bonds are limited by implicit rules associated with Maastricht treaty provisions on ECB financing for member states. As the composition of asset purchases has to be proportional to GDP (the capital key), the ECB is approaching its debt ownership limits (one-third of each member's debt) in a number of countries. If it were not for the QE tapering plan, the ECB would soon run out of eligible bonds to buy from Germany, the Netherlands, Slovakia and Finland.

Third, the tapering is expected to anticipate further monetary policy normalization with rate hikes, which should create policy room for eventual economic downturns in the future. This is particularly important as key advanced economies are already in the later stages of their economic cycles and recessions loom over the horizon of the next years.

Fourth, the QE was unable to deliver inflation within the ECB target and the side effects of the APP are creating financial stability concerns and undermining pension schemes. Inflation and specially core inflation are still subdued at 1.9% and 1.1%, respectively. Ultra-easy monetary policy has been inflating asset prices and prompting exhuberant market behaviour with bubble-like characteristics. Moreover, as pension funds rely on longer yields to match future liabilities, the compression of term premia is causing a lasting detrimental impact on European pension plans.

In short, the ECB achieved to prevent a deflation through its non-standard monetary measures, of which the QE program was the most important tool. However, several factors have contributed to the recent decision to start unwinding the QE, including its partial success in lifting the economy, idiosyncratic institutional constraints associated with the monetary union, a challenging global environment, and threats to financial stability and the soundness of pension systems.

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