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Monetary Policy Normalization in the Euro Area

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The ECB announced in October 2017 that it would begin to cut back the amount of monthly asset purchases starting January 2018 while extending the duration of the purchases until at least September 2018. At its latest Governor's Council meeting in January 2018 it decided to remain on this track despite a sharp appreciation of the euro in the meanwhile. These steps were just two on a longer and potentially slippery path back towards standard monetary policy. Market turbulences like the so-called "Taper Tantrum", which followed the Fed's 2013 announcement that it was considering to cut back its asset purchasing program, have made central banks wary of the risks of premature or overly explicit announcements of monetary policy normalization. This article provides a short review of quantitative easing (QE) in the euro area since 2015 and of the debate about the right timing for terminating QE.

Asset purchase programs: rationale and effects

In March 2015, the ECB Governor's Council presented an asset purchase program (APP) of 60 billion Euros per month aimed at reducing bond yields and lifting the inflation rate closer to its target of below, but close to, 2%. The APP was unprecedented in the history of the ECB and spurred an intense controversy in the euro area as critiques feared an overshooting of inflation or, more generally, increased risks to financial stability. Another worry, expressed inter alia by then-president of the German Savings Banks Association, Georg Fahrenschon, was that QE might ease the pressure to carry out necessary reforms on some euro area countries. These criticisms notwithstanding, and in the face of continuously low inflation rates, the ECB decided to temporarily increase the APP volume to a monthly 80 billion Euros over the months that followed.

Compared to quantitative easing (QE) efforts in the US and the UK, the ECB's decision to engage in QE came rather late. The Fed started its first round of asset purchases in 2008, relatively shortly after the onset of the global financial crisis, and the Bank of England started their asset purchases in 2009. These early asset purchases in the US and UK, undertaken when financial market distress was still high, had stronger effects on long-term bond yields than subsequent QE programs in the US and UK, as Altavilla et al (2015) point out. The ECB's APP, however, seems to also have been effective at driving down bond yields, despite having been implemented rather late and at a time when markets had already calmed down after the tumultuous years of the euro area crisis. Andrade et al (2016) report that, on average, researchers find the APP to have reduced 10-year government bond yields in the euro area by 0.43 percentage points.

De Santis (2016) and others have pointed out that most of the effect of the APP on long-term yields in the euro area already occurred before the official announcement by Mario Draghi in 2015: in 2014, already, the ECB indicated to markets that such a program was likely to follow soon. This evidence suggests that, in the APP, the so-called "signaling channel" – corroborating market expectations that the policy interest rate will remain low for a prolonged period of time – was most important for the effect on long-term yields. This is in line with the findings in Bauer and Rudebusch (2014), who argue that signaling is typically the main channel through which asset purchases by central banks affect long-term yields.

The literature further discusses the "portfolio balance channel" through which asset purchases might operate. In Vayanos and Vila (2009), for instance, the idea is that investors might have preferences for a particular maturity in government bonds, and that corresponding asset purchases by the central bank therefore reduce the yields in this maturity segment. A third important potential transmission channel is the "expectations channel" (e.g. Woodford, 2004), which reflects how asset purchases can reduce uncertainty by managing expectations about main macroeconomic indicators.

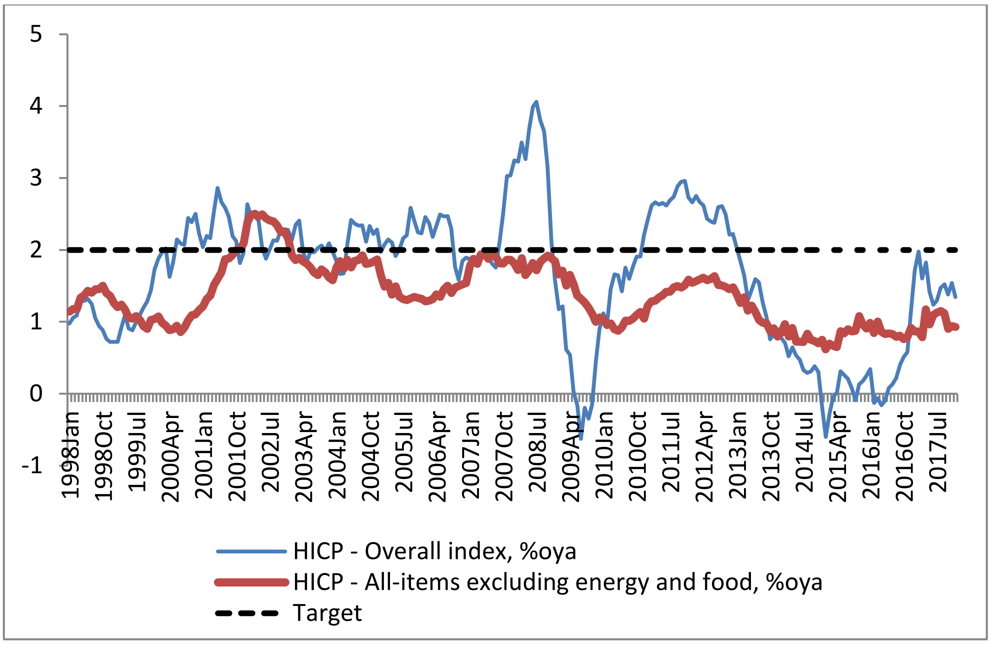
There are comparably few studies about the GDP growth and inflation effects of the ECB's APP since, having been announced in 2015, it is rather recent and still under way. Hohberger et al (2017) estimate its GDP growth and inflation effects and find them to be +0.4 and +0.5 percentage points, respectively. Andrade et al (2016) find that the APP increases inflation by 0.4% and GDP by 1.1%. Hachula et al (2016), assuming a 0.25% drop in long rates, find a GDP effect of +0.5% and a price effect of +0.3%.

Back to Standard Monetary Policy

Mario Draghi's announcement on October 26th, 2017 that the ECB would cut back its monthly asset purchases to 30 billion Euros while at the same time extending the APP to at least September 2018 came as no surprise to many market participants; the euro area economy is recovering and the ECB had prepared markets for the slowdown of the APP. This cautious communication strategy seemed especially warranted after what was a painful lesson for the Fed in 2013: when Chairman Ben Bernanke announced that the Fed was considering to "taper off" its QE activities, this led to tumultuous market reactions that became known as the "Taper Tantrum" (see Bisschop et al 2016). This announcement pushed up yields for months to come and also caused financial turmoil in several emerging markets (Aizenman et al, 2015; Avdjiev and Takáts, 2014; Mishra et al, 2014).

Avoiding a euro area Taper Tantrum while not missing the right moment to bring APP to an end has therefore been the main challenge for the ECB as macro-economic indicators increasingly suggest the time for QE might soon be over. Jens Weidmann, president of the German Bundesbank, has been urging for a cutback of the APP since early 2017. He also criticized the ECB's recent decision to go "lower for longer" for not setting a clear end date of asset purchases, but leaving open what happens from September 2018 onwards. The German Council of Economic Experts also took a skeptical stance in its annual report published in November. The council argued that there was no significant threat of deflation justifying a continuation of the APP, and criticized that a lack of transparency in ECB decision-making creates harmful uncertainty. Others welcomed the ECB's decision: Jeroen Dijsselbloem, president of the Eurogroup, said in November that the ECB was wise to slow down asset purchases gradually. On a more general note, Pier Carlo Padoan, Italian Minister of Economy and Finance, said that moving towards an end of the APP is the right thing to do now, since failing to throttle asset purchases could lull economies to sleep.

Inflation rates in the euro area



Source: ECB

Part of the difficulty for the Governor's Council is that despite solid GDP growth and a decline in unemployment, 2017 has not brought a substantial increase in the euro area inflation rate (see Figure). And ECB forecasts predict that the inflation rate will not reach its target before the end of 2019. This suggests the search for the right pace of policy normalization will continue to be a difficult one.

The academic literature surrounding tapering is comparably thin, especially with respect to the euro area. Contributions to the tapering literature include Lee (2016), who examines the effects of the U.S. Taper Tantrum and finds that they were "fundamental and persistent rather than financial and transitory", and Bisschop et al (2016), who find that during the Taper Tantrum, households and money market funds, in particular, engaged in procyclical selling of euro area bond portfolios, thereby aggravating price shocks. Ihrig et al (2015) discuss desirable features of monetary policy normalization in the US. For instance, they explain that the interest rate on excess reserves will be the primary tool for the Fed to drive the federal funds rate back up. Feroli et al (2014) find that turbulences like those following Bernanke's 2013 tapering announcement are likely to occur again whenever investors expect monetary policy to tighten. Krishnamurthy and Vissing-Jorgensen (2013) emphasize the importance of how an exit from asset purchases is communicated to the public. Employing different models, they find that asset prices react immediately to the news of a future termination of asset purchases. Finally, Clemens et al (2017) simulate different exit scenarios from the APP after the October 2017 announcement and find that a further piece-wise reduction in net asset purchases should cause only moderate reductions in GDP growth and inflation.

Conclusions

The APP was implemented to spur growth and raise the inflation rate in the euro area. The economic literature suggests that it achieved both, although the exact sizes of its effects are difficult to determine. As the economy in the euro area continues its recovery, the ECB now needs to find the right pace for monetary policy normalization. The economic literature in this field, although rather thin, emphasizes the importance of a good communications strategy as asset purchases are being reduced. So far, the ECB has managed to avoid extreme market reactions on its path back towards standard monetary policy. But finding the right pace for monetary policy normalization continues to be a crucial and delicate task for the ECB.

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