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INSIGHT

VIEWPOINT

Eurozone Policy Normalization:

Purchasing Less Debt, Buying More Time

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- Underlying fundamentals point to higher bond yields in the Eurozone; the question is whether the end of balance sheet expansion will accelerate this process and prove to be more disruptive than currently priced.
- We believe short term risks are well contained. The European Central Bank (ECB) recently announced a gradual approach to scaling down the asset purchase program. Technical hurdles, such as scarcity of bonds, can be bypassed for another year with modest tweaks in the program, most likely by purchasing a slightly higher share of corporate and Eurozone periphery bonds. Reinvestments will be sizable.
- We analyze the medium term outlook for Eurozone fixed income markets and briefly discuss factors that point to a low terminal rate, which in principle should anchor long term yields. But credit risk premium will rise if debt sustainability fears resurface. We can envision two scenarios: one in which yields are low due to a combination of low growth and policies that constantly adapt to keep heavily indebted countries afloat; alternatively, a more desirable equilibrium where real yields rise in line with higher growth potential, but bond demand remains healthy because debt sustainability concerns have eased.
- The second and more constructive scenario depends in part on the ability of President Macron and Chancellor Merkel to forge a new path forward for a Eurozone reform agenda. But the scope and timing of these efforts remain to be seen. Member countries must make good use of the time that ECB President Draghi is buying them. For example, there are current discussions on a Eurozone bank deposit insurance scheme and temporary fiscal transfer mechanisms to address shocks that hit individual economies asymmetrically. These are initiatives that may only gather support if growth-enhancing reforms take place in those countries that will benefit the most from broader Eurozone risk sharing.

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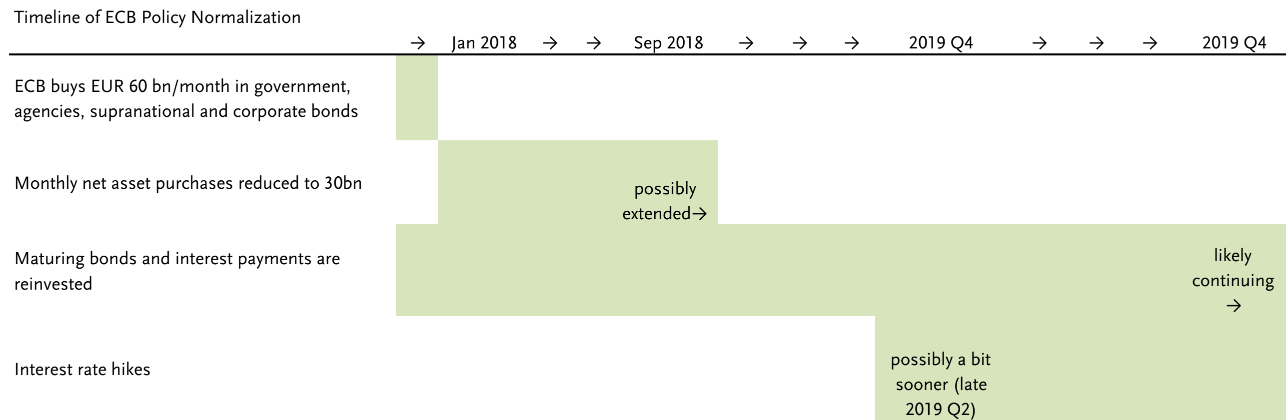
Exit from Unconventional Policy: The Roadmap

The ECB announced on October 26 that it is cutting in half its monthly net assets purchases from EUR 60 bn to EUR 30 bn, and extending the monthly purchases through at least September 2018. During the post-meeting press conference, ECB President Mario Draghi reinforced his core message: the ECB needs to proceed with caution and persistence until there is enough confidence in the achievement of the inflation objective (which means a sustainable increase of inflation to about 2%). Mr. Draghi acknowledged that there was no consensus in the policy committee on the announcement of an exact end date for net asset purchases. Instead, he managed to have policy committee members "largely agreeing" that it was better to leave the program open ended.

Exhibit 1: Timeline of ECB Policy Normalization



Source: For events beyond September 2018, author forecast based on ECB official communication

The policy sequencing envisioned by the ECB resembles the one implemented by the U.S. Federal Reserve: stop expanding the balance sheet and once you are well past that transition moment, start raising interest rates gradually. It took the Federal Reserve a bit more than one year to reach the interest rate hiking stage. It then took almost two years to announce a planned balance sheet reduction. This timeline implies interest rate hikes in the Eurozone no sooner than fourth quarter of 2019. Draghi's term expires in October 2019, and for reputational reasons may want to start the rates normalization process before his departure. Therefore, depending on the ECB's progress toward achieving its inflation target, we could see a first rate hike in the summer of 2019. Sooner than that seems quite unlikely.

Eurozone QE in a Global Context

By the time the ECB stops expanding its balance sheet, the bank will have purchased approximately EUR 2.0 tn worth of Eurozone government bonds and close to EUR 400 bn in covered and corporate bonds. The other large assets on the ECB balance sheet are loans that were part of "longer term refinancing operations" (LTROs), a program with a current total stock of EUR 763 bn. Exhibit 2 compares the total size of the ECB balance sheet (currently EUR 4.4 tn) as a share of GDP, with the experience of Japan and U.S.

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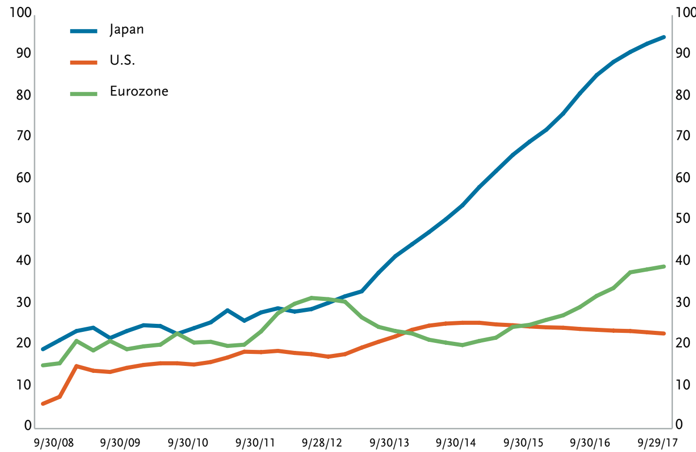
Exhibit 2: Central Bank Balance Sheet (% GDP)



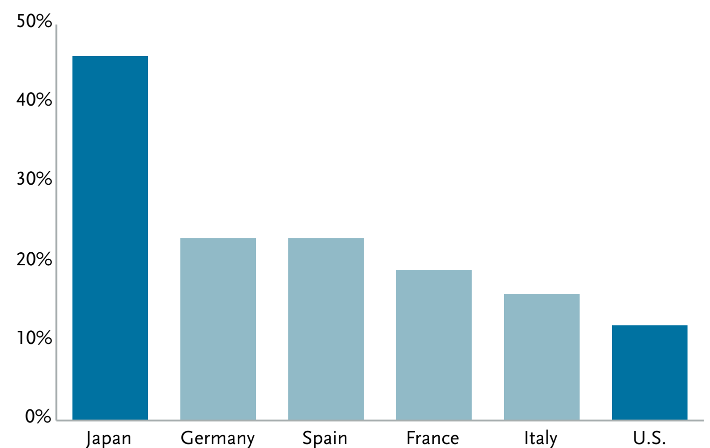
Source: Bloomberg, ECB, BOJ, U.S. Federal Reserve

The scope of ECB balance sheet expansion also falls between that of the Bank of Japan and of the U.S. Federal Reserve, when measured as government bond purchases as a share of the total public debt stock (EXHIBIT 3). What sets the ECB asset purchase program really apart is the fact that government bonds from different Eurozone countries were purchased in large scale relative to net funding needs, which raises issues such as outlook for funding sources and implicit fiscal transfers across Eurozone members. Heavily indebted Italy arguably benefitted from ECB quantitative easing in an asymmetric way. The ECB is on track to purchase EUR 302 billion in Italian government securities in the period 2015 -17 (an amount three times larger than net Italian issuance in the same period). Moreover, Italian banks alone were the recipients of one third of LTROs.

Since the ECB began signaling its tapering process, investors have started to focus on the relative importance of stocks versus flows. Is the fact that the ECB will be buying bonds at a reduced scale (lower flows) more relevant than the fact that the bank has already purchased a large share of bonds?

We believe the stock argument is particularly relevant for countries with higher indebtedness and whose yield levels depend on a credit spread relative to German bunds. On this topic, once again Italy is a good example. Since 2010, the share of foreign ownership of Italian bonds declined from 52% to 25%. Italian banks also reduced their exposure to Italian bonds, while Italian retail investors and pension funds increased exposure somewhat. One could interpret ECB participation in the Italian bond market as a factor that facilitated the unwinding of Italian risk exposure by certain market participants, so a process of risk reallocation that should be supportive of bond yields even when ECB purchase flows decline. ECB research suggests that, by reducing the term premium, the same portfolio rebalance process had a bigger impact on Bund yields than market interest rate expectations (Lemke & Werner, 2017)[1].

Exhibit 3: Share of Central Bank Ownership of Government Bonds Stock (% GDP)



Source: ECB, BOJ, U.S. Federal Reserve

1 "Dissecting long-term Bund yields in the run-up to the Public Sector Purchase Program", ECB working paper series No 2106.

Bond Scarcity Issues, "Tweaks" to the Asset Purchase Program, Reinvestments

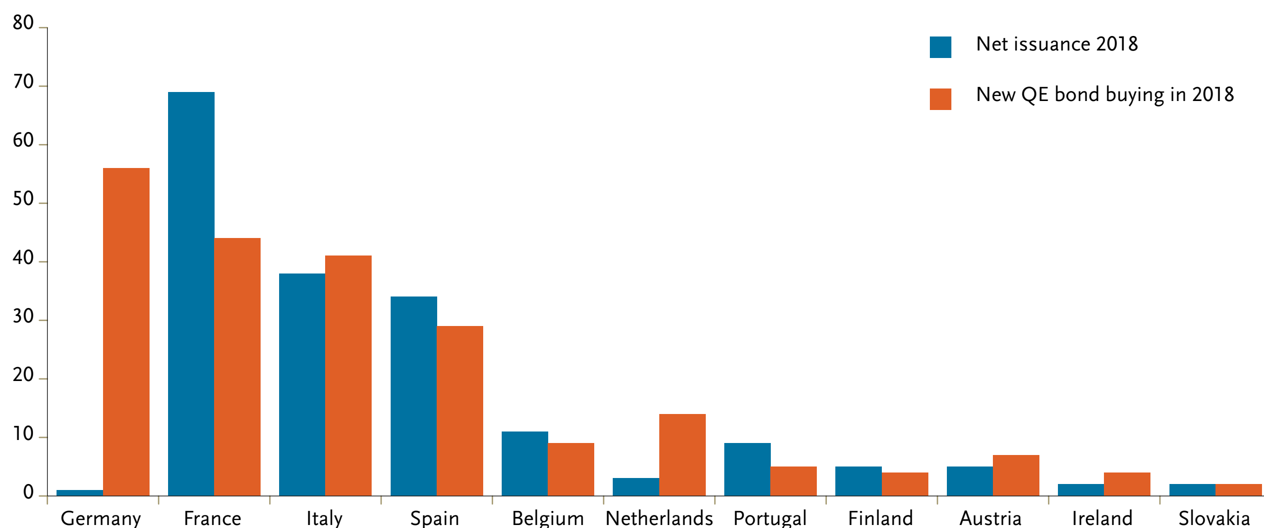
The ECB tapering announcement was not a surprise due to technical constraints that make it hard for the program to continue indefinitely. This has to do with the country distribution of asset purchases. The share of each country in ECB bond purchases was set at the member's capital key. In the case of each Eurozone member, the capital key is its portion in ECB capital subscription formula, which in turn takes into account GDP and population weights (excluding Greece). This parameter was used in order to enhance transparency of the program, as well as to minimize potential fiscal transfers across countries, but it has raised some challenges for the ongoing implementation of the program. For example, about 26% of asset purchases have been of Germany-issued bonds, but German treasury net issuance in the 2015-2017 period represented a meager 3.2% of total Eurozone government net bonds issuance. The program also caps at 33% the ECB ownership of a given government bond.

The mix of bond scarcity and the reluctance to adjust capital key restrictions became an important hurdle that imposes a de facto expiration date to ECB asset purchases.

The flexibility built into the program – small deviations from capital key, higher purchases of supranational and corporate bonds – buys the ECB some time and we do not expect the technical hurdles to be binding before early 2019. Beyond that point, it would be hard to maintain net purchases of government bonds (until now 80-85% of total net purchases), without larger and systematic deviations from the capital key. In a crisis scenario the ECB could and probably would adjust its own guidelines regarding bond purchases, but with the Eurozone economy growing briskly and the deflation scare in the rearview mirror, meaningful deviations from the program guidelines are unlikely.

Even when the ECB stops expanding its balance sheet, it will not exit the government securities markets (EXHIBIT 4). In order to keep the balance sheet constant (after the expansion phase is completed), the bank will make reinvestments. By the end of 2018, the size of the ECB bond portfolio will be such that average monthly reinvestments will be close to EUR 15 bn, inching higher to EUR 18 bn in 2019.

Exhibit 4: Eurozone Net Issuance vs ECB net purchases in 2018 (EUR bn)



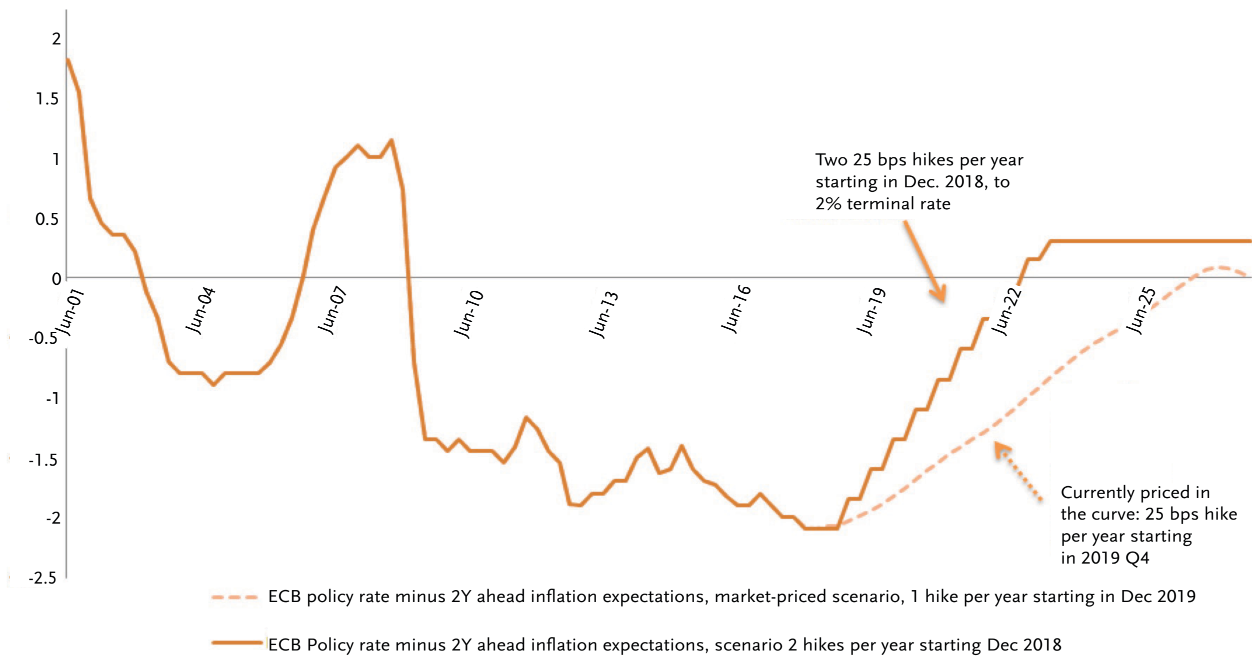
Source: ECB, JP Morgan

Thoughts on Eurozone Terminal Rate and Long Term Debt Sustainability Issues

Until recently, there was still an active debate among ECB board members regarding the appropriate policy sequencing, with a few members leaning towards earlier rates lift off. The consensus now appears to have shifted in favor of rate hikes only well after the balance sheet expansion phase has concluded. Various factors could explain this shift. The ECB staff research on banks' profitability in a low interest rate environment could have helped ease concerns about the negative impact of a protracted period of low rates (Altavilla, Boucinha & Peydró, 2017)[2]. Headline and core inflation have normalized relative to the 2015-16 sharp decline, although both remain substantially below the target. The ECB persistence in pursuing its inflation goal could result in low interest rates in the Eurozone for quite some time.

The current market scenario implies a 25 bps hike no sooner than the fourth quarter of 2019. After that, the implied pace of rate hikes is only 25 bps per year (Exhibit 5). According to the market scenario, then, it would take about ten years to reach 2% policy rate, without much room to exceed that level. Given the highest business confidence level in a decade and synchronized, healthy growth across Eurozone countries, is this market consensus too dovish?

Exhibit 5: Eurozone – Long Term Decline in Expected Real Interest Rate Points to Very Gradual Interest Rate Hiking Cycle



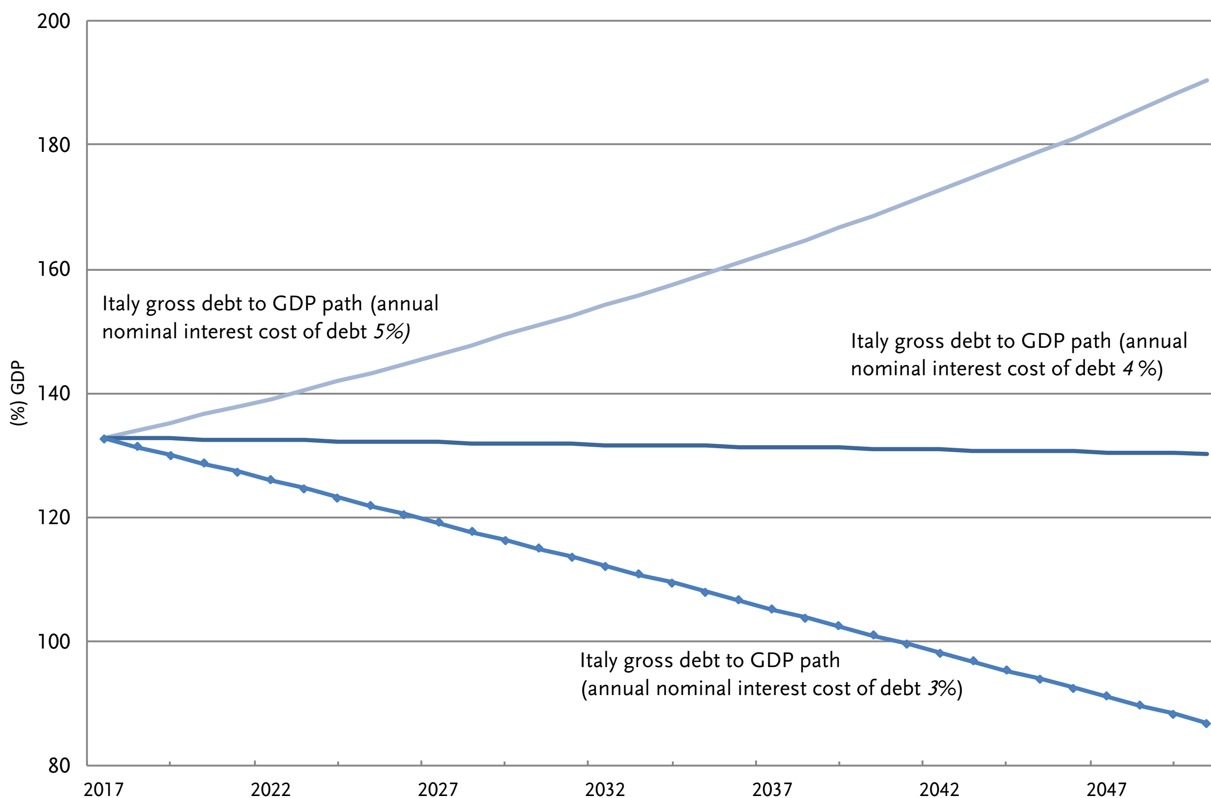
Source: ECB, author calculations based on Bloomberg data on yield curve.
2"Monetary policy and bank profitability in a low interest rate environment", ECB working paper series No 2105

This seemingly dovish consensus could be influenced by the Eurozone's real interest rate history. If we take the ECB policy rate and subtract annual inflation expectations over the next two years' horizon, the result is an average expected real rate of -1.5% during the last 10 years. During this period, the ECB systematically kept the policy rate well below inflation expectations, and any deviation from this approach was short lived. Looking ahead, if the nominal terminal rate is, let's say, around 2% and the Eurozone inflation and inflation expectations stay, on average, at the central bank target (close to, but below 2%) then the expected short term real rate will be zero or slightly higher than zero (which is already 150 bps higher than its 10Y average).

The bottom line is that for the nominal terminal rate in the Eurozone to be much higher than 2%, one of two things need to happen: a) Inflation and inflation expectations need to be sustainably higher than 2%; b) The ECB and the market need a paradigm shift in view regarding the level of sustainable short term real rates; in other words, positive short term real rates cannot be associated with risk of excessive tightening and deflation. In our view, both factors (a) and (b) are possible in the medium to long term, but unlikely in the short term.

Another way to look at Eurozone terminal rate issue is through the lens of Eurozone members' debt sustainability. To be clear, the ECB has an inflation targeting mandate, and it does not (or it should not) set policy in order to render sustainable the debt burden of highly indebted members such as Italy. However, higher real interest rates in the Eurozone would have implications for debt dynamics and potentially on Eurozone periphery credit spreads and market confidence. At least indirectly and with a lag, debt sustainability issues will be factored in ECB policymaking.

Exhibit 6: Italy Gross Debt to GDP Path Under Different Interest Rate Assumptions



Source: IMF data, author calculations. Assumptions include 1.9% headline inflation; real GDP growth and primary fiscal surplus were set at median historical average of 0.9% and 1.6% GDP, respectively.

The chart shows a simple debt dynamic exercise for the case of Italy. It highlights how sensitive the actual path is to different assumptions regarding the interest rate. Without higher growth, higher inflation or larger fiscal surpluses compared to historical averages, a stable debt burden requires a nominal interest rate cost no higher than 4%. Given that the average maturity of Italian public debt is approximately 7 years and current credit spreads are about 125 bps, the short term risk free rate consistent with this scenario is not much higher than 2%.

In summary, this simple exercise highlights the importance of taking steps toward growth-enhancing reforms for the outlook of demand of Eurozone bonds, as the ECB reduces its participation in that market. The asset purchase program parameters imply that no more than approximately 30% of a country's gross funding needs can be covered by ECB reinvestments once net asset purchases are phased out. A combination of higher, sustainable potential growth and enhanced risk-sharing mechanisms are the key elements without which the phasing out of unconventional policy could be a rather bumpy experiment. ■

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