Eurozone

ECB: a race against time

- **Conventional monetary policy can be, and often is gradual.**
- **Unconventional policy cannot afford that luxury.**
- **Four reasons are behind the necessity of acting as fast and boldly as possible once unconventional policies have been initiated.**

Conventional monetary policy, to smooth cyclical fluctuations of either inflation or inflation and economic growth, depending on the mandate of the central bank, tends to be a gradual process. During a tightening cycle, too aggressive an approach could cause overkill and push the economy in recession. During an easing cycle, gradualism reflects the willingness of avoiding a panic reaction of the public or a boom/bust cycle, if the easing were to turn out to be excessive. Gradual easing can also be based on the idea that if it fails in achieving the objective(s) of the central bank, unconventional policy still can be used as a last resort. This is exactly what has happened in several countries in recent years with quantitative easing being adopted by the Fed, the BoE, the BoJ and the ECB.

Non-conventional monetary policy is by design of a different nature than traditional policy. The central bank boosts the size of its balance sheet and financial asset prices play a bigger role as a transmission channel (the credit channel dominates with traditional interest rate cuts). These differences, however, imply that once a central bank adopts a non-conventional policy, it starts a race against time.

First, there are limits to quantitative easing. One argument is that by boosting the size of its balance sheet, the sensitivity to interest rate shocks increases. On a mark to market basis, the central bank is bound to face unrealised losses. Indeed, the objective of quantitative easing is to boost growth (intermediate objective) and by extension inflation (final objective). To the extent that the policy is successful, bond yields will ultimately rise. In case of the BoJ, which has been buying ETFs as well, the sensitivity of its balance sheet to equity market shocks is another element to be taken into account. Still, that argument is not key, as it is generally accepted that a central bank can function properly with low or even negative equity.

A more important argument is the scarcity of the bonds which are bought in the context of a QE programme. This makes the implementation of QE increasingly difficult the longer it lasts and the bigger it is. It also reduces the leeway in terms of increasing the volume and /or extending the programme in time. In the eurozone, it is estimated that the net issuance of government paper, taking into account the buying of the ECB, will be a negative EUR 303 bn in the second half of this year. Quite understandably the ECB has recently announced it would also buy investment grade corporate bonds, although there again the available supply is limited. This is probably one of the reasons why the deposit rate has been lowered further in negative territory, in order to exert additional pressure on interest rates across the yield curve.

Another reason to consider is the limit of negative rates. The rationale of negative rates is that it removes the constraint of the zero lower bound. The refinancing rate may very well be non-negative, the negative rate applied to excess reserves deposited at the ECB implies that the entire yield curve can shift down further than would be the case if only QE were applied. In addition to the incentive for banks to expand credit, it can trigger a portfolio rebalancing away from government paper and into riskier assets. There also is a signalling role: when the deposit rate is lowered further, one can assume it will take even more time until the refinancing rate is increased. Yet, the negative deposit rate as a policy tool meets with a lot of criticism. When the BoJ introduced it recently, a surprise move, it caused a decline in the equity market and in particular banking stocks as well as a strengthening of the yen. The latter was exactly the opposite of what the BoJ was aiming at, since it will weigh on inflation, and it reflected mounting doubts about the ability of the BoJ to boost inflation. One can suppose that these points have played a role in the recent decision of the ECB to limit the additional cut in the deposit rate. Moreover, looking at recent statements, it seems that the bar to lower it further is quite high now.

A third factor is that too little progress on the inflation front could weigh on the credibility of the central bank or more strictly, on the market belief that it will be able to boost inflation. Such doubts can lead to increased uncertainty and could even lead to an appreciation of the currency with negative consequences for growth and inflation.

Finally, the sensitivity of the eurozone to developments in the rest of the world makes it also necessary to realise progress on the inflation front. Indeed, a deterioration of the external environment would make it more difficult to reach the inflation goal. More concretely, we have to hope that inflation converges sufficiently close to the ECB's target before the US enters a recession. Admittedly, a recession in the US is not our base scenario for this year or next, but it is clear that it would trigger a deflationary shock in the eurozone via worsening export prospects and a stronger euro.

From a financial market perspective, the introduction of non-conventional monetary policy implies that a race against time has started: investors will be impatient to see progress on the inflation front. In reality, however, we don't know in advance by when inflation will have risen sufficiently. In such a situation, one understands the emphasis of the ECB on its ability and determination to do more if needed. We should also welcome that in recent communication the reference to achieving a pick-up in inflation as soon as possible has been dropped. The combination of patience and a willingness and ability to act if needed is the right way to run a race against time of an unknown distance.