EDITORIAL

FED ADAPTS FORWARD GUIDANCE, WILL ECB DO THE SAME?

In the early phase of QE, financial markets perceive central bank forward guidance on asset purchases and on policy rates to be closely linked. This generates a mutual reinforcement of both instruments. At a later stage, there may be mounting concern that the signalling works in the other direction as well. Scaling back asset purchases could be interpreted as a signal that a rate hike will follow soon once the net purchases have ended. In the US, Jerome Powell has been very clear that tapering would not signal a change in the outlook for the federal funds rate. In the Eurozone, both types of guidance are explicitly linked. This may complicate the scaling back of asset purchases in view of the impact on rate expectations. On the occasion of the decision on the PEPP, it might be worth to consider revisiting the link between APP guidance and rate guidance.

Quantitative easing may influence inflation via different transmission channels: better anchored inflation expectations, market liquidity, wealth effects, the exchange rate, commercial banks' excess reserves at the central bank which may entice them to increase their loan volume, portfolio rebalancing, a signalling effect with respect to official interest rates. The last two are considered to be particularly important. The introduction of an asset purchase program sends a signal that the central bank has no intention whatsoever to hike its policy rate. Consequently, policy rate expectations decline, which lowers bond yields. Portfolio rebalancing refers to the changing asset allocation of investors that have sold their bonds to the central bank. The latter has extracted duration from the market, thereby forcing investors to look for riskier instruments –corporate bonds, equities, real estate, etc.- to generate a sufficient return. The portfolio channel compresses risk premiums, thereby lowering the financing cost for companies. It can also generate wealth effects due to the rising asset prices.

In the early phase of QE, central bank forward guidance on asset purchases and on policy rates are closely linked, either explicitly or implicitly, in the perception of financial markets. It generates a mutual reinforcement of both instruments. At a later stage, there may be mounting concern that the signalling works in the other direction as well. Scaling back the monthly bond purchases could be interpreted that a rate hike will follow soon once the net purchases have ended. In the US, the minutes of the July FOMC meeting report the concern of several members in this respect. In his speech at the annual Jackson Hole symposium of the Federal Reserve Bank of Kansas City, Jerome Powell has been very clear that tapering would not signal a change in the outlook for the federal funds rate[1]. Bonds and equities rallied, reflecting that investors welcomed the clear separation between forward guidance in terms of QE and that which concerns the policy rate.

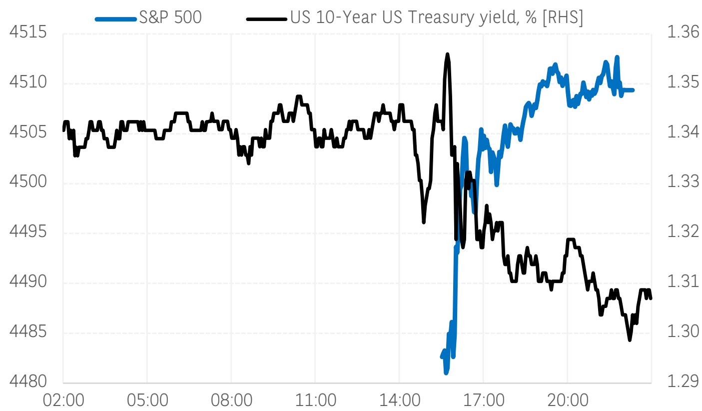
In the Eurozone, both types of guidance are explicitly linked. The Governing Council expects the net asset purchases under its asset purchase program (APP) *"to end shortly before it starts raising the key ECB interest rates"*[2]. This implies that, quite likely, any communication about reducing the monthly purchases under the APP, would influence policy rate expectations. One could argue that this risk is well under control given the strict conditions for a rate hike that have been set in the recently updated interest rate guidance.[3] Moreover, it looks premature to be concerned about such an outcome. The Governing Council first needs to decide on the pandemic emergency purchase

1. The timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test.

2. The full sentence reads as follows: *"The Governing Council continues to expect monthly net asset purchases under the APP to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates."* Source: ECB, Monetary policy decisions, 22 July 2021. This guidance was introduced at the Governing Council meeting of 12 September 2019 when the APP was restarted.

3. Inflation needs to reach 2 percent well ahead of the end of the projection horizon, it must be expected to remain at that level for the rest of the projection horizon and the observed progress in underlying inflation must be sufficiently advanced to be consistent with inflation stabilising at 2 percent over the medium term. Source: Philip Lane, The new monetary policy strategy: implications for rate forward guidance, The ECB blog, 19 August 2021

JEROME POWELL'S JACKSON HOLE SPEECH AND US MARKETS



SOURCE: BLOOMBERG (08/27/2021), BNP PARIBAS

> In the Eurozone, forward guidance on asset purchases is explicitly linked with that on the policy rate. This may complicate the scaling back of QE. On the occasion of the decision on the PEPP, it might be worth to consider revisiting the link between APP guidance and rate guidance.

program (PEPP), whether it will end in March next year, to what extent it would be counterbalanced with an increase in the APP, how long reinvestments will be made of paper bought under the PEPP, etc. ECB chief economist Philip Lane is not in a hurry. Ending the PEPP does not require a long lead time in terms of communication considering that the APP is ongoing. However, his comment that *"If we were in a pure taper situation, going from supporting the market to finishing net purchases, then preparing the market is an issue"*[4] shows that the ECB is very much aware it cannot afford a cliff effect when ending its APP. By making an explicit link between the two types of forward guidance, the ECB has put itself between a rock and a hard place: a late announcement of the end of the APP, implying a swift reduction in monthly purchases, could disrupt markets whereas tapering more slowly and hence announcing earlier, will increase expected short-term interest rates earlier as well. On the occasion of the decision on the PEPP, it might be worth to consider revisiting the link between APP guidance and rate guidance.

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4. Source: ECB, Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Balazs Koranyi and Frank Siebelt (Reuters), 25 August 2021.