Missing piece in QE puzzle

Reinvestment role in ECB's middle way

by Danae Kyriakopoulou in London

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The European Central Bank's governing council has long been split between doves and hawks over its quantitative easing programme. But consensus seems to be building ahead of its 26 October meeting to reduce the pace of asset purchases by half to €30bn per month for at least nine months.

This would be a welcome compromise between those who fear the market and economic reaction to the phasing out of monetary support, and those concerned about the negative consequences of the ECB's policies, including their distributional impact and disbenefits for savers.

A middle way solution on QE would satisfy, too, the ECB's commitment to data-dependent policy against a mixed macroeconomic backdrop. While underlying economic indicators and headline euro area growth have strengthened significantly, the recovery has been uneven across the 19-nation bloc. And while fears of deflation have dissipated, inflation remains below the ECB's target of 'below but close to 2%'. Other worries include the health of the banking sector, especially in Italy. Reflecting these concerns, as well as fears that, once ended, QE may not be able to restart, the ECB council is highly unlikely to announce a definite end to the programme .

Beyond economic factors, technical constraints will affect QE implementation. As shown in an OMFIF study published this month , the ECB may soon run up against a shortage of eligible securities owing to its self-imposed rule not to buy more than one-third of any one country's public sector bonds. The ECB has demonstrated in the past that it can change rules when dictated by an overriding requirement to maintain economic stability or, most drastically, to guard against euro break-up. But because the one-third stricture is founded on the legal principle of preventing the ECB and its constituent national central banks from becoming bound into debt restructuring in case of country default, this rule can be regarded as sacrosanct and is unlikely to change.

Some politicians and market participants argue that lowering asset purchases – or 'orderly adjustment', in the ECB's jargon – could have a detrimental effect on markets. In fact, the impact could be somewhat more muted. The maturing of government bonds in central bank portfolios over the next few years will provide the ECB with an additional tool to maintain gross purchases for longer. This would keep the balance sheet at about the same level, thus softening the effect of an eventual withdrawal of stimulus compared to the alternative where securities are allowed to mature or – more extreme – active selling.

The central bank has committed to a reinvestment programme for maturing bonds, following the example of the US Federal Reserve and the Bank of England. Reinvestments by the ECB began in March this year and are expected to accelerate significantly over 2018 and 2019 as a large number of bonds mature. The different average maturity of the portfolios suggests redemptions will be skewed towards Germany and the Netherlands, with redemptions of French and Italian debt particularly light. Between €100bn-€150bn of German bonds would have to be reinvested by 2019, the largest amount of any country – reflecting the relatively short-term nature of the Bundesbank-held government debt.

The ECB's guidance on the execution of the reinvestments has been somewhat vague, making this an important missing piece of the puzzle regarding the future of QE. Speaking in Washington at a Group of 30 seminar on Sunday at the close of this year's International Monetary Fund-World Bank meetings, ECB Vice-President Vítor Constâncio gave some guidance on the bank's reinvestment policies. He said maturing government debt held by constituent central banks will be reinvested according to the same investment and maturity structure as they were acquired under the QE programme. His remarks came a few days after Peter Praet, the ECB's chief economist, acknowledged the importance of improving communication of information around the bank's reinvestment portfolio.

But key questions remain unanswered. The ECB has not explained whether reinvestments will be country for country or spread in line with the capital key. Nor is it clear whether funds must be reinvested in the same type of security or whether they can be transferred to other eligible assets. Another imponderable is whether possible German constitutional court statements on the legality of the QE programme will impede

Bundesbank reinvestment. At the 26 October ECB press conference, there will be no shortage of issues needing clarification.

Danae Kyriakopoulou is Chief Economist and Head of Research at OMFIF. This belongs to a series of articles on the European Central Bank's policies ahead of its 26 October meeting. The next article in this series will appear on Tuesday 24 October.