The end of net asset purchases does not put a stop to quantitative easing

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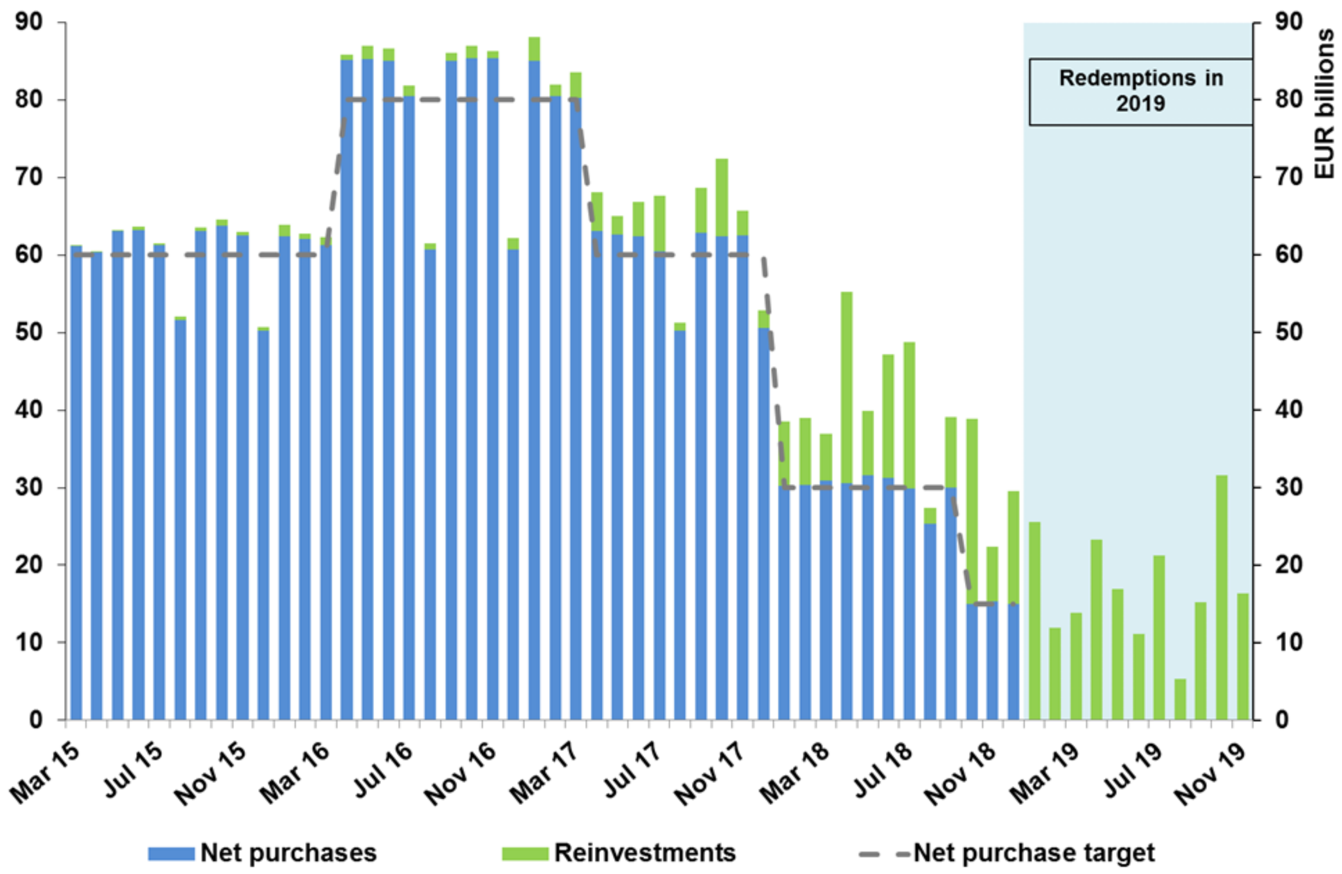
At its meeting of 13 December 2018, the ECB Governing Council confirmed that it would stop the net asset purchase programme begun in late 2014 at the end of this year. Quantitative easing nonetheless remains in place: it depends primarily on the stock of assets held by the Eurosystem rather than on the flow of purchases. This stock will remain unchanged for as long as the Eurosystem continues to reinvest the proceeds from maturing securities.

Chart 1: Eurosystem asset purchases and reinvestments since March 2015



Source: BDF, ECB. Note: Flow of purchases under all the APP programmes, in EUR billions. The dotted line shows the notional purchase target set by the Governing Council. March 2015: start of the public sector purchase programme.

A decision based on the progress of inflation and widely anticipated by the markets

The Eurosystem's asset purchase programme (APP) consists of three programmes for the purchase of private sector securities (covered bonds, asset-backed securities and corporate bonds) which were launched from October 2014 onwards, and a programme for the purchase of public sector securities (the Public Sector Purchase Programme or PSPP). The public sector purchases, which are the largest component of the APP in terms of volume, began in March 2015 when the euro area was facing the threat of deflation. Monthly net purchases were initially set at EUR 60 billion in March 2015, but the figure was subsequently raised to EUR 80 billion as of April 2016. It was then lowered again to EUR 60 billion, then to EUR 30 billion and finally to EUR 15 billion (Chart 1). The decision to halt the purchases at the end of 2018 is the first step towards the normalisation of Eurosystem monetary policy.

The move is justified by the progress made towards the euro area's inflation target – which is for inflation rates below, but close to, 2% over the medium term. According to the December 2018 Eurosystem staff macroeconomic projection exercise, annual inflation in the euro area is forecast to reach 1.6% in 2019, 1.7% in 2020 and 1.8% in 2021. The degree of confidence in the path of inflation has also increased in recent quarters, as demonstrated by the reanchoring and reduced dispersion of professional forecasters' long-term inflation expectations (ECB, 2018).

In light of this, the end of the net asset purchases was largely anticipated by market participants, especially since the Governing Council had already signalled its intention six months earlier at its meeting in June 2018. As a result, the confirmation of the decision did not trigger a significant market reaction after the 13 December Council meeting.

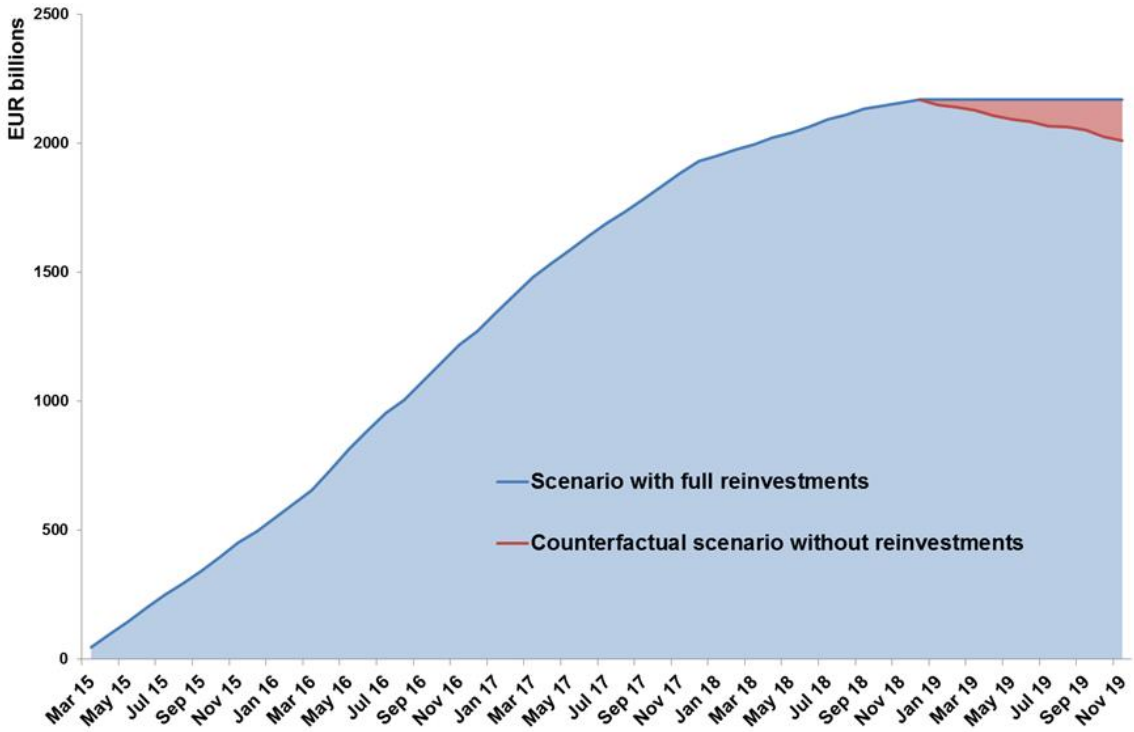
The flow of reinvestments should keep the Eurosystem's asset holdings at a constant level

January 2019 will see the start of a new phase of the APP consisting in the continued reinvestment of all principal redemptions from maturing securities. This will keep the size of the APP portfolio stable at just over EUR 2,500 billion. The reinvestment phase applies to all APP programmes, and will continue "for an extended period of time past the date when [the Governing Council] starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation".

Each month and for each programme, the Eurosystem publishes the amount of principal redemptions to be reinvested over the subsequent 12-month period. According to the latest available data, a total of over EUR 158 billion will be reinvested in 2019 under the PSPP (between January and November).

Chart 2 compares the projected trajectory of the PSPP portfolio over a 2019 horizon with a “counterfactual” scenario involving no reinvestment. Under this latter hypothesis, the size of the PSPP portfolio would start to fall from as early as January. The Eurosystem’s asset holdings would only decline gradually, however, as the average residual maturity of the PSPP portfolio is currently around 7.4 years. Under the reinvestment policy adopted by the Eurosystem, the asset holdings remain stable for as long as the reinvestments continue. The majority of market participants expect the period of full reinvestment to continue for 2 to 3 years.

Chart 2: PSPP holdings with and without reinvestments over a 2019 horizon



Note: The horizon of November 2019 corresponds to the period for which principal redemption amounts have been published and does not necessarily mean reinvestments will effectively end on this date.

The Eurosystem’s asset holdings will continue to place downward pressure on interest rates

The reinvestments will maintain the Eurosystem’s APP asset holdings at a level of just over EUR 2,500 billion. With regard to the impact on long-term interest rates, it is this stock of securities together with their maturity – rather than the flow of purchases – that matters the most. When a central bank holds or is expected to hold a large share of public sector securities, this reduces the net amount available for private investors. In this case, certain private investors will be willing to sell their public sector securities to the central bank and reallocate their portfolio towards other assets. However, others (e.g. insurers) have a strong preference for holding long-term public sector securities. If the central bank's asset purchase programme is large enough, these long-term investors will also be required to sell their holdings. To induce them to sell, the price of the securities will have to rise significantly, leading in turn to a significant fall in yields. Yields will then stay low for as long as the central bank continues to hold a large stock of securities. This channel can be reinforced by a signalling effect, whereby the implementation of the purchase programme by the central bank lends credibility to its commitment to keep policy rates low.

The predominance of this stock effect is confirmed by several empirical studies. In a Banque de France study of the PSPP, Arrata and Nguyen (2017) find that the purchase of 10% of the stock of French government debt leads to a decline of between 13 and 26 basis points in the yields on these securities. Andrade et al. (2016) show that the announcement and implementation of the PSPP in March 2015 led to an average decline of 27 basis points in euro area yields. In contrast, both studies find that purchase flows have a non-significant effect, and De Santis et al. (2017) find only a weak flow effect. Overall, taking into account more recent estimations (Praet, 2017), the APP and its successive recalibrations are estimated to have had a downward impact of 50-100 basis points on euro area 10-year sovereign yields since their announcement. These declines in long-term rates have been passed through to financing conditions in the broader economy, and have thus helped to support growth and inflation (Banque de France, 2016).

To conclude, the full reinvestment of principal redemptions from the APP will help to maintain the current high level of monetary accommodation. It will add to the effects of the other tools of Eurosystem monetary policy: the announcement that key interest rates will remain at their present levels "at least through the summer of 2019", and the provision of liquidity to the banking sector.