Investment Note

30 October 2017

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ECB Dovish Taper Not As Big As It Looks

The European Central Bank (ECB) ended market speculation by announcing plans to reduce the size of its asset purchasing program on last Thursday.[1] In this note, our Chief Economist Megan Greene argues that the announcement is much more dovish than the headlines might suggest, and highlights four key factors to which investors should pay attention.

Summary

ECB President Mario Draghi announced on last Thursday what most of us economists and analysts had expected in terms of the ECB's plans to taper its bond purchases. The ECB will reduce its monthly purchases from €60 billion per month to €30 billion per month from January through September 2018.[1] Mr. Draghi also highlighted that rate hikes would not start until long after that.[2]

Four key factors

1. It comes as no surprise that **Mr. Draghi's statement and rhetoric during the ECB's press conference was dovish**. A more hawkish tone might have sent the euro much higher, which the ECB does not want. One way the ECB President tried to reinforce this dovishness was to insist that the central bank might purchase assets beyond September 2018.[2]
   - I remain skeptical about what this statement means. The ECB is constrained on what assets it can buy based on its own self-imposed rules. In a crisis, it could change these rules and, for example, deviate significantly from the capital key[3] or buy equities. But these are incredibly politically difficult options and I think the ECB will likely want to avoid expanding the universe of assets it can buy in the absence of a real meltdown in the eurozone.
   - The ECB has been fairly transparent that it plans to buy up all that it is allowed, and I think the bond purchases through September 2018 should allow it to do so but there won't be much room for further asset purchases beyond the end of the year.

[1] European Central Bank: Press Release – Monetary Policy Decisions, 26 October 2017.
[2] The ECB President's response to a question on the issue during last Thursday's press conference is available on its website.
[3] Deutsche Bundesbank: Understanding The Capital Key, 16 January 2014.

2. Mr. Draghi went to great pains to highlight **the ECB's reinvestment policy**, which some took to be an academic point. I thought this was the most important piece of last Thursday's announcement.
   - The ECB will begin publishing its bond redemption and reinvestment schedule next month, so we do not yet have perfect data on what has or what will be rolling off or reinvested. What we do know is the ECB started buying assets in March 2015 and the shortest duration it could buy at the time was two years (the minimum duration was later shortened to one year).[4] Some bonds have since rolled off and were reinvested starting in March 2017, but probably not a huge amount.
   - According to most estimates, reinvestment will climb significantly next year. Some analysts suggest reinvestments could go up to €15 – €20 billion per month next year. While monthly bond purchases will fall to €30 billion, reinvestments should pick up significantly and so the overall removal of accommodation will be less significant than the headline taper announcement suggests. There are also some in the market who think that reinvestments next year will likely be heavily skewed towards German assets given that the Bundesbank issued a lot of short-term paper over the past two years.
   - If that were the case, we are likely to see spreads over German bunds rise next year. While the ECB will stick to its capital key, we do not as yet have much information on how the reinvestment program will work. Maturing sovereign bonds could be reinvested into corporate bonds in principle, for example. We only know that "redemptions will be reinvested in the jurisdiction in which the maturing bond was issued". [5] Maturing bonds will be reinvested as they fall due or "in the subsequent two months, if warranted by market liquidity conditions".[5] The ECB therefore has some flexibility with its reinvestment scheme to tweak according to economic and financial conditions.

3. Interest rate differentials and monetary policy divergence still matter for the foreign exchange market. **Last Thursday's dovish announcement by the ECB should provide a headwind to a further rally in the euro relative to the US dollar**. Once the Fed Chair announcement is out of the way[6] and markets begin to price in more than one rate hike next year (we expect two), the US dollar should appreciate relative to the euro.

[4] Details of the ECB's Asset Purchasing Program can be found on the bank's website.
[5] European Central Bank: Press Release – Additional Information On Asset Purchase Programme, 27 October 2017.
[6] Fed Chair Janet Yellen's four-year term ends on 3 February 2018. US President Donald Trump is due to announce if he will extend Ms. Yellen's term, or appoint a new Fed Chair soon.

4. In our view, **the ECB's forward guidance is now time-driven (after tapering is finished) rather than data-driven**. This could put the ECB in a bind if inflationary pressures do not come through in 2019.