European Central Bank “obfuscation” likely to fuel market volatility

Nick Beams
21 October 2016

The European Central Bank has left markets uncertain as to the future of its bond-buying program, deciding to discuss its direction at its next meeting in December. At this stage the scheme, under which the ECB makes purchases of €80 billion a month, is due to run in its present form until March 2017.

Speaking after a meeting of the ECB’s governing council in Frankfurt yesterday, in which it left all its monetary policy settings on hold, president Mario Draghi said: “Our decisions in December will tell you what we are going to do. That will define the monetary policy environment for the coming weeks and coming months.”

Draghi said the reason the ECB was waiting until December was because “we want to see all the inputs that are useful to have this discussion” and which will “ensure the smooth implementation of the purchase program until March 2017 or beyond if necessary.” He said it was “unlikely” there would be an abrupt end to bond-buying, indicating that it would gradually reduce purchases, that is, “taper” them.

The move not to make a decision is likely to mean that bond markets, already disturbed by the consequences of Brexit and the fall of the British pound, will remain volatile.

James Athey, fixed income manager at Aberdeen Asset Management, summed up the attitude in financial markets. “This was not Draghi’s finest hour,” he said. “He really wanted to shut down any suggesting that the ECB is going to taper any time soon. But what he actually did was to tell people to come back in December and see what the ECB thinks then.

“That will leave enough unanswered questions to keep bond markets volatile. An already nervous market will not take much comfort from his obfuscation today.”

The reason for the delay in the decision is not that the ECB wants more information before it makes a decision but the expectation that any move to further extend bond-buying will provoke intense opposition from Germany, which has only reluctantly gone along with monetary easing.

That opposition surfaced in an interview given by former ECB chief economist Otto Issing who was one of the architects of the single currency. In an interview with the journal *Central Banking* he said the ECB was becoming dangerously over-extended and the euro project was unworkable in its current form.

“Realistically, it will be a case of muddling through, struggling from one crisis to the next. It is difficult to forecast how long this will continue for, but it cannot go on endlessly,” he said. “One day, the house of cards will collapse.”

Issing said the ECB already held more than €1 trillion worth of bonds purchased at “artificially low” or negative yields. This would bring large paper losses once interest rates begin to rise. Bond yields and their prices move in an inverse relationship.

Issing warned that an exit from the quantitative easing policy was becoming more and more difficult with the consequences becoming potentially more disastrous.

“The decline in the quality of eligible collateral is a grave problem. The ECB is now buying corporate bonds that are close to junk,” he said.

Issing’s views are not confined to him but are reflected throughout the German financial establishment.

At his press conference following the governing council meeting Draghi was asked about comments by German finance minister Wolfgang Schäuble that there was too much liquidity in the market and whether he feared there could be German opposition to an extension of quantitative easing.

Draghi sought to deflect the question, stating that he thought Schäuble was referring to world liquidity and not directly to the euro zone and repeated his call that countries with "fiscal space"—thereby enabling them to increase government spending and boost the economy—should use it. "Germany has fiscal space," he said.

The concern in financial markets over the direction and duration of the ECB's monetary policy stems from fears that the rise in interest rates which would result from its cessation could spark a sharp fall in bond prices and lead to significant losses.

An analysis by Goldman Sachs issued earlier this week warned that bond investors could suffer major losses if interest rates suddenly increased. It concluded that a 1 percent rise in rates could inflict a loss of $1.1 trillion—a larger loss for bondholders than at any other time in history. Such an outcome was "far from a tail scenario"—that is, it did not have an extremely low, or negligible probability.

The Goldman study pointed out that there had been a shift to longer bond market maturities, which were now more than double the inflation-adjusted level of 1999. These longer-term bonds are more likely to experience an increase in interest rates. The "notional amount of duration dollars at risk is unprecedentedly high," it said.

Reporting the findings, a Bloomberg article noted that Goldman's $1 trillion loss estimate only took into account dollar-denominated investment grade bonds and may be a "conservative estimate." It excluded a "whole gamut of risks," including from "junk bond obligations, the trillion-dollar pile of fixed-rate mortgages, and corporate loans held on bank balance sheets."

Conflicts in the ECB are not the only potential source of volatility in financial markets. There is clearly a deepening split in the US Federal Reserve over whether and when interest rates should again be lifted following the 0.25 percentage point rise last December. Initially it was thought that there could be as many as four rises this year. However, at every meeting so far this year, the Fed has kept interest rates on hold. But opposition is growing with the September meeting resulting in a split vote of seven to three to maintain the status quo.

In a major speech last Friday, Fed chairwoman Janet Yellen, the chief supporter of the present low-interest rate regime, indicated she was in favour of "high pressure" policies, based on the maintenance of ultra-cheap money, to try to boost the economy and lift inflation.

But this perspective was countered by Fed vice chairman Stanley Fischer in a speech to the New York Economic Club on Monday. He said if the Fed kept going until the inflation rate "shows us we're wrong, then you're going to change too late" and attempts at "overshooting" had not been successful.

Michael Gapen, Barclay's chief economist in New York, told Bloomberg that Fischer's comments "reflect an ongoing divergence of opinion" at the Fed. Fischer "doesn't see much room for running the economy hot" while Yellen's views "seem to provide a wide-open door to do that. You have a chair and a vice chair who see policy quite differently now," he said.

Divergences in the Fed and conflicts in the ECB express the growing perplexity in financial circles over the failure of all the measures undertaken so far to provide a boost to the global economy, eight years out from the financial crisis of 2008, and could become the source of major financial instability in the coming period.