European Central Bank cuts asset purchases but insists “quantitative easing” continues

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The European Central Bank will reduce its purchases of financial assets from €80 billion a month to €60 billion from next April and continue the program to the end of 2017 and beyond if necessary, strenuously denying that the reduction is in any way a “tapering” of its program of “quantitative easing.”

Speaking at a press conference following a meeting of the ECB’s governing council yesterday, the central bank’s president Mario Draghi said “tapering” had not even been discussed. Responding to a question about whether there was “pressure” to discuss a possible exit from quantitative easing (QE), Draghi said the purpose of the decision was to “transmit a sense that the presence of the ECB on the markets will be there for a long time.”

While no names were named, the pressure to which the questioner referred is coming from Germany, which has opposed the QE program. Draghi claimed the measures he announced enjoyed a “very, very broad consensus” on the governing council. But even though the monthly asset purchases were reduced, German Bundesbank President Jens Weidmann cast a “no” vote.

Political considerations were apparent in the way the final decision was reached. The ECB had been weighing two options: to announce a six-month extension of the €80 billion per month asset-purchasing program or a nine-month extension at €60 billion. One of the reasons it decided on the latter course was to avoid announcing a decision on future policy in the midst of the German elections, which are expected to be held in September.

Draghi did not refer to these considerations and set out the decision in economic terms, saying that when the purchases had been upscaled to €80 billion a month last March the outlook for a sustained return to inflation was “very much darker” and deflation risks were “not immaterial.” But now the “risk of deflation has largely disappeared.”

“However,” he continued, “uncertainty prevails. Uncertainty prevails everywhere, and we’ll certainly see and assess the progress of the overall situation at the end of 2017.”

At the centre of those uncertainties is the long-term impact of the decision by Britain to quit the European Union (Brexit) and the impact of the Trump administration on the global economy.

Draghi said it was “very, very difficult” to immediately assess the effect of these big changes, including the “radically new administration” in the United States and the way it looks at the world. He cited the impact of Brexit and the outcome of the Italian referendum last weekend, which led to the resignation of Prime Minister Matteo Renzi following the overwhelming rejection of Renzi’s proposed constitutional changes.

Financial markets had proved to be more resilient in the face of these changes than had been expected, Draghi said, but “all these events—especially Brexit and the new administration in the United States—have effects that are, by their very nature, going to develop their full dimensions in the medium to long-term”.

Several questions were directed to the immediate situation confronting the Italian banking system and Italy’s reported request for the ECB for a delay on its program for a €5 billion rescue operation of the Monte dei Paschi di Siena bank, which has been called into question as a result of the referendum defeat.

Draghi said he could not comment on the issue of a delay, as that was the province of the ECB’s Supervisory Board.

The Monte dei Paschi (MPS) rescue operation is a

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complex debt for equity swap that centres on the injection of up to €2 billion from Qatar's sovereign wealth fund. This has been thrown into doubt. In the words of a recent report in the *Financial Times*, with a decisive referendum "no" vote and the departure of Renzi, who had pledged reforms to the financial system, "Qatar or any other investor big beast is expected to lose interest in being MPS's new anchor."

If the rescue plan falls through, MPS could be wound up or restructured under ECB rules, hitting small bond holders and investors with losses.

On the issue of the vulnerabilities of the Italian banking system more broadly, Draghi said these had been there for a long time and he was "confident that the government knows what to do and they will be dealt with."

But as another questioner noted, it was still unclear what would happen in Italy and what government would emerge.

Throughout his press conference, Draghi sought to reassure financial markets that the "underlying narrative" of the ECB decisions was to "maintain that extraordinary degree of monetary accommodation that we have in place."

The official rationale for the policy, which provides ultra-cheap money to the banks and the financial system more broadly, is that it is aimed at lifting inflation to "below but close to 2 percent." Asked whether the ECB's projection of 1.7 percent inflation in 2019 met that definition, Draghi replied "not really" and the ECB would have to "persist."

This is in line with the demands of the financial markets, as expressed in a *Financial Times* editorial yesterday. Noting that the ECB president was under pressure from critics of "ultra-loose monetary policy" both from within the governing council and from Berlin, the newspaper said inflation was still short of the target, the euro zone recovery remained weak and "investors are increasingly sensitive to the risk of political upheaval in the coming year."

While it was true, as Draghi had claimed, that the risk of outright deflation had receded since last March, when the EBC had set purchases at €80 billion a month, this "does not make it the right time for the central bank to scale back its support for the euro zone economy."

At his press conference, Draghi sought to convey the impression that the ECB was determined to maintain a "steady hand" and continue with monetary accommodation to achieve its objective. But the situation it confronts has become more complex.

Besides the longer-term impact of the policies of the Trump administration, there is the immediate effect of the policies of the Federal Reserve, which is almost certain to lift US interest rates when it meets next week. This creates the risk of financial turbulence because two key central banks could end up trying to move in opposite directions.

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