ECB makes first move to wind back quantitative easing

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9 September 2017

The European Central Bank has given its strongest indication yet that it will set out proposals to start to reduce its holdings of €2 trillion worth of financial assets—corporate and government bonds—when it holds the next meeting of its governing council in October.

Speaking at a press conference following its September meeting on Thursday, ECB president Mario Draghi said the bank was likely to take the "bulk of decisions" next month on winding down its €60 billion per month asset purchasing program. There had only been "very, very preliminary discussion" so far.

The meeting was preceded by further pressure from Germany for a winding down of the ultra-low interest rate policy and the bond buying program that began in 2015.

In an address to a banking conference in Germany earlier this week, German finance minister Wolfgang Schäuble called on the ECB to end its program of bond buying and negative interest rates. He said that the economic recovery in the euro zone was now strong enough for a return to a more "normal" monetary policy.

Schäuble was supported by the chief executive of Deutsche Bank, John Cryan, who called for an end to the policy which has hit banks' profitability. "The era of cheap money in Europe should come to an end—despite the strong euro," he told the conference in Frankfurt.

But the rise in the euro poses a dilemma for the ECB as it considers its next policy move. The official rationale for the low-interest rate regime is that it is necessary to lift euro zone inflation to near, but below, 2 percent.

However, the fall in the value of the US dollar is pushing up the value of the euro—it is now around $1.20—having risen more than 14 percent against the US currency this year and 6 percent on a trade-weighted basis. The rise in the value of the euro tends to push down the rate of inflation which the ECB is trying to lift.

The impact of the higher euro value was reflected in the ECB estimates for euro zone inflation set out by Draghi in his remarks to the press conference. Inflation was expected to be 1.5 percent for 2017, falling to 1.2 percent in 2018 and rising to 1.5 percent in 2019, well below the ECB's target. Draghi said the estimate for inflation had been "revised down slightly, mainly reflecting the recent appreciation of the euro exchange rate."

While economic expansion appeared to be solid and broad-based, Draghi said, "the recent volatility in the exchange rate represents a source of uncertainty" which had to be monitored with regard to the implications for the medium-term outlook for price stability.

Economic expansion had yet to translate into "stronger inflation dynamics," he said. Therefore "a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up."

Accordingly, the ECB made no change to its interest rate policy leaving the main refinancing rate at zero with its deposit rate at minus 0.4 percent. Draghi said the ECB expected rates to remain at their current levels "for an extended period of time, and well beyond the horizon of our net asset purchases."

As in the US, where inflation is also significantly below the Fed's target of 2 percent and has been exhibiting a downward trend, one of the main reasons for low inflation in the euro zone is that wages are not increasing despite the increase in job numbers. This is because many of the additional jobs are either low-paying part-time or casual positions.

Draghi acknowledged that corporate profits in the euro zone have increased as a result of the low-interest rate regime but cost pressures “notably from labour markets are still subdued.”

He made it clear that the essential class agenda of the ECB—cheap money for the finance houses and corporations coupled with worsening conditions for workers—will continue and be intensified.

Draghi said that, in order to reap the “full benefits” of monetary policies, other policy areas had to contribute. “The implementation of structural reforms needs to be substantially increased to increase resilience,” he said.

In response to a question, Draghi further elaborated on the impact of the so-called “flagship reform” of the labour market by the Macron presidency in France, which aims to “liberalise” the labour market by eliminating previous protections. The questioner pointed out that, in as much as many of these jobs would be “precarious” or “low paid,” this would make the inflation target of the ECB much harder to achieve.

Draghi’s response could be described as a baring of the teeth. He expressed “full confidence” that the French government knew exactly what it was doing to undertake needed “structural reforms” and that one of the main targets had to be what he called “dualism” in the labour market.

“Dualism” refers to the situation where certain sections of the labour market were “rigid”—that is, governed by regulations restricting to some extent the ability of employers to hire and fire at will—while other sections were “very, very flexible.”

According to Draghi, the experience of the economic crisis was that it was in these latter areas that job losses had been the most significant. His prescription was not that further measures had to be introduced to prevent a recurrence of this experience, but rather that “all reforms of labour markets should aim at decreasing or eliminating this dualism.”

In other words, the Macron measures should be extended more broadly to remove what remains of regulatory protections for the jobs and wages of workers across the euro zone.