REGULATORY UPDATE - MALTA APRIL 2017
Policy note drafted by the Eurofi Secretariat

The ECB's asset purchase programme and future prospects

The ECB has engaged in a very bold expansionary monetary policy, particularly since the beginning of 2015. It decided then to buy monthly 60 Billion Euros of public and private securities for a period of 18 months. These unprecedented amounts were raised to 80 Billion Euros in May 2016. They represent close to 2/3 of the total issuance of Eurozone sovereign debt. At its December meeting, the ECB decided to extend the asset purchase programme beyond March 2017 with the intention of conducting its purchases until the end of December 2017 or beyond. Starting from April 2017, the net asset purchases will run at a monthly pace of €60 billion, and the ECB will reinvest the securities purchased earlier under its programme, as they mature. This will add to the monthly net purchases.

Fiscal reforms engaged notably in peripheral countries have played an important role in the acceleration of the convergence of interest rates in the Eurozone. But the ECB has decisively contributed to the rapid setting of a lower and more homogeneous interest rate pattern in the Eurozone with its expansionary monetary policy. It is in particular remarkable that the ECB has helped to reduce interest rates on loans to non-financial corporations. These monetary policy measures have increased demand for credit and supported domestic consumption

Many observers also consider that QE has had a strong effect on the exchange rate channel, reducing the euro-dollar exchange rate substantially, potentially supporting exports and that QE has contributed to avoid deflation trends in Europe. The Governing Council of the ECB continues to expect interest rates to remain at present or lower levels until inflation has converged substantially towards of its objective of below but close to 2%.

However according to some observers, a monetary policy that is too accommodative for too long may have several drawbacks and shortcomings and may having decreasing returns over time.

Firstly in Europe there has been no rebalancing of savings and consumption so far.

Yields - close to 0 or even lower – on riskless investments should, normally, deter economic agents from saving and induce more consumption, which would support growth. But, contrary to the hopes of many, "financial repression" does not always result in an increase in consumption especially in Europe.

When the yields fall or, sometimes even disappear, because of monetary policy, it would be logical to see savings switch to equity instruments that can provide, over the longer term, more satisfactory returns, all the more so if investors believe in an upturn of the economy. This happened in the US as a consequence of QE, where equity markets rebounded exactly in line with the creation of liquidity by the Fed, triggering a "wealth effect" which contributed to more consumption. But in the Eurozone, this process does not seem to work: no significant shift to equities, nor wealth-effect has happened so far. Indeed European savers are not the same as those in the US. They are mostly risk-adverse, their savings are mainly in relatively safe assets and they are not inclined so far to buy shares. Moreover the tax system often does not sufficiently encourage equity investment. More worryingly, the shift of repressed financial savings to consumption does not seem to have happened either. Indeed, probably due to existing uncertainty, a significant number of savers are trying to offset lower returns by further saving.

Secondly very low interest rates have a negative impact on the profitability of banks which may have negative consequences for the financing of the economy and the transmission of the monetary policy in Europe.

EU banks are very sensitive to the spread between their funding costs (deposits and borrowings) and the return on their assets. Clearly the decline in interest rates which is accompanied by a significant flattening of the yield curve, weighs on the profitability of retail deposit banks that traditionally benefit from maturity transformation activities. The consequences of this decline of profitability are manifold.

If banks are not profitable, they will not lend more, which goes against the objective of the monetary policy to support credit. It seems therefore essential that monetary policy and regulation are well adjusted in this respect. Moreover another important issue is that there are less incentives for investors to buy bank shares, which is reflected in the low price-to-book ratio in the EU banking sector.

The balance sheet of insurance companies and pension funds is also a matter for concern. Such institutions have to meet the long term liabilities of their retiring clients, with assets (like sovereign bonds) that carry no return.

Thirdly, resource allocation tends to lose its efficiency when interest rates get very low. Indeed, the only projects that can be financed are the ones which are viable with very low rates. Less profitable and more risky investments (but perhaps socially more beneficial) may be left aside. Furthermore, investment duration is bound to be reduced in an environment of low interest rates; cheap credit may also help unproductive and non-viable firms to survive for too long.

Fourthly, an evolution towards negative interest rates does not seem sustainable over time. Indeed interest rates are the price that a saver is entitled to expect for having accepted, for a given period of time, to postpone immediate consumption. To say that such a price should become negative goes against common sense, abolishing the notion of time and could bear grave consequences for the future. It is for example difficult to see how one could calculate expected returns on an investment with a negative rate. This could have important consequences in particular for long term investment projects that involve high fixed costs and high risks.

More generally, expansionary monetary policies create a growth in the central bank money supply (liquidity) which is a source of financial instability. When a central bank buys a financial asset from any agent and pays for it by giving them money, that economic agent can use the money freely, to buy (and then resell) financial assets (equities, bonds...) or real-estate assets in various countries. As the quantity of this money created by the central bank increases, the buying and selling of various assets also expands, and financial instability is increased.

Finally, systematic liquidity creation does not appear to be the major solution for relaunching growth in many European countries that are mainly hampered by decelerating productivity growth and insufficient structural reforms.