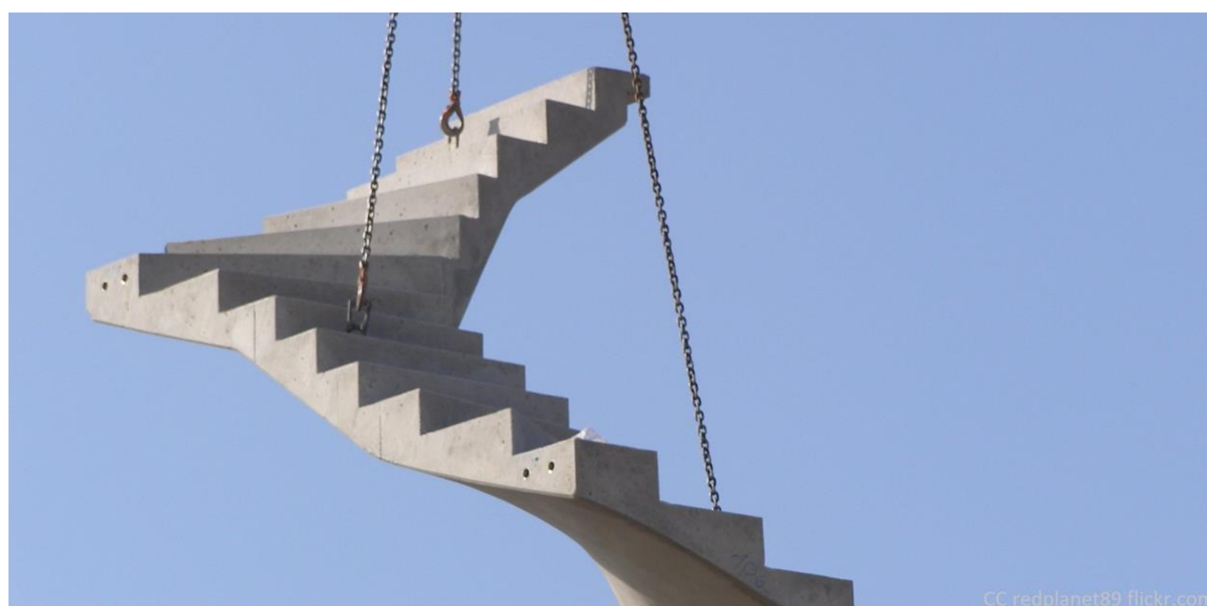
JACQUES DELORS INSTITUT
BERLIN

BLOG POST 07.06.2017

Exit revisited: Why the US tapering is not a blue print for the euro area

Philipp Ständer
Research Fellow at the Jacques Delors Institut – Berlin


CC redplanet89 flickr.com

As the euro-area recovery strengthens, the pressure on the ECB increases to work out a smooth exit from its expansionary monetary policy. The US Federal Reserve already went down this road. It terminated its asset purchasing programme between 2013 and 2014. This blog post compares the economic situation and financial market risks in the US at that time with the situation in the euro area today.

Pariser Platz 6
D – 10117 Berlin
Tel.: +49 (0)30 467 26 09 – 01

Online: delorsinstitut.de
E-Mail: office@delorsinstitut.de
Twitter: @delorsinstitut

1 Monetary normalisation on the horizon

Unemployment in the euro area fell by almost one percent over the last 12 months and most Member States are now growing at a solid pace. The broadening economic recovery strengthens the case for scaling back the ECB's non-conventional monetary policy measures in the near future. The ECB's policy currently consists of three main elements: the negative deposit facility rate, the asset purchase programme, also known as quantitative easing (QE), and forward guidance on the future evolution of both asset purchases and interest rates.

Since headline inflation has climbed closer to the ECB target in early 2017, speculation has started when the ECB will announce plans to normalise its expansionary monetary policy and how it will be done. Markets will watch the details carefully: When and at what pace will the ECB scale back (taper) its €60 billion of monthly asset purchases? And at what point will it start raising interest rates, most importantly the deposit rate, currently at -0.4%?

The tapering experience of the US Federal Reserve (Fed) often serves as case study for the euro area. In December 2013 the Federal Open Market Committee (FOMC) announced that it would scale back bond purchases from $85 billion to $75 billion and continued to cut back QE until October 2014. This blog post explores to which extent the two cases are comparable along two dimensions: (1) the economic situation in relation to the central bank mandate and (2) constraints to exit strategies such as financial stability risks.

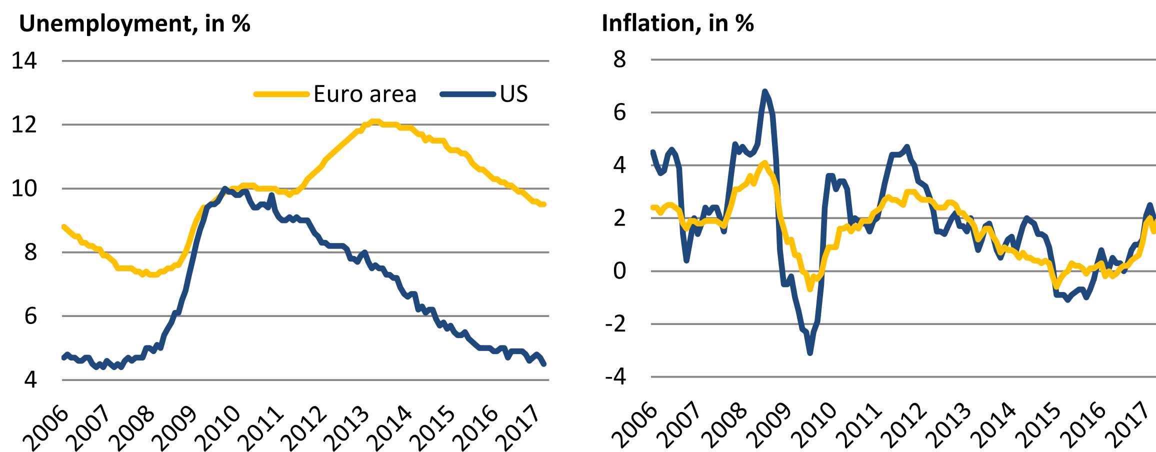
2 Different focus: unemployment vs inflation

In the second half of 2013 growth in the US economy accelerated to 3.75 percent annually and unemployment dropped to 6.6 percent, while inflation remained well below the inflation target at 1.1 percent on average. Credit conditions for companies and consumers eased further and growth was carried by increasing private investment and consumer spending. The Fed was also optimistic about the international economic environment, with the euro area starting to recover from the sovereign debt crisis and higher growth rates in China and other emerging economies. Furthermore, the oil boom in the US was still in full swing, helping to boost exports.

A meaningful and lasting improvement of labour market conditions was the key criterion for the Fed's decision in December 2013 to scale back its asset purchasing programme. Since the onset of the Fed's third QE programme in August 2012 unemployment had fallen by 1.5 percentage points. The Fed stated that it was nevertheless appropriate to keep interest rates near zero for an extended period of time, mainly because inflation was still significantly below the target of two percent. Furthermore, unemployment was still considered to be above sustainable levels.

The prospect that inflation would remain low for longer motivated the Fed to adjust its forward guidance. It signalled that it would keep interest rates down well beyond its previously set threshold of unemployment falling below 6.5 percent was met.

Unemployment and inflation developments in the euro area and the US



Source: Eurostat

Today, the euro area also experiences a sustained recovery. Two thirds of euro area countries register growth rates above 1.5 percent. Unemployment has dropped by 1.7 percent since the ECB started its QE programme in March 2015 but is still above pre-crisis levels, just as in the US in 2013. Inflation also recovered and was on average at 1.8 percent in the first four months of 2017, although it fell back to 1.4 percent in May.

Would the ECB apply the same criteria as the Fed, it is not inconceivable that it would have started tapering already. In December 2013 unemployment in the US was 2.3 percentage points above pre-crisis levels, in the euro area the distance today is only 2.0 percentage points. By pinning the tapering decision to the recovery of the labour market, while inflation was still below target, the Fed prioritised its employment objective over price stability. The dual mandate of the Fed allows for this choice.

For the ECB unemployment is secondary by law. The European treaties oblige the central bank to preserve price stability, which it defined as below but close to two percent inflation. As a consequence, a policy move of the ECB only becomes likely when the following criteria are met: (1) the inflation objective has to be achieved over a medium-term horizon, meaning reflected in future projections; (2) durable, meaning adjustment in core inflation; (3) self-sustained, meaning not dependent on extraordinary monetary stimulus; and (4) broad-based across the euro area.

3 Financial stability implications

Besides applying different criteria the ECB also has to consider two financial stability risks that are in conflict with each other: (1) tapering QE could increase stress in government bond markets while (2) the low interest rates weaken banks as they put pressure on profitability.

Quantitative easing has helped to push down government bond yields to historically low levels and thereby provided significant breathing space for indebted governments on both sides of the Atlantic. The link between monetary policy and borrowing costs of governments forces central banks to consider the implications of their policies on bond markets.

Since the outbreak of the financial crisis the debt burden of the US and the euro area increased strongly. In 2008, the debt-to-GDP ratio in the US was at 74 percent. In 2016 it stood at 107

percent and is set to rise to 117 percent until 2022 according to IMF projections. In the euro area public debt climbed from 67 percent in 2008 to 94 percent in 2014. However, it has fallen since to 91 percent in 2016 and is set to decline to 80 percent in 2022.

Despite a more sustainable outlook on the aggregate, the ECB argues in its latest Financial Stability Review that an abrupt repricing in government bond markets remains one of the major financial stability risks in the euro area, mainly because of the persistent fragility of public finances in many former crisis countries. Stress in bond markets (measured by an index of bond spreads) edged up in early 2017 because of increasing political uncertainty prior to the French elections. The ECB itself claims that its QE programme has played a role in taming the stress which stayed well below conditions seen during the euro area sovereign debt crisis in 2012.

The ECB will be careful to avoid a 'taper tantrum', an overreaction of global financial markets that occurred when the Fed in May 2013 talked for the first time about the possibility of tapering. Markets quickly raised their expectations of future US interest rates, which led to turbulences particularly in emerging markets. Yields on US government bonds also rose by about one percentage point. After the actual tapering decision in December 2013 financial markets remained surprisingly calm. If the US experience can be any guidance, it is that central banks have to prepare markets gradually for the actual tapering announcement. The ECB seems to succeed in this respect.

Bank profitability is a second weak spot of the euro area. Besides structural problems in the banking sector, the current low-interest-rate environment weighs on the interest margins of European banks. In 2016 the return on equity (ROE) remained broadly stable at around 5 percent but is still significantly below cost of capital of about 9 to 10 percent. In contrast, US banks recovered quite quickly from the crisis and generated ROEs between 9 and 10 percent since early 2013. Thus, the health of the banking sector is another important difference between the situation in the US in 2013 and in the euro area today.

The risk configuration in the euro area differs from the one the Fed faced about four years ago. The Fed's 'taper tantrum' was problematic for emerging markets, but no serious risk for sovereign bond yields in the US. In the euro area the ECB has to balance a potential intra-euro area flight to safety with the financial stability risks of continuing weak bank profitability.

4 Outlook

The comparison shows that while the single mandate provides the ECB with a good reason to trigger tapering later than the Fed would have done, it also operates in a more delicate environment. The economic recovery masks that the ECB faces a trade-off between the risk of an abrupt sovereign bond repricing and pressure on bank profitability. While the ECB cannot ignore such risks, it has to work itself out of this situation as soon as possible; otherwise it may be captured by these contradicting dependencies. If the ECB announces tapering in the third quarter of 2017, as markets expect today, implications on bond yields should be moderate and member states would be able to adjust structural policies if necessary.

Herausgeber: Prof. Dr. Henrik Enderlein. Die Publikation gibt ausschließlich die persönliche Auffassung der Autoren wieder. Alle Rechte vorbehalten.

Nachdruck und sonstige Verbreitung – auch auszugsweise – nur mit Quellenangabe zulässig.

Originalfassung © Jacques Delors Institut – Berlin, 2017.

NOTRE EUROPE
JACQUES DELORS INSTITUTE

Hertie School of Governance