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The End of the Eurozone's QE Era?

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As the traditional summer lull in market activity draws to a close, investor attention turns to key monetary policy meetings across the globe, kicking off with the European Central Bank meeting on September 7, which some commentators believe could see the announcement of a change in monetary policy approach. Here, David Zahn explains why he thinks the beginning of the end for European quantitative easing may be nigh, but why the ECB is likely to remain in accommodative mood for some time to come.

We know the European Central Bank (ECB) likes to flag changes to its monetary policy approach well before they're implemented. That's why we expect an imminent announcement from ECB President Mario Draghi that the bank will start winding down its quantitative easing (QE) programme next year.

That announcement could come as soon as September 7 when the ECB's governing council next meets, although we don't expect the actual tapering of the programme to begin until 2018.

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While any announcement is likely to cause a dramatic response from the financial markets—all the more so because few markets seem to be pricing in the possibility of a change in tack at the moment—we don't foresee a quick end to the ECB's asset-buying programme.

In our view, the prospect of interest-rate hikes across the eurozone is even further off. Draghi's term as ECB president is due to run until the end of 2019, and we'd be surprised to see a rate hike before then.

Strengthening Euro Pressures Inflation

The ECB probably finds itself in bit of a conundrum, which we think adds to the likelihood of a steady approach to unwinding QE. The euro has strengthened since the beginning of the year, which has put pressure on the ECB's core inflation metrics. However, it is only slightly higher than it was at the same time in 2016.

If the bank were to tighten its monetary policy too quickly it could push the currency up even faster, in turn increasing the downward pressure on inflation. In those circumstances, the bank would face calls to increase its easing bias.

The ECB is an inflation-targeting central bank. Its 2019 inflation forecast is currently at 1.5%,[1] which was actually revised downward from its prior forecast in the last governing council meeting. So, it's not getting close to its target of just under 2%. Growth continues to improve, as does the political environment. We think the ECB governing council members could look at those factors and conclude it doesn't need to be ultra-accommodative, but does need to have an accommodative stance.

Increasing Similarities in US/Eurozone Economies

In our view, the ECB needs to consider its approach to QE, not least because of the increasing similarities between the trajectories of the eurozone and US economies.

The two economies, for example, are a similar size and their growth rates are strikingly similar. Inflation is also not that different. It's slightly lower in Europe, but not dramatically. And, employment data isn't too far removed either. Although European unemployment hasn't hit the rock-bottom levels of the United States, it is at a nine-year low.

Against that background, one might justifiably ask whether it makes sense to have one economy (the United States) in a tightening monetary policy cycle, while the other (eurozone) presses on with its more accommodative easing programme.

To be clear, we're not suggesting the ECB should start tightening, but we do think it needs to start winding down the amount of QE it has been undertaking.

Asset Buying Constraints

That coincides with the expectation that the ECB will run into constraints on the amount of bonds it can buy next year, due to limits on bond issue ownership. (Currently it cannot own more than one third of a bond issue).

We think it's important to acknowledge that QE has been very successful in the eurozone. It's brought interest rates down to levels that are very accommodative.

The ECB has been able to iron out the discrepancy between bank lending rates in northern and southern Europe. Before QE started, rates were much higher in southern Europe, meaning it was much more expensive to borrow money there.

And, we have started to see some positive loan growth, which we hadn't had in Europe for a long time. Having positive loan growth demonstrates that getting rates down actually creates effective lending and growth.

The ECB will hope that growth will feed through to inflation. In the short-term, however, we think low inflation trends in the eurozone mean the ECB is likely to remain accommodative for quite some time.

What Are the Risks?

All investments involve risks, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in an investment portfolio adjust to a rise in interest rates, the value of the portfolio may decline. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments.

1. The ECB defines inflation as the year-on-year percentage change of the Harmonised Index of Consumer Prices published by Eurostat.