

The ECB Should Tell Us What It's Thinking

Greater clarity over how the bank would gauge the success of its bond-purchase program would reduce market volatility.

By
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After years of falling yields and rising prices, bond markets finally crashed in late April. Valuations have since stabilized, but the “flash crash” shows how deeply insecure today’s overvalued markets have become. The fall in German Bund yields to zero and below, for instance, was not based on economic fundamentals. After all, the German economy is growing and prices are rising. Rather, ultralow yields were the result of the European Central Bank’s announcement of its €1.1 trillion bond-buying program—and the ensuing speculation that quantitative easing (QE) would force down yields even further.

The sudden spike in yields shows the perils that loom in publicly plumped-up markets that have no guidance to cling to: Any sign of normalization in inflation data, credit markets and economic growth can prompt investors to take profits. Those who are betting on ever-rising bond prices might then be forced to sell into a falling market.

The ECB could support stability if it provided more forward guidance. In particular, it should define clearer rules for its QE program. A rules-based policy can provide direction and guidance to the markets, as the U.S. Federal Reserve’s tapering process has illustrated. While the ECB has left itself the flexibility to exit QE early—or extend it—as needed, ECB President Mario Draghi has so far been cagey about the criteria the central bank would use for such a decision. He should not hesitate to clarify them.

When Mr. Draghi announced QE in January, he explicitly said it was meant to avert the risk of sustained deflation. He explained that he intended to continue buying bonds until September 2016, or until such time as inflation moved back towards the ECB’s reference value of less than, but close to, 2%. The ECB later clarified that only trends in inflation, not temporary blips, would be taken into account.

But this is still pretty vague. The ECB should have a discernible rule on which to base its bond purchases. Such a rule could, for example, include several of the inflation indicators that the ECB deems relevant for its policy decisions: actual annual consumer-price inflation, the three-month moving average (to pick up trends), and five-year inflation expectations (since these play a major role in ECB decisions).

Using these three data series with equal weights, we have constructed a simple composite inflation indicator. The ECB could use – and communicate – such an indicator to guide its future decisions on asset purchases.

Looking back, the composite inflation indicator fell steadily to -0.3% at the beginning of this year from 1.8% in early 2013. But since then, it has been ticking up again, and by March it was back in positive territory.

By midyear, based on mainstream assumptions, it should reach 1%. This would signal that the risk of deflation is no longer acute, and bond purchases could be reduced by, say, 25%. Based on the same assumption, the indicator should exceed 1% by a comfortable margin at the end of 2015, and the ECB might want to reduce purchases by another 25%. By mid-2016, it might hit 1.5%, sufficiently close to the reference value for the ECB to stop blowing up its balance sheet.

An exit rule of this type would allow the ECB to wind down its asset purchases in the case of a continued recovery, without having to surprise the markets. It would also impose some discipline on ECB policy making by making it more difficult for the ECB to extend the QE for reasons unrelated to inflation.

Some observers will insist that such a rule is too rigid. The eurozone recovery remains fragile and unemployment is far too high, they will say. In addition, continued uncertainty over Greece's euro membership would descend into panic without the cushion of QE.

It is questionable whether the ECB's mandate extends to mollifying fears about a Greek exit from the euro. But even if it did, there would be other, better-targeted instruments to protect countries vulnerable to contagion, notably the Outright Monetary Transactions program, designed to help stabilize the euro by acquiring the sovereign bonds of distressed members in the secondary market.

It is even more questionable whether central bank bond buying is a good way of fighting unemployment. All the ECB does here is buy time, time that some eurozone governments have used for too long to avoid restoring fiscal sustainability and strengthening their economies so that they start creating jobs again.

Whereas the effectiveness of QE for managing the economy is debatable, the risks in terms of asset bubbles, volatility and currency overshooting are real. The ECB might want to tie its own hands, for all to see.

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