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EURO AREA

QE-exit should be rule-based

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The economic recovery in the eurozone is firming up, with economic growth likely to come in at 1.5% this year. Assuming stable oil prices and an ongoing low external value of the euro, inflation is likely to pick up appreciably as the year progresses. In this scenario a debate is likely to flare up soon on the need for unconventional monetary policy and full implementation of the central bank bond-purchasing program which is fueling major distortions on the financial markets.

We believe that a rule needs to be communicated early on to serve as a basis for the further implementation of the bond-purchasing program and, where appropriate, also a reduction in the monthly purchase volumes. This rule should be linked to inflation development, since this is, after all, what the ECB wants its program to influence. As soon as inflation starts moving in the desired direction again, consideration should be given to scaling back the bond purchases in specific steps communicated in advance. Given financial market expectations of a very protracted phase of extremely loose monetary policy, such a rule could provide more security in terms of what to expect. The clearer the rule, the less likely any negative surprises, with knock-on effects on the markets, would be.

What form could such a rule take which prompts a reduction in central bank bond purchases? We believe that it would make sense to attach weightings to several inflation indicators that the ECB deems to be relevant and use this as a basis for bond purchases.

As an example, we have calculated an inflation indicator comprising three equally weighted components: the rate of change in the harmonized consumer price index year-on-year in %, the annualized rate of change in a three-month average based on the seasonally adjusted consumer price index compared with the previous three-month average in %, and long-term market-based inflation expectations based on the five-year, five-year forward inflation swap rate. The indicator selected for inflation expectations plays a key role in the ECB's analyses. We have included changes in the three-month rate together with the annual rate of inflation in order to capture changes in inflation trends more quickly.

The readings of our inflation indicator have fallen steadily from around 1.8 in early 2013 to -0.3% in January of this year. Since January the figure has been ticking up again, and in March was back in positive territory at 0.1. Based on our inflation forecasts, we have extrapolated the indicator up to the end of 2016, assuming fairly stable oil prices on a slight upward trajectory, a relatively low value of the euro and an economy that continues to stabilize.

Under these assumptions, the indicator already starts to head upwards in the course of the first half of 2015, reaching around 1 by mid-year and thus no longer flagging the risk of deflation. In this event, bond purchases could be reduced by, say, 25% as early as in the summer of this year. If the inflation figure were to rise significantly above 1 towards the end of the year, a further 25% reduction in the original volume would make sense. Readings of at least 1.5, which come close to the ECB's reference value, would call for a full exit from the expansionary bond-purchasing program in order not to have to chase a runaway inflation trend. Such a rule, focused clearly on inflation developments, should not trigger any turbulence on the financial markets. The proposed tapering rule is different to that used by the US Federal Reserve. This is appropriate given that in Europe the policy is aimed not at repairing bank balance sheets, as was the case in the US, but rather clearly aims to ward off deflationary risks. Given success on this front, the bond-purchasing program, with its substantial adverse repercussions on savers and financial market stability, should be scaled back.

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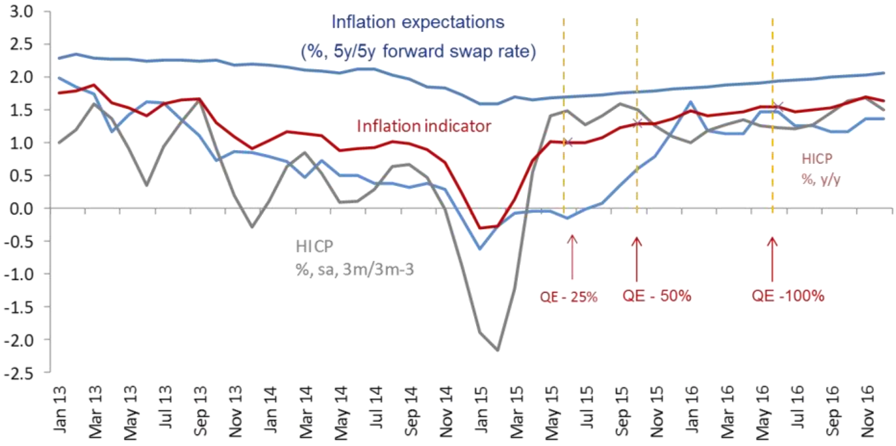

Sources: Ecowin, own calculations.

- EZ economy likely to surprise on the upside → quicker correction of subdued inflation trend
- Proposal: Rule-based QE-tapering tied to an **inflation indicator** to minimize risks of a pro-cyclical monetary policy
- Rules for a gradual QE-exit
  - Value ≥ 1.0* → QE – 25%
  - Value ≥ 1.2* → QE – 50%
  - Value ≥ 1.5* → QE – 100%
- Result: Complete exit from QE already by mid-2016

	Inflation expectations 5J/5J forward swap rate	HICP %, y/y	HICP %, sa, 3m/3m-3	Inflation indicator
Jan-14	2.18	0.78	0.10	1.02
Feb-14	2.14	0.71	0.64	1.17
Mar-14	2.10	0.47	0.84	1.14
Apr-14	2.09	0.72	0.53	1.11
May-14	2.06	0.49	0.09	0.88
Jun-14	2.11	0.50	0.11	0.90
Jul-14	2.11	0.38	0.28	0.92
Aug-14	2.02	0.37	0.64	1.01
Sep-14	1.97	0.31	0.67	0.98
Oct-14	1.84	0.38	0.46	0.89
Nov-14	1.83	0.28	-0.01	0.70
Dec-14	1.73	-0.16	-0.88	0.23
Jan-15	1.59	-0.62	-1.90	-0.31
Feb-15	1.59	-0.28	-2.16	-0.28
Mar-15	1.70	-0.08	-1.23	0.13
Apr-15	*1.65*	*-0.04*	*0.54*	0.72
May-15	*1.67*	*-0.05*	*1.40*	1.01
Jun-15	*1.69*	*-0.16*	*1.48*	1.00
Jul-15	*1.71*	*-0.01*	*1.27*	0.99
Aug-15	*1.73*	*0.08*	*1.41*	1.07
Sep-15	*1.75*	*0.34*	*1.58*	1.23
Oct-15	*1.77*	*0.60*	*1.49*	1.29
Nov-15	*1.79*	*0.78*	*1.26*	1.28
Dec-15	*1.81*	*1.18*	*1.09*	1.36
Jan-16	*1.83*	*1.62*	*0.99*	1.48
Feb-16	*1.85*	*1.18*	*1.18*	1.40
Mar-16	*1.87*	*1.14*	*1.27*	1.43
Apr-16	*1.89*	*1.14*	*1.34*	1.46
May-16	*1.91*	*1.46*	*1.25*	1.54
Jun-16	*1.93*	*1.46*	*1.22*	1.54
Jul-16	*1.95*	*1.26*	*1.21*	1.47
Aug-16	*1.97*	*1.26*	*1.27*	1.50
Sep-16	*1.99*	*1.16*	*1.45*	1.53
Oct-16	*2.01*	*1.16*	*1.63*	1.60
Nov-16	*2.03*	*1.36*	*1.67*	1.69
Dec-16	*2.05*	*1.36*	*1.49*	1.63

* for two consecutive months

Sources: Ecowin, own projections.

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