Peter Praet: The APP impact on the economy and bond markets

Intervention by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the annual dinner of the ECB's Bond Market Contact Group, Frankfurt am Main, 30 June 2015.

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It is a pleasure for me to welcome you to the annual dinner of the Bond Market Contact Group (BMCG), also on behalf of my colleagues of the Executive Board.[1]

We regard the BMCG as a forum to improve our dialogue with the financial market community on bond market-related issues. Understanding bond markets is obviously key for us, and even more so as bond purchases have become a central part of our non-standard measures. The broad composition of the group has proved useful for understanding the implications of our actions and other market developments for all bond market participants. In remarks today I would like to briefly assess the current economic situation before addressing a few salient points about the ECB's expanded Asset Purchase Programme (APP).

So far the economic recovery in the euro area remains on track and, importantly, we are seeing evidence that it is starting to broaden. Real GDP rose by 0.4% q-o-q in the first quarter of 2015, with domestic demand continuing to be the main driver behind output growth. While growth has been mainly supported by private consumption in recent quarters, there are encouraging signs that private investment is picking up as well. The latest survey results, though showing some signs of stabilisation, remain consistent with continued growth in the second quarter at around the same rate as in the first quarter.

A number of factors are underpinning the recovery in activity. First, the earlier fall in oil prices is contributing to higher real disposable incomes and corporate profitability. Second, the accommodative monetary policy stance, including the expanded APP, has led to improvements in financial conditions and credit supply conditions. Third, euro area activity is expected to be increasingly supported by the past depreciation of the euro and the gradual strengthening of external demand. These three factors mean that, while remaining on the downside, the risks surrounding the economic outlook have become more balanced.

It is nonetheless clear that monetary policy and external factors cannot alone be the basis for a lasting recovery. I see two risks in particular to a stronger, structural recovery. The first is that pessimism among firms about future growth prospects continues to weigh on investment. 5 years ahead growth expectations among forecasters have been falling continuously since 2001, from around 2.7% then to 1.4% today, which may have sapped "animal spirits". The second is the persistence of a debt overhang in parts of the euro area which acts as a major drag on firm and household spending. In both cases structural reforms come to the fore, as lifting expectations of trend growth is key to reduce uncertainty about the outlook and deleverage private sector balance sheets.

This context of a firming recovery underpins our expectation for inflation to steadily return towards our objective. Since the trough in January, headline inflation for the euro area has followed a generally upward trajectory as the negative contributions from energy prices have declined. Though Eurostat's flash estimate for euro area HICP in June came in at 0.2% – 0.1 percentage points lower than for May – this slight decrease largely reflects calendar effects and does not affect our baseline forecast. We still expect inflation to remain low in the months ahead before accelerating later this year, in part on account of base effects associated with the fall in oil prices in late 2014. Thereafter, inflation is expected to gradually converge towards levels closer to but still below 2%.

[1] I would like to thank Beatriz Sotomayor Aparicio for her contributions to this speech.

That outlook is of course contingent on the full implementation of our APP. As of 26 June 2015 the ECB had purchased EUR 297.1 bn under the entire APP, including EUR 193.9 bn under the Public Sector Purchase Programme (PSPP), EUR 94.6 bn under the Covered Bond Purchase Programme (CBPP3) and EUR 8.6 bn under the Asset-Backed Securities Purchase Programme (ABSPP). Accordingly, the ECB's balance sheet has expanded by EUR 527 bn to EUR 2,539.5 bn since end-September 2014, mainly due to the asset purchases and the four TLTROs.

For the PSPP we have been able to achieve all operational targets (i.e. announced quantities and parameters of the asset allocation) and purchases have by and large not been disruptive to market functioning. Since mid-April, however, volatility has risen markedly, reversing the initial downward impact of the PSPP on sovereign bond yields. GDP-weighted euro area sovereign yields are now roughly half a percentage point higher than the level reached on the day of the PSPP announcement. But we need to be patient in assessing the significance of these developments. Such a reversal of the downward trend in sovereign yields following a QE announcement is common to other jurisdictions which undertook similar policies in the past.

Our purchases of private assets have also proceeded relatively well. The CBPP3 has had a strong downward impact on covered bonds spreads, which reached the tightest levels in the last five years at the start of June this year. And though from mid-April yields have increased in line with other fixed income assets, they have done so to a lesser extent. As a result, the attractiveness of covered bonds has declined compared to government bonds, contributing to an increase in the amount of offers available for CBPP3 purchases. This has helped the smooth implementation of the programme thus far.

In terms of ABS, while the announcement and start of ABSPP led to a general compression of spreads across all euro area countries, since mid-April the spreads of more stressed jurisdictions have widened and moved above the levels prevailing at the start of the programme. Even so, we understand that the ABSPP is seen as providing the asset class with a credibility boost, which should in turn contribute to revitalising simple and transparent securitisation and reducing its stigma among investors – a key objective of the programme. We have also recently had some encouraging re-openings of public issuance across a broader set of euro area countries, which could invite other issuers to follow up.

What ultimately matters from a monetary policy perspective, however, is not how well we achieve our operational targets but how much our interventions are reflected in a reduced cost of borrowing for firms and households. Here we see a positive impact from the APP on both the bank and market finance. The cost of market-based debt has followed a downward trend since end-2011 and stabilised at historically low levels in February-April 2015, before rising again somewhat in May (+16 bp) and June (+20 bp). Market-based financing flows have nevertheless continued to increase in recent months, implying that the lower cost of market-based finance has had an important "first order" monetary policy effect.

On the bank side, the APP seems to have been effective in further reducing wholesale funding costs, as portfolio rebalance effects have led to a compression of, for example, bank bond yields. Consequently, while the cost of borrowing from banks for households and firms has been declining since mid-2014, the pace of the decline has increased in recent months. In April, the composite bank lending rates for households for house purchase and for non-financial corporations stood at 2.25 and 2.30%, respectively 61 and 49 bps below the values observed in June 2014. These developments reflect both the effect of the APP and of the previous measures taken in the summer of last year.

While it may be too early to see a clear upward effect in terms of quantities, there are several signs that the APP is also contributing to an easing of credit constraints in the euro area. For instance, according to the Bank Lending Survey (BLS) banks have indicated that they intend to react to APP purchases primarily by granting loans. In addition, banks in the survey expect capital gains and a slight improvement in their capital ratios from the APP which could support an expansion of lending, notwithstanding their expectations of a negative impact of the programme on net interest margins and overall profitability (due to sharp flattening of the term structure in a QE environment).

It must be noted, however, that banks' expectations that the APP will negatively impact profitability do not seem to be aligned with either market evaluations or our own internal appraisals. Market studies suggest that, on average, monetary policy news that is expected to lead to a flattening of the yield curve causes an increase, rather than a decline, in banks' share prices. This is confirmed by estimates of the impact of the APP on banks' profit and loss accounts and their solvency situation performed by ECB staff. The overall effect on bank capital is found to be positive, as capital gains on securities held, lower funding costs, improved credit quality and higher intermediation volumes outweigh the negative impact of the flattening of the term structure on net interest income.

In sum, it is fair to conclude that, thus far, the APP has been producing its intended aim of easing of monetary and financial conditions, including in the context of heightened volatility since mid-April. The very short end of the curve – because of expanding surpluses of liquidity – has remained well-anchored around levels that are broadly in line with our forward guidance over those horizons. We note however that the expected policy rate path implied by markets has shifted up and steepened noticeably in a context of market re-pricing. Still, at present we judge that the recent strong fluctuations in financial markets have not materially altered money and credit dynamics, but close monitoring and continuous assessment are warranted from a monetary policy perspective.

Moreover, to ensure sufficient predictability for markets and citizens about our future policy, we have provided communication on our reaction function. We have underlined that the APP is intended to run until the end of September 2016 and, in any case, until we see a sustained adjustment in the path of inflation. Our monetary policy stimulus will stay in place as long as needed to deliver our mandate on a truly sustained basis.

In addition, we have broadened and refined our arsenal of instruments during the crisis years, and we have tested many of these instruments. Building on our past record, the public knows that the ECB is determined to respond to disruptions in the monetary transmission mechanism that would affect our price stability objective. Such disruptions could include an undesirable tightening of financing conditions or a renewed surge in macroeconomic uncertainty, with downside risks to inflation. In that case, we would make full use of the flexibility afforded by the measures already in place and activate other policy instruments if necessary.

We are not only willing to act, but capable of doing so. The recent ruling by the European Court of Justice, while finding that OMTs fall within the scope of the ECB's mandate of maintaining price stability, also stated clearly that the ECB must be allowed "broad discretion" when preparing and implementing its monetary policy.

In short, we have the tools available, if needed, to ensure the appropriate monetary policy stance for the whole euro area, and to react to specific impairments in the transmission mechanism – if, as was the case in the past, such impairments were judged to undermine the recovery and slow the process by which we anticipate inflation to return to levels closer to 2%.

Stability cannot however be provided by monetary policy alone. All policymakers have to play their role in improving the functioning of monetary union, both by meeting their responsibilities domestically and by fundamentally strengthening the euro area's common institutions.