

Joachim Wuermeling: Operational challenges in the implementation of monetary policy in the euro area

Keynote speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, at the Official Monetary and Financial Institutions Forum (OMFIF) Lunch discussion, London, 22 November 2017.

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1 Introduction

Ladies and gentlemen,

Let's be honest: monetary policy implementation is not exactly an appealing lunch topic.

As a kind of reward for your audacity to come along regardless, I will focus my remarks on the implementation of the Public Sector Purchase Programme (PSPP) as the main pillar of the Eurosystem's asset purchases.

As a general reminder, I would like to mention that the question of how to implement purchases of public sector securities is not the first question that monetary policymakers need to ask themselves. The first question to be asked is whether such purchases should be implemented at all. The Bundesbank has always been critical of government bond purchases in a monetary union because purchases of this kind blur the boundary between monetary policy and fiscal policy. In our opinion, government bond purchases should only be used as an emergency tool. That is also why the Bundesbank has called for a clear PSPP expiration date.

I will argue in my remarks that the operational challenge for the Eurosystem is to ensure a smooth implementation of the PSPP. Smooth implementation does not only mean achieving the intended monthly purchase volume; it also means minimising negative side-effects on market functioning. There have recently been some misconceptions in this regard. Finally, I will argue that a smooth implementation of the PSPP does not mean rewriting the rules whenever compliance would impose any kind of restrictions.

2 Ensuring a smooth implementation of the PSPP

2.1 *Achieving the intended monthly purchase volume*

So let's start with the first of two important elements of a smooth implementation of the PSPP: achieving the intended monthly purchase volume.

The PSPP purchase volume has been very substantial since the inception of the Eurosystem's asset purchase programme (APP). At present, overall Eurosystem holdings under the APP amount to about 2.2 trillion euro at amortised cost. PSPP holdings amount to 1.8 trillion euro. This means that the PSPP holds a share of about 80 per cent in the APP. When it comes to country allocation in the PSPP, at the end of October 2017 a book value of 437 billion euro had been purchased in German debt securities, 356 billion euro in French debt securities and 310 billion euro in Italian debt securities. The background is that the Eurosystem is guided by a capital key allocation in terms of PSPP book value amounts per country.

By allocating purchases to each country in accordance with the ECB capital key, the Eurosystem seeks to avoid the moral hazard that could arise as a result of purchasing a disproportionately large amount of bonds issued by highly indebted governments.

If it is not possible to purchase the envisaged amount of bonds in a given country, the relevant national central bank conducts so-called substitute purchases, consisting of bonds issued by

international organisations and multilateral development banks located in the euro area. This is to ensure a smooth implementation of the national central banks' share of purchases throughout the life of the APP.

To this end, the Governing Council of the ECB has also adjusted the parameters of the PSPP along the way. These adjustments include decisions to

- ♦ increase issue share limits from 25 per cent to 33 per cent (September 2015)
- ♦ include bonds issued by regional and local governments located in the euro area (December 2015)
- ♦ increase the issuer and issue share limit for EU supranational bonds from 33 per cent to 50 per cent (March 2016)
- ♦ broaden the maturity range by decreasing the minimum remaining maturity for eligible securities from two years to one year (December 2016)
- ♦ permit to the extent necessary purchases of securities with a yield to maturity below the ECB's deposit facility rate (December 2016)

In October, the APP was reviewed again by the ECB Governing Council in the regular cross-check of economic and monetary conditions in the euro area. As a result, the Governing Council decided to recalibrate the APP. From January 2018, net asset purchases under the APP will be reduced from a monthly pace of 60 billion euro to 30 billion euro. The ECB Governing Council pointed out that this recalibration is due to improvements in the economic and monetary environment in the euro area.

As far as alleged shortages are concerned, let me emphasise that, since the inception of the PSPP, the Bundesbank has never faced and does not face difficulties in purchasing the intended amounts of German government bonds on the secondary markets.

2.2 Minimising negative side-effects on market functioning

But there is more to a smooth implementation of the PSPP than just achieving the intended monthly purchase volume. The Eurosystem at the same time has to minimise negative side-effects on market functioning. There have been some misconceptions in this regard of late.

In August, for instance, a German newspaper reported that the Eurosystem had deviated from the capital key in the PSPP and had bought disproportionately large amounts of Italian government bonds. The Eurosystem was, according to this article, using the purchase programme as a tool to fight political risks. The newspaper referred to the Italian share of net purchases in July, which – when measured against the capital key – had indeed been slightly elevated.

Let me be very clear on this point: temporary, limited deviations are not a new phenomenon. In fact, as some countries have been relying on the substitute purchases I have just mentioned to achieve their intended volume, slight deviations do not come as a surprise. However, these deviations are not a discretionary policy choice to support individual countries but are purely mechanical. There are technical reasons for them.

With regard to the July purchases: In view of tighter liquidity conditions, the reinvestment of proceeds from French bonds maturing in July 2017 was spread over several months. This resulted in a temporary decline in the share of French bonds in net PSPP purchases and a mechanical over-allocation for other jurisdictions in July – among them, Italy.

The PSPP's design – and the APP's design in general – allows for flexibility in its implementation to limit the interference of bond purchases with the market's price formation mechanism and to preserve market liquidity. The pattern of monthly purchases has reflected this flexibility.

Let me give you two other examples. First, in view of expected lower market liquidity in the summer and towards the year-end, the Eurosystem frontloaded APP purchases, raising them above the target for a number of months, while reducing them below target in August and December. Second, in the day-to-day implementation of the programme, bond purchases are also responsive to signs of scarcity of individual bonds.

To be more transparent about key factors influencing the monthly gross purchase volume, the Eurosystem recently started to publish the expected monthly redemption amounts for the APP.

This decision reflects the increasing relevance of reinvestments, given the higher redemption amounts that will be seen in 2018. Principal redemptions on securities purchased under the PSPP are reinvested by the Eurosystem in a flexible and timely manner in the month they fall due, on a best effort basis, or in the subsequent two months. As in the case of July, the monthly net purchase volume per jurisdiction may therefore fluctuate owing to the timing of these reinvestments.

Again, the allocation of purchases across countries is clearly rules-based. Temporary deviations are due to various – in part, even overlapping – technical reasons. These deviations reflect the fact that we want to be as market-neutral as possible in our monthly purchases.

On a side note: Another instrument to support market liquidity is the Eurosystem's securities lending. Bonds purchased under the PSPP have been made available since 2 April 2015, while bonds purchased under the other programmes were added to the framework later.

2.3 No rewriting of the rules whenever compliance would impose any kind of restrictions

Ladies and gentlemen,

So far, I have explained to you what it means operationally to ensure a smooth implementation of the PSPP. Namely, to achieve the intended purchase volume and at the same time to minimise as far as possible negative side-effects on market functioning.

But it is equally important to consider what a smooth implementation of the PSPP does not mean. Namely, to rewrite the rules whenever compliance would impose any kind of restrictions. Apart from the detrimental impact this would have on our credibility and reputation, adherence to our monetary policy mandate is at stake.

For instance, there has been talk of the flexibility of the issue share and issuer limit, and of abandoning the capital key as a reference value for the allocation of the overall purchase volume to bonds issued by euro area member states.

The limits relating to issue shares and issuers are important to prevent an awkward situation from arising given that the Eurosystem has a crucial role in any sovereign debt restructuring that may be deemed necessary. The Eurosystem would have to make use of its blocking minority in order not to violate the prohibition of monetary financing.

As I mentioned earlier, by using the ECB capital key as a reference value, the Eurosystem intends to avoid the moral hazard that could arise as a result of purchasing a disproportionately large amount of bonds issued by highly indebted governments.

It is quite obvious that changes to these parameters – which the ECB Governing Council has set itself for good reason – would take monetary policymakers deep into the realm of fiscal policy.

Government bond purchases blur the line between monetary and fiscal policy, and they have made us the largest creditor of the euro area countries. This poses a threat to our independence. Furthermore, if the capital markets are to encourage fiscal policymakers to embrace fiscal

prudence, it is vital that market mechanisms generally continue to function properly.

I believe that changing the parameters – which is sometimes discussed rather carelessly, in my opinion – would have considerable negative repercussions for those mechanisms. A clear sense of scepticism is also apparent in the German Federal Constitutional Court's decision to refer the government bond purchase programme to the European Court of Justice.

3 Conclusion / Outlook

So let me recap my main points on the PSPP.

First, the Eurosystem has been successful in smoothly implementing the PSPP. Purchases will be recalibrated as a result of improvements in the economic and monetary environment in the euro area.

Second, temporary deviations from the capital key are not a discretionary policy choice to support individual countries. They have purely technical reasons and reflect the fact that we want to be as market-neutral as possible in our purchases.

Third, smooth implementation of the PSPP does not mean rewriting the rules whenever compliance with the rules would impose any kind of restrictions. Abandoning the capital key as reference value or increasing the limit for issue shares and issuers would take monetary policymakers deep into the realm of fiscal policy – in my view, too deep.

Ladies and gentlemen,

In the last 15 minutes the focus was on the PSPP. But let's not get too carried away with this instrument. I would warmly recommend that you take the trouble to broaden your view to the other decisions by the ECB Governing Council, including private sector purchases, reinvestments, forward guidance, targeted longer-term refinancing operations and, of course, key rates. On aggregate, the monetary policy stance of the Eurosystem will remain highly accommodative for a while yet.