PICTET
1805

Flash Note

Euro area: monetary policy

ECB QExit: mapping the scenarios

Pictet Wealth Management - Asset Allocation & Macro Research | 15 September 2017

The ECB is expected to announce the "bulk" of its decisions on QE at the 26 October meeting. We still forecast asset purchases to be scaled down to EUR40bn for between January and June 2018, with risks tilted towards a 'slower for longer' extension. We look at alternative scenarios including changes in the composition and parameters of QE that we think will be necessary given bond scarcity constraints.

We have long argued that the ECB can, should, and will increase QE flexibility within the current framework, i.e. maintaining existing rules for issuer limits and capital keys. Specifically, we expect the ECB to change the composition of asset purchases, including a higher share of corporate and supranational debt purchases, while tolerating larger deviations from capital keys as a fair price to pay for a credible QE extension.

If everything goes according to plan, the ECB looks set to terminate its QE programme by the end of next year. The upward adjustment we forecast in terms of euro area core inflation, however slow and bumpy, should justify a gradual unwinding of unconventional measures in accordance with the 'Patience, Persistence, Prudence' framework described by Mario Draghi.

But, as the ECB knows only too well, it is better to prepare for the unexpected. **Two known unknowns in particular could challenge the ECB's exit in 2018**: (1) a further sustained appreciation in the EUR; (2) a temporary drop in headline inflation to 1%, or below, in Q1 2018.

Mario Draghi said that he expected "the bulk of decision" on QE to be made at the 26 October meeting. We would expect a broad commitment to extend QE beyond 2017 at a reduced pace, but several options are possible and additional technical details could be postponed to the 14 December meeting. Our baseline scenario remains for asset purchases to be scaled down to EUR40bn for six months, before being wound down to zero in the course of H2 2018. The final decision will depend on the ECB's assessment of two conflicting signals: the pick-up in underlying price and wage dynamics, and the tightening of financial conditions driven by the exchange rate.

- If the EUR stabilises below 1.20, close to staff assumptions, we expect the baseline scenario to hold. We also envisage a change in QE composition including a higher share of corporate and supranational debt purchases (*scenario 6*). A sharper EUR depreciation towards 1.15 or below could lead to a faster tapering (*scenario 5*).
- If the EUR rises to 1.20-1.25, we would expect the ECB's path of least resistance to involve a 'slower for longer' reduction in asset purchases with a stronger emphasis on reinvestment flows and additional changes aimed at mitigating bond scarcity issues (*scenario 2*). An open-ended QE rescaling (*scenario 3*) or a 'total envelope' approach (*scenario 7*) look less likely, in our view.
- If the EUR appreciates sharply to, or above 1.25, translating into an "unwarranted tightening" of financial conditions and lower inflation projections, the ECB could be forced to extend QE at the current EUR60bn pace into 2018, postponing tapering (*scenario 4*). In order to address scarcity constraints in a credible way, we believe that changes in both QE composition and parameters would be necessary using the programme's flexibility in full (*scenario 8*).

AUTHOR

Frederik DUCROZET
fducrozet@pictet.com
+41 58 323 4582

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

- If push comes to shove and you believe in Draghi's statement that there will be "no technical limits" to the ECB's mandate, then a wild card might involve an extension of the eligible QE universe to a new asset class, e.g. senior bank debt. However, our impression is this scenario would require a massive shock to the economy.

Scenario #1 (baseline): rescaling in H1 2018, tapering in H2

Under our baseline scenario, the ECB will announce **a 6-month extension in asset purchases at a reduced EUR40bn monthly pace** (from EUR60bn currently), until June 2018, or beyond if necessary. All components of the Asset Purchase Programme (APP) would be scaled down proportionally (using indicative monthly averages): the Public Sector Purchase Programme (PSPP) down from EUR50.5bn to EUR34bn; the Corporate Sector Purchase Programme (CSPP) down from EUR6.5bn to EUR4bn; the Covered Bond Purchase Programme (CBPP3) and the Asset-Backed Securities Purchase Programme (ABSPP), down from EUR3bn to EUR2bn on a combined basis.

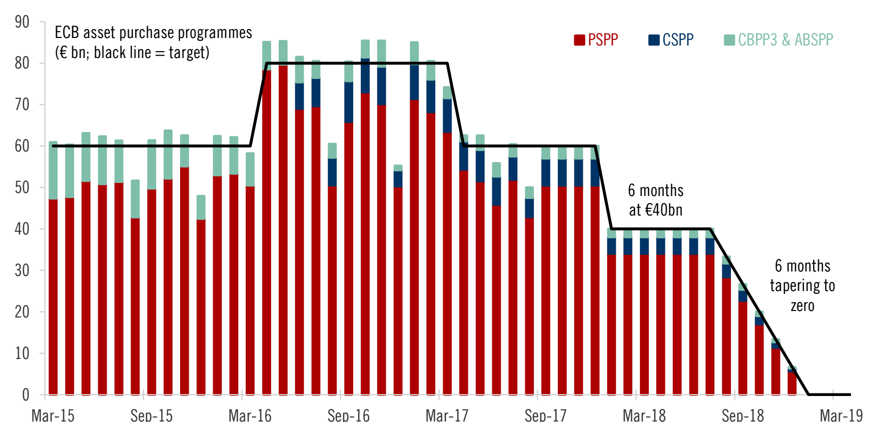
Then, by June 2018, the ECB would make moves towards a proper tapering of asset purchases, which would be **scaled down from EUR40bn per month to zero in the space of six months**, i.e. out to December 2018. The relative proportions of each sub-programme would be kept constant.

Throughout the QE rescaling and tapering process, the ECB would continue to exploit the programme's flexibility, adjusting to liquidity conditions and trying to be as 'market neutral' as possible. We have long argued that without a change to QE parameters, the ECB's flexibility will imply steady (if not larger) deviations from capital keys in Germany but also in the Netherlands, Finland, or Portugal (see appendix for details). Under this scenario, we estimate that **ECB QE could be wound down completely by December 2018. However, room for manoeuvre would remain narrow in the event of another extension**.

Pros: a well-flagged strategy allowing for flexible adjustments out to June 2018, possibly with a clearly stated option to increase QE again if needed.

Cons: no fix to scarcity in the event that a larger extension is needed; strategy would subsequently be vulnerable to EUR strength and/or inflation upsets given the lack of credibility of the option to increase QE.

Chart 1: ECB QE reduction path under the baseline scenario



Source: Pictet WM – AA&MR, ECB

Scenario #2: slower for longer

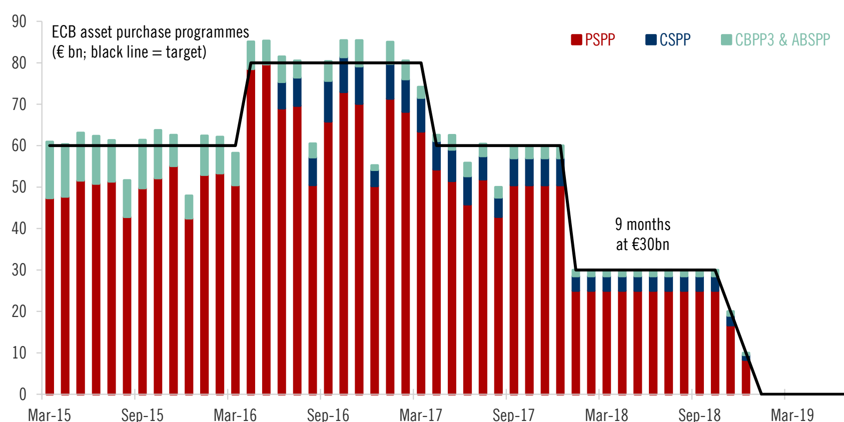
In this alternative scenario, the ECB would announce a longer QE extension at a slower-than-expected pace, in a similar vein as in December 2016. Typically, **asset purchases could be reduced to EUR30bn all the way to September 2018**, or beyond if necessary, before a final taper decision is made. A more extreme option would be to extend QE at a rate of EUR20bn until December 2018, which would be a more efficient way of dealing with scarcity constraints.

Again, all components of the APP would be scaled down proportionally. Assuming an aggregate monthly pace of EUR30bn, the PSPP would be reduced to EUR25bn, the CSPP to EUR3.5bn, and the CBPP3 and ABSPP to a combined EUR1.5bn. Under this scheme, scarcity constraints would be more largely mitigated. Bearing in mind German-related constraints, and assuming that substitute purchases and deviations would help deal with scarcity in regard to smaller countries, we estimate that **ECB QE can run at a EUR30bn pace until approximately Q1 2019**.

Pros: greater visibility for markets with the added advantage of reinforcing forward guidance; a more credible fix to scarcity constraints, potentially combined with technical changes to QE composition and parameters.

Cons: a larger reduction in monthly flows of purchases could endanger risk appetite, possibly with a knock-on effect on sovereign spreads.

Chart 2: ECB QE reduction path under the 'slower for longer' scenario



Source: Pictet WM – AA&MR, ECB

Scenario #3: open-ended rescaling

In this scenario, asset purchases would be scaled down and extended but without the ECB specifying a date when the programme would end. For instance, QE could be scaled down to EUR20bn in 2018, “for as long as necessary, until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim”. Based on our forecasts for GDP growth and core inflation, we believe that the ECB would be in a position to terminate QE by early 2019.

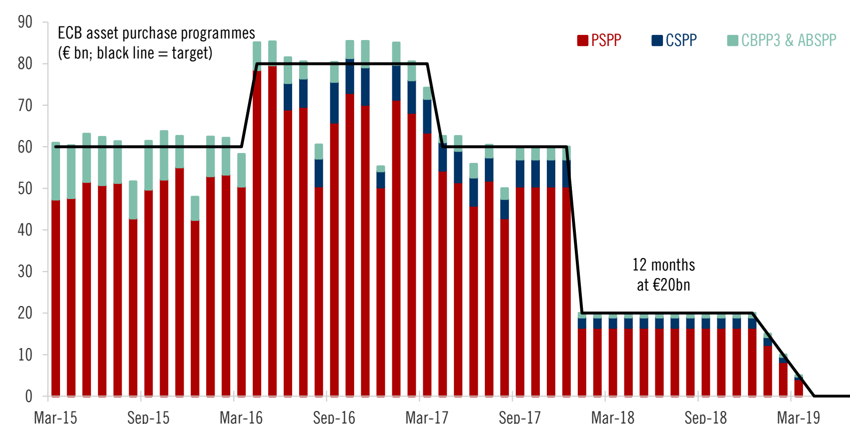
The market reaction should be positive on balance as forward guidance would be strengthened and scarcity constraints significantly reduced.

With asset purchases reduced to EUR20bn per month, and barring a change in composition, the PSPP would drop to EUR16.5bn, the CSPP to EUR2.5bn and the CBPP3 and CSPP combined to EUR1bn. Combined with existing flexibility in terms of substitute purchases, carcity constraints would be significantly reduced with **(German) QE potentially running until Q4 2019 at a EUR20bn pace.**

Pros: strong boost to forward guidance; highly credible fix to scarcity constraints, potentially combined with technical changes to QE composition and parameters.

Cons: sharper reduction in peripheral debt purchases could lead to wider spreads, although the open-ended nature of the QE extension could favour carry trades.

Chart 3: ECB QE reduction path under the ‘open-ended extension’ scenario



Source: Pictet WM – AA&MR, ECB

Scenario #4: extension at current EUR60bn pace

In the event of a sharp tightening in financial conditions, most likely driven by EUR appreciation above 1.25, the ECB might have no choice but to extend QE at the current pace of EUR60bn for some time. In that case, we believe that changes in both QE composition and parameters would be required to ensure smooth implementation of the programme.

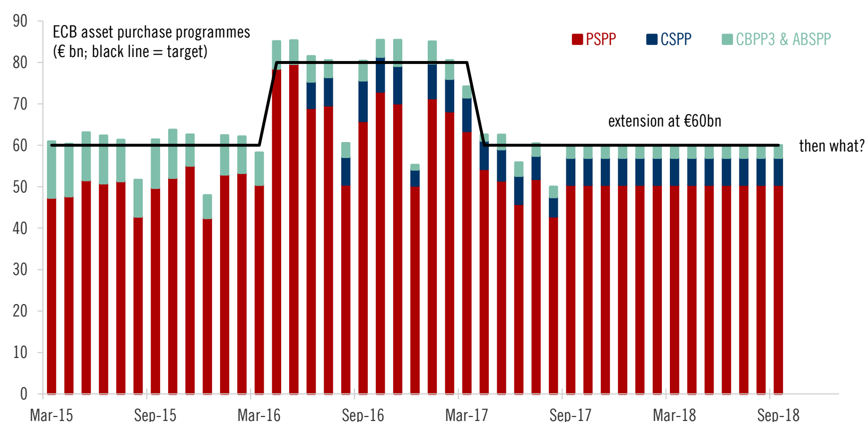
Without any change to QE rules, we estimate that the current programme could run until at a EUR60bn pace until the end of Q2 2018, at best. If QE composition is changed in order to reduce the relative share of PSPP (scenario 6), then the ECB could buy itself three more months' time until Q3 2018. Finally, **in the most favourable case using full flexibility of the programme, we estimate that QE could run at the current pace until Q4 2018**.

Ultimately, the ECB would face a difficult decision as any further QE extension would require a more radical change of rules.

Pros: market positive to some extent as the current flow of purchases supports peripheral debt markets in particular.

Cons: strategy would ultimately be challenged by scarcity constraints on QE unless/until rules are changed.

Chart 4: ECB QE reduction path under 'QE status quo extension' scenario



Source: Pictet WM – AA&MR, ECB

Scenario #5: fast and furious tapering

In the event of a sharper depreciation in the EUR and/or a stronger-than-expected rebound in core inflation, asset purchases would be wound down more rapidly than markets expect (although the devil would be in the details). **The ECB would most likely retain a degree of caution and flexibility**, for example by announcing a rescaling of QE to EUR40bn for three months with an objective to taper asset purchases depending on progress made on the inflation front during that time. Assuming inflation criteria are met by March 2018, the ECB could then scale down QE to EUR20bn for another three months, and then to zero by autumn.

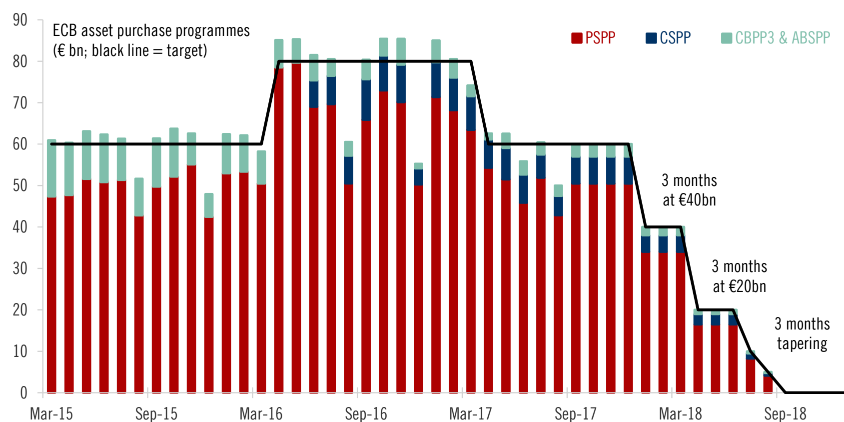
Alternatively, the most aggressive option would be for the ECB to pre-commit to a QE tapering path upfront, with an option to reassess its plans further down the road.

All components of the APP would likely be scaled down proportionally.

Pros: concerns over bond scarcity would all but disappear.

Cons: market reaction would likely be negative to very negative, leading to further currency appreciation, widening of spreads and losses on equity markets.

Chart 5: ECB QE reduction path under the 'fast and furious tapering' scenario



Source: Pictet WM – AA&MR, ECB

Scenario #6: change in QE composition

In this scenario, asset purchases would be scaled down but in differing proportions, depending on the asset class and the ECB's assessment of transmission channels. We think that **the bulk of the rescaling could be applied to sovereign debt purchases** (excluding supranational debt).

First, such an approach would help alleviate hawks' concerns that the ECB will end up having a "dominant" position in some public debt markets, potentially as a trade-off for a longer extension to the programme. Second, it would be consistent with the ECB's view that public-debt QE produces diminishing marginal returns and that the bank credit transmission channel is more suitable. Third, it would all but eliminate the scarcity constraints the ECB is facing, as the share of German PSPP purchases would be reduced dramatically under most scenarios.

This option would still have to overcome technical hurdles. Private debt markets are also affected by QE-induced distortions. Moreover, if supranational debt purchases are maintained at current levels, their share in the programme would have to be increased, from 10% of PSPP currently. This might also require an increase in issuer limits for supranational debt, upwards of the current 50%, with negative consequences in terms of market liquidity. However, **we think the ECB would view those adjustments as a fair price to pay for a credible QE extension**.

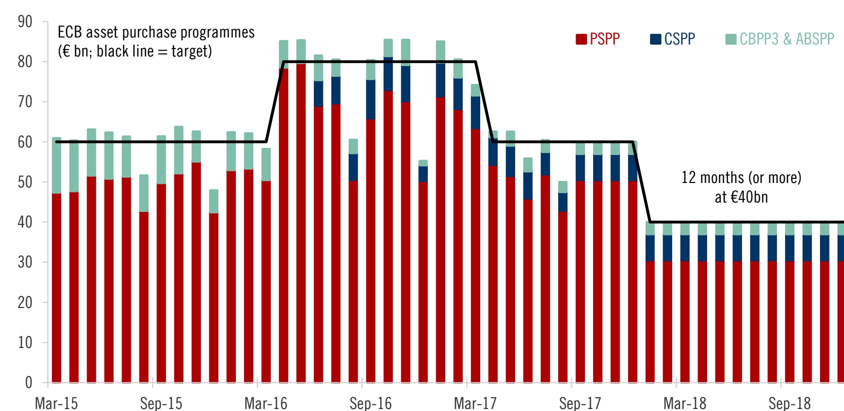
If QE is scaled down to EUR40bn at the full expense of sovereign debt purchases, the PSPP would drop to EUR30.5bn instead of EUR34bn in the baseline scenario, and the German PSPP would decline to EUR6.7bn per month instead of EUR8.1bn, with supranational debt purchases and all other programmes maintained at today's levels. **This would give the ECB up to three more months' worth of purchases, extending them out** to Q4 2018.

If QE is scaled down to EUR30bn, the PSPP would drop to EUR20.5bn (the German PSPP to EUR4.1bn) and **the programme could run until Q3 2019**.

Pros: effective way of mitigating scarcity constraints.

Cons: larger reduction in sovereign debt purchases, all else being equal.

Chart 6: ECB QE reduction path under 'change in composition' scenario at EUR40bn



Source: Pictet WM – AA&MR, ECB

Scenario #7: full flexibility (amount)

The ECB could change its approach to QE extension and commit to a global amount of additional purchases to be spread over time, until the Governing Council believes that inflation has moved higher on a self-sustained basis. With the ECB staff projections for inflation likely to improve at the next quarterly meeting (and the medium-term horizon is extended to 2020), the 'inflation gap' relative to ECB's target is likely to be smaller. We estimate that **the required amount of additional asset purchases would be EUR200-300bn**, depending on the ECB's assessment of QE marginal returns.

Pros: flexibility would help the ECB to adjust to liquidity conditions, also depending on the monthly amounts of reinvestments to be made.

Cons: lack of clarity over the monthly flows of purchases and the programme's end-date might weigh on market sentiment.

Scenario #8: full flexibility (modalities)

Our understanding from the September meeting is that an increase in the 33% issuer limit is ruled out for the foreseeable future. Moreover, the operating PSPP framework based on capital keys is very unlikely to be abandoned, even if the ECB decides to tweak the rules. Finally, the ECB could increase the universe of eligible assets, but every option has drawbacks (bank debt, ETF, loans).

What the ECB could do it to relax all the limits and parameters *within* this self-imposed framework, including the share of private debt and supranational debt purchases (as well as issuer limits, much less legally challenging than for sovereign debt) and the share of purchases implemented directly by the ECB. Some additional changes could apply to the reinvestment strategy. In other words, this option would be scenario 6 on steroids in the sense that the ECB would abandon all quantitative targets that are not dictated by political and legal constraints.

Pros: maximum flexibility for the ECB to adjust to market conditions and for a given amount of monthly purchases.

Cons: full flexibility at constant issuer limits for sovereign debt would still be interpreted by market as a larger PSPP rescaling than under other scenarios.

A last few words on capital keys and substitute purchases

For those interested in technical details related to APP implementation, we recommend the ECB's various explainers (see here and here). The legal acts are for legal experts and ECB geeks. On our side, we have written on those topics extensively, including "Bond scarcity under new ECB QE rules" following the ECB meeting in December 2016.

We would like to stress a couple of technical, albeit important points:

- **Capital keys**: this set of rules is the structure governing the proportion of bonds that the ECB aims to buy from each euro area country. We quantify deviations from adjusted capital keys using recalibrated values excluding Greece (e.g., 26.3% for Germany). For a given month, we subtract supranational debt purchases from total PSPP and calculate each country's theoretical share of public debt purchases (central government, agencies and municipal bonds). The difference between actual PSPP purchases and this theoretical value is the monthly deviation from the capital key, which can be expressed in absolute EUR terms, as a share of national PSPP purchases, or in percentage of total PSPP purchases.
- **Substitute purchases**: the reality is slightly more complicated than that given the option for national central banks to participate in substitute purchases (essentially supranational bonds) and given that the total share of supranational debt purchases cannot exceed 10% of the PSPP. Last but not least, the ECB purchases 10% of the PSPP itself, although it does not buy supranational debt securities.
- In effect, this set of rules limits the extent to which national central banks can deviate from capital keys, but **we estimate that the cumulated deviations can at least double in the future**, from around EUR2-2.5bn per month recently to EUR5bn without any change to QE parameters. As we argue in the scenarios 6-8, we believe that further tweaks are possible, including an increase in the share of supranational debt purchases and their respective issuer limits, as well as in the share of ECB purchases (also helping the ECB to improve coordination in the rescaling process). Those options are likely to be viewed as **a fair price to pay for a credible QE extension**.
- **All in all, steady, if not larger deviations from capital keys in the future will continue to be reflected in larger sovereign debt purchases in Italy and in France, all else being equal, which is likely to be tolerated provided that the ECB sends a clear signal that it is heading to the exit in 2018.**

Notice: This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.
The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.
Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.
Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.
Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance.
The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.
This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2017.
Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).
Distributors: Banque Pictet & Cie SA, Pictet & Cie (Europe) SA