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EXITING QE: A POSSIBLE WORKING STRATEGY AND ITS CONSEQUENCES*

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The fight against inflation by the European Central Bank (ECB) is escalating after the bad data in October on the growth of prices in the Euro area, which still shows few signs of slowing down. The ECB board seems intent on launching as soon as possible what can be considered the most impactful restrictive policy measure: the reduction of the part of the balance sheet assets (€ 4,900 billion) made up of government and corporate bonds purchased over the course of 7 years of Quantitative Easing (QE).

THE IMPACT EVALUATION IN TERMS OF PROFITS OF THE REFUND OF TLTRO SUBSIDIZED LOANS

The Quantitative Tightening (QT, the reversal of the balance sheet asset expansion process) was actually already started on 23 November by the early repayment of € 298 billion TLTRO subsidized loans by the banks (yellow area in Figure 1). In the last meeting of 27 October, the ECB in fact launched a change of the methods for determining interest on these borrowed sums, which significantly increases costs and encourages banks to repay them immediately.

Now for the first time since 2014 the balance sheet assets of the ECB will begin to fall, and the complete repayment of € 2,200 billion of loans is expected by June 2023, despite the first tranche of repayments being lower than expected (€ 500 billion) .It's plausible that the banks were not yet technically ready due to

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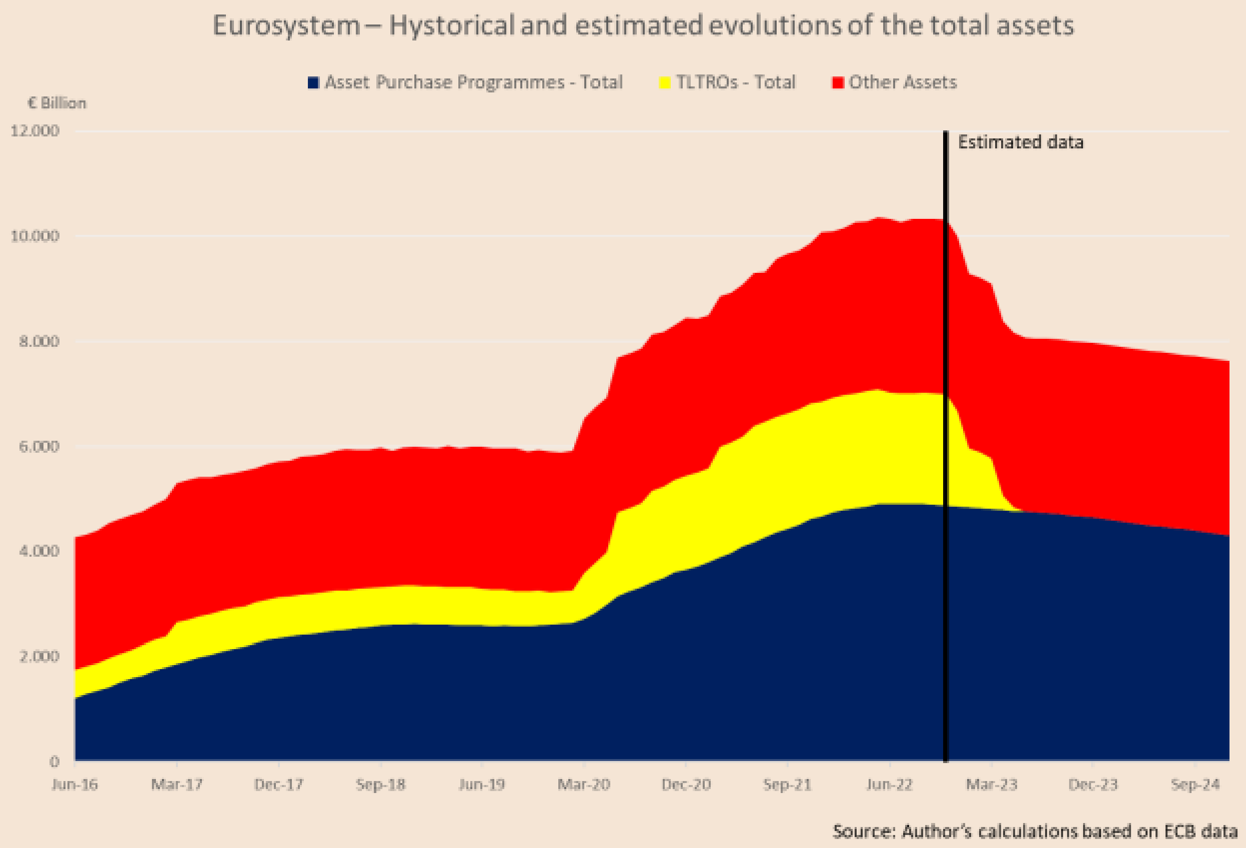
the limited time available between the announcement and the first repayment window. In December there is a further date available and analysts expect that the intermediate objective of reducing the stock of loans by € 1,000 billion by the end of the year will in any case be respected.

Figure 1



The early start of the repayments of the TLTROs had led analysts to believe that the need to start reducing the stock of government and private securities on the balance sheet was less pressing (the blue area in Figure 1). However, in the last few weeks something has evidently changed in the attitude of the members of the ECB board, who appear more aggressive in this regard.

The guidelines for managing the reduction process will be defined in mid-December and the hawks represented by the President of the Bundesbank (BuBa) Nagel foresee a launch of the measure as early as next January. More moderate exponents refer to the second quarter of 2023, but in any case it seems highly probable that the QT on government bonds will be operational within the first half of next year. A big difference compared to the estimates of June 2022, which envisaged the start not before the end of 2024.

What has changed? Rumors indicate that an agreement in principle has been reached between the hawks and doves of the board: a reduction in the rate of interest rate hikes (reasonably from 75 to 50 basis points) in exchange for an acceleration on the deployment of the QT.

THE POSSIBLE STRATEGIES AHEAD; PASSIVE BEHAVIOUR AND SMALL INITIAL MOVES

In any case, there is agreement of views among the various speakers who have alternated in recent days: the QT on securities will be very gradual, even slow in the start-up phase.

The historical experiences of reducing balance sheet assets are few and characterized by various types of problems: the Federal Reserve (FED) made an attempt between 2017 and 2019, using a passive type technique; in other words, it did not reinvest maturing government and securitized *mortgage backed securities*. An active strategy would have envisaged the sale on the secondary market of assets with a significant residual life.

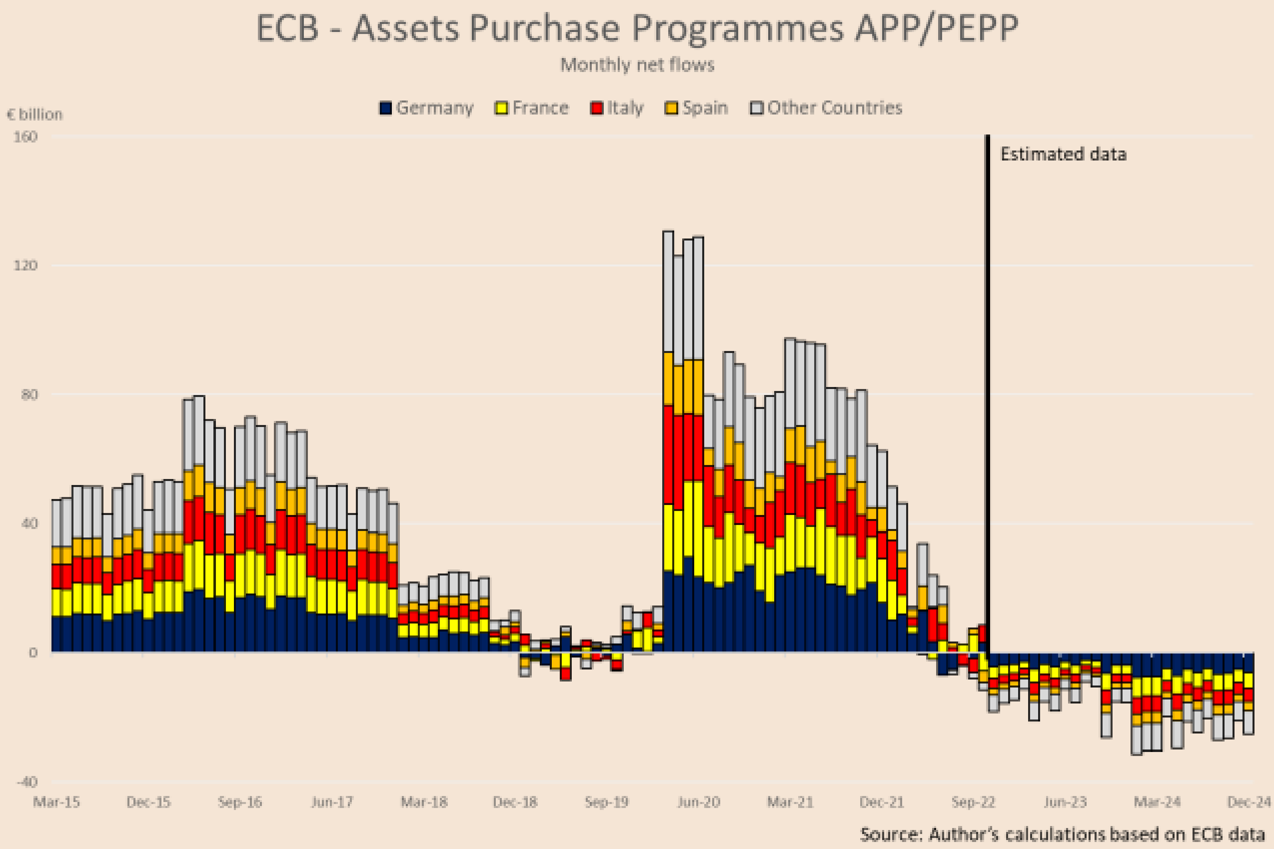
After about 2 years and a contraction in assets of about 15%, the Fed had to abruptly interrupt its operations due to growing problems of access to liquidity for small banks on the money market and was forced to launch a semi-permanent support facility. Simultaneously, the FED stopped raising interest rates, abruptly ending the cycle of restrictive policy.

The FED has been trying again since May 2022: the pace of liquidity reduction is significantly higher and the fear that problems on the money market could quickly reappear is high. Also in the United Kingdom, the QT strategy just presented by the Bank of England (BOE) was postponed due to a crisis of confidence in the secondary market for government bonds, dangerously extending to pension funds, which forced a restart - albeit temporary – of purchases of government bonds.

Therefore, even in the radical vision of the president of BuBa, the QT on bonds would be characterized by a passive type strategy, further limited by the reinvestment of a significant percentage of maturing securities. The pool of securities concerned would only be that pertaining to the older Asset Purchase Programs (APPs), launched by the ECB between 2015 and 2016, amounting to around €2,750 billion. The € 1.8 trillion mainly government bonds purchased between March 2020 and March 2022 under the Pandemic Emergency Purchase Program (PEPP) would instead be exempt until at least December 2024.

In order to understand what could be a reasonable path to reduce the balance sheet over the next 26 months and evaluate its possible impact on the markets, references to public statements of the ECB board have been taken into account. The start of a QT in January 2023 was therefore assumed, which would impact 50% of maturing securities, which are currently fully reinvested by the ECB. Only in 2024 is it assumed that the percentage of non-reinvested securities will rise to 100% (see Figure 2).

Figure 2



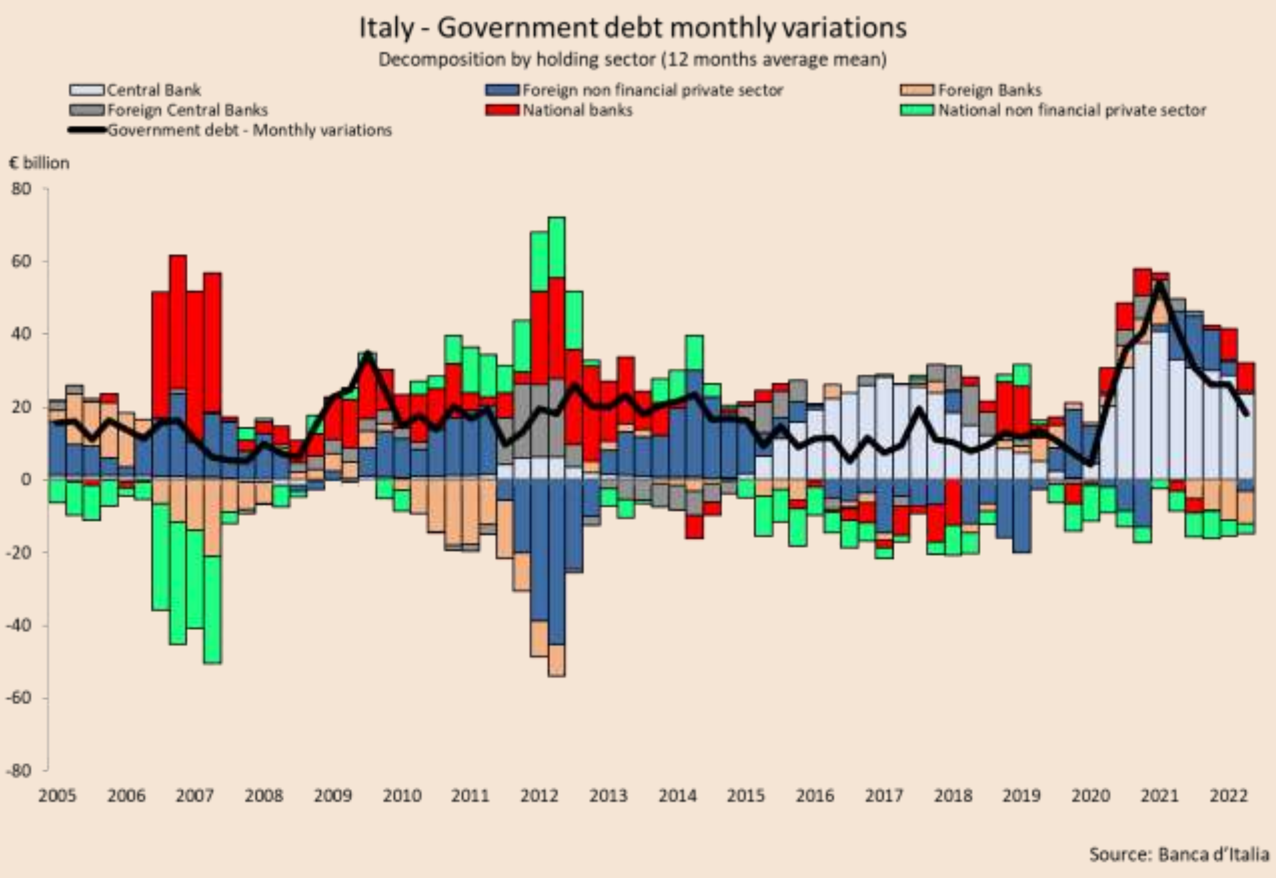
Using these parameters in the simulation, in 2023 the stock of bonds in the ECB portfolio would contract by approximately €180 billion, which would rise to €310 billion in 2024. BTPs maturing in 2023 correspond to €30 billion, €50 billion in 2024, in total about € 80 billion which would not be reinvested in equivalent securities. At first glance, the situation appears to have little impact: if we consider that the ECB holds €773 billion of Italian government bonds, the reduction should only concern 10% of the stock over the next two years.

If the principal buyer of government debt disappears, what happens?

However, unlike the equivalent programs performed by the FED and the BOE, the ECB's QE was more complex because it involved heterogeneous securities, in terms of creditworthiness, market depth and demand structure. Consider the evolution of the monthly variations of the Italian and Spanish public debt broken down by holder, to understand the structural characteristics of the demand for the so-called "peripheral securities" of the Euro area (see Figures 3 and 4).

De facto, in the decade of semi-permanent QE, the weight of the ECB on the secondary market of peripheral countries' securities became enormous, while banks and private investors took advantage of the central bank's purchase programs to reduce the stock of government securities. In a logic of economic convenience, it is more than normal that private sector investment flows have shifted from zero (if not negative) yielding assets towards mutual funds or shares. The point is that this phenomenon took place in a context where public debt in the post-financial crisis years was progressively concentrated in the hands of national investors.

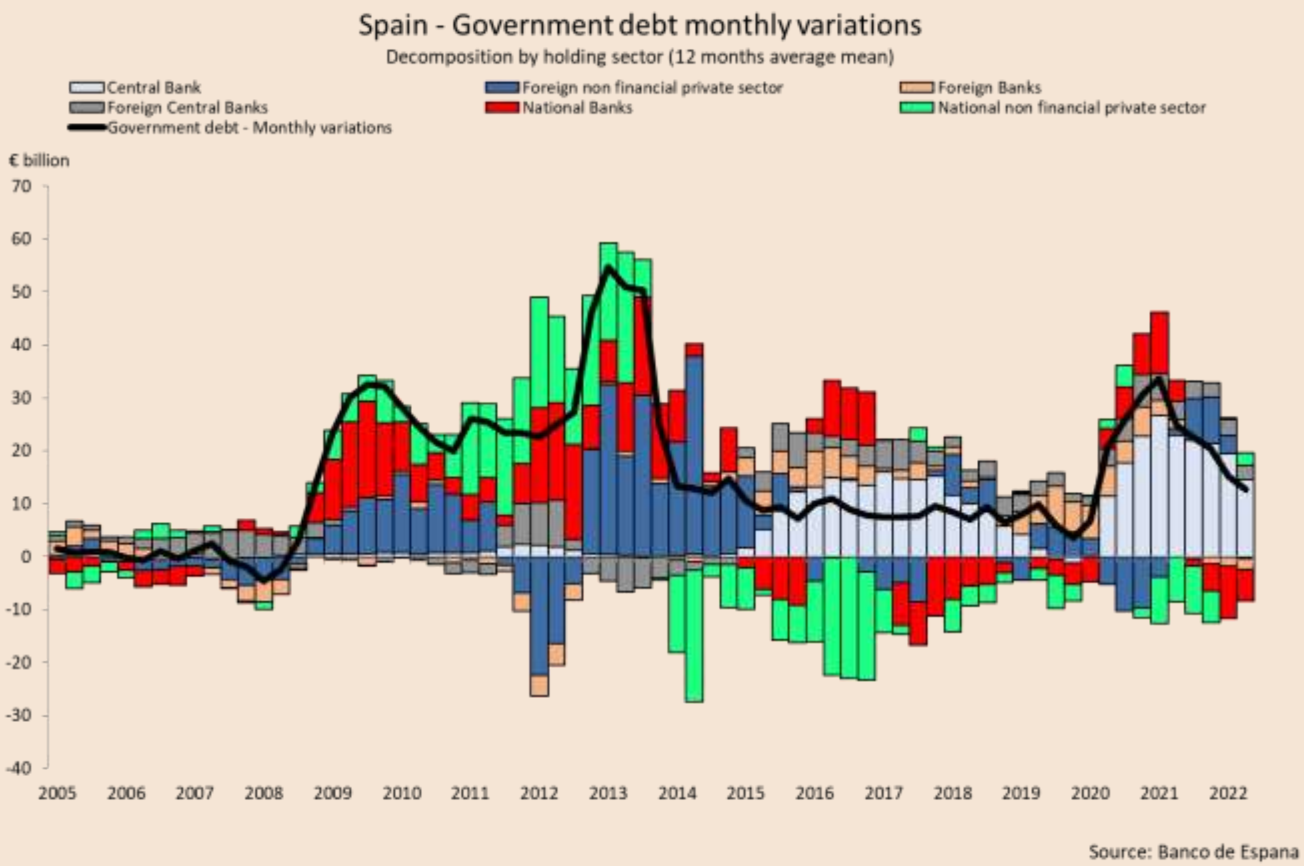
Figure 3



Since 2015, the launch of the QE shifts the focus of the demand for government bonds on the Bank of Italy (light gray bars). One can observe the first round of purchases between 2015 and 2018 in which virtually all other holding sectors deleverage sovereign risk (particularly the foreign non-financial private sector). After a short break in 2019, the cycle repeats itself with greater intensity in 2020-2021 by virtue of the launch of the PEPP and the resumption of QE. Since the mid-2021 peak the light gray bars have been contracting and in a few quarters they are guaranteed to move into negative territory. Who will replace this missing ECB demand?

Figure 4 repeats the analysis in the case of Spain. The interpretation of the data is similar with regard to the role played by the ECB.

Figure 4



To have a further measure of the impact of the ECB's demand, consider that in 2021 it represented 44% of the € 471 billion gross BTP issues by the Italian state. In net terms (net of repayments), demand for ECB debt exceeded supply by €51 billion. For 2022, the weight of demand with respect to gross issues is estimated to drop to 22%, while BTP issues net of further purchases by the Eurosystem should be positive again (+ €12 billion), although still almost entirely covered by the ECB demand on the secondary market. It is a change of pace that can already be considered remarkable.

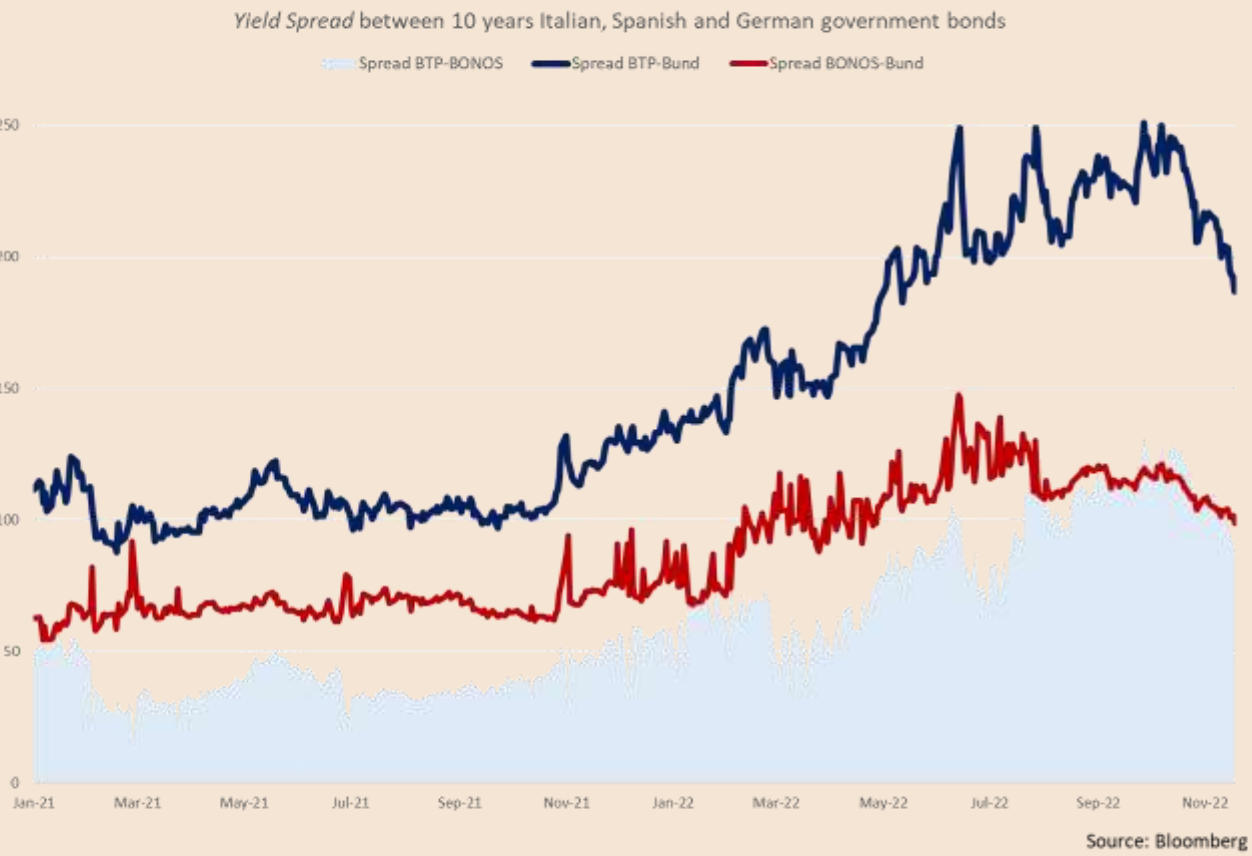
In 2023, net issues will rise to €73 billion (the gross ones are estimated - by various institutions - in a range between €380 and €460 billion), while in the hypothesis of starting the QT with 50% of reinvestments allowed, the ECB's request will stop at just € 30 billion.

If one argues that the private sector will displace demand from the ECB, one must naturally assume that interest payments will need to rise to stimulate demand. Already in 2022, interest expenditure will rise to €77 billion, 22% more than the €63 billion in 2021. Recent projections (but which do not take into account the additional impact of an early QT) indicate that debt service will absorb resources equal to 4.1% of GDP in 2025.

CONTROLLING THE SPREAD DURING QUANTITATIVE TIGHTENING: IS IT POSSIBLE?

After the tensions of the pre-election period, which coincided with the launch of the new anti-spread shield TPI (*Transmission Protection Instrument*), the spread between the yields of Italian and German/Spanish government bonds is tending to shrink, even if it remains on historically rather high values (see Figure 5).

Figure 5



Part of the spread-tightening result can be attributed to the effective functioning of what has been defined as the "first level" of defense against the fragmentation of government bond yields: the flexible reinvestment of maturing bonds under the pandemic programme.

In fact, between August and September, the proceeds from redemptions were almost entirely reinvested in securities of peripheral countries, while there was a net reduction in stocks attributable to core countries. To all intents and purposes therefore, an *ad hoc* QE continued for BTPs and Bonos while German Bunds experimented already a real QT, albeit for limited amounts.

Given that until 2024 the full reinvestment of the securities purchased through the PEPP seems confirmed, the deployment of the first line of defense would be guaranteed. From 2025, however, there would be a substantial erosion of the firepower that can be mobilized by this strategy and any periods of prolonged tension could only be managed through the TPI, which remains a measure conditioned on compliance with the rules on the budget that are being defined and on the whose usability many questions remain.

Ultimately, the ECB's next budgetary moves will have very significant consequences - in the short and long term - on public debts and on the stability of the European financial system. Prudence is a must, but it is still terra incognita.

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