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The ECB faces a major challenge in 2018

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Since the outbreak of the global financial crisis, and in response to the subsequent European debt crisis, the European Central Bank (ECB) has adopted various measures to stabilise the economy and to aim at achieving its ultimate goal: price stability. In particular, in mid-2014 the low growth and the sharp drop in inflation expectations in the euro zone pushed the ECB to take drastic measures. Because... what could possibly be done? With interest rates close to zero, standard monetary policy tools were very limited. Therefore, the institution decided to adopt three atypical (or indeed unconventional) measures. Firstly, it introduced negative interest rates. Secondly, it provided banks with long-term financing at very low interest rates. And thirdly, it decided to launch a programme to buy bonds from the sovereign states of the euro zone (which joined the securitisation, bond and corporate bond programmes), better known as quantitative easing (QE).

This set of measures facilitated the return to normal functioning of the financial markets. This is particularly true in both the public and private debt markets, where interest rate spreads have narrowed, correcting the huge divergence between countries in the core and on the periphery of Europe. This has facilitated access to financing in the financial markets for the different parties (banks, companies and governments).

In the specific case of the public asset purchase programme (QE), the monetary authority has purchased as much as €1,723.82 billion in sovereign bonds of euro zone countries without including the bonds of the supranational organisms, all of which is equivalent to 25% of the total debt outstanding of the main countries in the euro zone with maturities of between 1 and 30 years.- In the case of Germany, the stock of purchased bonds represents even more than that, being close to 30%. Of course, having such a powerful and recurrent buyer in the market has greatly facilitated the work of government funding in recent years. Because even though the ECB is prohibited from financing the governments of the member states, its strong demand for bonds in the secondary market has lightened the bond portfolios of the rest of the investors, so that they have been able to easily absorb the new issues of debt. In fact, since 2015, the total amount of bonds purchased by the body chaired by Mario Draghi is almost three times the total net financing needs (without depreciation) of the main member states. In Spain, for example, this amount is somewhat lower, but even so the €230.26 billion in Spanish sovereign bonds purchased by the ECB account for almost twice the net financing needs of the Treasury accumulated since 2015.

It is clear that the purchase of European Central Bank bonds has been one of the factors that has favoured the strong reduction of the interest rates of the debt in the Eurozone. In the case of the 10-year German bond, which is the benchmark risk-free rate for the European market, its profitability came to negative levels (-0.19%). In Spain, this programme has boosted investor confidence in Spanish debt, even in times of greater political uncertainty or doubts over growth expectations. Thus, the Spanish risk premium, measured as the spread between the yield on Spanish and German 10-year bonds, has been consolidated at levels below 130 basis points. It currently stands at around 100 basis points, and has only occasionally exceeded 150 basis points in the face of certain risk episodes.

In this context, the ECB faces an important challenge in 2018: to adjust the recalibration of the asset

purchase programme (defining the end date) and begin to communicate the next exit phase from its accommodative monetary policy (when the rate increases will begin of interest) and doing all this without there being a tightening of financial conditions.

In particular, this reduction in the asset programme will also affect the sovereign bond programme, and there is a risk of a rebound in interest rates on sovereign debt or an increase in financial fragmentation due to the lower potential for purchases by the ECB. But despite the moderation, the monetary authority will remain a benchmark purchaser in the market this year. It is estimated that its demand for sovereign bonds will reach €230 billion in 2018, without including the amount that would be involved in the reinvestment of the bonds that expire. This amount is sufficient to cover the net financing needs of the main governments in the area. In the case of Spain, it is estimated that purchases by the ECB will reach €31 billion. This amount would cover more than half of the net financing needs foreseen in 2018 of €40 billion, which represents a significant level of assistance, albeit lower than in previous years. Therefore, the withdrawal of stimuli will support a rise in debt yields, but the presence of the ECB as a benchmark investor should favour a moderate rise, compatible with the consolidation of economic growth in the euro zone.

For the time being, the Central Bank is in no hurry, but sooner or later it will need to be ready to adjust its policy. What is clear is that this normalisation will not occur immediately or simultaneously. The case of the Federal Reserve in the US (the Fed) shows that the exit strategy from unconventional measures is complex and will take time.

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