

Rate hikes vs quantitative tightening; the ECB's trade-offs

As central banks move to cool inflation pressure, they are faced with various policy options. As well as hiking base rates, they can also shrink their balance sheets. The European Central Bank is no exception



Christine Lagarde,
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From full denial to tightening in less than one year?

The European Central Bank (ECB) has gone through an enormous change. Within less than half a year, the inflation narrative has changed from calling the inflation surge temporary and warning against too-low and not too-high inflation in the medium run, to a doubling of its 2022 inflation forecasts and a warning against upside risks to price stability. Despite the change in its take on inflation, the ECB is in no position to consider tightening any time soon. Instead, the discussion on the drivers behind inflation at the current juncture, but also in the longer term, will continue and won't be solved any time soon.

The ECB's discussion on the future path of monetary policy will obviously be closely linked to this inflation debate. We think that this debate and the ECB's road to normalisation can be divided into three different stages: tapering, the end of negative interest rates, and finally moving towards a more neutral monetary policy stance.

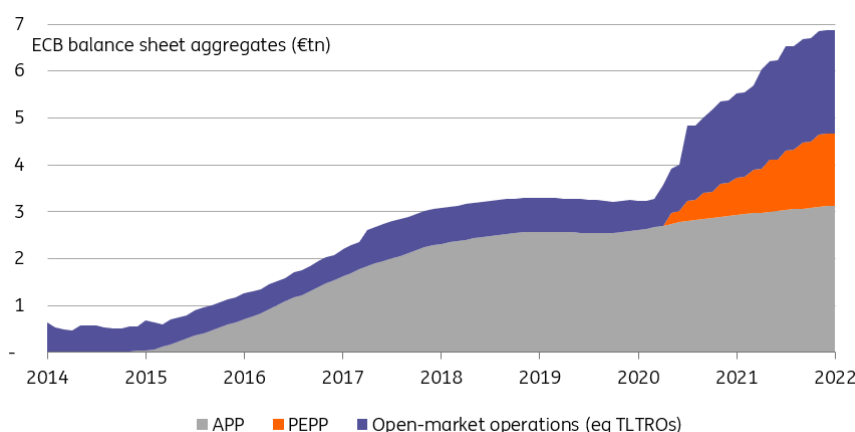
- **Tapering.** The longer headline inflation remains at elevated levels and the faster the

eurozone economy rebounds from the fourth wave of the pandemic, the weaker arguments to continue with asset purchases will be. Here, the short-term inflation assessment will matter most.

- **The end of negative rates.** Once net asset purchases are brought to an end, the next crisis tool will be subject to discussion and is likely to be returned into the toolkit.
- **Hiking interest rates.** The timing of the first rate hike will be highly dependent on the ECB's longer-term inflation view, in particular its view on whether or not structural factors, such as the fight against climate change, demography and deglobalisation will push up inflation. If they do, a series of rate hikes is the most likely option once all crisis tools are back in the toolkit. Unless the ECB starts to realise that rate hikes have as limited impact on inflation driven by global drivers as rate cuts had on deflation driven by global drivers.

In any case, the ECB has often stressed that it will stick to the so-called sequencing, i.e. first bringing quantitative easing (QE) to an end before considering rate hikes. Even if the pace of asset purchase reductions could easily be increased, a tightening of monetary policy in 2022 looks unlikely.

Unlike other balance sheet items, the ECB has direct control over the size of its QE portfolios



Source: ECB, Datastream, ING

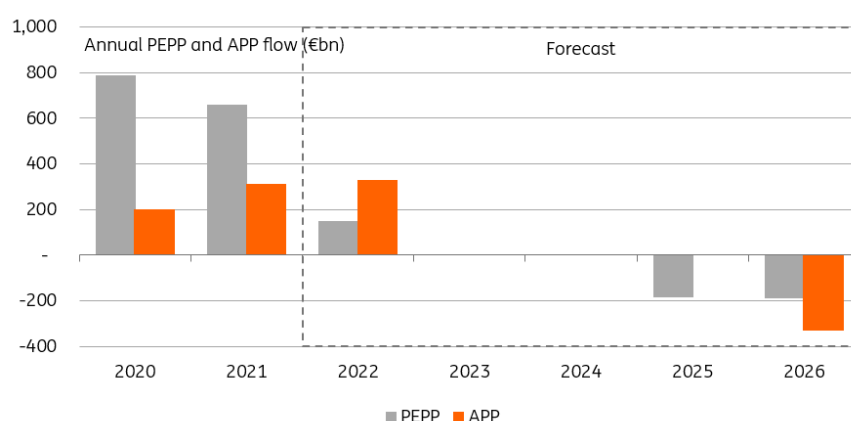
When discussing central bank tightening, market participants often talk about policy rate hikes. However, over the last few years, asset purchases have become a more powerful instrument for central banks than policy rates. When looking at options to tighten, therefore, balance sheet reductions will be important. In this regard, it is important to distinguish between asset purchases and liquidity operations (funding for banks). In the case of the ECB, bank funding operations (targeted longer-term refinancing operations, pandemic emergency longer-term refinancing operations etc) account for roughly one-third of the current balance sheet.

When talking about quantitative tightening, we think it makes sense to focus on asset purchases only. So how important are central bank bond purchases? It depends on who you ask. It also depends on when you ask. These two questions form the basis of our analysis: depending on which market and on what market regime, changes in a central bank's asset portfolio might have a very different impact.

The everything channel

Duration is the everything channel. There is abundant literature from the ECB, and other central banks, on the channels through which asset purchases impact markets and the economy. Restricting ourselves to financial markets here, the duration channel, reducing the risk compensation of bonds and hoping that this will push investors into riskier alternatives, is in our view the one likely to have the most lasting impact. It is also the easiest to quantify, and the one that has the most linear effect.

Under current guidance, we do not see the ECB's quantitative tightening before 2025



Source: ECB, ING

The first stage of the ECB portfolio reduction will only amount to a slowdown of reinvestment purchases

Another channel is through market liquidity, where purchases effectively act as a backstop in periods when market participants all look to reduce their bond exposure at the same time. It is most impactful when financial markets are in stressed conditions. Not only is its impact unlikely to be constant over time, we argue that it isn't symmetrical. Since quantitative tightening should only amount to a slowdown of reinvestment purchases, barring a decision to sell bonds outright, we are tempted to say that its impact through the liquidity channel will only prove transient.

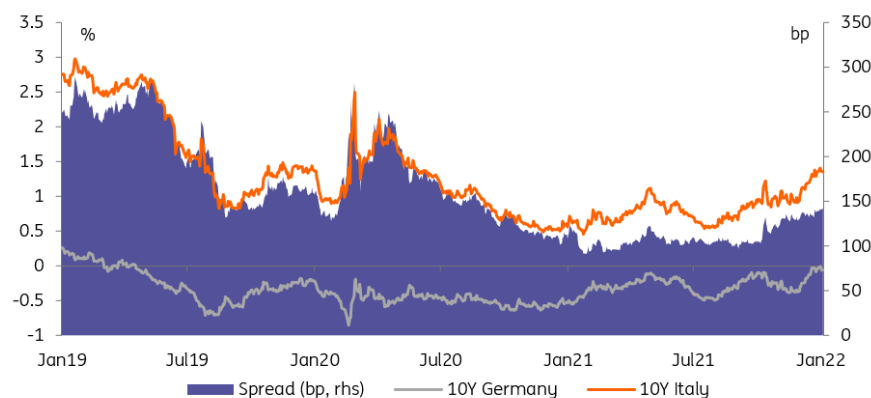
This is by no means an exhaustive list, however. Over the years, a number of justifications for asset purchases have been put forward, including the confidence channel, and the rate signalling channel.

Focusing on the long term

It is also worth noting that we focus here on the impact of quantitative tightening, the part of its balance sheet that the ECB controls directly. The case can also be made that its bond portfolio is most relevant for long-term financial decisions, as the 'duration channel' of assets is much

stronger on long-term interest rates and credit spreads.

High-beta fixed income would feel the most impact from quantitative tightening



Source: Refinitiv, ING

And indeed, we find that relative to changes in policy rates, the ECB's bond portfolio is most impactful on higher-beta fixed income. For instance, we find that a €187bn reduction in the ECB's portfolio would impact 10Y Italian yields as much as a 25bp hike. At the other end of the spectrum, we find that German government bonds would care a lot more about a 25bp increase in the ECB's deposit rate. So-much-so that quantitative tightening would largely be irrelevant in comparison.

A €187bn reduction in the ECB's portfolio would impact 10Y Italian yields as much as a 25bp hike

The temptation is to average out as many indicators as possible to arrive at a single number. The reality is, in our view, that the impact of quantitative tightening on the most vulnerable borrowers is likely to hold more sway over the ECB. For that reason, the sequencing highlighted above makes sense. One could even argue that continuing asset purchases while base rates are increased would reduce the risk of markets skidding off-road as it tries to get inflation under control, although this has to be weighed against wider implications of asset purchases for financial stability and wealth distribution.

So far, the ECB has always stressed the need for neatly sequencing: first, bring asset purchases to an end and then start hiking rates. This would follow the Federal Reserve's current example. Given the very special setup of the eurozone, the closer the ECB gets to hiking rates the more second-guessing this sequencing the ECB will be.

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