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The ECB and Its Watchers XIX - Goethe-University Frankfurt

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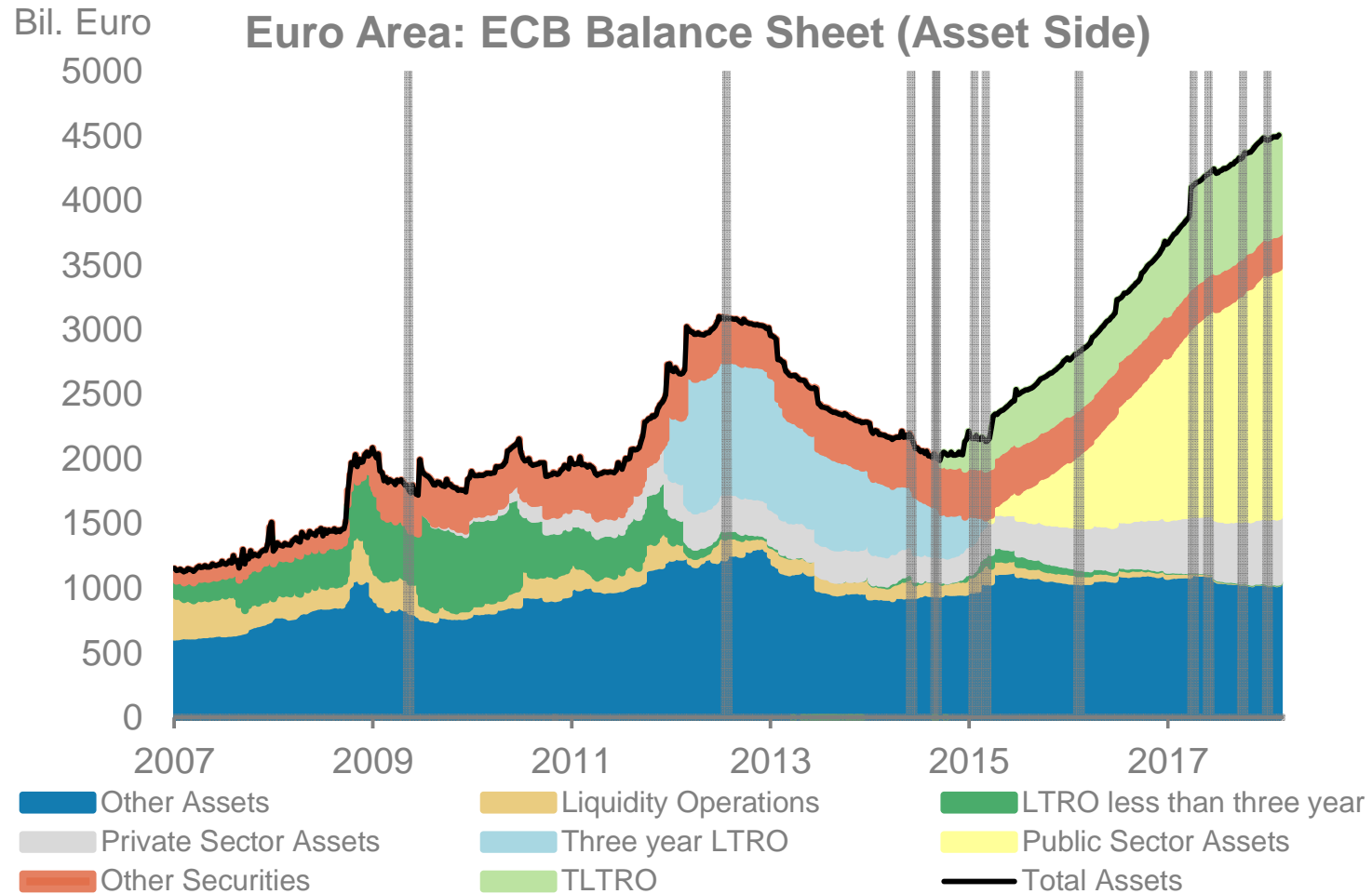
Assessment of Quantitative Easing and Challenges of Policy Normalization

For important disclosures, refer to the Disclosures Section, located at the end of this report.

ECB QE – Much Better Late Than Never

- **Late in the game, subject to various restrictions, but still highly effective**
- **Reinforces Eurosystem as (LoLR) after OMT restored ‘Keynesian’ order**
- **QE turbo-charged by negative interest rates (higher velocity, steeper curve)**
- **Door open for more in the future: Not yet at the ELB, could add equities**

ECB QE Is More Than Just Asset Purchases

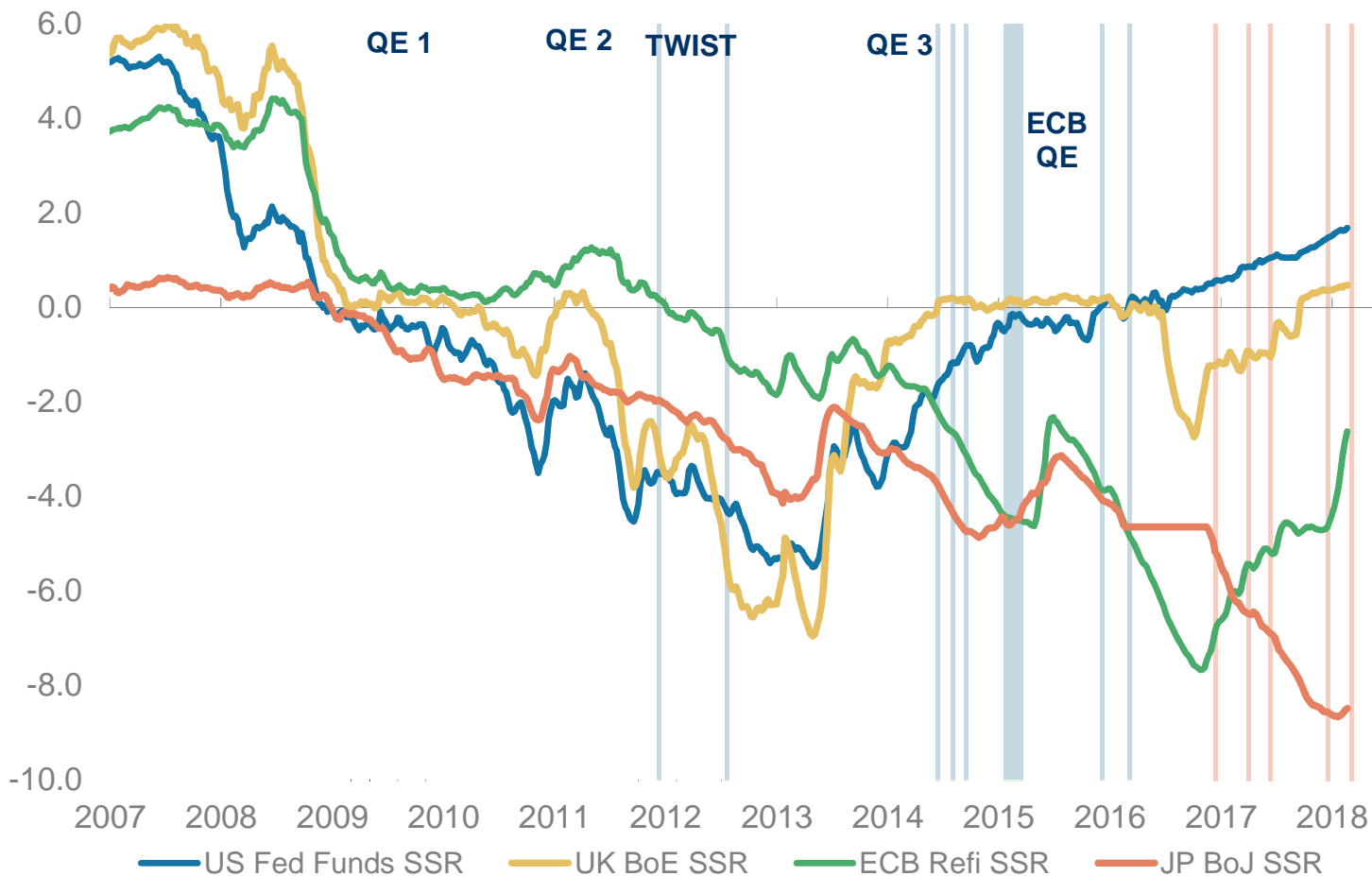


Source: ECB, Morgan Stanley Research Note: The vertical gray bars represent the key policy announcements/speeches with respect to policy easing by ECB. Securities Market Purchase Program start in May 2010 and peaked at €220 bn in Feb 2012. The public sector assets purchased prior to 2014 is included in "Other Securities".

The Power of ECB Policy Despite Strong Headwinds

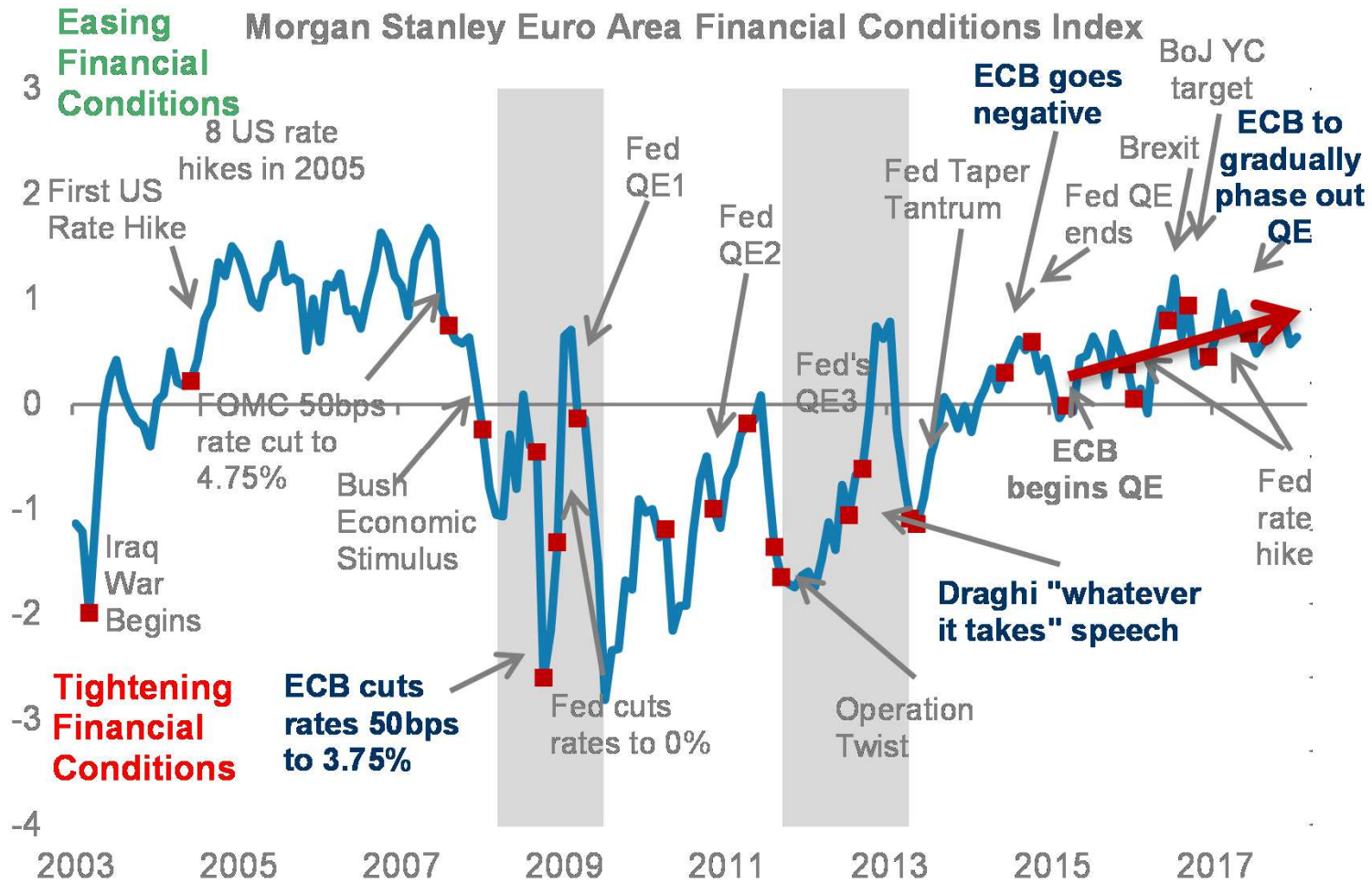
- **Euro crisis weakened common currency, caused material fragmentation**
- **Banking system remained fragile, recapitalisation was painfully slow**
- **ECB, not backed by ‘Euro Treasury’, found way that limits risk pooling**
- **Intense debate about the legality of QE esp. in core countries**
- **Political risks in key member states (e.g. France, Germany, Italy)**

Shadow Short Rates Show the Power of ECB Policy



The vertical gray bars represent the key policy announcements/speeches with respect to Policy Easing by the ECB. The labels at the top refer to Fed Policy. Source: RBNZ, Morgan Stanley Research

Financial Conditions Easing and Stabilizing Since Start of QE



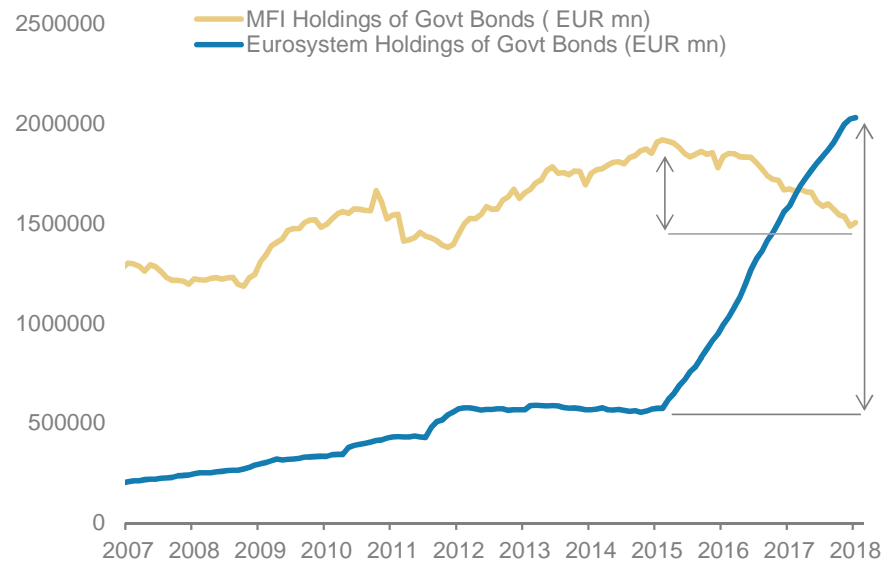
Source: Morgan Stanley Research

Euro Economy Rebounding Strongly, but Inflation Still Muted

- **Easy financial conditions boosted GDP by 1.2% and HICP by 0.4%**
- **A key driver of the growth surprise in the euro area last year**
- **Now economy is strong and steady, but no longer accelerating**
- **Output gap likely to be closed in the course of this year**
- **Inflation should gravitate back towards the objective**
- **Domestic demand rebound, but credit impulse dipped**

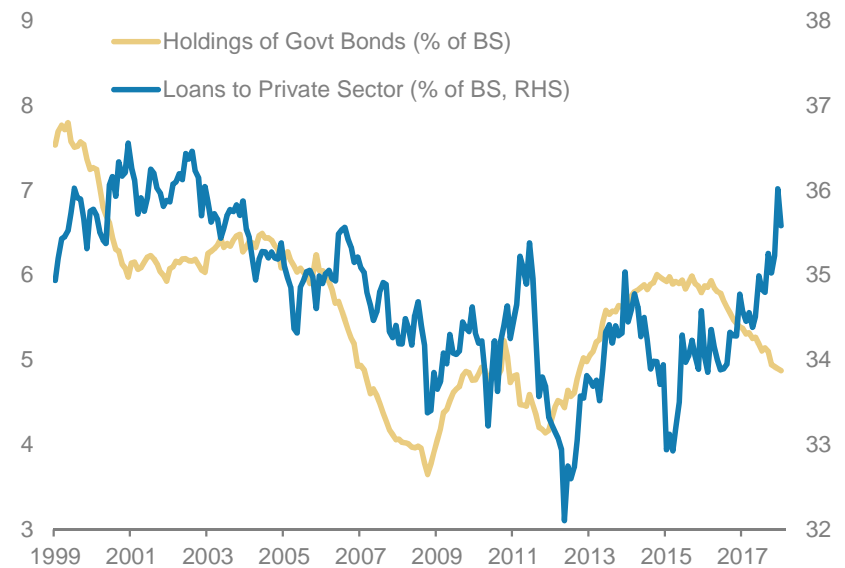
Tracking the Transmission of ECB QE

ECB QE Lowers Bank Bond Holdings a Bit



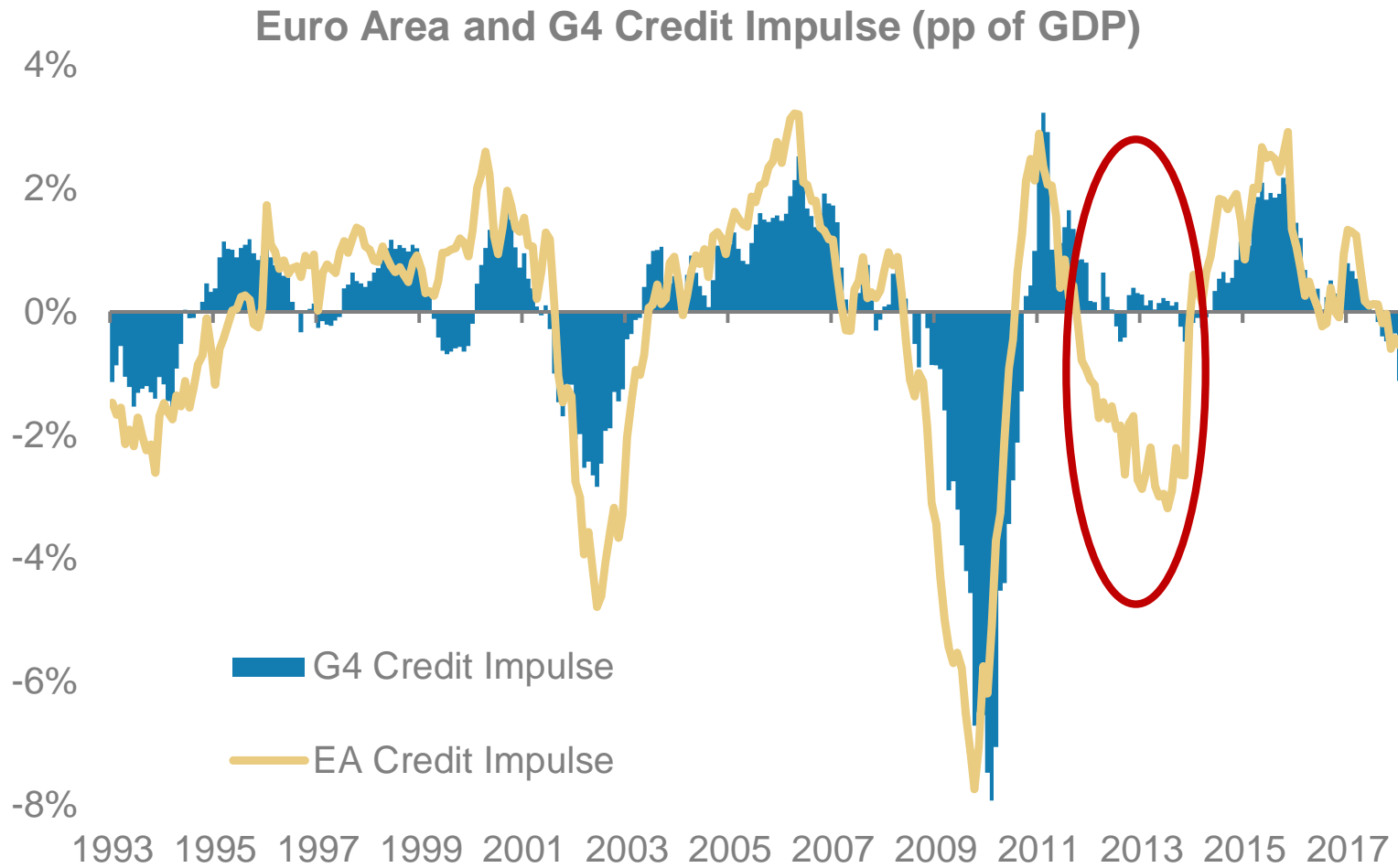
Source: ECB, Morgan Stanley Research

Banks Switch from Bond Holdings to Lending



Source: ECB, Morgan Stanley Research

EA Credit Impulse Compared to the G4 Credit Impulse



Source: FRB, ECB, BoE, ONS, BoJ, PBoC, IMF, Morgan Stanley Research

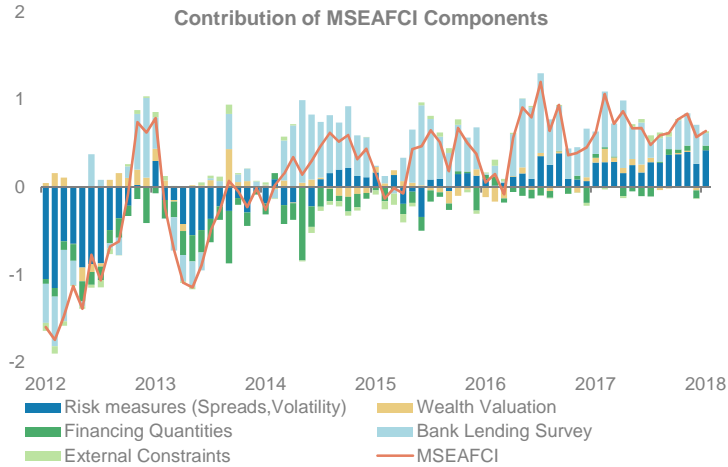
On the Challenges of Policy Normalisation

- ***Per se* not normalisation that worries, but the leeway in the next downturn**
- **Given limited ammunition, ECB cannot afford mistakes in normalisation**
- **But: if in doubt probably better to let it run hot a bit**
- **Two steps: (1) Remove emergency measures. (2) Get back to “normal”**
- **Clear communication on Q-Exit, tapering to signal timing of first rate hike?**
- **Raise rates gradually, start with a small step, pause, move to 25 bp clips**
- **Raise rates before balance sheet wind-down, but not as high as the Fed**

Appendix

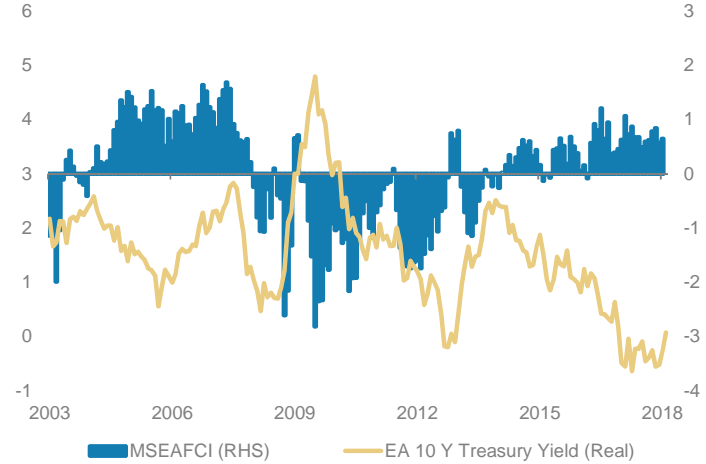
Euro Area Financial Conditions

Components of MSEAFCI



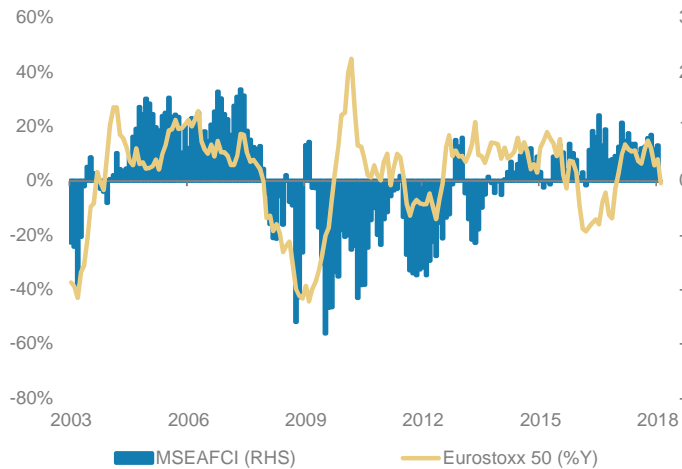
Source: Morgan Stanley Research

MSEAFCI vs Euro Area Real 10Y Government Bond Yields



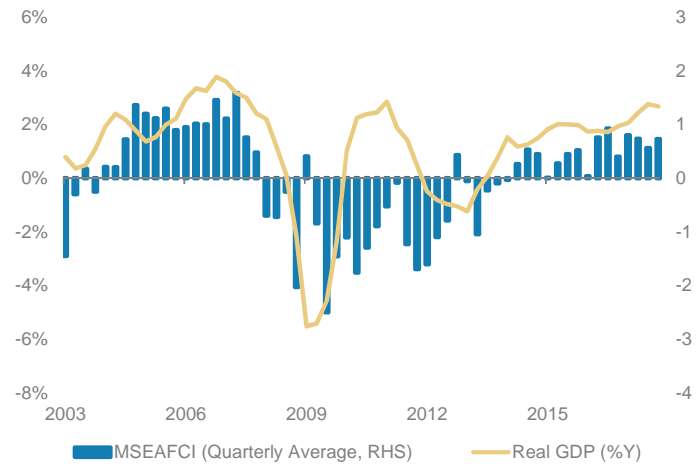
Source: ECB, Morgan Stanley Research

MSEAFCI vs Euro Area Equity Markets



Source: STOXX, Morgan Stanley Research

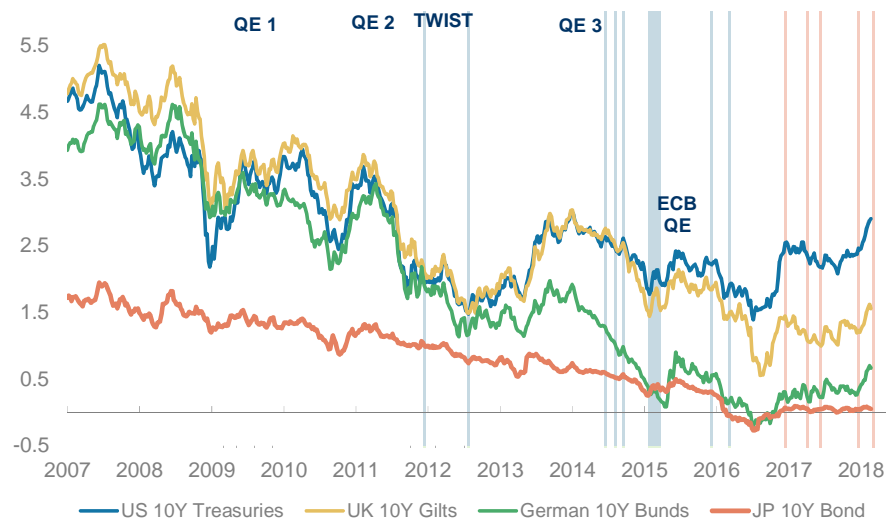
MSEAFCI vs Quarterly GDP Growth



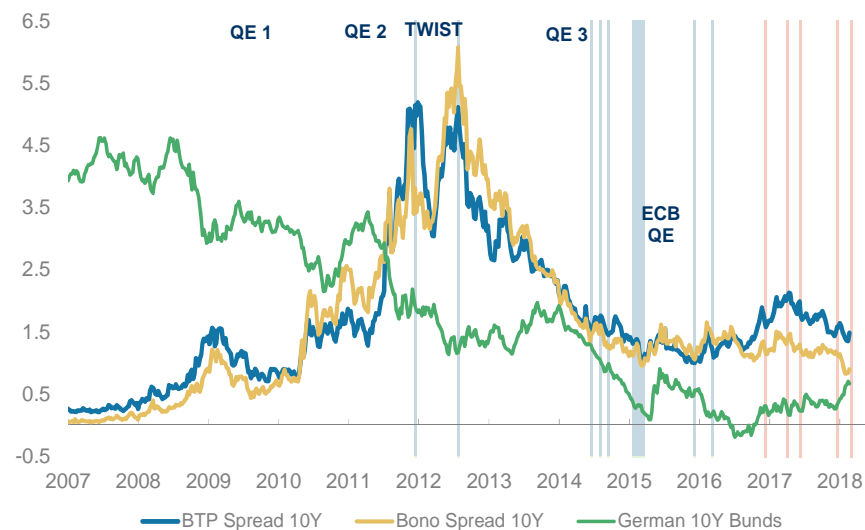
Source: EUROSTAT, Morgan Stanley Research

Financial Market Developments Around QE

G4 10Y Government Bond Yields, % p.a.



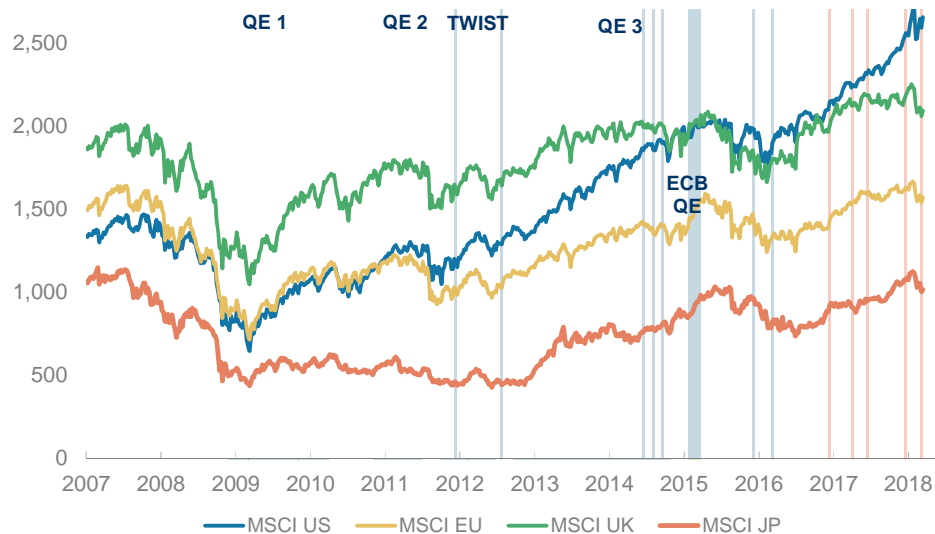
Selected Euro Area Government Spreads, in bp



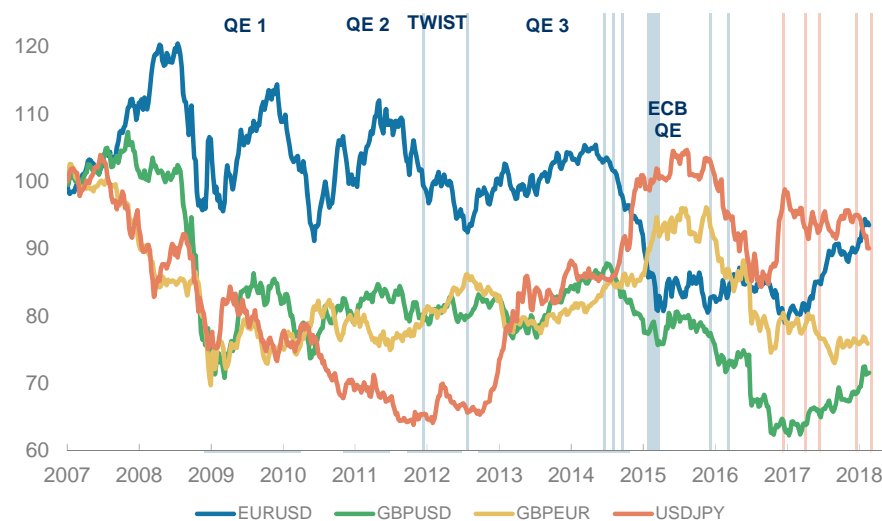
Note: The light blue bars represent policy announcements/decisions with respect to NIRP and QE by the ECB. The red bars represent policy announcements/decisions with respect to normalisation by the ECB.
Source: Reuters, Financial Times, FED, BoE, Morgan Stanley Research

Financial Market Developments Around QE

G4 Equity Market Index Dynamics



Bilateral Exchanges Rate Dynamics



The light blue bars represent policy announcements/decisions with respect to NIRP and QE by the ECB. The red bars represent policy announcements/decisions with respect to normalisation by the ECB.
Source: Reuters, Financial Times, FED, BoE, Morgan Stanley Research

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