

»» “Taper tangram” – the ECB’s exit is a game of patience

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In June, the European Central Bank again left its monetary policy unchanged because euro area inflation is normalising only at a very sluggish pace. Core inflation in particular, which excludes energy and food prices, has remained virtually unchanged at just under 1% for years (see Figure).

So the exit from the unconventional monetary policy drags on. It resembles a puzzle for the solution of which a lot of patience is required. Perhaps it is best compared to a Chinese tangram, in which seven triangular and four-sided puzzle pieces need to be assembled to form a square (or, alternatively, other meaningful shapes).

Legend has it that in ancient China a student monk dropped a valuable tile and struggled long to put the broken parts back together. Unlike this accident, the ECB’s policy always was and still is a deliberate act. The central bankers therefore know exactly what steps need to be taken to return the monetary situation back to normal. And they know how much skill and patience are needed to avoid undesired distortions in the financial markets and the real economy.

The ECB’s “taper tangram”¹, the exit from its unconventional monetary policy, which centres on gradually reducing its asset purchases (also referred to as “tapering”), might be resolved as follows:

Tangram piece number 1: End additional asset purchases

The ECB has already laid the first piece of the “taper tangram” puzzle in April. Since then it has been purchasing securities worth EUR 20 billion less each month than in the twelve months before. With this step it took back its latest

increase in asset purchases of early 2016.

Piece no. 2: Modify communication

The second piece was added this month when the ECB modified its ‘forward guidance’, that is, its communication concerning the more distant future. In its introductory remarks to the press conference in June the central bankers removed their remark that key interest rates might be reduced even below current levels.

No. 3: Announce further reduction in asset purchases

The next step in the ECB’s game of patience would be to verbally prepare the general public for the further exit from the asset purchase programme. That is something the ECB could do, for instance, directly after the summer recess in September, when its research staff presents new projections on the business cycle and inflation. The question remains whether the ECB would then already announce genuine “tapering”, that is, a rule-based reduction in asset purchases down to zero within a specific period of time. Alternatively, the central bankers could determine a further reduction in the level of monthly purchases for a certain period. The latter variant, which allows the ECB more flexibility, currently appears to be more likely in the face of continuing weak inflation.

Piece no. 4: Implement the announced purchase reduction

Half the battle would be won if the gradual exit were to be not just announced but actually implemented – probably in January 2018. The deadline thus far specified for the current purchase volumes of EUR 60 billion a month would then have expired.

Piece no. 5: Cut asset purchases further to zero

After that, securities purchases would have to be reduced further to zero at some point in time – that is, the tapering would have to be specified. Its end might come in the second half of 2018 provided the current upswing in the euro area remains intact.

No. 6: Increase key interest rates

A gigantic step towards normalisation would be to raise key interest rates for the first time since early 2011, presumably towards the end of 2018.

No. 7, the last tangram piece: Dissolve asset holdings

The normalisation of monetary policy and the “taper tangram” would be complete once the ECB dissolved its securities holdings again. However, a great deal of patience is necessary before this goal is achieved. The US Federal Reserve, for example, increased key interest rates one and a half years ago already as part of its exit. But it has just recently started to ponder a reduction of the (previously bought) assets in its balance sheet. ■

Figure: Euro area inflation (in per cent)



Sources: Eurostat, KfW Research

¹ The term ‘tapering’ was coined by representatives of the US Federal Reserve in reference to the process of gradually reducing their asset purchases. In 2013, when the process was supposed to begin, interest rates in the financial markets spiked dramatically. This phenomenon is now referred to as ‘taper tantrum’.