ECB's rapid pace of bond purchases may not equal lower long term yields

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At the ECB Governing Council meeting on 11 March, it was announced that the total envelope for purchases under the pandemic emergency purchase programme (PEPP) would be left unchanged at 1.85 trillion euros. But, based on its assessment of current financial conditions and the outlook for inflation, the ECB expects that the pace of its emergency bond purchases will significantly increase in Q2.

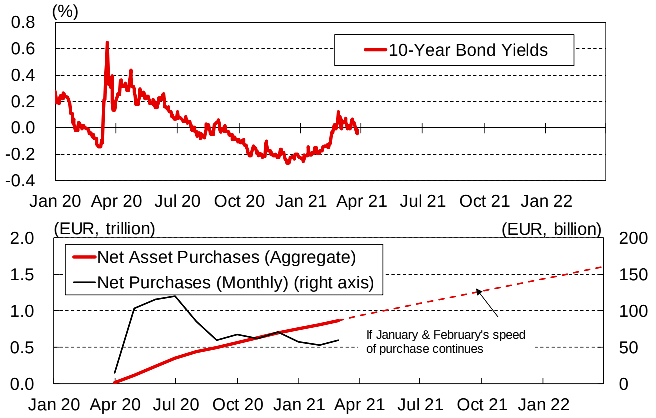
Before this meeting, the key nominal GDP-weighted Eurozone 10-year sovereign bond yield surpassed 0% for the first time since September last year (Figure 1 upper) following upward pressure on US yields. ECB executive board members have shown some concern about the sudden rise in interest rates (Table 1). Within the Eurozone, the stringent restrictions on activity remain in place, and the consensus is for negative economic growth in Q1. Against that background, it is not a surprise that a large majority of the members consider it necessary to prevent premature rises in interest rates, which is incompatible with their outlook for inflation and growth.

However, whether ECB will execute large-scale bond purchases to control long-term interest rates is questionable. First of all, at the press conference after the meeting, ECB President Christine Lagarde denied the notion that interest rates would be pegged to a particular level. Then, within the same speech, she said the following: “we will purchase flexibly”; “if favourable financing conditions can be maintained…the envelope need not be used in full”; “the envelope can be recalibrated if required to maintain favourable financing conditions to help counter the negative pandemic shock to the path of inflation.”

The mixed comments above were in Lagarde’s speech at the time of the ECB Governing Council in December, and were confirmed again in the same manner this time. We can surmise that the constant in both meetings is the stance to pursue efficient easing results by limiting bond purchases if possible (the pace of purchase has not increased after the increase and extension of PEPP in December last year– see Figure 1 lower).

This stance is characteristic of Europe. As we sometimes see in the policy account, some members of the governing council are strongly aware that there is a risk of relaxed fiscal prudence and government bond market distortion as a side effect of the PEPP. As such, based on recent speeches (Table 1), as long as the future rise of the long-term yields is accompanied by a sound economic recovery with the pandemic under control in Q2, the level of the yields ECB considers accommodative would go up. Also, it is possible that the ECB will accept actual rise of the yields despite the inflation forecast which won’t reach the 2% objective.

Figure 1：10-Year Eurozone Central Government Bond Yield, PEPP Net Purchases



Caution: Based on weighted average using previous years' nominal GDP
Source: Bloomberg、Eurostat, ECB, MUFG Economic Research Office

Table 1：ECB Executive Board Members' Speeches

Speaker	Date	Comments
Philip R. Lane	25/02/2021	・The two key yield curves in the euro area for the funding conditions of all sectors in the economy are the overnight index swap (OIS) curve - a proxy for a risk-free curve in the euro area- and the GDP-weighted sovereign bond yield curve. ・The ECB is closely monitoring the evolution for longer-term nominal bond yields.
Isabel Schnabel	26/02/2021	・A rise in real long-term rates at the early stages of the recovery, even if reflecting improved growth prospects, may withdraw vital policy support too early and too abruptly given the still fragile state of the economy.
Fabio Panetta	02/03/2021	・The steepening in the nominal GDP-weighted yield curve we have been seeing is unwelcome and must be resisted.
Isabel Schnabel	16/03/2021	・What concerns us is not so much the level of interest rates - which are still very close to their historic lows - but rather the rapid change.
Philip R. Lane	16/03/2021	・Our objective is basically to make sure the yield curves, which play an important role in determining overall financing conditions, do not move ahead of the economy. ・I should say that our favourability assessment of financing conditions is dynamic. Over time, the relation between the appropriate level of yields and inflation will move.

Source: ECB, MUFG Economic Research Office

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