UNWINDING QE: What will it look like and what impact will it have?

Executive Brief

Fitch Solutions

Central Bank QUANTITATIVE EASING (QE) Programs

Since 2009, four global central banks: the US Federal Reserve, European Central Bank (ECB), Bank of Japan and Bank of England have been engaged in quantitative easing (QE) programs. Between them, on average they have purchased the equivalent of US$1.2 trillion of fixed income assets per year over 2009-2017. In total, they have spent about US$10 trillion on large scale asset purchases. But now that the global economy is on firmer footing, and risks of deflation have largely dissipated, the era of QE is set to come to an end.

Fitch Ratings has assessed each central bank's plans to pare back asset purchases and estimates that in 2018, QE purchases will fall to less than US$500 billion in total. By 2019, net asset purchases will to fall to zero, and from 2020 onwards, the net figure is likely to be negative. The Federal Reserve has led the way in exiting extraordinary monetary policy, beginning with stabilizing the central bank balance sheet by stopping new purchases while reinvesting maturing proceeds, slowly raising policy rates, and then once rates have reached a high enough level, beginning to shrink the balance sheet. This shift, from net annual purchases of over US$1trillion to net sales in just a matter of a few years, will have significant market implications. The central banks have been non-price-sensitive buyers, purchasing bonds until they met self-imposed targets, but soon, that non-price sensitive buying will move into reverse as central banks unwind their holdings as bonds mature and are not reinvested.

Some market commentators believe that central banks have stepped into the markets with such an enormous impact, that they dare not stop. The biggest fear is that exiting QE prematurely could push national economies back into recession with deflation risks re-emerging – and the central banks will then get the blame. But with economic slack significantly reduced and output gaps disappearing over the past decade, unemployment rates at cycle lows in many countries, and global growth picking up, the risks have changed. If the major central banks do not start unwinding their balance sheets now, they run the risk of damaging their own credibility. Maintaining such large asset holdings in the face of a strengthening macroeconomic position could lead to accusations of fiscal and financial market dominance, in which the central bank is implicitly subsidizing government spending and backstopping risky financial assets at the first sign of volatility.

What will unwinding QE mean for the GLOBAL ECONOMY?

Fitch Ratings broadly supports the argument that without QE, the global economic performance of the past decade would have been much worse. Fairly robust academic evidence supports this view, with most estimates indicating that QE has provided between a one-to-three percent boost to GDP relative to the counterfactual situation where QE was not implemented. But overall, the impact of policy normalization on the wider economy is probably going to be relatively mild. The global economy is now in much more solid shape, and it must be recalled that QE was first introduced in part to boost demand at a time of high excess capacity and financial system stress.

Today, the interest coverage of the household and corporate sectors is substantially stronger than immediately after the financial crisis. Consequently, there can now be a fairly large increase in interest payments without it affecting credit metrics in a significant way. Importantly, the unwinding of QE is going to be much more gradual than the build-up in assets, so the impact on the real economy should be relatively muted.

What impact could REDUCING QE have on the bond markets?

The unwinding of QE and the associated tightening of monetary policy will have a broad impact on global bond markets, and generally, it points to higher long-term yields. There is clear evidence that QE substantially reduced the term premium on long-term bonds (by as much as 100 basis points in the US's case), meaning that yields could rise as this impact is unwound. The ECB has been purchasing around three times the net issuance of eurozone public sector debt, forcing private sector investors into assets ranging from non-core eurozone sovereign debt, to US Treasuries, to emerging market assets, to corporate debt. To put this into context, even when the Federal Reserve's QE purchases were at their peak, the Fed was still not buying as much as the US Treasury was issuing because of the huge fiscal deficit in the US which was 10 per cent of GDP at that point.

Apart from a likely rise in market rates, the unwinding of QE and normalization of interest rates could also lead to increased price volatility in the bond markets from which some of the trading firms and trading banks will benefit. In the last few years, there has been a de facto partial nationalization of the bond markets by central banks. We are now likely to see them being fully privatized again. If increased bond price volatility occurs, there could be a return of the term premium and spread widening. Clearing houses, exchanges, and inter-dealer brokers will also stand to benefit from increased bond trading volumes.

How will normalization affect commercial BANK LIQUIDITY and asset quality in the US?

As QE starts to unwind and interest rates normalize, there are two important structural changes that could affect commercial bank liquidity and asset quality. Firstly, in recent years commercial banks in the US have been able to meet Liquidity Capital Ratio (LCR) requirements in part by keeping excess reserves at the Fed. Furthermore, these reserves could be classified by banks as High-Quality Liquid Assets (HQLA). Secondly, since October 2008 at the height of the 2007/08 financial crisis, the Fed has paid interest on required reserve balances and on excess reserve balances. This has incentivized banks to keep excess liquidity on the Fed's balance sheet.

Now, the bulk of assets held on the Fed's balance sheet are held by the larger advanced approach banks with assets in excess of $250 billion and disproportionately by the eight G-SIBs (Global Systemically Important Banks). These banks have to meet the full LCR requirements and tend to be the most dominant in terms of excess liquidity. Large regional banks with assets greater than $50 billion also have to hold HQLA but only have to meet the modified LCR. As QE unwinds commercial banks' excess reserves would fall as the Fed reduces its asset holdings.

Finally, Fitch Ratings has carried out some detailed analysis covering the last four tightening cycles and has found that in three out of the four cycles, asset quality has deteriorated. Not surprisingly, the most material in terms of the amount of deterioration and its severity occurred during the 2007/08 financial crisis, but typically tightening leads to asset quality deterioration.

HOW FITCH SOLUTIONS Can Help

The unwinding of QE by the four global central banks will impact national economies, global financial markets and financial institutions. Its effects and the degree of uncertainty it introduces into the banking system further increases the need for banks to utilize a structured and holistic approach to assess counterparty risk.

More than at any time since the financial crisis, in this new economic environment of increased market liquidity and wider net interest spreads, counterparty credit risk professionals will in their analysis need to take account of a much wider range of risk factors. These include increased attention being paid to country risk, macroeconomic forecasts and geopolitical factors including continuous tracking of any changes to foreign and domestic policies by national governments which could impair or restrict capital flows.

The Counterparty Risk Solution on Fitch Connect provides risk analysts with a complete solution for managing exposure to bank credit risk, enabling them to make better informed credit decisions by:

- Accessing risk data and research including the credit ratings and research of Fitch Ratings and third-party ratings, fundamental data for banks, insurers, sovereigns and corporates;
- 'Getting behind the numbers' to develop an evidence-based understanding of counterparty risk from using multiple data sources such as a curated news service and Fitch Solutions Financial Implied Ratings;
- Improving counterparty risk analytical processes and workflows from being able to integrate risk data, research and tools from Fitch into internal systems and third-party platforms;
- Gaining a broader geopolitical and macroeconomic understanding from the Country Risk Research, Country Risk Indices and Macroeconomic Data provided by BMI Research on more than 200 global markets; and
- Helping to manage regulatory and capital adequacy requirements by using transparent credit information on more than 35,000 private and public banks that includes corporate hierarchies and shareholder ownership data.

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About this Executive Brief

Plans by central banks to reverse asset purchase programs will cause significant change for the global macroeconomic environment and could have a significant impact on financial institutions.

Brian Coulton, Chief Economist, Fitch Ratings and Joo-Yung Lee, Managing Director, Head of Fitch Ratings' North American Financial Institutions, discussed the scaling back of QE and the normalization of interest rates in front of an audience of credit analysts and risk management professionals at an event organized by the Capital Markets Credit Analyst Society (CMCAS). The event took place at the New York offices of Société Générale on October 19, 2017.

This executive brief contains edited highlights from their wide-ranging discussion. A video recording of the event can be viewed at: **http://bit.ly/UNWINDINGQE**

Further Reading

Fears of 'Mission Creep' Will Spur Central Banks to Unwind QE Fitch Ratings Non-Rating Action Commentary, 06 November 2017

Quantitative Easing – The Beginning of the End Fitch Ratings, November 2017

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