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Thinking ahead for Europe

Time for the ECB to bite the bullet

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The time has come when the European Central Bank must act with 'unconventional' tools to achieve its target of an inflation rate 'below but close to 2 per cent', for two simple reasons. The first is that the annual rate of (consumer price) inflation became negative in December 2014, has been below 1% since October 2013, and is not certain to recover soon on its own. The second reason is that all other tools available to the ECB have been tried, including the new facility of ultra-cheap refinancing of banks launched last September, but have not worked, owing to the fact that the demand for loans by the private sector remains flat or is shrinking in many eurozone member states. Inflation expectations in the two-to-five-year horizon are falling towards zero in all the main financial markets in the eurozone, indicating that financial markets are losing faith in the ability of the ECB to achieve its inflation target.

While the final decision of the Court of Justice of the European Union is not yet available, the opinion of Advocate General Pedro Cruz Villalón has also strengthened the legal position of the ECB: he has maintained that the ECB must have broad discretion when framing and implementing the EU's monetary policy and, more specifically, that bond purchases (under the OMT programme), although an unconventional instrument entailing some risks, nevertheless fall within the ECB's mandate.

The only option left to the ECB to regain its credibility with financial markets and the public at large is to launch a 'quantitative easing' (QE) programme entailing large purchases in the open market of long-term securities, and thus bring down aggressively nominal interest rates on long maturities.

Some economists and market analysts are sceptical that the interventions would succeed in raising the inflation rate and economic activity: their arguments are unconvincing. They do not seem to see the special conditions created by the 'balance-sheet recession' that we are living through, with its long-lasting impact on private savings (dramatically up), private demand (dramatically down) and core inflation – with a dimension specific to the eurozone added by market fragmentation. Under these circumstances, the effects of expansionary monetary (and fiscal) policy need more time to materialise and may not be fully visible for quite some time.

An aggressive programme of quantitative easing will lower the exchange rate of the euro – which has already been pushed down by the expectation of QE. The unreasonably high exchange rate of the euro since the inception of the financial crisis has been a main factor

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depressing inflation (as often acknowledged by ECB President Mario Draghi) and demand, through net exports, in the Eurozone. Its impact has been especially detrimental to employment in low-labour productivity southern eurozone countries. In practice, for the past seven years the euro has been the residual currency in the international monetary system, taking the brunt of aggressive monetary expansion in the US and the UK and importing deflation from the rest of the world.

The lower exchange rate will raise the price of imported goods and spur exports, stimulating manufacturing activity; sooner or later this will translate into higher employment and wages, after years of depressed demand for labour. Investment demand will be encouraged by ultra-low long-term interest rates, starting with private housing, as is already happening in southern eurozone countries. Moreover, and most importantly, as long-term interest rates fall below the nominal rate of increase of GDP, the process of deleveraging – the reduction of excessive debts accumulated in the past by the private sector – will accelerate and make it possible for them to reduce savings and increase spending. This is the most positive and less questioned result from the US experience with QE. Market fragmentation will also recede, as interest rates converge in the main markets, thus fully restoring the transmission channels of monetary policy. This feature, unique to the eurozone, should strengthen the effectiveness of QE.

Of course, there is one country that may benefit less from QE than the others, and this is Germany, where ultra-low low interest rates already depress the returns to financial investment and hence private demand, partially offsetting the positive impact stemming from net exports and a stronger recovery in the other eurozone economies. The paradox in the present situation, however, is that without QE Germany might suffer even more, as capital continues to flow mainly or exclusively into German markets in search of safe investments, while shunning riskier securities in highly indebted eurozone partners. In this regard, QE should help, rather than damage, by creating greater confidence that the eurozone will not run into serious trouble again and thus slow the flow of capital into Germany.

To be credible, the QE programme must entail large purchases of securities over a protracted period of time; given the relatively small size of private securities markets, it will inevitably comprise large purchases of sovereign debts. There are two options for determining the size and duration of QE purchases: the first is to announce a constant monthly rate of purchase as long as inflation doesn't revert to some positive number well above 1% (perhaps, not fully 2%, in order to avoid overshooting the target); the second is to announce that purchases will continue until the ECB balance sheet has reached the €2 trillion (thousand billion) target already decided by its governing council. Any other approach, such as capping the programme at some arbitrary number, say €500 billion, as advocated by some, would undermine the credibility of the ECB action from the start while still exposing it to the same risks.

If these purchases are spread out evenly across all the main markets – perhaps according to some predetermined key, such as countries' share in eurozone GDP or ECB capital – the ECB will avoid any accusation of acting to facilitate the deficit financing of some member states relative to others. For the same purpose, as has been suggested by the CJEU Advocate General, the open market purchases of sovereigns must be implemented in such a way "that a market price can form in respect of the government bonds concerned so that there continues to be a real difference between a purchase of bonds on the primary market and purchase in the secondary market".

However, it is also important to understand that all purchases of securities by the ECB will reduce interest-rate spreads between the main markets, even if the ECB only bought German

Bunds: this happens because banks and private investors will then inevitably allocate their extra liquidity to purchase the (riskier) securities yielding higher returns. Thus, after starting QE, falling interest-rate spreads would not indicate that the ECB is favouring some member states over others with its operations, thus trespassing the border between monetary policy and economic policy (which is off limits for the ECB).

A critical aspect here is how to avoid that the ECB interventions generate moral hazard by weakening budgetary discipline or economic reform efforts in highly indebted countries, as interest rates on their sovereigns fall. On this, it must be recalled that the ECB will have full discretion to exclude some sovereign paper from its purchases, and publicly announce those exclusions, should the issuing member state (say, a new Greek government after the forthcoming elections) signal the intention to renege on its reform commitments. Financial markets would then immediately and severely punish the offender.

The last hurdle for the ECB to resolve before launching QE concerns the sharing of risks stemming from its purchases of sovereigns. To be sure, this must be the risk of a sovereign default or debt restructuring, rather than more broadly the risk of capital losses on the securities portfolio stemming from market gyrations, which will inevitably stay with the ECB. In any event, the ECB can initially be expected to make large gains on the value of its securities, as interest rates fall: these gains will constitute a sizeable buffer against potential losses on individual sovereigns.

The question raised here, however, is not one of shielding the ECB from market risks on its operations, but rather that of avoiding any *transfer of resources of a fiscal nature* between the member states of the eurozone through the ECB's balance sheet – which has become the constant obsession of those who believe that monetary union must exclude any risk sharing or risk transfer between its participants. On this, a member of the ECB Executive Board has hinted that *some* burden for these losses may have to fall on national central banks. This seems feasible without undermining the unitary nature of ECB market interventions: one may imagine schemes to transfer first losses up to a given percentage to national central banks, which would absorb them within their plentiful capital.

What makes me shiver in horror, on the other hand, is the idea of entrusting each national central bank with the task of buying its own sovereigns: this would not only throw the ECB open market purchases "in the same murky waters as its emergency liquidity assistance" (Claire Jones, FT, 14 January 2015), but could be taken as the anticipation of a possible unravelling of monetary union, should serious stress re-emerge on eurozone sovereigns. Indeed, as Daniel Gros and Christian Kopf convincingly argue in a forthcoming commentary ("There's no QE without risk-sharing"), such an approach might create a 'diabolical' loop between national central banks and their own governments, that not only would negate the separation between monetary policy and national fiscal policies mandated by the EU Treaty, but could truly break monetary union under renewed financial shocks such as those experienced in 2011-12.