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The QE Placebo

Daniel Gros

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It has now been nearly half a year since the European Central Bank declared its intention to buy some €1.1 trillion ($1.3 trillion) worth of eurozone bonds. When it first announced the so-called 'extended asset-purchase programme' in January, the ECB emphasised that it was only expanding an existing programme, under which it had been buying modest quantities of private-sector bonds, to government paper. But this pretence of continuity was just that: a pretence.

In reality, by purchasing large volumes of government bonds, the ECB was crossing the Rubicon; after all, it is explicitly prohibited from financing governments. The ECB's defence was that that the programme was the only way to move inflation closer to its target of close to 2%. Moreover, it pointed out, it was merely following the example of other major central banks, including the Bank of England, the Bank of Japan, and especially the US Federal Reserve, whose programme of quantitative easing (QE) entailed the purchase of more than $2 trillion worth of long-term securities from 2008 to 2012.

Legal uncertainty aside, whether the ECB's decision to pursue QE can be justified ultimately depends on its impact. But after six months, that impact remains difficult to assess.

One reason for this is that long-term interest rates are affected not only by the actual bond purchases, but also by financial markets' expectations about future monetary policy. Indeed, just one day after the ECB made its announcement, interest rates fell by a fraction of a percentage point throughout the eurozone, although the programme was to be implemented weeks later.

When the purchases began, rates did continue to fall for a few weeks, so much so that many were concerned that there would not be enough German bonds to meet the ECB's country-debt quota (determined according to euro-area member states' GDP and population). But rates have since risen again and have now returned, in real terms, to pre-QE levels. In this sense, the ECB's bond-buying programme has been a failure.

Daniel Gros is Director of CEPS. This commentary was also published by Project Syndicate, 9 June 2015, and syndicated to newspapers and journals worldwide (http://www.project-syndicate.org/commentary/qe-ecb-bond-buying-program-by-daniel-gros-2015-06). It is republished here with the kind permission of Project Syndicate.

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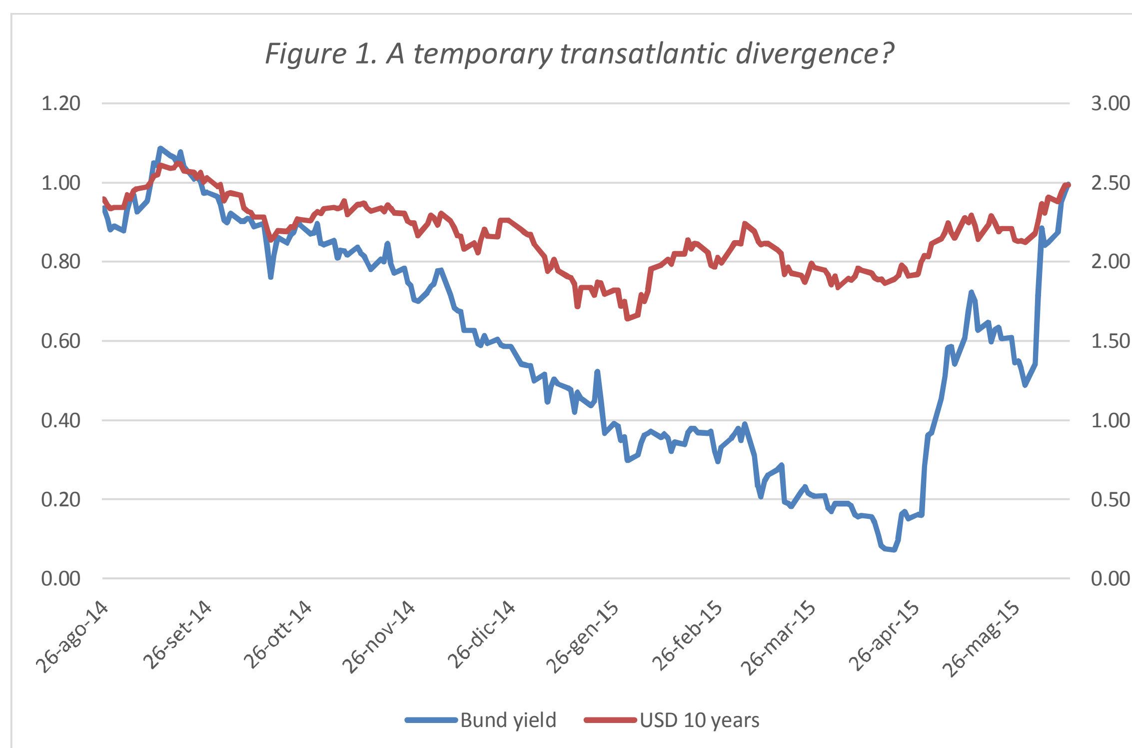
Figure 1 below shows that with the onset of the ECB's bond-buying programme, German long-term yields (the blue line) have become rather volatile. Starting towards the end of 2014, when QE became ever more probable in the euro area, German yields declined rapidly and the decline continued over the first few weeks of actual purchase. But more recently, these rates have returned to their previous level. Moreover, the figure also shows that German rates are now back to the same level relative to US rates they had before QE started in the euro area.



Source: Own calculations based on ECB data.

Other indicators, however, paint a different picture. Notably, price growth turned positive last month, suggesting that the threat of deflation has been eliminated. This has prompted a modest uptick in expected inflation – the ECB's favourite measure of price stability – not for the immediate future, but in five years, and then for five years.

In concrete terms, the ECB is measuring its policy's success today according to the inflation rate expected from 2020 to 2025. This figure, calculated from the prices of different types of indexed, and non-indexed, five- and ten-year bonds, is based on the somewhat heroic assumption that all of the markets for these bonds work efficiently.

This presents a fundamental contradiction. QE is supposed to work via 'portfolio balance effects', which implies that markets are not fully efficient: purchases of longer-term bonds affect financial conditions by changing the types and quantity of financial assets that the public holds. How can one use market prices as an indicator of inflation far into the future and simultaneously justify QE by claiming that most investors stick to certain asset classes and thus do not follow market signals efficiently?

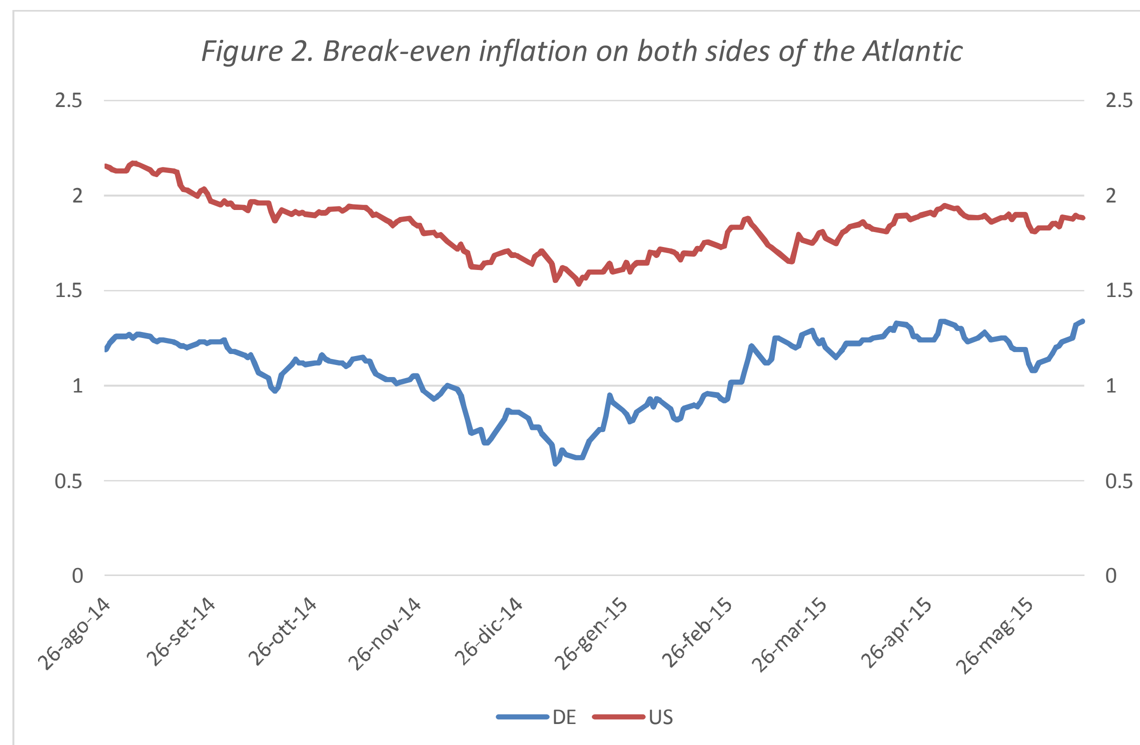
Another problem with using the five-year, five-year-forward rate of expected inflation to gauge QE's effectiveness is that the rate is correlated with oil prices. Indeed, when oil prices fell last year, so did inflation expectations (however imperfectly measured). And the ECB's QE announcement coincided with the beginning of the oil-price recovery, which could be expected to increase inflation expectations somewhat.

With such coincidences and contradictions arising in nearly every aspect of the QE debate, it seems that evaluating the policy's effectiveness is more of an art than a science. Unfortunately, this leaves plenty of room for distortion and bias.

Most glaring is QE supporters' tendency to ascribe any decline in interest rates before the policy was announced to market participants' expectations that QE would be coming. Yet they do not apply the same reasoning to the decline in inflation expectations that occurred during the same period. They have followed the same logic since the purchases began, ignoring recent increases in interest rates, while lauding the small rise in inflation expectations as proof of QE's effectiveness.

In reality, of course, QE – whether the expectation or the execution of it – would affect both interest rates and the inflation expectations that are derived from them. So, when ECB President Mario Draghi stressed some weeks ago that nominal interest rates were lower than last August, he should have also acknowledged that, given low inflation expectations, real interest rates have moved little.

This remains true today. As Figure 2 below shows, inflation expectations have moved in tandem on both sides of the Atlantic, and in the euro area they are now back to the level they were last summer. There was a dip in-between (which had motivated the ECB to undertake its QE), but it remains difficult to detect a lasting impact of QE.



Source: Own calculations based on ECB data.

But such pragmatic thinking has been sorely missing from discussions about QE. Instead, each side has caricatured the other: supporters emphasise that QE has not led to runaway inflation anywhere, while opponents point out that nowhere has QE alone reignited robust growth.

In fact, there has been neither inflation nor growth: central banks can seemingly pour hundreds of billions of dollars, euros or yen into the market with little discernible effect. So QE basically consists of an exchange of two low-yielding assets – long-term bonds against central-bank deposits. In broad and efficient markets, that exchange does not amount to much.

Related publications

Daniel Gros, "QE 'euro-style': Betting the bank on deflation?", paper commissioned by the European Parliament's Committee on Economic and Monetary Affairs, June 2015 (forthcoming publication on the European Parliament's and CEPS' websites).

Daniel Gros, Cinzia Alcidi and Willem Pieter De Groen, "Lessons from Quantitative Easing: Much ado about so little?", CEPS Policy Brief No. 329, CEPS, Brussels, March 2015 (www.ceps.eu/publications/lessons-quantitative-easing-much-ado-about-so-little).

Diego Valiente, "The 'visible hand' of the ECB's quantitative easing", CEPS Working Document No. 408, May 2015 CEPS, Brussels (www.ceps.eu/publications/%E2%80%98visible-hand%E2%80%99-ecb%E2%80%99s-quantitative-easing).

Willem Pieter De Groen, "The ECB's QE: Time to break the doom loop between banks and their governments", CEPS Policy Brief No. 328, CEPS, Brussels, March 2015 (www.ceps.eu/publications/ecb%E2%80%99s-qe-time-break-doom-loop-between-banks-and-their-governments).