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Quantitative easing would sow the seeds of crisis not recovery

By Michael Heise

The policy could push the eurozone in the wrong direction, writes Michael Heise



The fear of a descent into Japanese-style deflation is starting to influence monetary policy making in the eurozone.

Inflation in the currency union continues to creep downwards, standing at 0.3 per cent in August. The European Central Bank is contemplating whether to follow the central banks of the US, the UK and Japan in implementing a programme of quantitative easing, buying assets in large quantities.

But such a strategy would not prevent a Japanese-style “lost decade”. It may in fact lead to the very predicament it aims to avoid.

There are several reasons why the ECB should not go down the route of QE. First, the recent low inflation rates are in part a result of the decline in oil and other commodity prices. They also reflect necessary adjustments in the eurozone periphery – wage moderation and the impact of structural reforms are feeding through into lower prices across the board, which is exactly what countries such as Greece and Portugal need to restore competitiveness and bolster purchasing power.

There is no sign of a vicious circle of falling inflation expectations and consumer restraint. Inflation rates will gradually climb again as the economy recovers.

Second, although the ECB has several options when it comes to implementing QE, there are serious objections to all of them. Buying asset-backed securities or corporate bonds would expose the European taxpayer to credit risk. If the ECB bought bonds issued by eurozone governments in proportion to each country’s output, its intervention would be focused on Germany, where bond yields have already hit rock bottom, with the 10-year yield now below 1 per cent. But any programme of asset purchases that concentrates on the slower-growing economies would result in a politically unacceptable redistribution of risk in the eurozone and set the wrong incentives for fiscal policy.

Third, the impact of further monetary easing on output and price levels would be negligible. That is because the recession in many parts of the eurozone is caused by the hobbling effect of the unsustainable amounts of debt that were built up by public and private actors during the boom years. Over-indebted households and companies are unlikely to pile up more debt; on the contrary, they are trying to pay it down. This makes monetary policy ineffective.

For many southern European banks, ECB liquidity has replaced the money market. It cannot be sensible to eliminate market disciplines for extended periods of time

Fourth, the collateral damage from ultra-loose monetary policy is accumulating. Risks to financial stability are growing as investors are piling into riskier assets in search of higher returns. Already, some assets such as junk bonds are trading at what look like inflated prices.

Fifth, further monetary easing would delay the much-needed adjustments in the balance sheets of European banks and companies. An abundance of cost-free liquidity from the central bank enables commercial lenders to continue propping up weak creditors. It is exactly this type of “zombie lending” that has curbed growth in Japan for more than a decade.

For many southern European banks, ECB liquidity has replaced the money market. It cannot be sensible to eliminate market disciplines for extended periods of time.

The ECB is right to assume the function of a lender of last resort for the eurozone. But it has already flooded the European economy

with liquidity, for example through the targeted longer-term refinancing operations that are about to start.

The ECB's forward guidance should not consist of further promises that free liquidity will be available forever. Banks that operate on the assumption that they can avoid the money market have no incentive to get into shape. They should be told that, sooner or later, interest rates will return to normal levels, an eventuality with which they must be able to cope.

Monetary policy alone cannot and will not return the eurozone to sustainable growth, as Mario Draghi, the ECB president, pointed out at the Jackson Hole gathering of central bankers last month. Improvements in labour markets and the investment climate, sustainable fiscal reforms and a shift of public spending towards growth-boosting investments in infrastructure and education are what Europe must focus on now.

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