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QE Is the Wrong Fix for Europe

Some disinflation is good for Europe, and attempts to fight it won't work anyway.

By Michael Heise

Speculation is rife that the European Central Bank might announce bold new monetary easing measures at its policy meeting this month, in particular a program to purchase eurozone sovereign bonds, or quantitative easing. The goal would be to expand the ECB's balance sheet by €1 trillion ($1.21 trillion).

Yet anyone who thinks QE would be the policy that at last jolts the eurozone out of its torpor is in for disappointment. QE is unwarranted. It also would most likely be ineffective.

Investors and policy makers hope QE would avert a Japan-style deflation, especially after ECB President Mario Draghi warned at the last Council meeting that the ECB's 2% inflation aspiration was becoming harder to achieve. This fear of deflation is exaggerated. Falling eurozone inflation has in part been caused by the collapse of international oil prices. The other component is the reform process underway in Spain, Portugal and other former crisis economies, where policy changes are allowing prices and wages to fall from their unsustainably high pre-crisis levels. Both factors are good for competitiveness and restore conditions for growth.

What is more, QE is unlikely to give the eurozone economy the hoped-for boost. The evidence from other countries is mixed at best. Japan, which has resorted to QE since 2010, remains stuck with low growth and, after a short uptick, is returning to low inflation again. In the U.S. and the U.K., QE seems to have supported recoveries that look impressive compared with the eurozone's lackluster performance.

Caution is needed, however, when applying the U.S. and U.K. experiences to the eurozone. The American financial system relies heavily on capital markets. Therefore, the Federal Reserve's purchases of securities have a stronger impact on corporate-financing conditions and private wealth than in the eurozone. In the U.K., a strong inflow of capital and labor from abroad, combined with an almost stagnant supply of housing and the slow pace of fiscal consolidation, all played a bigger role than monetary easing in spurring consumer borrowing and a recovery in housing prices.

In the eurozone, QE would have to work via the banking system. Banks would sell bonds to the ECB in return for liquidity, which they could use to make loans. But demand for loans from consumers, businesses and house-builders remains very weak. Portions of the ECB's existing facilities, which already offer all the liquidity the banks might need at rock-bottom interest rates, remain unused.

Storing more liquidity created by QE in the ECB's deposit facility would be highly unattractive given negative deposit rates**.** Such a penalty for holding liquidity is counterproductive if the aim is to boost the ECB's balance sheet. To achieve this goal, it would make more sense to pay a positive rate on these deposits that are a liability for the central bank.

The ECB could circumvent the banks and buy bonds directly from savers, insurance companies or pension funds. This would further increase bond prices and reduce yields, which are already very low. The money that bond sellers would make in such transactions would most likely be reinvested in equity, covered bonds or real estate, which would push prices up in other asset classes as well.

Proponents of QE argue that the resulting wealth effect would stimulate demand for goods and services. This assumption is questionable. The main beneficiaries of higher asset prices are wealthier households that can afford to save and that hold a large share of outstanding assets. The losers are households that are less well off, that spend most of the money they earn and whose modest savings tend to sit in bank accounts where real interest rates are already negative.

The biggest impact monetary policy can have is through the exchange rate. The ECB's announcements of further easing have triggered, or at least reinforced, a depreciation of the euro, which in turn has boosted exports. However, a weaker euro would blunt incentives to implement much-needed but unpopular economic reforms. Japan's experience also warns that this can be bad for households. Inflation-adjusted wages in Japan have fallen steadily in recent years as a dramatic yen depreciation has increased import prices faster than worker pay.

That leaves inflation expectations as the only other justification for QE—the idea being that if Europeans believe QE will stimulate inflation, that belief itself will lead to inflation even if QE in practical terms doesn't. There is little evidence for this. Short-term inflationary expectations are more strongly affected by actual inflation than by changes in the central bank's balance sheet. And long-term inflation expectations beyond five years have, in any case, remained stable at around 1.7%.

The ECB did an excellent job helping the eurozone weather the 2008 financial crisis and the sovereign debt crisis through a number of smart measures. But presently it is raising expectations too high. Loan demand in the eurozone will remain weak as long as households and companies are deleveraging. The ECB can't be expected to generate economic growth and price inflation overnight to save the eurozone economy. The best it can do is supply all the required liquidity at basically zero cost. This is the lender-of-last-resort function that the central bank has fulfilled forcefully since 2008.

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