Free exchange

The Exceptional Central Bank

The European Central Bank should adopt quantitative easing now rather than as a last resort

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ALONE among its peers, the European Central Bank (ECB) has resisted quantitative easing (QE). That policy—creating money to buy financial assets—has been used at varying times by the central banks of America, Britain and Japan to fight deflation and stimulate economies flattened by the financial crisis of 2008. Yet the ECB still shuns QE, treating it as a weapon of last resort, even though the euro zone is suffering from “lowflation”, with prices rising by just 0.5% in May and June, far below the bank’s target of almost 2%. Is it right or wrong to forgo a policy that has become standard practice elsewhere?

One reason to doubt the efficacy of QE in the euro area is that banks rather than markets dominate the provision of credit there. In America, in contrast, companies raise much of their funding in the bond markets. One of the main ways that QE has boosted the American economy is by lowering corporate borrowing costs. As the Federal Reserve bought Treasuries and government-guaranteed mortgage securities, pushing down their yields, investors turned to corporate bonds, in turn driving down their yields. This effect would necessarily be feebler in the euro zone.

This suggests that the ECB should work through the banks in fighting lowflation. It is striving to do that in two main ways. In June it brought its main lending rate down to a new low of just 0.15% and became the first big central bank to introduce negative interest rates, which in effect charge banks that leave deposits with the ECB. This has helped lower money-market rates in the euro zone almost to zero—and cap the appreciation of the euro, which was contributing to disinflationary pressures.

As well as this general stimulus to the euro zone, the ECB is also seeking to galvanise the recovery in southern Europe, where small firms in particular remain starved of credit. Mimicking a policy invented by the Bank of England—the funding-for-lending scheme—the ECB will make funds available at dirt-cheap rates to banks until 2018 as long as they do better in lending to the private
sector (excluding household mortgages).

The new funding operations, starting in September, will take time to work their way through to the economy, but the ECB is prepared to be patient. It has always insisted on a long horizon for meeting its inflation target. It points to inflation expectations, gauged both through the financial markets and the views of professional forecasters. These suggest that inflation, despite its recent lows, will eventually return to the target of just under 2% and thus remains “anchored”.

Even if these forecasts are correct, however, the euro zone stands out among big economies for the depth and likely duration of its bout of low inflation. Lowflation is already hurting debtors in the euro area since their incomes are rising more slowly than they expected when they borrowed. Their plight would intensify if lowflation mutated to deflation. The real burden of debt rises when prices are falling. That effect would be especially pernicious in the euro area as levels of private and public debt are perilously high in many countries.

Moreover, the risk of deflation is greater than the ECB acknowledges. Deflation crept up on Japan in the 1990s even though inflation expectations remained positive. The ECB draws comfort from the consensus among forecasters that inflation will return to the target in five years’ time, but that view is more a vote of confidence in the ECB than a reading of the economic tea leaves. Inflation expectations over shorter horizons, as inferred from financial markets, have been falling. Consistent with this, broad money has been growing this year by only about 1%, which supports the case for QE to inject more money into the economy.

There is nothing to prevent the ECB from pursuing QE as well as its funding operations to promote higher lending to the real economy. Britain also relies more on its banks than does America, but that did not dissuade the Bank of England from deploying QE between 2009 and 2012. Moreover, it also launched the funding-for-lending scheme while it was still carrying out QE.

The ECB would be a late adopter of QE, but this in itself is an advantage, in that the policy has already been road-tested by more adventurous central banks. Early foreboding that QE would debase the currency and cause a debilitating inflationary surge has been discredited.

Paroled sovereigns

The real reason for the ECB’s allergy to QE lies in its unique status as a supranational central bank setting monetary policy for countries that retain fiscal sovereignty. Private-asset markets in the euro zone are not big enough for purchases to have much impact so, like the other big central banks, it would have to buy lots of government debt. But unlike its peers, it would be buying the debt of 18 different countries, in amounts linked to the respective sizes of their economies. These purchases would have a much bigger impact in peripheral Europe, where credit ratings are poor, than in Germany, which retains AAA status. The Bundesbank in particular fears that QE would relieve the pressure on less creditworthy countries to overhaul their economies and to keep deficits in check.
And it would mutualise within the ECB the risk of holding dodgy sovereign debt.

These risks are real, reflecting the dash for a premature monetary union before the right fiscal and political conditions were in place. But the ECB already crossed the Rubicon in 2012 when it promised, if necessary, to buy unlimited amounts of the bonds of euro-zone governments under attack by investors. That guarantee saved the euro from the fury of the markets. However, a slide down a debt-deflation spiral could also create an existential crisis. In these circumstances patience is imprudent: the ECB should get a move on.

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