The case for quantitative easing is compelling but it requires broad support, writes Reza Moghadam

The European Central Bank is sidling towards the printing press. After taking tiptoe steps for more than a year now, in recent weeks it has begun treading more heavily.

It is clear why the central bank had to abandon its former coyness. The stubborn fall in inflation and growth, and declining prospects for both, have made clear that the old approach is no longer enough. Setting short-term interest rates close to zero and buying assets so as to push down longer-term rates has not lifted the eurozone out of its slough. It evidently believes that it is time to try something less conventional.

Still, not everyone agrees quantitative easing would be effective in Europe — and the doubts are by no means confined to a few stalwarts of monetary orthodoxy in the Bundesbank. Printing money, the sceptics say, is not worth the coin.

There are philosophical objections, of course; a popular view in Germany is that QE amounts to a pact with the inflation devil. But there are also doubts about the effectiveness of such policies. These practical considerations fall into three broad categories: problems of diagnosis, practice and politics.

The diagnostic problem is the idea that low inflation, as a byproduct of low growth, has more to do with poorly functioning markets than a shortage of demand. The implication is that printing money, a measure intended to stimulate demand, will be of little help.

This is wrong. Output did not contract at the start of the crisis because of labour and product market regulations — those have been around for decades. Rather, it did so because demand collapsed. Even Germany, with many fewer structural rigidities, is sputtering because of continued weakness in domestic demand.

Yes, reforms are needed. Arguably they should be part of a larger European response to the economic crisis. But supply-side reforms alone are not going to solve the problem of low inflation or deflation, which is undercutting growth and employment. This is a threat to the eurozone's very existence.

The practical problem is that, although QE might have shown impressive results in places such as the US, it is less likely to work in Europe. QE works by lowering bond yields and depressing the currency; but these have already fallen a great deal — and are perhaps as low as they can go. Furthermore, although the yields on bonds would fall if central banks embarked on a buying spree, most European companies rely on banks rather than bond markets for their capital needs. The economic channels through which the stimulus of QE is supposed to be delivered are far narrower in Europe than elsewhere.

But these observations, too, are misleading. Yes, yields on sovereign bonds have fallen and the euro has weakened — but this is because people expect QE to happen. More importantly, interest rates for private sector loans have not fallen much; adjusting for lower inflation, they in fact have risen.

If the ECB starts buying assets of a certain type — government bonds, say — it will stimulate demand by forcing the sellers to replace those assets in their portfolios with either foreign assets (in which case the euro falls) or equities and other eurozone assets (in which case equity prices rise and interest rates fall). Higher equity prices help companies by reducing debt as a proportion of net worth, sparing them the need to cut back investment in order to repay their debt. This also makes it easier for companies to obtain loans, since the lender’s claim on them is more valuable when the company’s equity is worth more. Even in a bank-centric system such as Europe’s,
QE can be powerful.

The final concern about effectiveness is political — and there is no convincing riposte to it. Without German support for QE, the ECB would have too little freedom of action. It could not adjust the programme as needed, and it could not credibly deliver promises to do “whatever it takes” along the way. Germany is the cornerstone of perceptions about eurozone viability. Without support from Berlin, an ECB programme would resemble the halfhearted, and hence unsuccessful, interventions of the Bank of Japan in the 2000s.

The case for QE is compelling, and anyone watching ECB president Mario Draghi’s last press conference might think that he too has reached this conclusion. But effective QE requires broad political support. And it needs to be grounded in a broader strategy that includes ambitious structural reforms, public investment and a measure of fiscal stimulus. It is now up to the political establishment to do its part to deliver Europe from protracted stagnation and worse.

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