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Easing would be the wrong move for the ECB

by Michael Heise

Will the European Central Bank go down the route of quantitative easing (QE)? For some while now, Anglo-Saxon economists and commentators have been calling on the ECB to follow the Fed and the Bank of England and start pumping liquidity into the lackluster eurozone economy. Such a measure, they argue, is even more imperative now that the Eurozone appears threatened by damaging deflation. Having long been reticent on the question of QE, now even hawkish members of the ECB leadership are discussing it openly. Yet the Bank is unlikely to start buying assets on a grand scale. Nor should it.

There is, as yet, no clear threat of persistent deflation. The fall in eurozone inflation to 0.5% is due to factors that are independent of ECB policies. The prices of oil and other commodities have declined. Wages are falling in Europe's struggling periphery and this is feeding through into lower output prices – which is exactly what is needed to restore competitiveness. There is no sign that people are refusing to spend: savings rates are stable and in some places they are falling.

Yes, say the proponents of QE, but what if inflationary expectations dip because people no longer believe in the ECB's ability to keep inflation in positive territory? Deflation would then become a self-fulfilling prophecy.

It is true that inflationary expectations have declined significantly. But this reflects to a large extent the decline in actual inflation due to the factors just mentioned. This is normal: inflationary expectations tend to follow actual inflation rates down as well as up. For example, in 2011 and 2012, commodity prices pushed up inflation and inflation expectations spiked. Neither stayed high. The ECB must make it very clear that its inflation target – of below but close to 2% – is meant for the medium term, not day-to-day management.

Supporters of QE also point to the lack of credit in the European economy, which may store up deflationary trouble in the future. The credit supply is indeed still contracting. But it is questionable whether ECB bond purchases could boost the financing of the real economy. First, the decline in loan volumes represents a correction after a credit-fuelled boom that left many countries with unsustainable debt levels. Demand for loans is of course subdued in such a situation. Second, the ECB is supplying the eurozone banking system with practically unlimited liquidity. The lack of bank credit is therefore less a result of liquidity shortages, and more of capital shortages in the banking sector. Banks must write down the remaining bad debt in their balance sheets to create room for new profitable investments.

Finally, friends of further easing argue that QE would keep longer-term bond yields at a low and investment-friendly level. This, of course, has been the Fed's aim when buying corporate paper and mortgage-backed securities. Should the ECB also push up asset prices? Eurozone government bonds – even those of the highly indebted and weaker member countries – have recovered significantly. If the ECB bought them at these valuations, it would put European taxpayers' money on the line and risk its own standing as an independent, non-fiscal institution. If the ECB instead bought corporate bonds – also at fairly high prices – it would expose taxpayers to direct credit risk in its own balance sheet.

While the benefit of such bond purchases remains uncertain, they would further complicate the eventual exit from expansionary monetary policies. If and when inflationary pressure returns, the ECB could be forced to sell the securities from its balance sheets directly into a falling market, which would not only result in valuation losses but also further push up yields.

So what should the ECB do ? It should not try to come up with a panacea to what is, after all, likely to be a temporary and welcome dip in inflation. It should continue supplying abundant liquidity to Europe's banks, which are still operating in a rather dysfunctional money market. But it must now increase the pressure on banks to clean up their balance sheets through the forthcoming asset quality review and the stress tests. This would end the current situation in which Europe's stronger

banks are paying back their precautionary ECB loans while the weaker ones are still completely dependent on ECB funding.

The ECB could accelerate the balance sheet clean-up through some new forward guidance: it should announce that practically unlimited liquidity at no cost will not be available indefinitely. Such a statement would help to re-activate money markets and put pressure on banks to write off non-performing loans to zombie companies. The lesson from Japan is to avoid a situation in which the central bank replaces the money markets in the long run and too many banks and corporations become hooked on practically zero interest rates.

The ECB should reconsider QE if the financial crisis flares up again or markets over-react to the AQR and stress tests. But QE is not a sensible option against the background of economic recovery, presumably rebounding inflation rates and undeniable signs of very high risk taking on financial markets.