QE is the name of the game in Europe's monetary union

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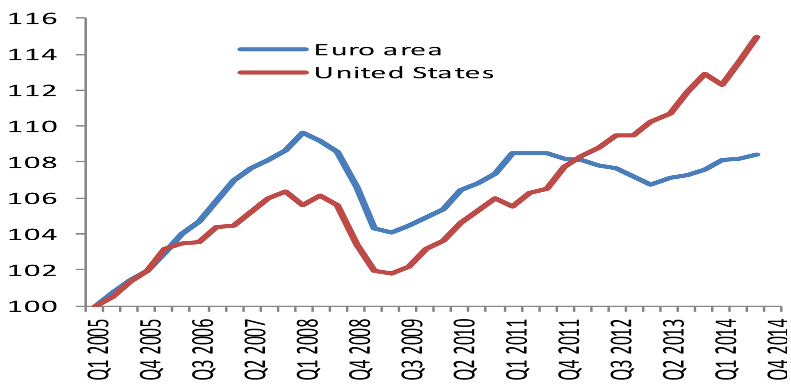
What the paper says

- Within Europe's monetary union, 'one size fits all' monetary policy has always been a problem, but lack of flexibility in domestic fiscal policies has turned monetary policy in the only 'game in town.'
- QE is the expected outcome of Mario Draghi's doctrine of 'whatever it takes'. However, it is unlikely to make a substantial difference to growth while its contribution to anchoring inflation expectations remains to be seen.
- The reality is that QE à la ECB goes only so far as Germany allows it – and it creates more fragmentation in the euro area.
- We advocate a more decisive action in support of economic growth through a coordinated fiscal expansion through a bolder Junker Plan to support EU-wide infrastructure projects.
- QE does not remove the risk of a protracted slump in the euro area that feeds onto itself, with deflation taking root, putting the political viability of the euro area at risk.

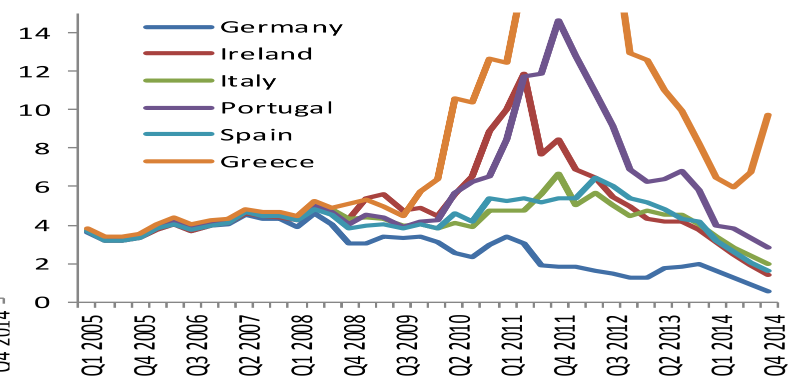
The economic outlook remains problematic

The euro area predicament

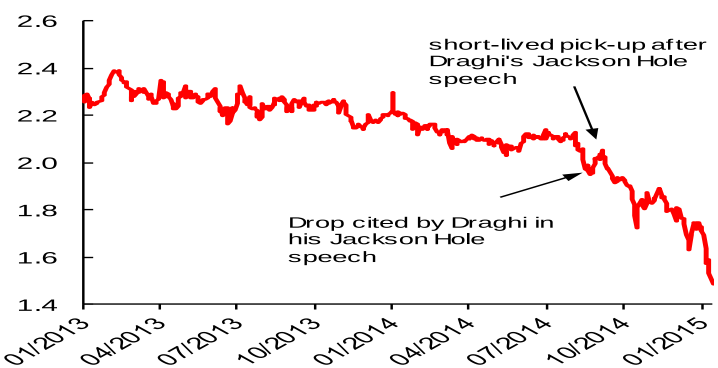
A. Lack of growth (real GDP, index, Q1 2005 = 100)



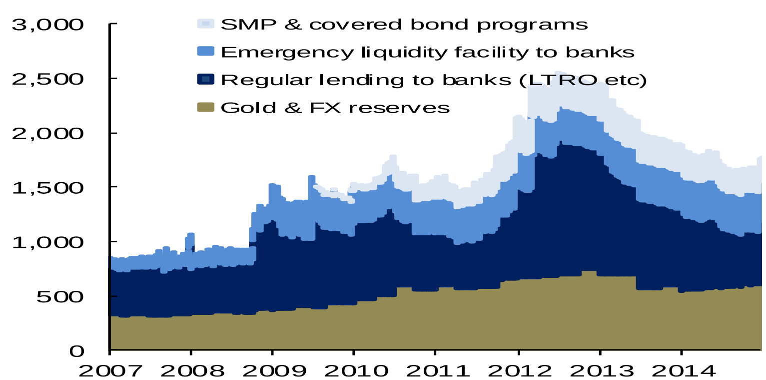
B. Volatility in sovereign yields (10Y, %)



C. Falling inflation expecations (5Y/5Y inflation swaps, %)



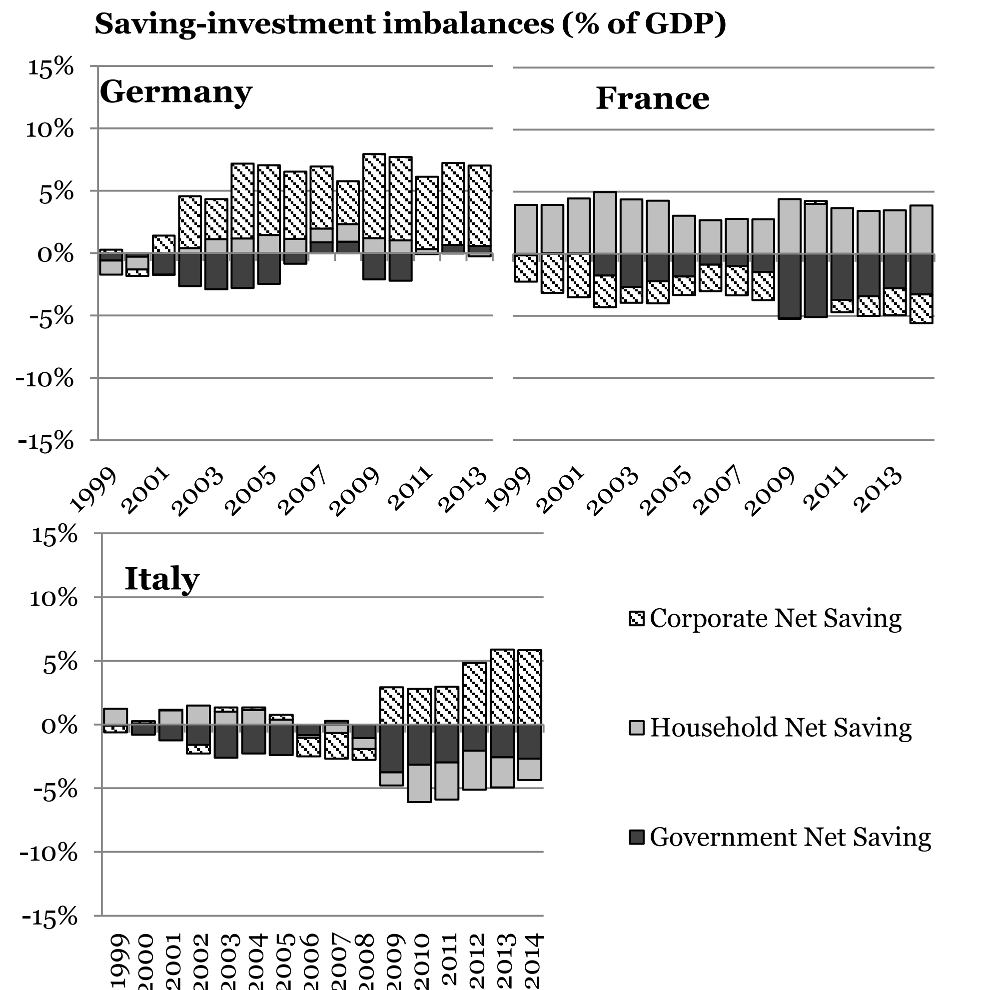
D. Shrinking ECB balance sheet (EUR bn)



Source: Thomson Reuters Datastream

Pre-crisis imbalances explain the euro crisis

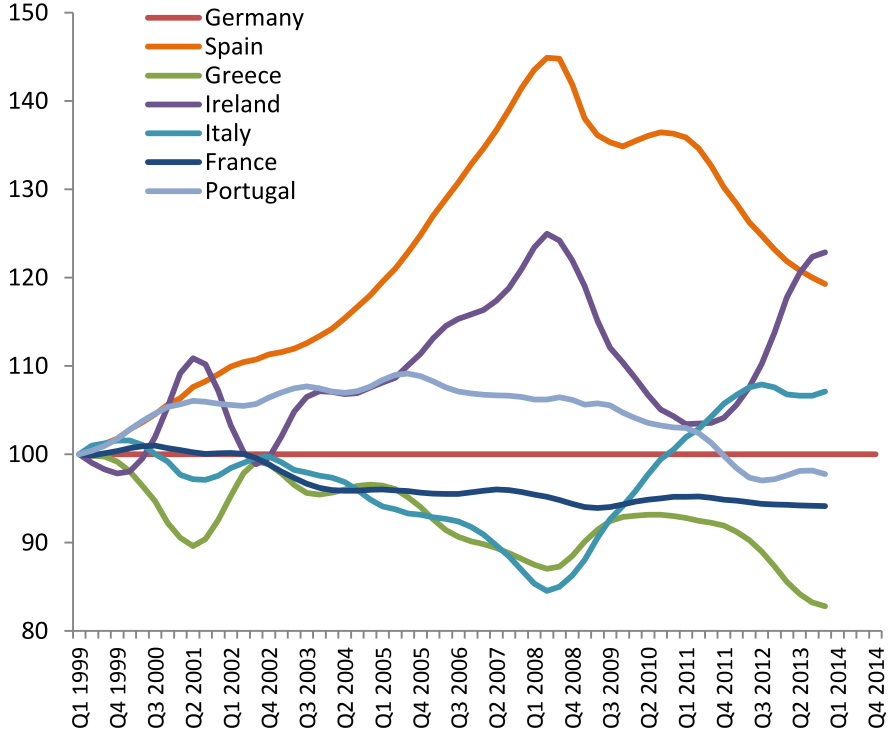
- Too low interest rates in the periphery
- Net saving surplus for German businesses
- In France households as net savers and businesses and government as dissavers
- Eroding competitiveness and wider current account deficits in the periphery



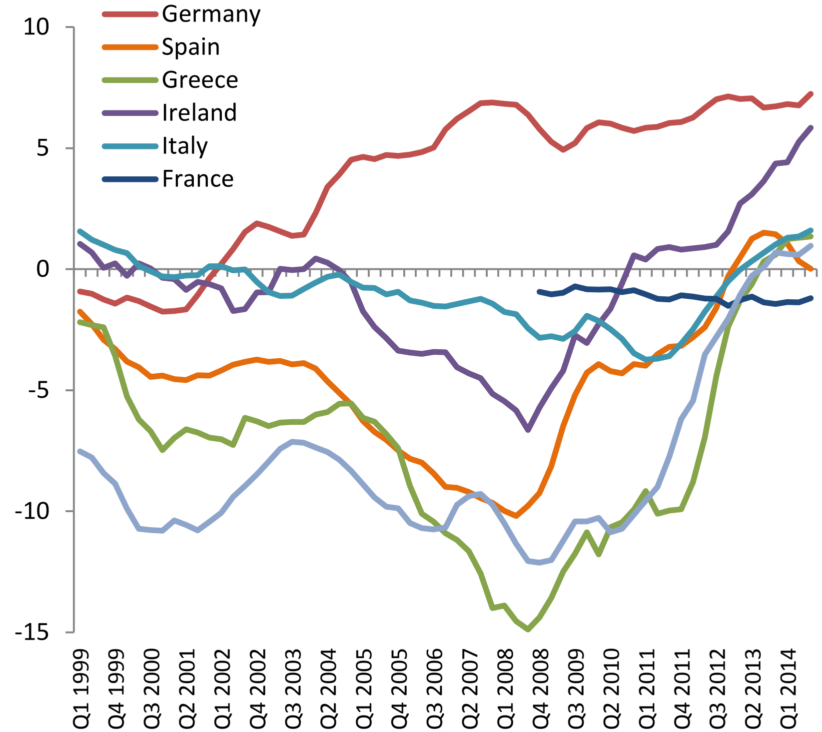
Source: Thomson Reuters Datastream

Competitiveness drives imbalances

A.Real effective exchange rate against Germany (as % of GDP)



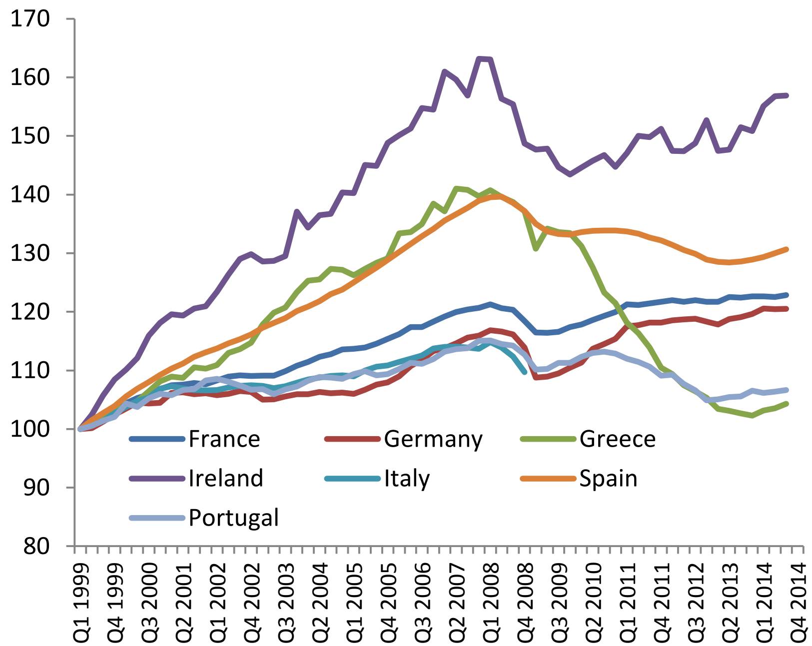
B. Current account moving average (as % GDP)



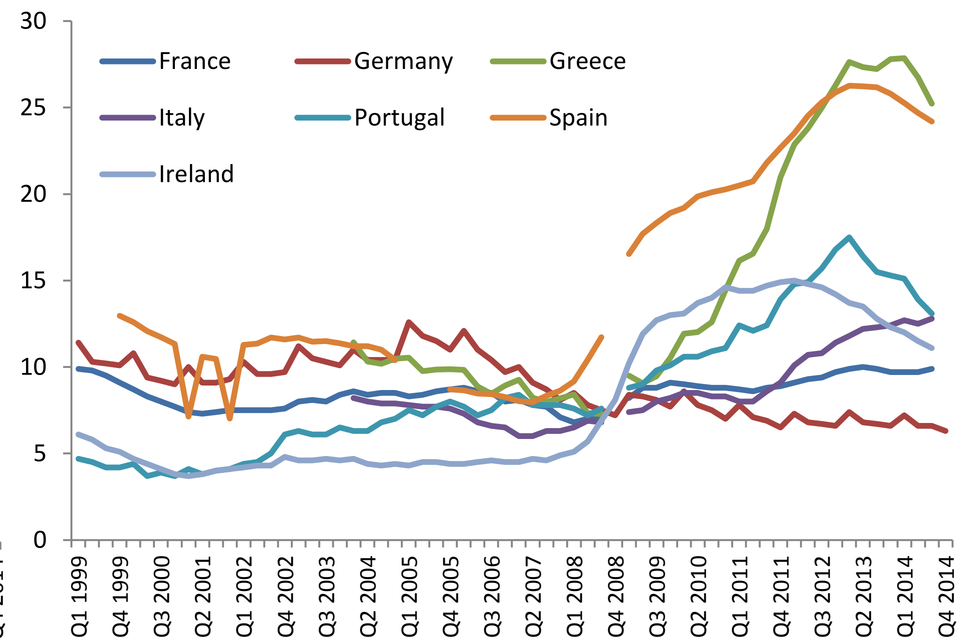
Source: Thomson Reuters Datastream

And it affects growth and job creation

A. Real GDP (1999 Q1 = 100)



B. Unemployment rate (%)



Source: Thomson Reuters Datastream

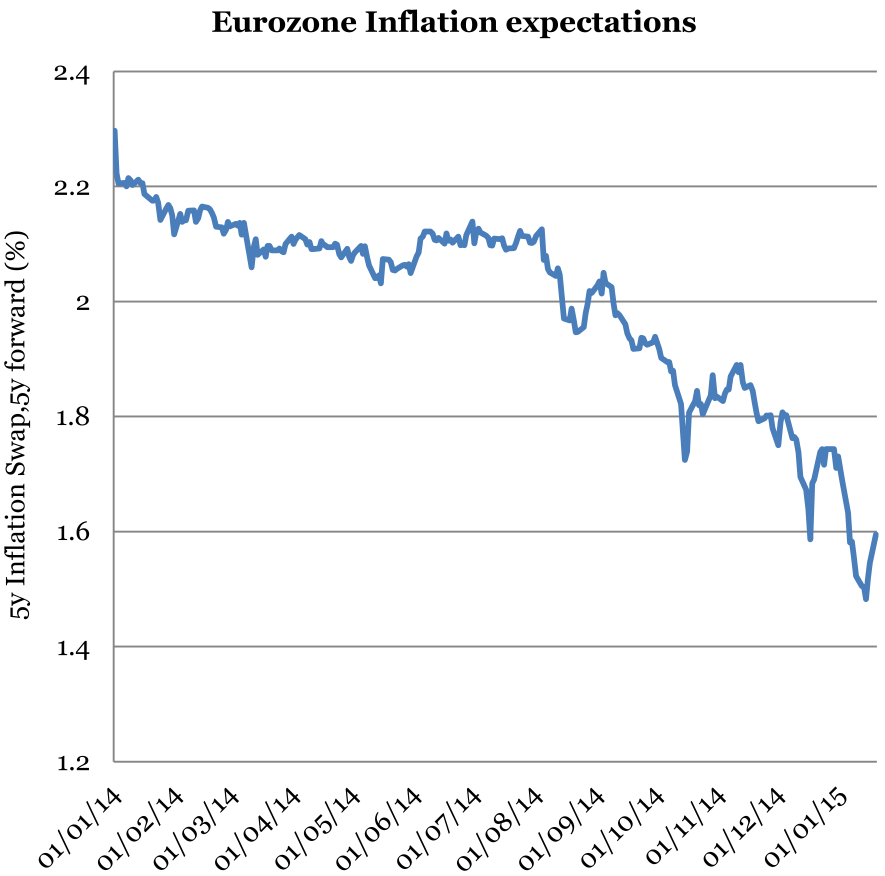
Asymmetric policies to deal with asymmetry

- Fiscal tightening, deleveraging and reduction of the current account deficit in the periphery

- But collapse of domestic demand and higher unemployment

- Not highly effective transmission of monetary policy through the banking channel

- The eurozone, especially the periphery, is now facing falling prices, nominal contraction, rising public and private debt burdens ("debt deflation"), continued deleveraging, fiscal contraction



Source: Thomson Reuters Datastream

Where do we go from here?

- The ECB will start to buy sovereign bonds (up to EUR60 billion a month from March 2015 to September 2016).
- But the ECB pushes most of the risk on national central banks, creating more fragmentation.
- The move is likely to have little impact on growth because of limited transmission of monetary policy (ie more credit to support investment) and the less favourable global environment (ie the exchange rate effect).
- The impact of QE on inflation expectations remains to be seen, but the move may prevent the creation of a 'liquidity trap'.
- More decisive policy action to use the available liquidity to push infrastructure projects is needed.

Thank you