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

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Introduction

The euro area has hit the headlines again as the European Central Bank (ECB) is unfolding its own programme of quantitative easing (QE) in response to deflationary pressures. According to the latest figures, in December 2014 consumer prices dropped by 0.2% in the euro area as a whole. Despite attempts, earlier on, to play down deflation – such as, for example, Claudia Buch, deputy president of Germany's Bundesbank, who at the end of November said that a disinflationary scenario in the euro zone was not "imminent"[1] – the ECB has indicated that it will take action to contain deflation even if it has not clarified, at time of writing, how this policy direction will be implemented. It has not been an easy decision for the ECB which over the past months has faced the open opposition of some countries, notably Germany, to a fully-fledged QE programme. Credit goes to ECB president Mario Draghi who since mid-2014 has been 'forward' guiding market participants to expect more than he could actually deliver. But the unfolding of QE in the euro area, especially if compared with the experience of other central banks such as the Federal Reserve, the Bank of England and even the Bank of Japan, has shown a high level of pain and uncertainty, indicating, once again, how difficult it is for a group of sovereign countries with a common monetary policy and national fiscal policies – and objectives – to coordinate their action.

In this paper we argue that a common monetary policy has always been problematic for the euro area, but the lack of flexibility, in the post-crisis years, in domestic fiscal policies has constrained each country's adjustment to 'one size fits all' approach of monetary policy. As the ECB is ready to activate a fully-fledged QE, we maintain that Mario Draghi's approach "whatever is needed" served the eurozone well during the market emergency of 2011-2012 and to stabilize the markets in the following years. But it cannot continue to replace domestic policies that appropriately stimulate demand.

Our key point is that the crisis has created more polarisation in the euro area – both in political and economic terms. In the paper therefore we look at the increased economic divergence among eurozone member states and we argue that the crisis has exacerbated an existing situation (that pre-dated the crisis). Using a few examples from the pre-crisis years we argue that countries joined Europe's monetary union without fully understanding the adjustments that they needed to pursue in order to live with the euro (and within the euro). The global financial crisis that then morphed into a sovereign debt crisis was the trigger that pulls apart the EMU construction and showed its shortfalls. But then failure to understand that the crisis was not (or not only) a fiscal crisis and inappropriate

[1] CNBC, Deflation is not a major risk: Bundesbank, http://video.cnbc.com/gallery/?video=3000333833

policy responses have contributed to undermine GDP growth in the currency union as a whole while they have pushed countries like Italy and Greece on the brink of a 'secular stagnation'.

The current predicament of the euro area is perhaps best illustrated by the four charts grouped in Figure 1. It shows that output never returned to its pre-crisis level, sovereign bond yields have been on a roller coaster, and inflation expectations are plummeting while the European Central Bank is struggling to expand its balance sheet. In a nutshell, what we see here is an economy that grapples with persistent slack while *en route* for deflation.

The paper is organised as follows. The first section assesses the impact of the crisis and the asymmetric shocks and imbalances. The point that we stress in this section is that these imbalances that pre-dated the crisis. We then go on to discuss the policy responses at the time of crisis and how these policies have exacerbated the existing asymmetries. We conclude by looking at the current options and by advocating policies to support investments in infrastructure through a pan-European approach that goes beyond the rather timid attempt provided by the Junker Plan.

Reassessing the crisis

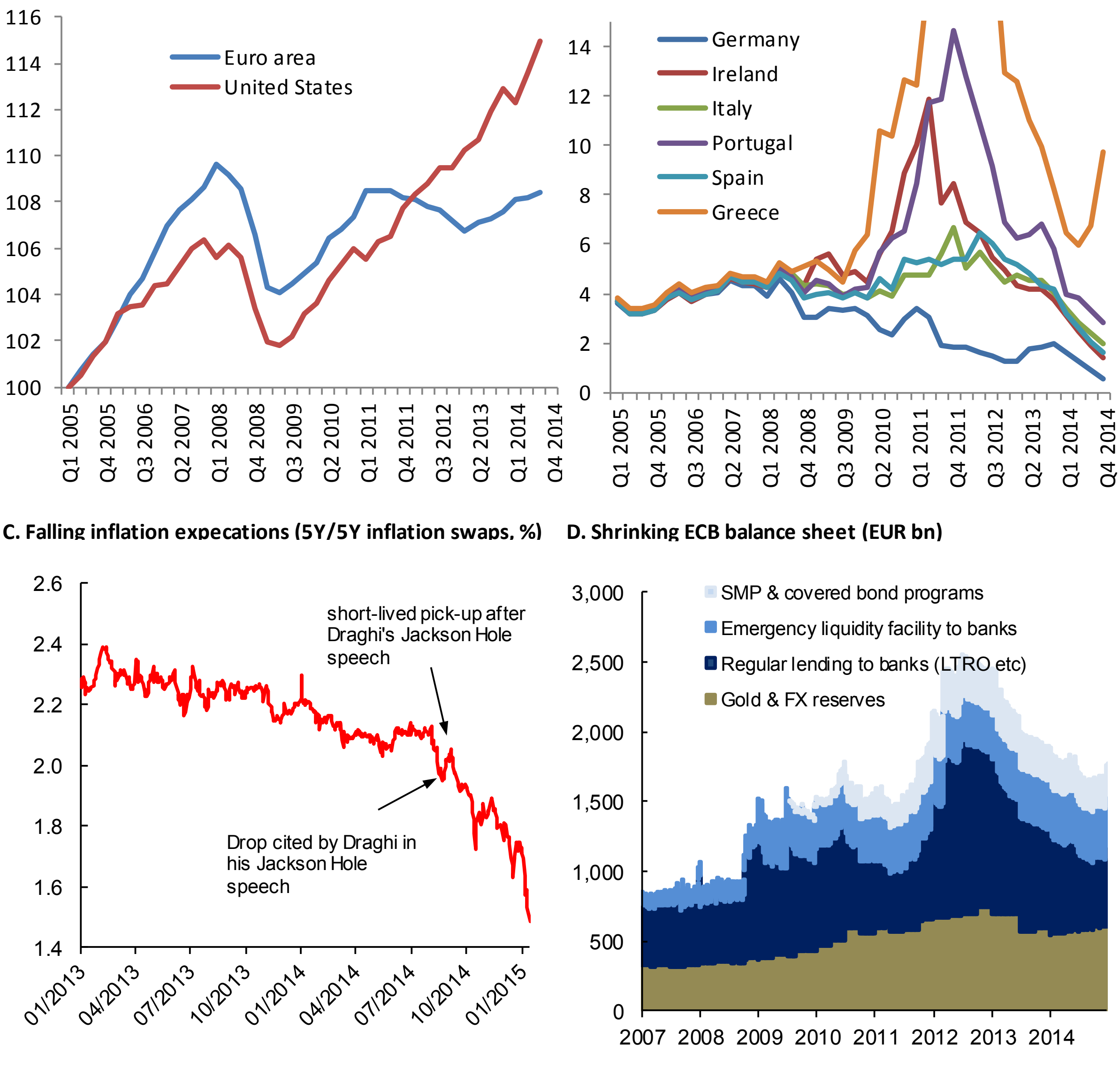
In the years 2010-2012 the euro area went through -- and barely survived -- an existential crisis, starting with speculation of a Greek exit from the euro area in May 2010. At first only smaller countries were hit by financial turbulence, and bailed out by so-called Troika rescue programmes, but when much larger Spain and Italy were hit by the threat of sovereign default as yields soared, the euro area faced a near-death experience. This ended when Mario Draghi, the ECB president, in July 2012 made a promise to "do whatever it takes" to rescue the euro area. This was understood to mean he would buy any amount of sovereign debt necessary to prevent default, in exchange for conditions – so-called Outright Monetary Transaction (OMT). Even if this move was heavily disputed by German observers and officials (and indeed legally challenged by them), bond markets calmed in response, apparently believing that betting against a central bank able -- and willing -- to print reserve currency for debt purchases *ad infinitum* is a losing game.

After this bout of financial instability in 2012 the euro area entered a period of relative calm, only briefly interrupted in 2013 by the default and rescue of the government and banks of Cyprus as the latter had been heavily exposed to Greek debt "haircuts". Despite this relative calm the economy nonetheless went into a second dip recession in 2012-2013. Lasting for about a year and a half, it was not as deep as the 2009 "Great Recession" post-Lehman, mostly because it, not surprisingly, was concentrated in the periphery economies. These countries experienced depressions as bank lending stopped, households and business were forced to deleverage and unsustainable fiscal positions were reined in – in part imposed on them by the creditors running the rescue programmes (IMF, EU and ECB).

It was only in the course of 2014 that most periphery economies had stopped contracting, with Spain and Ireland leading and Italy lagging. But the economy nonetheless failed to take off because of adverse external shocks, especially the Ukraine crisis to which several euro-area economies were heavily exposed, including Germany. In addition, Greece has entered yet another bout of financial instability as an ultra left-wing government is set to enter office just when the country's Troika programme is about to expire and its sovereign bonds may no longer be eligible for ECB funding of its banks. Meanwhile, the ECB is set to expand its balance sheet after earlier attempts failed with a so far untested instrument: the massive purchase of sovereign bonds, or quantitative easing (QE).

Figure 1: The euro area predicament

A. Lack of growth (real GDP, index, Q1 2005 = 100) **B. Volatility in sovereign yields (10Y, %)**



Sources: Reuters Datastream, Bloomberg

We believe that, although QE is necessary in view of falling inflation expectations and the headline rate of inflation actually negative since December 2014, this is not the panacea. What needs to be done to safeguard the viability of the euro area is much more wide-ranging, for which QE will at best buy time. For a proper understanding of the necessary policy response we think it is useful to go through the deeper causes of the area's predicament. These causes are partly political and partly economic in nature, but can all be grouped under one label: *asymmetry* -- of imbalances, of shocks and of the policy responses.

Asymmetric shocks and imbalances

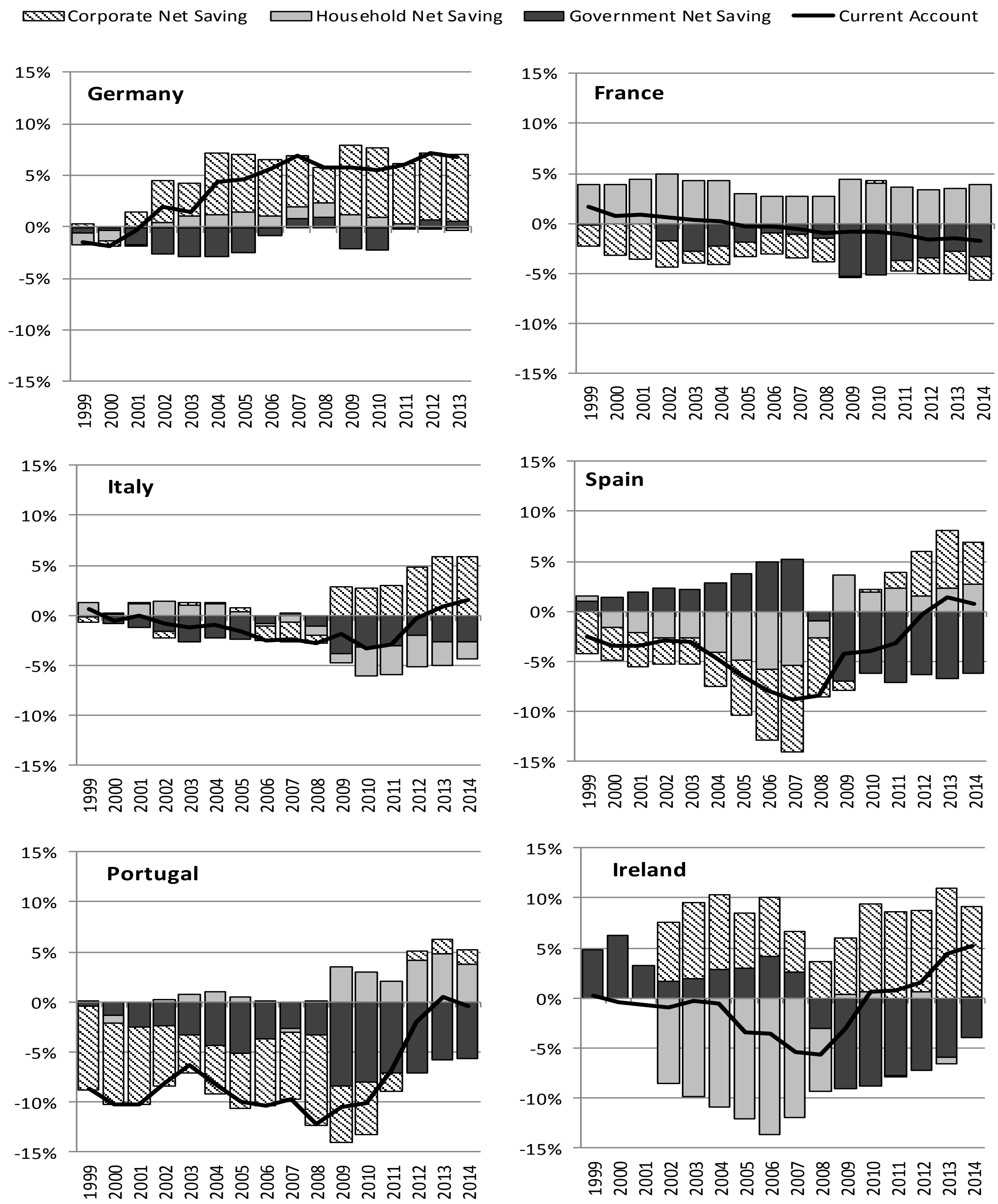
The roots of the euro crisis reside in the asymmetries stemming from the very different initial conditions across member countries when the euro was created. Right from the outset the current debtor countries had been running large and growing current account deficits and building up private cross-border debt. Eventually they were hit by sudden stops – as usually happens in a world of open capital accounts – where jurisdictions do not print a reserve currency and also cannot draw, without constraints, on credit from jurisdictions that do. Similar sudden stops would never occur in, say, California, because California shares the risk of default of its banks, the fiscal risks of recession, and indeed financial and economic risks at large, with the federal government and the federal reserve system of the United States. Euro member countries lack such risk sharing mechanisms and therefore have been exposed to sudden stops. This is something the founding fathers of the single currency surely understood. But they decided to sweep it under the carpet so as to not jeopardise the launch of the currency in 1999 – a decade after the Cold War had disappeared as a unifying force in Europe and the re-unification had rendered Germany too powerful for comfort, prompting other nations to want it to be "locked into" Europe.

The imbalances that ensued after the creation of the single currency were the result of a string of 'start-up shocks' playing out (see Figure 2):

- In the periphery interest rates sharply fell with the removal of exchange rate risk and these countries acquired access to easy finance given that capital controls had been removed a decade earlier as part of the Single Market. This triggered a financial and real estate boom in most periphery countries, but not in all. Each country has its own story. Italy had been trapped in a low-growth pattern since the late 1990s as competitiveness was lost, Greece was a case of pure fiscal profligacy and Portugal was inflation prone while its economy was structurally weak. But they all felt somehow "protected" by the euro. Inflation in the periphery persistently exceeded that of the core (see Figure 3). Driven by buoyant (but unsustainable) domestic demand, output and jobs creation outpaced that of the core by a large margin. In the case of Greece this was exacerbated by the Olympic Games and massive inflows of European "structural funds" used to build public infrastructure at excessive cost (mostly due to corruption).
- In the core, and in particular Germany, business sectors were running net saving surpluses. In Germany the economy was working off excess supply in construction sector after reunification had produced a construction bubble in the early-1990s. Demand was subdued, inflation low, and real interest rate comparatively high. Current account surpluses built up as businesses deleveraged, and capital was exported to the periphery, mostly through banks. Obviously not all surplus capital was exported to the periphery, as some ended up in the emerging economies in Eastern Europe where German business was building up new supply chains. This, along with a string of labour market reforms launched in the mid-2000s by Chancellor Schroeder, served to erode the bargaining power of German unions, further contribution to stronger competitiveness and export performance.
- The odd man out is France, where households have always been a net saver and business and the government have net dis-savers. Although before the crisis France was at a similar path as the periphery, with competitiveness eroding and the current account deficit widening, it was never forced to adjust. This could be sustained because markets put French bonds in the same basket as German bonds on the assumption that the German-French axis will always be rock-solid. This is rooted in historical experience. For instance, when currency pegs against the Deutschemark in the European Exchange Rate Mechanism (ERM) came

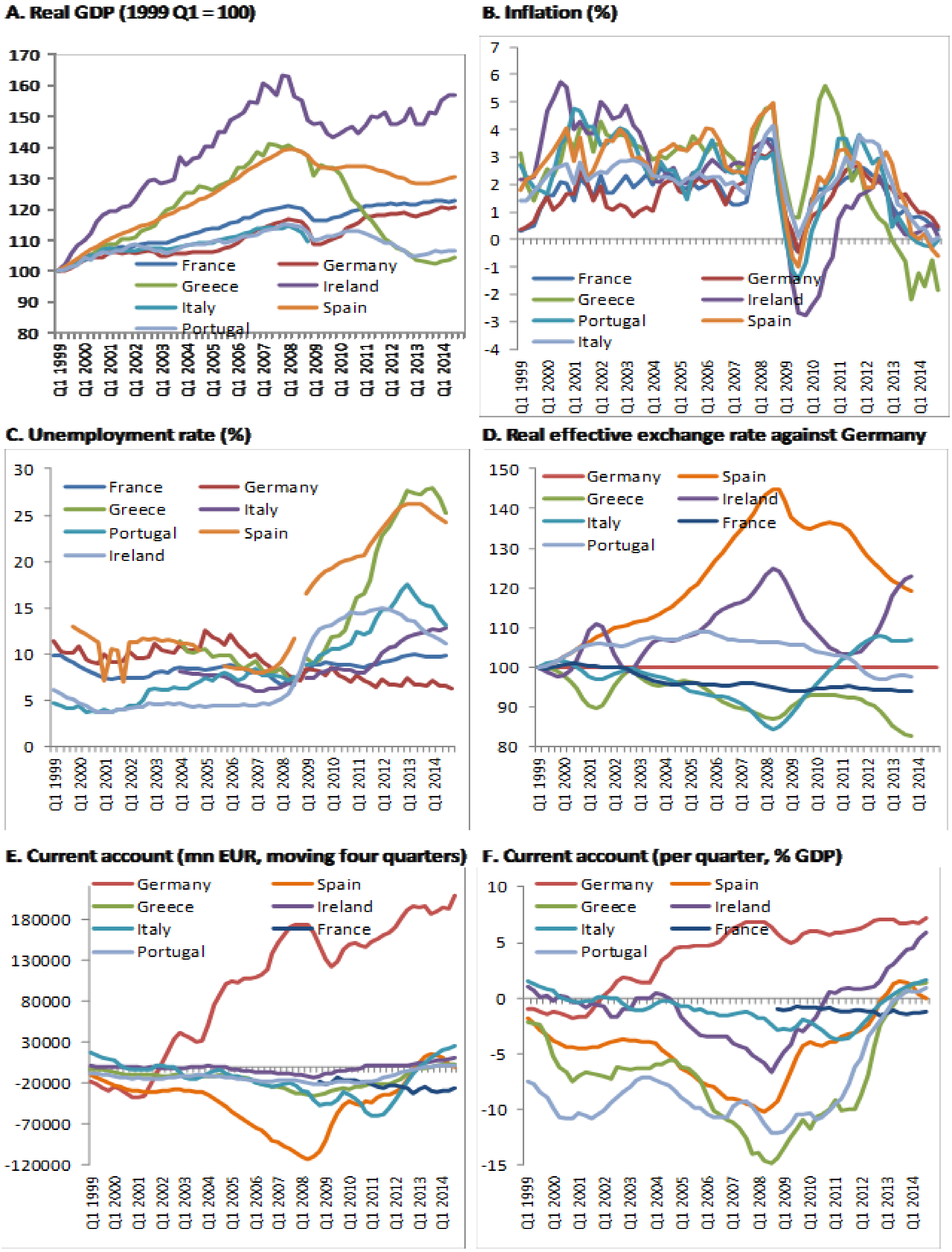
under strain in the early 1990s after the Bundesbank had tightened monetary policy to stem the post-unification economic boom. Though it had not blinked when other currencies were attacked, the Bundesbank backpedalled when the French franc came under attack.

Figure 2: Saving-investment imbalances (% of GDP)



Source: Reuters Datastream

Figure 3: Adjustment indicators



The upshot is that in the euro area economies were on a divergent and unsustainable path, with debtor and creditor countries moving in opposite directions. This had to stop, and it did. After Lehman, the periphery went into a tail spin due to falling risk appetite and investors realising the no-bail-out clause in the Treaty could actually bite, while also competitiveness losses (which accumulate over time) started to seriously affect foreign trade. The sudden stop of capital inflows alongside housing booms turning to bust in a number of periphery countries produced a banking crisis. Official financing had to take over private financing in exchange for 'austerity', and bank credit began to shrink – not only in the periphery but also in "core" countries that had been exposed to periphery risk or were grappling with the unwinding of housing bubbles at home. This is why Europe entered a second dip recession in 2012 But obviously henceforth the interests of creditor and debtor countries were conflicting. The former wanted their money back, and therefore wanted debtor countries to deliver. The latter called on the former to "show solidarity" and provide bail-outs on at favourable terms. The policy reaction that emerged from this conflict of interest was deeply asymmetric.

Asymmetric policies

When sudden stops hit the debtor countries of the euro-area periphery, international creditors (IMF, ECB, EU and creditor countries led by Germany) were called in to rescue them. The latter demanded tough conditionality in exchange for bail-outs. It is precisely because the IMF had valuable practical experience and expertise handling balance of payments crises that Germany wanted this institution to be part of the rescue team – nicknamed the Troika. Conditionality referred to requirements of structural reform and fiscal consolidation. This is easier said than done and the list of measures was long and many of them politically and socially painful. In some cases (Italy, Portugal and Greece), EU bureaucrats entered governments to facilitate.

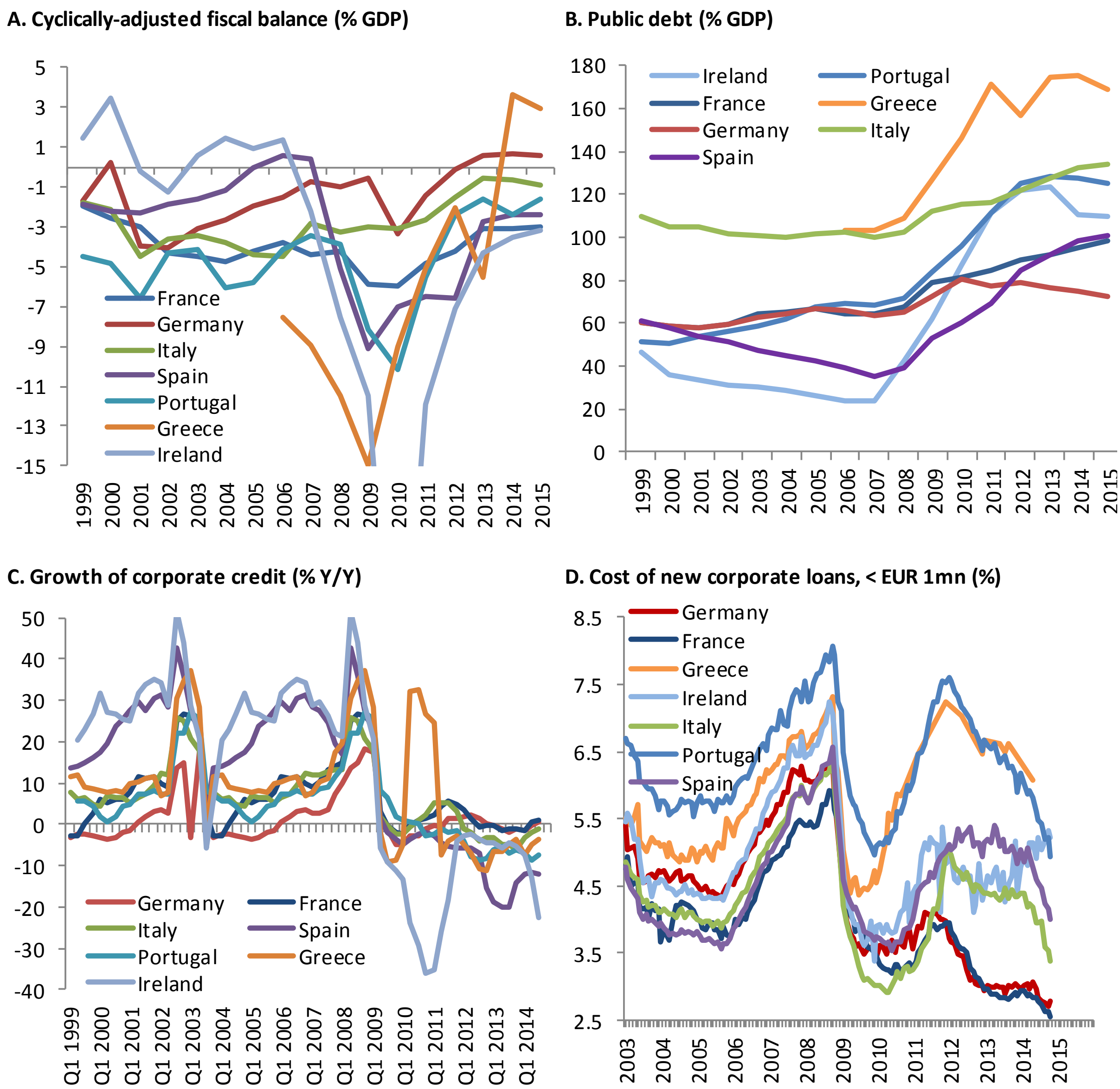
As part of the adjustment that ensued, unbalances in the euro area have eased. In the periphery current account deficits have disappeared, households, businesses and banks have made progress with deleveraging. But investment has plummeted along with household consumption, governments have cut spending and increased taxes, and unemployment has soared. This has given rise to "occupy" movements and other street protests in many periphery countries, along with the emergence of protest anti-establishment and in some cases anti-euro parties that are now becoming a normal part of the political landscape. Meanwhile the northern core has also seen the emergence of protest parties, mostly right-wing and hostile towards sovereign bail-outs in the south. Needless to say that this change in the European political landscape is complicating, or worse, future steps towards federalisation. As we will discuss further below, this is potentially undermining the single currency project.

The immediate economic problem associated with these political developments is that they exacerbate the asymmetry of policies. While the periphery adjusts in one direction (fiscal tightening and deleveraging), the "core" fails to adjust in the opposite direction, i.e. it is not easing its fiscal stance or using its much stronger external position to fund private investment. As a result aggregate demand in the euro area as a whole has been weaker than it otherwise would have been. The fiscal rules in Europe have been designed to secure fiscal discipline in the south but not to secure fiscal stimulus in the north – they are asymmetric in that sense. As a result Germany is now running a current account surplus of over 7% of GDP and e.g. the Netherlands (the fifth-largest economy of the euro zone) a surplus of over 10% of GDP. The result is an area-wide demand slump, with the area as a whole running a current account surplus of around 3% of GDP.

Monetary policy by the ECB has so far failed to pick up much of the slack, partly because the transmission channels of monetary policy are broken due to weak bank balance sheets and deleveraging needs in the private sector, and partly because the ECB has been much slower to respond to demand slack than its counterparts in the US, UK and Japan. This -- alongside the large current account surplus -- has tended to put upward pressure on the euro exchange rate and thus contributing to external demand weakness in addition to domestic demand weakness. Again, there is an issue of asymmetry here in the sense that the blockage of the monetary transmission channel has been most prevalent in the periphery where banks are also reluctant to lend because they are concerned – righlty or not – about the new and stricter regulatory framework.

It is thus not surprising that inflation has been falling unabated in the euro area. While this is partly the result of falling energy and food prices, core inflation has also fallen. Moreover, falling food and energy prices should be attributed at least to some extent to weak demand in Europe.

Figure 4: Fiscal stance and corporate credit



The risk Europe is facing is that more countries get trapped in a bad equilibrium of falling prices, nominal contraction, rising public and private debt burdens ("debt deflation"), continued deleveraging, fiscal contraction and south and persistently high unemployment – periphery situation Italy and Greece are already in. The ECB understands this risk, but is sure to be behind the curve and in any case can only treat the symptoms and buy time for elected politicians to move ahead with the necessary steps for lasting economic recovery. These necessary steps entail, in the sort-run, a large fiscal expansion over the EU budget – to by-pass fiscal rules and constraints at the country level – and, in the medium to longer run, the deepening of the European Single market, the liberalisation of product and labour markets at the country level, the creation of a genuine banking union in which bank insolvency risks are fully shared, and a symmetric treatment of fiscal and external imbalances (with surplus countries subject to the same type of triggers and sanctions as deficit countries). How much of this agenda will be achieved is an entirely open question. In fact, a number of ongoing developments are not encouraging.

Where we go from here

Looking at the short-run first, at the time of writing it was not known what policy decision the ECB was to take on 22 January 2015, but most likely it will have adopted – for the first time and more than five years after the Fed and Bank of England made similar moves – a programme of large-scale sovereign debt purchases (sovereign QE). This is after the ECB cut interest rates in several steps since late-2013-- with the deposit rate now in negative territory – and attempted to expand its balance sheet through other means such as collateralised long-term lending operations and the purchase of asset backed securities and covered bonds, so far with only limited success.

Initial rumours were that sovereign QE would be capped at EUR 500bn, but subsequent press interviews given by board member Cœuré suggest some upside risk to this number. But in all likelihood at least initially the programme will be smaller than its UK and US equivalents. The other major complication is the Greek election on Sunday 25 Jan. Our baseline scenario is that Syriza wins but needs more moderate left-wing Potami as a junior coalition partner to form a government. If so, negotiations on a programme extension (expiring on March 1st) and debt relief could end well, despite initial wrangling (one country, Finland, has come out saying it is against further debt relief), as nobody sees Grexit as an option. The ECB could announce the purchase of "all eligible sovereign bonds", thus leaving it open whether or not this will include Greece until programme extension is secured. In this scenario market volatility may be high until indeed extension is secured, which may take several weeks.

But there is yet another complication. Several countries (most vocally so Germany) require that national central banks purchase their own sovereign debt and carry all risk associated with it. In our view, QE without a risk-sharing arrangement would be counterproductive. It would increase the market perception of fragmentation and with it the sovereign risk of the periphery. This would eventually increase market pressure on already stressed countries. And it could produce a financial market backlash nipping an incipient cyclical recovery (spurred by the ongoing weakening of the euro exchange rates and falling oil prices) in the bud.

The reason why the ECB is likely to respond this way – notwithstanding the decisive "whatever it takes " move in the summer of 2012 – is the reluctance (to put it mildly) of some (notably German) members of the policy-setting Governing Council of the ECB to buy sovereign debt. Their arguments are multiple, but can be grouped in three. First, they resist ECB exposure to sovereign (or any) credit risk as this would also expose their tax payers without political legitimization. Second, they see QE as an ECB (sovereign) bail-out which they fear will produce moral hazard and weaken the incentives for structural reform fiscal consolidation. Third, they reject QE on the basis that it would produce inflation down the road. All these arguments are biased. The first one is not wrong per se, but at odds with the required move towards a federal fiscal union which is a prerequisite for a functional monetary union, though admittedly electorates were never consulted – see our remarks upfront. Neither is the second wrong per se, but we would argue it is not the central bank's role to gear its policy to outcomes in policy domains outside its (strictly monetary policy) mandate. The third one is plainly wrong in the context of an economy afflicted by persistent demand slack – though obviously the Germans would argue that slack is entirely structural and can only be addressed with structural reform.

Quantitative easing is clearly needed in the current circumstances and indeed the ECB has no choice as it must respect its inflation mandate. Policymakers in the UK and US have consistently emphasised the role of the portfolio balance channel as a key element in the expected transmission of asset purchases to the rest of the economy. According to this mechanism, purchases of financial assets financed by central bank money increase liquidity and push up asset prices, as those who have sold assets to the central bank rebalance their portfolios into riskier assets. This, then, stimulates expenditure by increasing wealth and lowering borrowing costs for households and companies.

However, in Europe this transmission mechanism may not be as powerful as in the aforementioned economies anyway because securities markets are comparatively smaller, and wealth effects accordingly also smaller. The ECB is therefore expected to rely more on the exchange rate channel of QE. To the extent central bank liquidity is used to purchases foreign assets; it will drive down the exchange rate, and therewith stimulate net exports and growth which in turn boosts corporate earnings and ultimately investment. If, moreover, QE induces foreign investors to sell their EA sovereign holdings and convert the proceeds in other currencies, it would drive the euro down further and thus reinforce the exchange rate channel. And by driving the exchange rate down, and by signalling a willingness to do "whatever it takes" to get inflation up, it helps anchoring inflation expectations.

But unfortunately this is second-best policy. It is second-best because it does not address head-on the source of disinflation, which is the persistent lack of demand associated with deleveraging and fiscal restraint in the periphery. Only coordinated fiscal policy can do this, and in a context of record-low bond yields should do this. First steps in this direction are envisaged in the framework of the "Juncker Plan" adopted late last year to launch EU-wide infrastructure projects financed partly by EU funds, but mostly by private funds lured into these projects through sovereign guarantees to reduce the cost of funding. But the plan is way too modest, and much more ambitious fiscal expansion is necessary. And not only that, also the debt to fund it should not count against the fiscal rules for individual countries and be eligible to purchase by the ECB.

In a recent paper, Chatham House has developed a pan-European infrastructure strategy to encourage 'good' infrastructure investment, address constraints and remove bottlenecks. It would promote the use of project bonds to fill financing gaps in the riskier stages of infrastructure projects undertaken by the private sector and included in the European pipeline. It would be funded by issuing European-backed bonds (or 'eurobonds') with long maturities for infrastructure projects. Since issuing Eurobonds fully backed by all EU member states is still a sensitive political issue, bonds could be jointly issued by national development banks together with the EIB. These hybrid bonds would be transnational and jointly guaranteed by participating national governments, making them more attractive to investors. And of course they could be eligible for QE purchases by the ECB.

Concluding remarks

Pushing down the euro is seen by many as a solution to stagnation and deflation in the euro area, but this paper argues it needs to be supported by a coordinated fiscal expansion. Unfortunately the incentives for creditor countries to embark on fiscal stimulus are weak. Yet without a fiscal expansion the current account surplus would widen further in response to exchange rate depreciation, thus exacerbating the current imbalances – excess saving in Germany alongside indispensable deleveraging in southern Europe. It would risk producing a protracted slump that feeds onto itself, with deflation taking root. If that risk were to materialise the amount of coordinated stimulus needed would increase progressively, putting the political viability of the euro area at risk.