The Last Resort: The EU's Rocky Road To Quantitative Easing

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With the European Central Bank having commenced a programme of Quantitative Easing (QE), roughly six years after the United States, Ellen Brennan examines this scarcely used measure. Involving high investment and relatively low returns, she describes QE as unreliable and potentially fraught when implemented in an economy as varied as the EU. Emphasising the lack of integration within the EU countries with respect to monetary and fiscal policies, she describes potential pitfalls but also the possible rewards rewards of a well-implemented programme of QE.

Introduction

In 2012, the president of the European Central Bank (ECB), Mario Draghi, promised to do 'whatever it takes' to save the shared Euro currency from ruin (Draghi, 2012). This promise came to include the controversial implementation of quantitative easing (QE). There remains little to no consensus amongst experts as to whether QE truly helps or hinders an economy. Despite such uncertainty, some of the world's largest economies implemented QE as a last resort to revitalise their struggling economies following the global financial crisis which shook the world in 2008. It took 6 years for the EU to follow in their footsteps. In the early stages of 2016, less than a year into the ECB's first ever attempt at QE, the outcome of this contentious and arguably desperate policy is still unclear. However, it is clear that the EU has an economy like no other. The sheer size, not to mention the multifaceted and ever changing nature of the EU economy, poses unique challenges to implementing a one size fits all monetary policy, such as QE. As the deadline for the ECB to end QE draws nearer, the success of this unusual policy and likewise the future of the single currency relies almost exclusively on further integration of the EU, both economically and politically. This essay will explore the intuition behind QE, drawing from the experiences of the US, UK and Japan, to highlight the importance of further integration for the future of the EU economy.

No Interest in Quantitative Easing

The basic assumption behind all monetary policy starts with the central bank making small changes to the nominal interest rates in the short term. The effect of this leads to changes

in asset prices, which then drives further economic decisions in the marketplace, such as whether consumers buy a house, firms invest and banks lend. When an economy starts to lag, monetary policy is one of the simplest and most effective ways to get things back on track. However, sometimes this short-term fix isn't enough. As Keynes warned, once interest rates tend toward zero, the economy is ensnared into a liquidity trap and thus conventional monetary policy is essentially useless (Keynes, 1936).

This is the predicament in which the European economy found itself in the years following the crisis. When economies reach the lower zero bound, central banks, including the ECB, have few other options but to accept the last resort of QE. It's essentially gambling. Central banks buy up long-term assets, like bonds, with money they do not really have making a bet that their bluff will pay off. This money, created out of thin air, increases the size of banks reserves allowing them to give out more loans, effectively bypassing the issue of lower short term interest rates (Coenen *et al.*, 2004). It is meant to have the same stimulating effect as conventional monetary policy by altering the monetary base in the economy rather than the nominal interest rates. However, as many economists warn, nothing is guaranteed. It is possible that unsecured overnight lending rates will plummet to zero, there will be record low government borrowing rates and uncontrollable inflation paired with low confidence. Furthermore, unconventional monetary policy, like QE, was basically unheard of before the crisis and no two QE programs since have been the same. What limited QE programs there have been vary significantly among economies depending on the specific aims of the central bank as well structural differences, effectively making each new attempt at QE a shot in the dark. While the outcomes of the most recent QE programs in the US, UK and Japan seem to have at least helped a little, the jury is still out.

Peer Pressure

On a global scale, the European QE program is late to the party. In 2001, the Central Bank of Japan (BOJ), followed in 2008 by the US (Fed) and UK (BOE), began purchasing government bonds, asset backed securities and equities to stimulate their struggling economies. Figure 1 shows the interest rates of each of these central banks from 1999 to 2015 converging towards 0 as a response to the crisis. The crisis policies of these nations not only prompted the ECB to adopt its own QE program in 2015, but also deliver important insight into the future of the ECB's policy.

The ECB announced the first bout of QE, buying securities from EU institutions and agencies, in 2015 christened the Public Sector Purchase Programme (PSPP) (Claeys *et al.*, 2015). So far, the ECB's approach to QE has mirrored the Japanese program the most. The ECB chose to focus more on lending money to banks in the EU rather than buying significant amounts of bonds outright. Japan is no stranger to QE as the first coun

try in the world to officially attempt it. The ECB can learn a lot from Japan's 'Abenomics' (Ito and Mishkin, 2006). It's clear from Japan's massive investment, equivalent to €1.3 trillion, that the ECB might be playing it too safe. For QE to work, especially in a bank centric economy like the EU's, the banks must be flooded with excess liquidity, as Japan did in 2001 and 2006 (Bowman *et al.*, 2011). The ECB has committed to investing €1 trillion into its QE program. While this is a significant amount of money, as the world's largest economy, the EU should be investing much more than the world's 5th largest economy. Proportionally, the numbers do not add up, which means the ECB is going to have to be prepared to create a lot more money to reach its targets in the long term. Furthermore, Japan's relapse into another QE program has shown that QE is not a permanent fix. When there are unattended structural failures, like Japan's aging population, the issues will never completely go away. Until Japan and the EU attend to other such issues inherent in their economies this won't be the last time they're forced into QE.

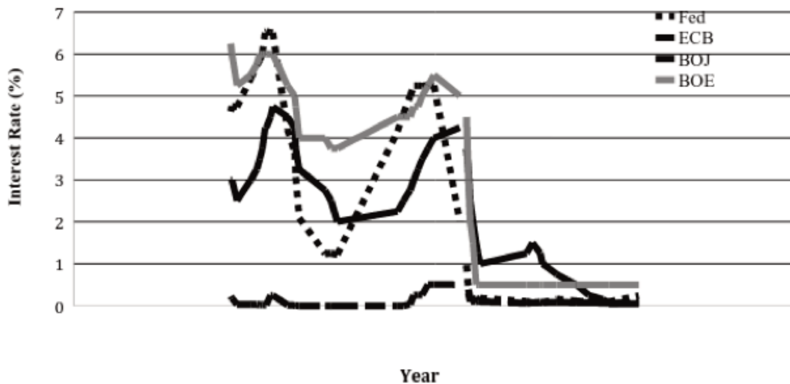

Figure 1: Key Policy Rates from 1999 to 2015 (Source: ECB main financing operations, FED federal funds target rate, BOJ uncollateralized overnight call rate, BOE official Bank rate)

The lessons from the US and UK are pertinent as well. The Fed went through three rounds of QE, starting in 2008 when the housing bubble burst, acquiring a total of $4.5 trillion in securities (Appelbaum, 2014). The recovery the US experienced at the end of their program, while impressive, represented only a fraction of the money that was put in. The same was seen in the UK whereby GDP increased by 3 per cent of the original QE spending (Monaghan, 2014). QE is subject to diminishing returns, so investment in the EU should be exponentially higher than the results the ECB expects to obtain. Thus, instead of worrying about the effects of too much new money, like out of control inflation, the ECB should prepare itself for the effects of not enough, like the stagflation felt in the US, UK and Japan. The experiences of those who attempted QE before the ECB are sobering.

They reaffirm what economists have been saying this whole time: QE is unreliable at best. While it's still up for debate whether these cases can be considered successes, the ECB should pay close attention if it hopes to experience anything close to their recovery.

An Ever Closer Union

The European Union is a one-of-a-kind institution so, while comparison to other nations is useful, QE poses unique problems within the EU. The majority of these can be traced back to a lack of integration within the EU project. The Vice-President of the ECB, Víctor Constâncio, noted, 'The lesson from the crisis is quite clear, namely that we need more integration within the monetary union' (Constâncio, 2015). While politically this sentiment is less popular, the fact that the EU has been forced into the last resort policy of QE is evidence enough that integration is lacking. Furthermore, the longest recession in Europe's history would not have happened if the EU's Economic and Monetary Union (EMU) were fully functional. While the Five Presidents' Report sets out goals to reach a fully integrated economy in the coming years, the economy must make some pretty major changes soon to see real growth from QE.

Currently the EU functions more like separate countries with a trade agreement than one streamlined economy. In federal systems, investment into public goods, like technology, is an integrated group effort among states. In the EU, investment is still very decentralised (Cottarelli and Guerguil, 2014). QE is the perfect opportunity to invest significant amounts into infrastructure and technology, as many bail out packages do. As of now, the PSPP leaves much of the purchasing up to national banks, which have acquired mostly sovereign debt and agencies such as French social security debt (CADES). As Figure 2 shows, the majority of purchasable debt made available by the ECB is sovereign.

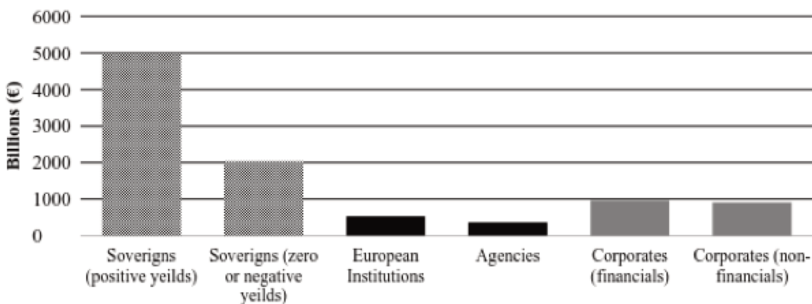

Figure 2: ECB's Purchasable Agencies and Institutions (Source: ECB)

While safe investments, these do little to promote long-term growth and innovation. The ECB should take this opportunity to promote further integration of investment in the EU and focus its spending on agencies like National Promotional Banks or aspects of the Junker Plan, which will contribute to the long-term growth and, in turn, ensure QE succeeds.

With innovation centralised the EU can overcome intrastate competition. Policies like Ireland's low corporate tax rate highlight the inwardly focused nature of member state economies. This mind-set takes the focus away from the competitiveness of the EU as a whole. By coordinating fiscal policies between members, levelling the playing field, the effects of QE will be felt much more consistently throughout the EU. This means sharing risk, making big fiscal decisions together and creating regulations on policies that give one state an unfair advantage. As Benoît Cœuré said in his speech to the ECB, 'we cannot advocate a Europe of solidarity while believing that the economic policies of each euro area country are the business of that country's parliament alone' (Cœuré, 2015). Likewise, when the national economic goals of states are aligned with the supranational goals of the ECB, QE will have a much greater chance of increasing growth and stability in the region. This also means further integration of the European banking sector. Creating a more streamlined and accountable banking union will ensure not only that QE can be effectively implemented everywhere, but also that a recession of this magnitude will never happen again.

Finally, the EU must stand by and protect the integration it has fought hard to achieve, namely, the Schengen Agreement. This is the cornerstone of the economic union and an important aspect of maintaining the optimum currency area in the region. Without free movement it will be very difficult to increase production and growth through QE. The influx of refugees, currently seen as the threat to the Schengen agreement, will actually help the EU's long-term growth according to the head of the IMF (Lagarde, 2015). They will replace an aging population of workers and add to consumption and investment in the medium and long term, the very goal of QE. The EU's PSPP has quite a few roadblocks to overcome before the region sees meaningful change. While much is still uncertain, the EU is on the right track with their new goals to fully integrate the EU economy in the coming years. Time will tell whether this will be enough to make QE, and the euro, a success.

Conclusion

QE remains somewhat of an enigma. While vast amounts of research have been done on the subject, its use in the real world remains limited. The Chair of the Fed, Ben Bernanke, famously joked in 2014, 'The problem with QE is it works in practice but it doesn't work in theory' (Bernanke, 2014). However, this remains to be seen. Without counterfactual

data on QE it's impossible to truly say that QE 'worked'. Thus the international community may have to remain split on the matter forever. Regardless, the real merit of QE lies in the fact that it can be used when nothing else will work. Like it or not, in times of crises QE is the last saving grace available to struggling economies. This is the circumstance that led the EU, rather contentiously, into its QE program in 2015. Less than a year into the program the ECB can still learn a lot from those who have attempted QE before.

Primarily, that the ECB must be prepared to significantly increase its spending if it hopes to reach anything close to its goals of near 2 per cent inflation and lower long-term interest rates. Furthermore, for QE to be a success for the European community and never be necessary again, further integration of the Economic Union is vital. The economies of the EU must become more centrally focused with shared fiscal goals, more regulation on policy and banking, and EU wide investment starting with the money QE has created. It must also be steadfast in protecting the integration already in place and not let the high unemployment and stagnant economy dismantle the amazing success of the EU project. While the EU is on rocky road to recovery, all is not lost. If the EU can attend to the structural issues plaguing the economy QE will remain an unconventional monetary policy.

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