Understanding QE in the euro area

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THE EURO-ZONE: WHERE DO WE COME FROM AND WHERE ARE WE NOW?

Where do we come from?

- Two recessions since 2008 and barely out of the second
- Not back to pre-crisis GDP level – not clear whether it will go back to the pre-2008 trend growth rate
- Unemployment projected to be around 10% at the steady state (2016 according to ECB projections)
- Non performing loans still weighing on some peripheral countries
- Public debt not stabilized
- Very low inflation – below ECB target

However …

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- Signs of a recovery
- Low inflation but no deflation
- Overall public debt relatively low – mostly an intra euro area distribution problem
- Recapitalization of banks came late but is now ongoing

NCIs for the US and Euro Area
Indicator of yearly growth rate

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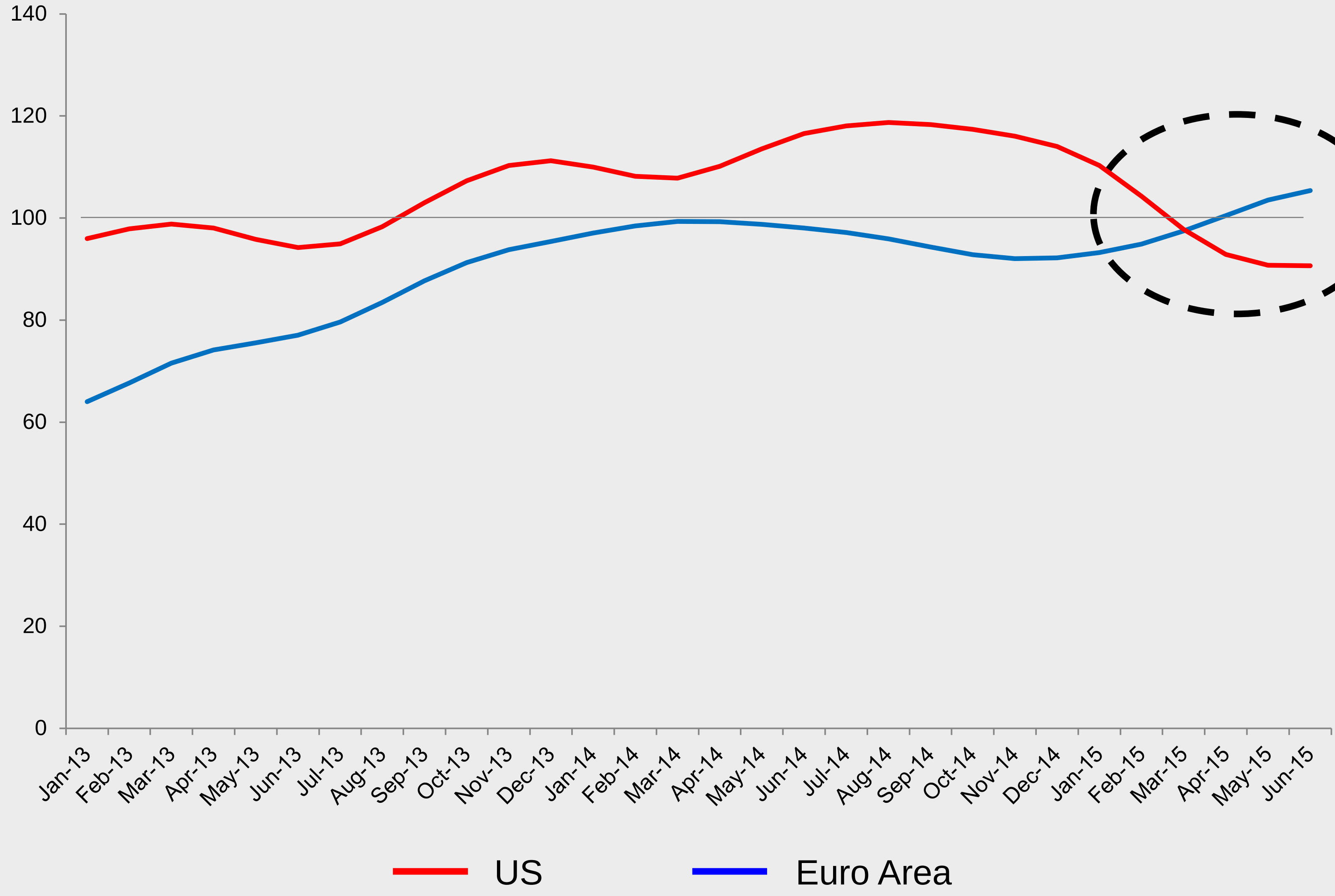

M1 and M3 have picked up in Spring 2014 while headline inflation continued to decline ….

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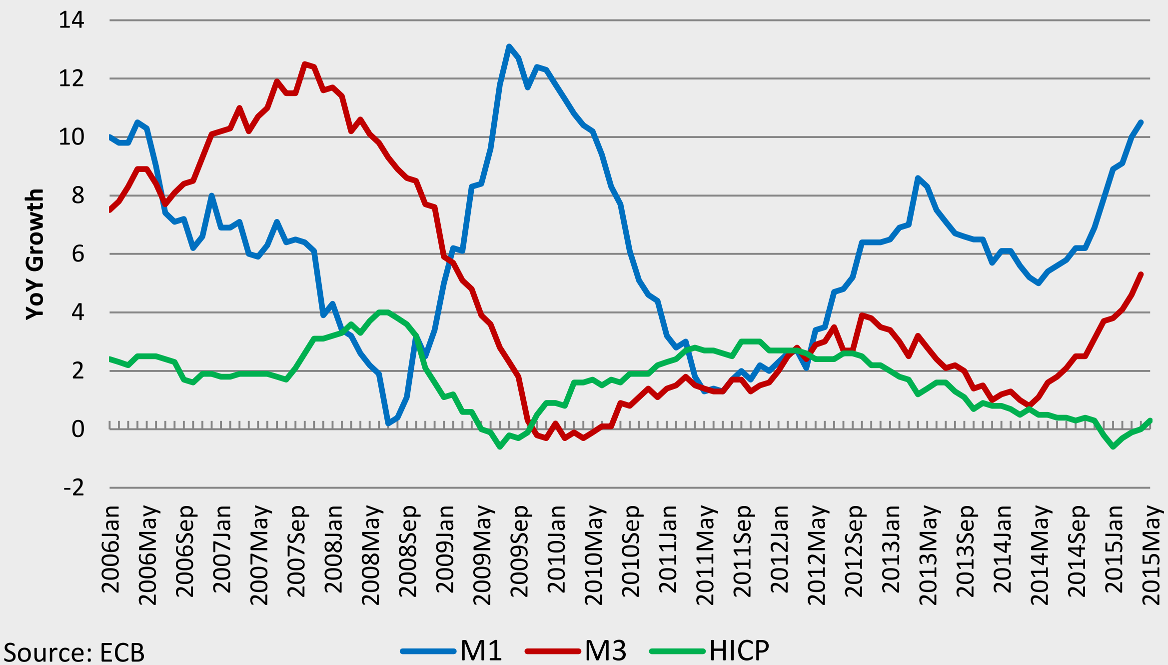
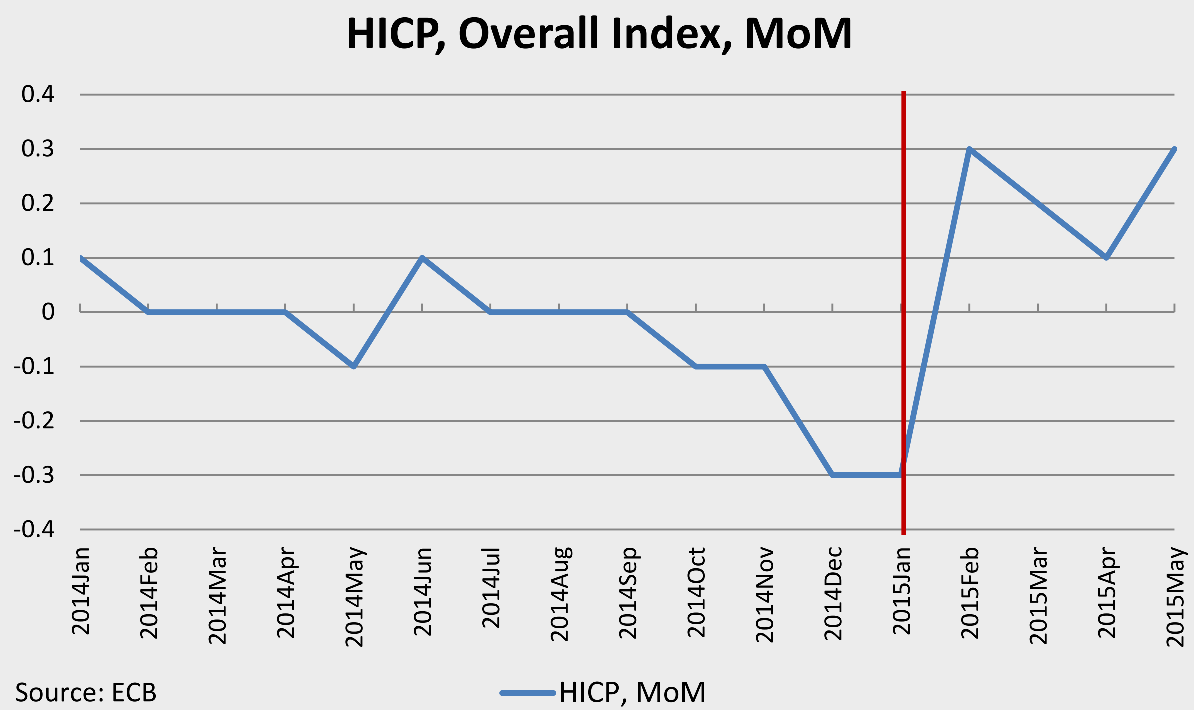


Source: ECB

Positive readings of HICP since QE but too early to say …



Source: ECB

WILL QE WORK IN THIS CONTEXT?

Understanding QE in the euro area: general issue

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- QE in a monetary union without common budgetary authority is a unique experiment

Issue: complex relationship between fiscal and monetary aspects - distribution of credit risk and risk sharing

- Must be understood in the context of the leverage situation of the public sector and credibility of public debt consolidation policies at national level (…)
- Public debt in the euro area is less "safe" than in Japan or the US – it is risk-free as long as the market does not have any doubt about the ECB action

In the next few slides I will focus on debt-deficit adjustment since 2008 before returning to the QE question

-- The 2008 recession is associated with an unprecedented increase in public deficit and debt --

-- Since 2009 large adjustment

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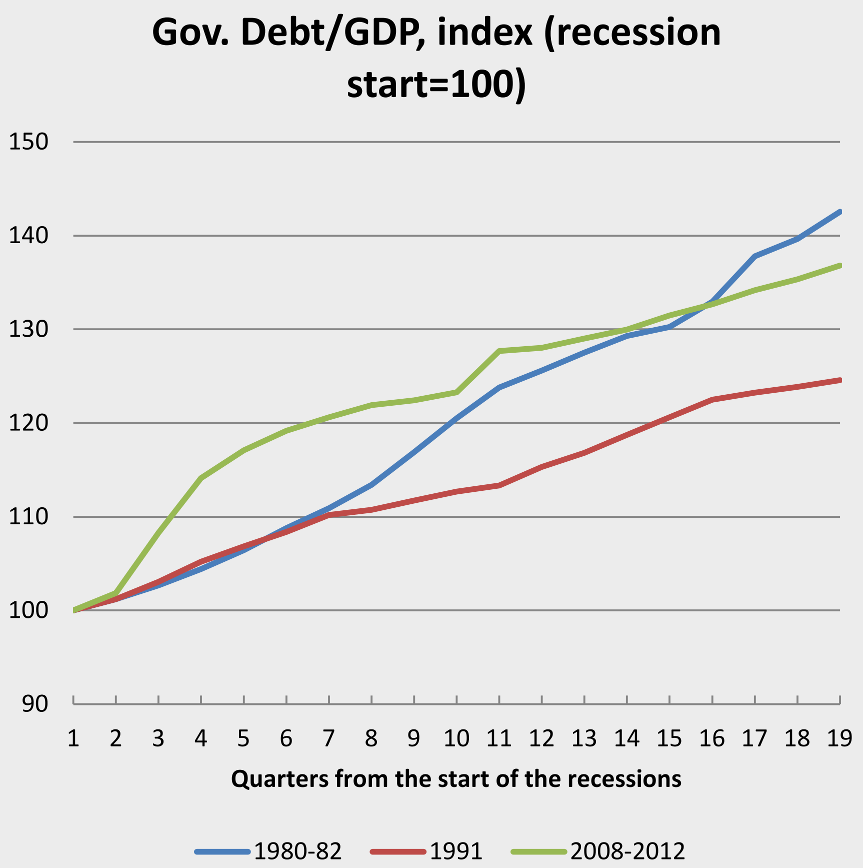

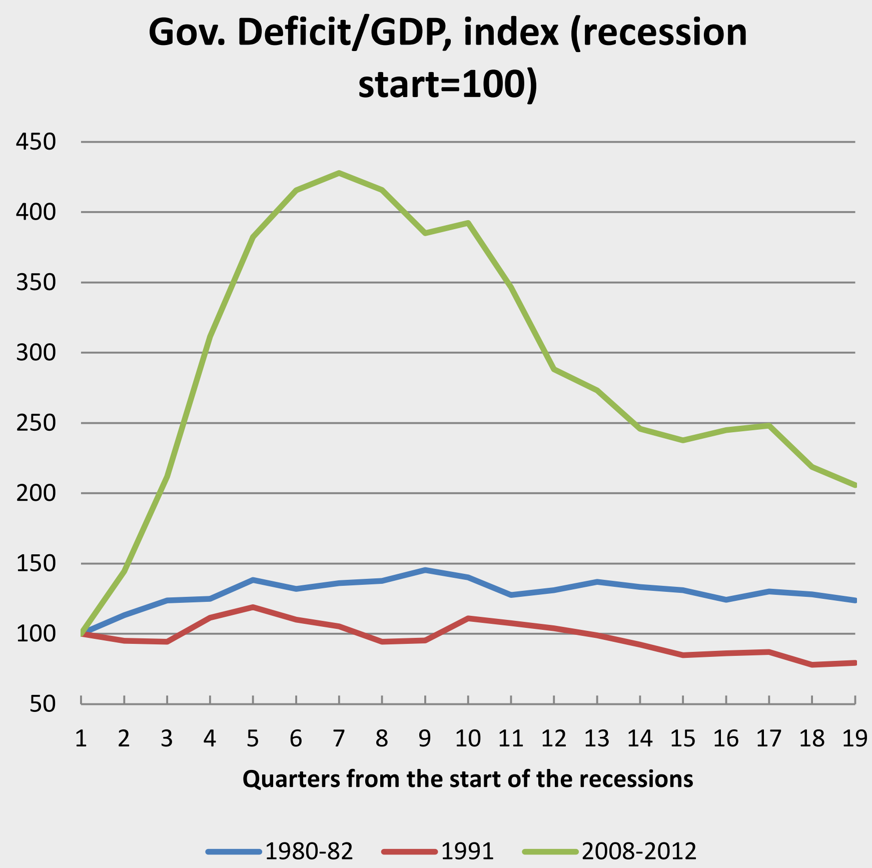

Fiscal consolidation since 2009q4 led to an inversion in the relationship!!

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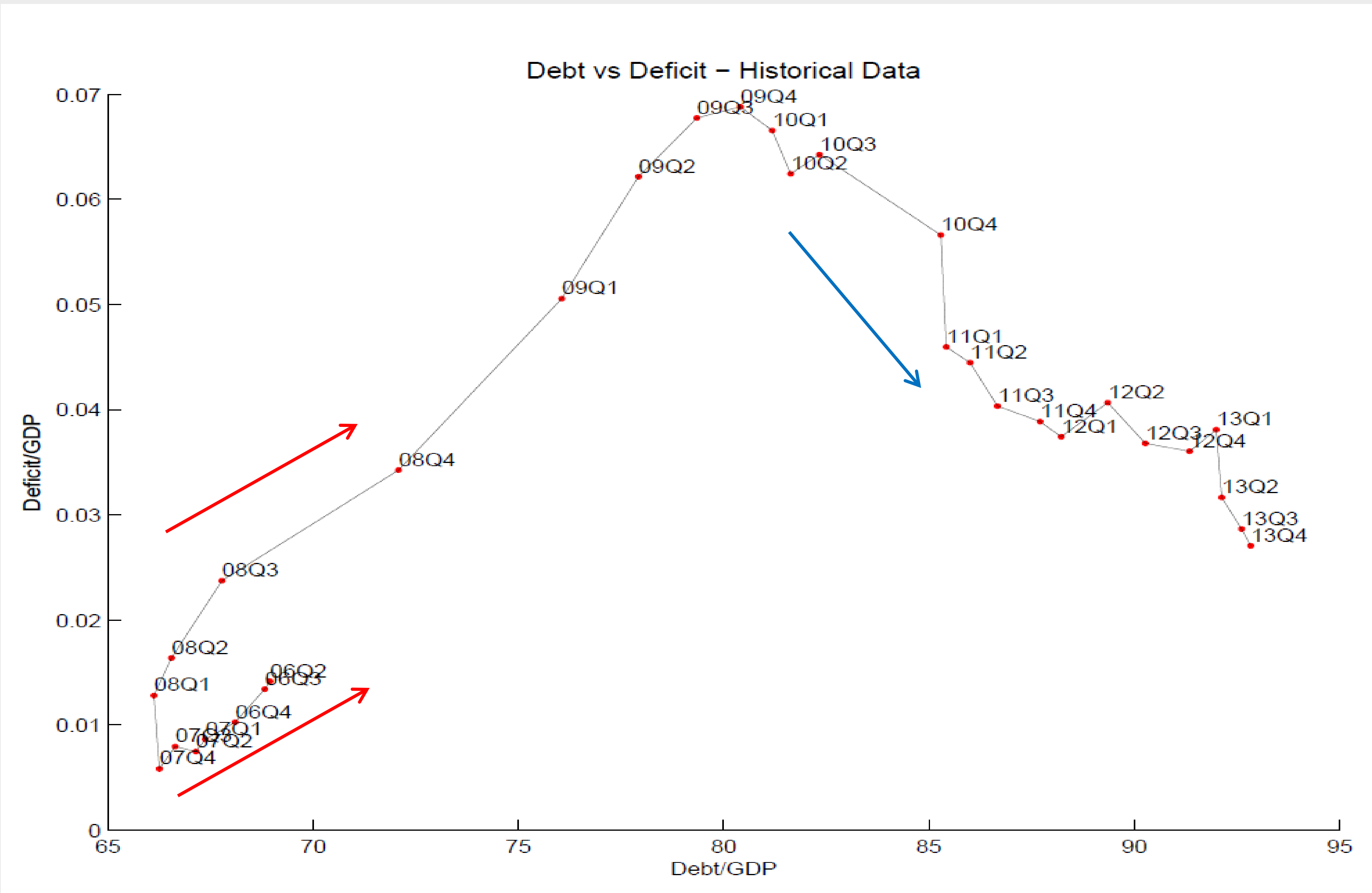
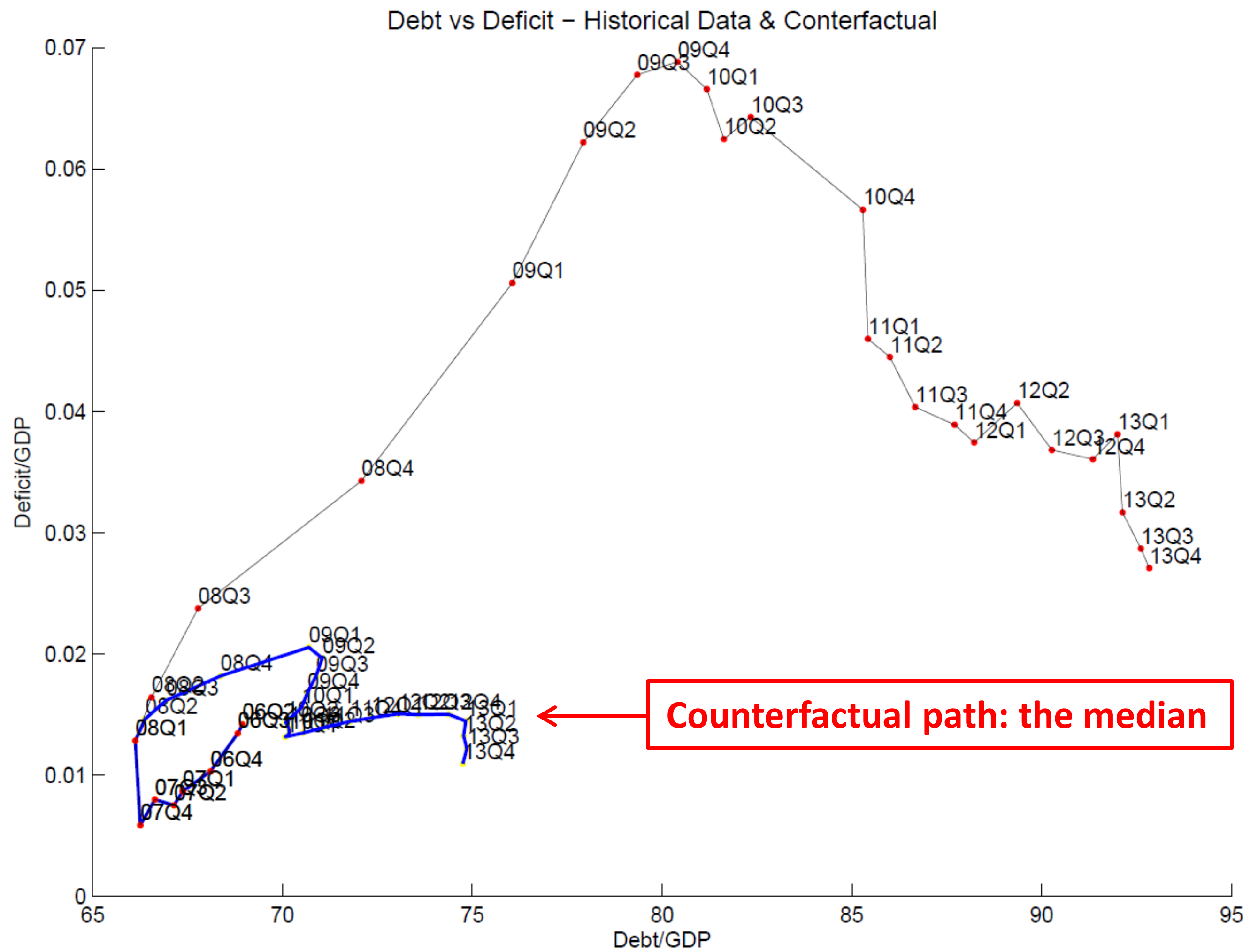


… unprecedented



… unprecedented

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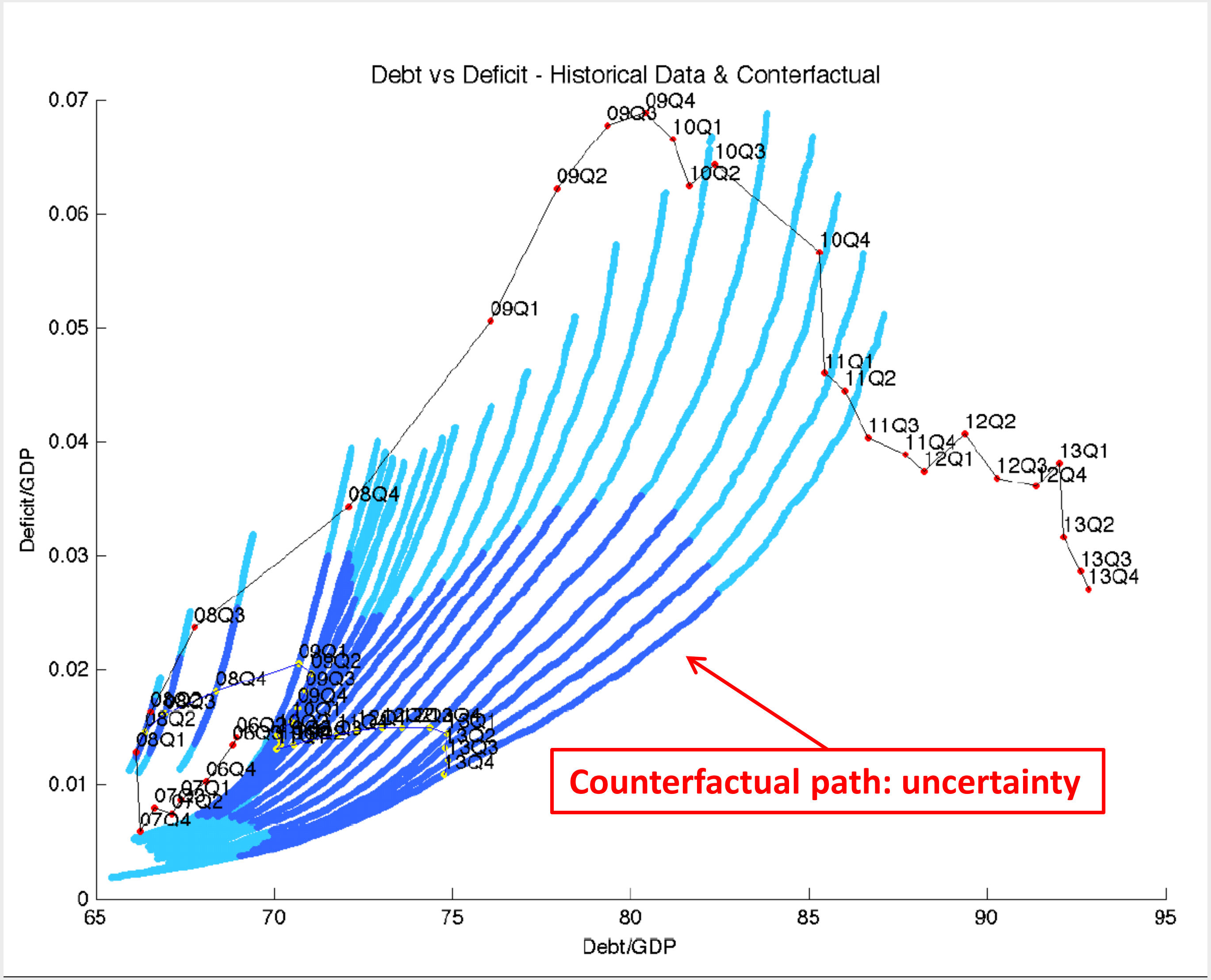
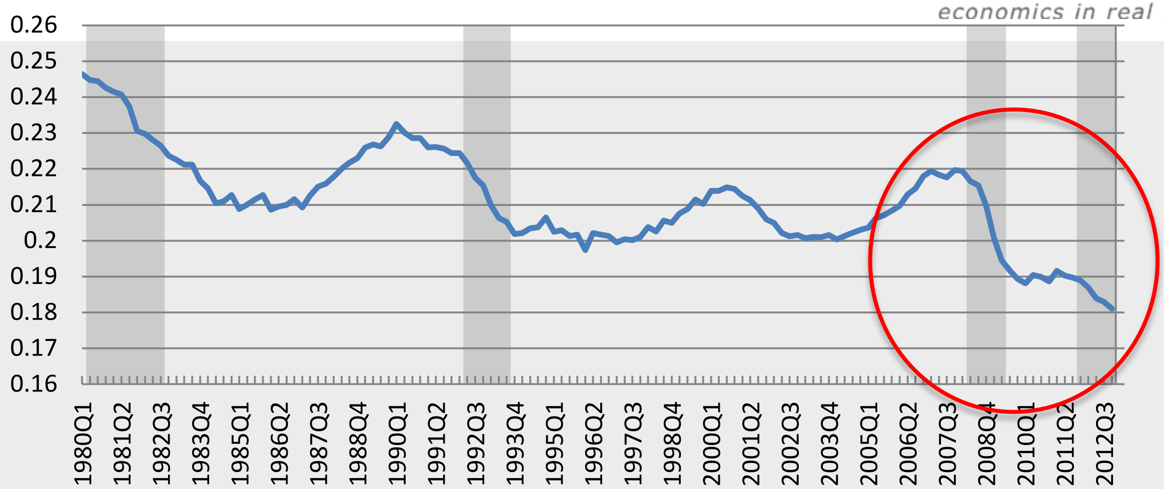


The chart says …

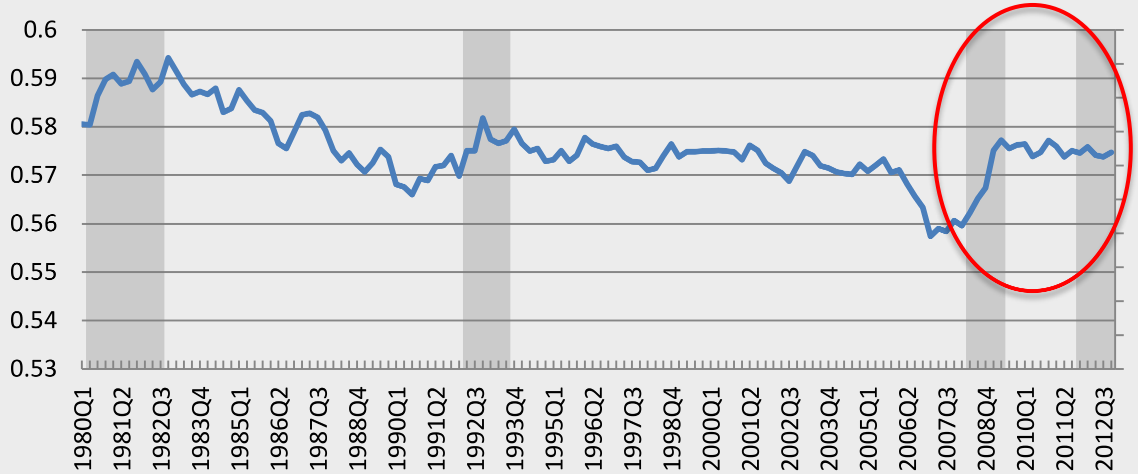
- Initially both debt and deficit have been higher than what could have been expected given the observed path of GDP (support to financial sector, risk premia, social payments, …)
- Once the deficit started shrinking in relation to GDP due to consolidation policies, the adjustment became self-defeating

Fiscal consolidation hit investment more than consumption

Investment / GDP (%)



Consumption / GDP (%)



Is it a balance sheet recession?

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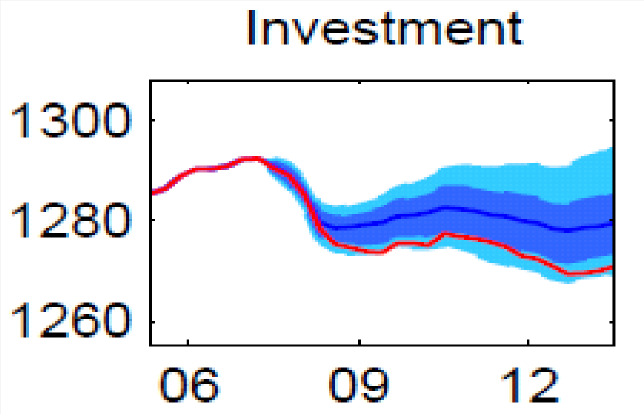
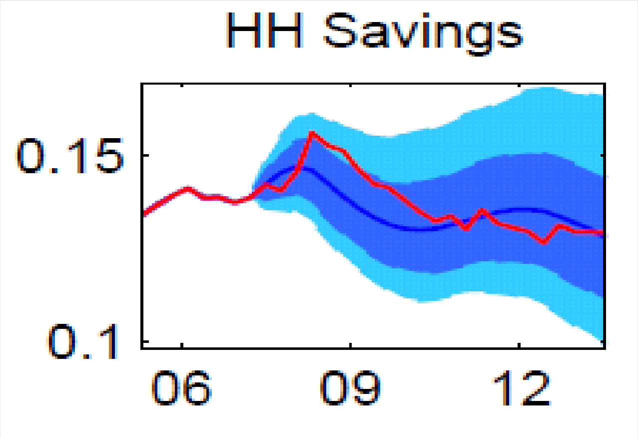
- Not a "classic one" …
- Not driven by households' adjustment but by the combined depressing effect of the current account adjustment and fiscal consolidation …
- Affecting investment and, with a delay, unemployment

What else has been "unexpected" given the observed GDP path?

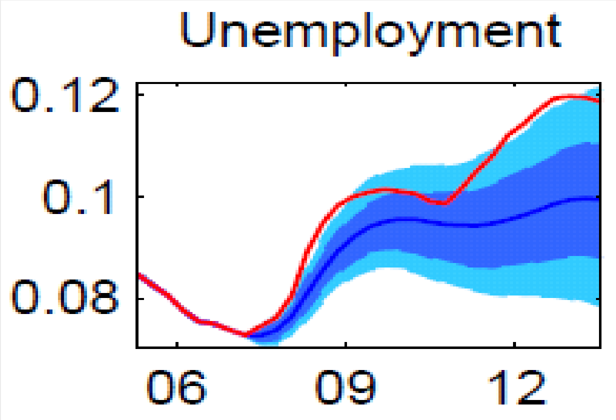
Investment exceptionally weak since 2008



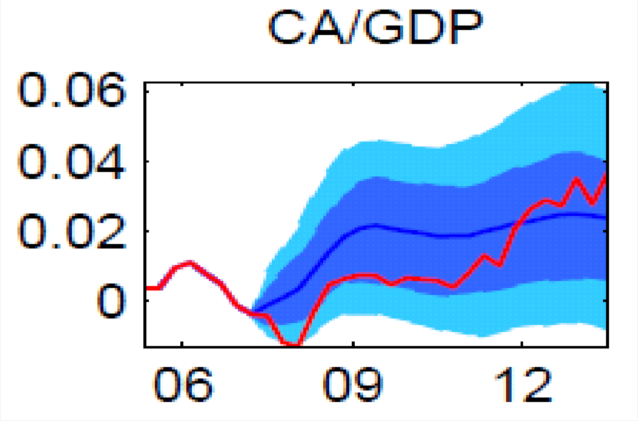
No traditional b/s recession for hh



Big shock in U especially after 2011 (2nd recession)



External adjustment



In this context …

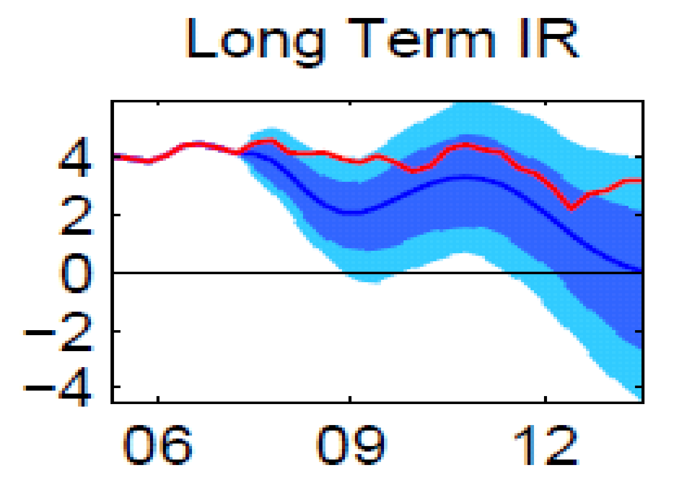
The ECB's QE must understood as a way to achieve two goals:

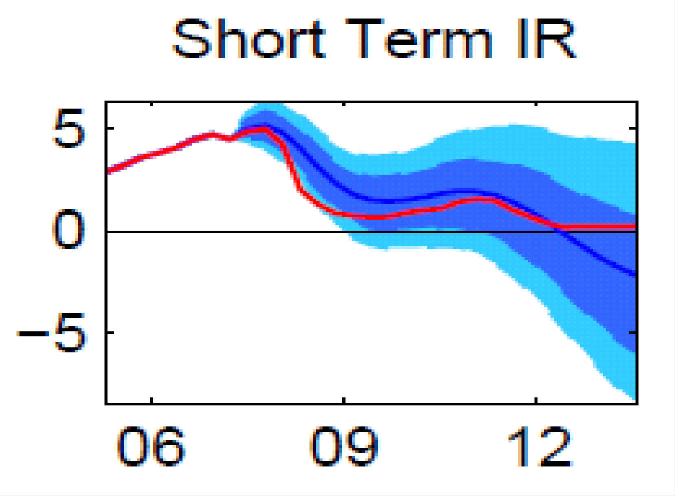
(i) Keep risk premia down (de facto targeting the yield curve)

(ii) Reassure the market that it is serious about a euro-wide inflation target irrespective of distributional consequences of asset purchases

Indeed QE was implemented too late … Since 2012 the EA had both a binding zero lower bound and an exceptionally steep yield curve

Steep yield curve and zero lower bound after 2012





Risks

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- The ECB is doing too much … first best option would be a fiscal-policy mix
- Not feasible without a federal budget
- Therefore the ECB is the “federal institution of last resort”
- and it is dealing with a paradox ….

The paradox of the Treaty

In principle the rationale for QE is purely a monetary policy one (inflation objective) but ECB must deal with a paradox:

- On one hand, in order to limit the redistribution effects of monetary policy the Treaty has rules to impose legal restrictions on the ability of central banks to assume or finance fiscal functions and, via the 'no bail out' clause, limits cross-country sharing of fiscal risks within the union
- On the other hand, when pressured, the ECB is called to defend the common currency and it has done so by preventing exit or default.
- Knowing that the ECB will ultimately defend the euro, the market will expect that debt is implicitly guaranteed by ECB. Hence market incentives are weak
- But even small shocks triggering uncertainty can lead market to a "risk off" mode

Looking ahead

- Because of this it is likely that the ECB will be in QE mode for a long time
- But even with very low rates nominal GDP needs to pick up to clear risks on debt sustainability
- If not the ECB will end up buying a large proportion of government debt
- Which means assuming sovereign/credit risk on its balance sheet
- This will ultimately be divisive

➢ This is the reason why Draghi has insisted on a framework at the federal level to deal with both the problem of the overall fiscal stance and monitoring of competitiveness

➢ But no framework will be in place without further integration …

Summarizing

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- Main issue in the EA is public sector deleveraging in a context in which risk premia may re-emerge due to uncertainty about lender of last resort function of the ECB
- QE needed to stabilize the yield curve in the context of debt overhang
- Ideally best response would be a monetary-fiscal mix but fiscal policy is constrained in the Monetary Union so QE is second best
- The problem is not that QE is useless but that without a recovery it will ultimately be divisive
- Need other tools … what is on the table not very convincing

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THANK YOU!