ISSN: 1791-35 35

Eurobank Research
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GLOBAL ECONOMIC & MARKET OUTLOOK
February 5, 2015

Eurobank

FOCUS NOTES

# The ECB's sovereign quantitative easing will be supportive to the euro area economy but it is not panacea

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- Quantitative easing (QE) has contributed to a significant depreciation of the EUR currency and conveys a strong signal about the ECB's determination to defend price stability and keep real rates low. Both developments are expected to support the euro area economy.
- However, the limited risk-sharing scheme of the QE program may constrain its potential to reduce financial fragmentation in the euro area.
- Already low sovereign and corporate bond yields as well as the bank-based nature of the euro area economy raise concerns about the effectiveness of QE to lead to lower funding costs for firms through the portfolio rebalancing channel.
- The impact of QE on euro area households' wealth and disposable income is also expected to be less pronounced than was the case with the Fed's QE.
- QE could have a limited impact on spurring bank lending, as banks remain hesitant to extent credit on the back of muted economic prospects, elevated unemployment and lingering uncertainties.

Short of other options to fend off persistent deflationary pressures, the ECB made a historic leap and complemented the basket of its existing asset purchase program with debt issued by euro area sovereigns and EU agencies. With monthly purchases of €60bn until September 2016, of which about €50bn will be public debt, the ECB intends to increase in sustainable manner the inflation rate close to 2%. Quantitative easing (QE) impacts the real economy through several channels. In this report we briefly discuss these channels with a focus on the shortcomings posed by the economic and political peculiarities of the euro area.

The weakening of the euro currency is expected to be a main channel through which quantitative easing will be transmitted to the euro area economy. Cheaper euro area products should support corporate earnings through increased exports to the rest of the world and subsequently, translate into higher investment. The nominal effective exchange rate of the euro has already declined sharply (about 5.3%) since last December (Figure 1), when speculation of the ECB embracing QE started to intensify. The large size of the program (€1.14tn) and its open-ended feature[1] are expected to keep the currency in check.

The signaling effect is another channel of transmission of QE. The higher than expected size of the program and the declared intention to extend it beyond September 2016 if price dynamics fail to recover, gives a strong signal that the ECB is determined to preserve price stability. The consequent rise in inflation expectations (Figure 2) should lead to lower future real interest rates and stem downward pressures on wages. Both developments are

[1] Mr. Draghi mentioned that "purchases are intended to be carried out until end-September 2016 and will in any case be conducted until we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2%".

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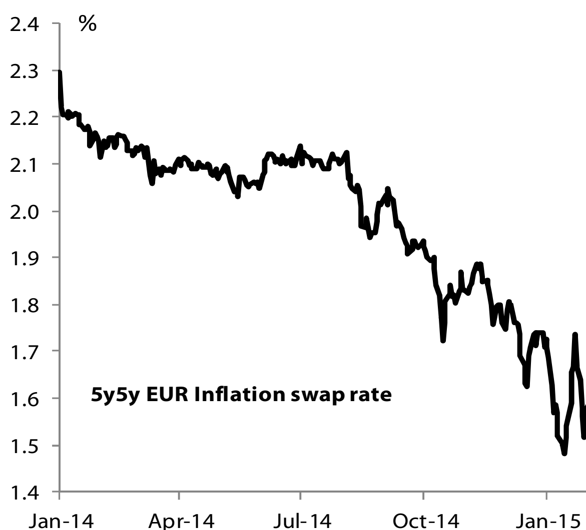
supportive to firms' capital expenditure and households' consumption.

**Figure 1**
**EUR nominal effective exchange rate**

*Source: Bloomberg*

**Figure 2**
**Long term inflation expectations**




*Source: Bloomberg*

However, in our view, the strength of the signaling effect is contained by the limited risk-sharing of the program. According to the details spelled out, only 20% of the additional asset purchases will be held at the ECB's balance sheet, whereas the remaining purchases will be conducted by national central banks (NCB), which will have to bare the credit risk of the purchased bonds. This feature should be viewed as a concession to mollify fierce opponents to the program, who perceive sovereign bond purchases as monetary financing and raise apprehensions over the program's purportedly negative impact on structural reform discipline.

Yet, the decision to defer possible losses on the P&Ls of NCBs may decrease the clout of the asset purchase program to reduce fragmentation in bank lending and in the sovereign bond market. The limited risk-sharing feature illustrates that not only the euro area is far from being a fiscal union but it also conveys the message that the monetary policy may not be single.

Furthermore, the pari-passu status of the ECB is compromised by the non-sharing scheme. If a government were to restructure its debt, it could either choose to include bonds purchased by the local central bank or not. In the latter case, losses for private bondholders would probably be larger. In the first case, the state would need to recapitalize the central bank, thus incurring a debt burden shouldered by tax payers. This extra burden would most likely be taken into account by the government, leading once again to higher losses for private bond holders[2].

Portfolio rebalancing is another channel through which asset purchases influence the economy. Purchases of sovereign bonds by the central bank lead to a decline in their yields. The central bank buys bonds whose maturity spans over a wide range in order to drive the entire yield curve downwards[3]. Thus, yield hunters, awash with cash as they have sold their bonds, turn to other more risky asset classes, such as corporate bonds and stocks, bidding up their prices[4]. As a result, firms may benefit from lower corporate bond yields and higher stock prices in order to finance their investment plans. Additionally, households may increase their spending due to positive wealth effects.

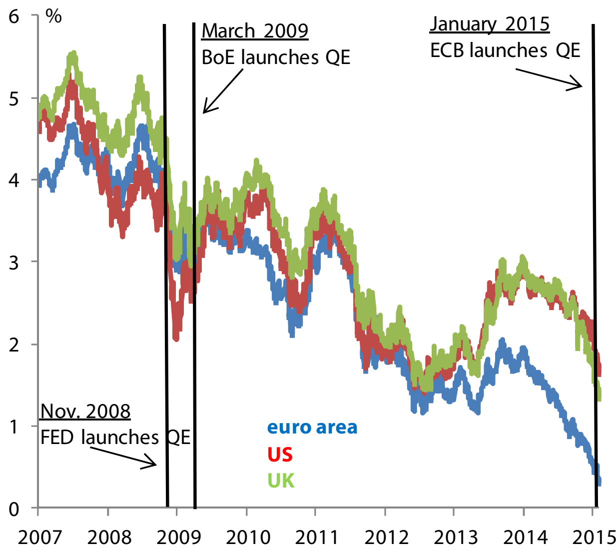
Ominously for the effectiveness of the portfolio rebalancing channel in the case of the ECB's QE, yields of most members' sovereign bonds are already very low (Figure 3). The same holds for corporate bond yields (Figure 4). This is in sharp contrast to the level of rates of the respective US and UK bonds at the time when their central banks embraced quantitative easing. Despite low corporate bond yields in the euro area, investment remains muted due to sluggish demand and modest business confidence. To make things worse, the euro area economy is a bank based economy, with capital markets being less developed and playing a limited role in financing firms' capital expenditure plans.

In a similar vein, the potential to spur consumption through the wealth effect of QE is also expected to be less pronounced in the euro area than was the case in the US. In the euro area, households' wealth related to equity and investment funds amount to 24% of their total assets, as opposed to their US peers, whose respective wealth corresponds to 42% of their total assets. Furthermore, the Fed included in its asset purchase program

[2] See: "Sovereign QE and national central banks- leaving national central banks to carry the default risk is impossible and dangerous" by Guntram B. Wolff, Bruegel.
[3] The ECB will buy bonds of minimum remaining maturity of 2 years and a maximum remaining maturity of 30 years.
[4] The portfolio rebalancing effect is based on the fact that money is not perfect substitute for other asset classes.

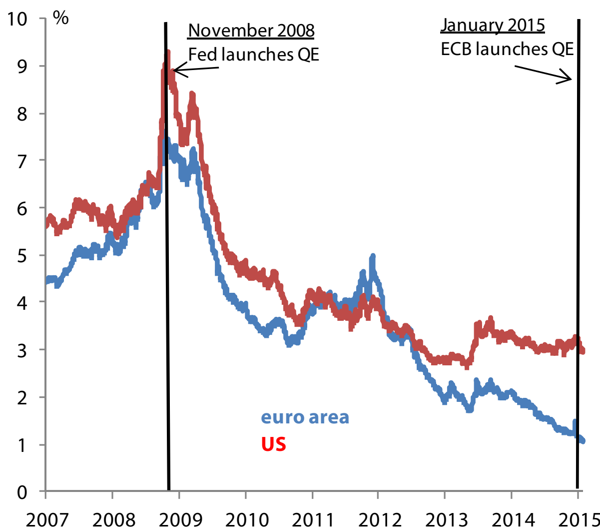
securities issued by mortgage agencies, which resulted in lower mortgage rates and higher home values. American households availed of the opportunity to refinance their adjustable mortgage obligations[5] and borrow through the home equity loan facility (i.e. a loan in which the borrower uses the equity of their home as collateral). A similar channel to affect the households' wealth and disposable income is not available in the euro area.

**Figure 3**
**10-year government bond yields**




*Source: Bloomberg*

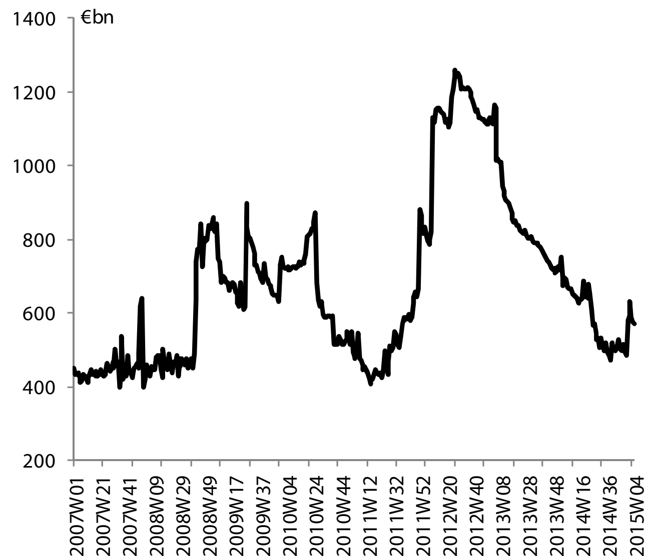
**Figure 4**
**Corporate bond yields**




*Source: Ecowin*

The bank lending effects of quantitative easing might also prove weak due to ongoing headwinds to the euro area economy. Liquidity on banks' balance sheets is expected to increase as a result of the central bank buying sovereign bonds owned by banks themselves and banks' customers. Yet, liquidity does not constitute a constraint to bank lending, as is evident by the reduced recourse to the ECB's TLTROs in September and December 2014 (Figure 5). Instead, banks remain hesitant to extend new credit to the economy mainly due to poor economic prospects, elevated unemployment and persistent uncertainties. Given these considerations, government bond purchases might do little to tackle the impaired access of SMEs to bank lending. That being said, negative deposit rates should act as an incentive to banks investing excess liquidity to the economy instead of keeping it idle.

**Figure 5**
**Eurosystem liquidity provision**




*Note: ELA is not included*
*Source: ECB*

Finally, there is no leeway for the sovereign debt purchases to work through the fiscal channel in the case of the euro area. The purchase of government bonds by the central bank reduces the state's obligations in paying interest and principal (assuming bonds are held to maturity), as the central bank funnels back to the state coffers any income arising from holding the bonds. Governments could exploit this fiscal space created by QE, along with lower yields on bonds, and increase public spending. However, this is not an option for the euro area members. First and foremost, fiscal discipline continues to be the orthodoxy in correcting accumulated imbalances in public finances. Second, strong opposition to sovereign QE implies that purchased bonds

[5] Household debt service payments as percent of disposable personal income has declined to 4.67% in Q3 2014 from its peak at 7.19% in Q4 2007.

might not be held to maturity, i.e. the taxpayers will eventually have to face the burden[6].

Overall, we believe quantitative easing will be supportive to the euro area economy, while it will buy time for governments to continue their reform policies. However, it will not be panacea. There remains the need to complement accommodative monetary policy with growth friendly fiscal initiatives, such as the European Commission's Investment Plan. Such a policy mix would boost demand and employment, as member states continue their efforts to adjust their public finances.

[6] See: "Effective Eurozone QE: Size matters more than risk-sharing" by Francesco Giavazzi and Guido Tabellini, Voxeu.org

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