Quantitative Easing in Europe: What it is, why it is legal and how it works

Pacces, A.M.; Repasi, R.

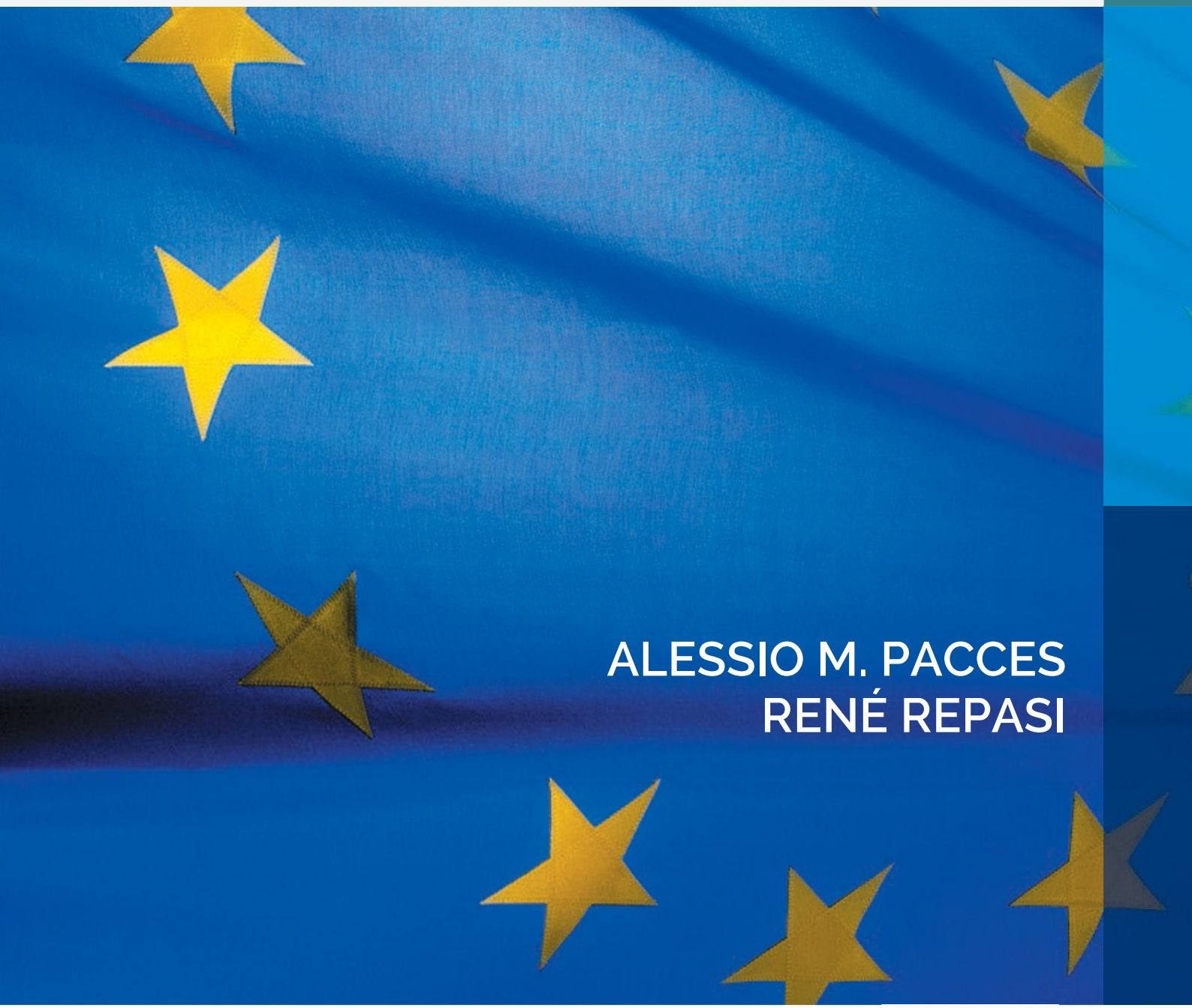
Publication date
2015
Document Version
Final published version

European Research Centre for
Economic and Financial Governance
euro-cefg.eu

DECISION OF THE ECB ON QUANTITATIVE EASING

Quantitative Easing in Europe
What it is, why it is legal and how it works

EURO-CEFG Commentary



ALESSIO M. PACCES
RENÉ REPASI

Universiteit Leiden
The Netherlands

TU Delft Delft University of Technology

Erasmus University Rotterdam

DECISION OF THE ECB ON QUANTITATIVE EASING

Quantitative Easing in Europe
What it is, why it is legal and how it works

EURO-CEFG COMMENTARY

On 22 January 2015 the Governing Council of the European Central Bank (ECB) decided to launch an expanded asset purchase programme, known as Quantitative Easing (QE). This decision was the first taken under the new voting rules of the ECB, which are to be implemented because of the accession of Lithuania as the 19th Euro Member State.[1] This programme consists of a 60 bn € "combined monthly purchase of public and private sector securities." Purchases will be carried out until the end of September 2016 and may be prolonged afterwards if necessary to get Eurozone (EZ) inflation close but lower than 2%. The amount of purchases of bonds issued by EZ Member States and European institutions will equal the share of national central banks in the ECB's capital key. Government bonds issued by Member States under a financial assistance programme of the European Stability Mechanism have to meet additional requirements in order to be eligible for QE. Hypothetical losses will be shared partially. Loss sharing will involve securities issued by European institutions, which will be bought by national central banks (12 % of the total purchases) and 8 % of the purchases made by the ECB. Potential losses of the remaining 80 % of the purchases will have to be borne by the purchasing national central bank alone.

ECONOMIC ANALYSIS: WHAT IS QUANTITATIVE EASING AND HOW DOES IT DIFFER FROM OMT?

Quantitative Easing is a tool of monetary policy aimed to increase the quantity of money through the purchase of financial assets (typically, but not exclusively, government bonds) other than short-term treasuries. Because the standard way for a central bank to conduct monetary policy is to buy or sell short-term treasuries in order to respectively increase and decrease the quantity of money (Open Market Operations, OMOs), QE is often labelled "unconventional" monetary policy although it is executed through OMOs as well. The name Quantitative Easing offers a simple way to define its main characteristics.

QE is "quantitative" because it aims to create a certain quantity of money through bond purchases, programmed for a given period or also indefinitely, until given macroeconomic targets are reached.

QE works by "easing" the banks' balance sheet constrains from the assets being bought by the central bank, in the hope that banks will use the liquidity created to lend to the private sector.

QE clearly differs from other forms of unconventional monetary policy, such as Outright Monetary Transactions (OMT). OMT are also executed through bond buying. However, because the liquidity created through bond purchase is sterilized by offsetting OMOs, the aim is not to increase the quantity of money. OMT only aim to secure the transmission of ECB policy rates throughout the Eurozone (EZ) countries by ruling out speculations that one of them will exit the Euro to restructure its debt. As such, OMT does not need to be ever implemented so long as its announcement credibly affects expectations – as it did. QE will likewise be effective only if it credibly affects expectations. However, a precondition for this to happen is that a quantity of money is created in the first place.

[1] According to the new voting rules, the 5 national central bank governors of Germany, France, Italy, Spain and the Netherlands share 4 voting rights. All others (14) share 11 voting rights. The Governors take turns using the rights on a monthly rotation. This follows from Article 10 of the ECB Statute that requires the introducing of new voting rules after the accession of the 19th Member State to the Eurozone.

WHY DO WE NEED QUANTITATIVE EASING?

One may wonder why the ECB must create money to do its job, instead of continuing policing short-term interest rates. The simple answer is that when interest rates are nearing zero there is not much else a central bank can do to stimulate the economy. This is called the Zero Lower Bound (ZLB) problem. QE can supposedly remedy this situation, if only by raising inflation expectations. With nominal rates being further pushed towards zero through the purchases of long-term assets, positive inflation makes real interest rates negative and this should reduce the excess of Savings over Investments at the root of a recession. However, it may be not so easy to prop up inflation expectations in the absence of the very economic recovery being aimed for. Moreover, the ECB is in principle not concerned with economic recovery, but only with price stability (Article 127(1) TFEU). The problem of limited ECB mandate does not occur in a deflation, where economic stagnation is accompanied by decreasing prices. Therefore, the ECB could start considering QE only in the presence of a serious risk of deflation. Unfortunately, a deflation makes the ZLB problem dramatically worse. When prices are expected to fall, it is simply rational to postpone borrowing, investment and consumption indefinitely, which makes deflation a self-fulfilling prophecy. No matter how much money the central bank injects into the system, money will be hoarded if it is expected to be worth more tomorrow than is worth today. As central bankers often put it: "You can lead a horse to water, but you can't make it drink." Monetary policy is ineffective if money is not spent.

REAL AND IMAGINARY DISADVANTAGES OF QUANTITATIVE EASING

The main advantage of QE is that it might avoid a deflation if carried out in such a way as to effectively stimulate lending and spending. Conversely, the main disadvantage of QE is that it might not work, dooming the EZ to decades of stagnation and financial instability similarly to Japan since the late 1990s. All other oft-mentioned disadvantages of QE by the ECB do not materialize out of this doomsday scenario.

The first objection to QE is that it may lead to hyperinflation. This cannot happen so long as expectations remain deflationary. However, deflation will eventually lead some sovereigns to default and to the likely break-up of the Eurozone, which may well lead to inflation getting out of control. If, on the contrary, the EZ economies recover, the ECB will always have enough bonds to retire liquidity when inflation returns closer to the 2% target.

The second objection is the mutualisation of the costs of QE. Retiring excess liquidity with increasing interest rates will entail costs which may balloon if some of the bonds previously purchased have defaulted in the meantime. However, this perspective neglects that the ECB is entitled to an indefinite stream of seigniorage profits, increasing in the interest rates, so long as it maintains the right to create money. Moreover, central banks can work with negative equity until they have recovered the losses through seigniorage. Conversely, if deflation materializes and the Euro eventually breaks up, the losses of the ECB will have to be divided between the national central banks (and perhaps the national governments).

The third objection is that QE is rewarding the profligacy of reckless borrowers (including some sovereigns) thereby inducing moral hazard. Although this objection has more virtue, the problem will partly solve itself if QE is successful and the economies of the EZ eventually recover. At that point, the debtors that have failed to repair their balance sheets will not be able to service their debt with increasing interest rates. The challenge would be then to let those debtors fail, but this has nothing to do with QE because it will be long discontinued by then. More important for the success of QE is that while the distressed sovereigns repair their balance sheets, those who are not distressed spend or lend the money created.

TO BE EFFECTIVE, QE MUST LEAD TO SPENDING AND LENDING

Milton Friedman – a monetarist economist – once said that the easiest way out of a deflation would be to drop money from a helicopter. The intuition behind this metaphor is that printing money at the ZLB is costless. Helicopter money, however, can stop a deflation because it is an expansive fiscal policy measure. It is actually the government to give households money to spend and they will spend it so long as the government is committed not to retire it later on via higher taxes. Dropping money from helicopters would be unthinkable for the ECB as for any other central bank, because of the well-established separation between fiscal policy and monetary policy

(and the principle of central banks' independence stemming from it). But this example is useful to show how an expansive fiscal policy may be necessary to make QE effective.

The effectiveness of QE in the EZ will not depend so much on bond purchases lowering long-term interest rates, for these are already very low. Similarly, QE is unlikely to have much impact through the exchange rate as the Euro is at its 11-year lowest and the EZ depends relatively little on outside exports. For QE to have any impact on economic activity banks must lend and the governments must spend part of the money injected in the system. These behaviours are outside of the ECB's control. However, they are more likely to occur is QE is structured in the following way:

1. QE should be large and preferably unlimited in duration. Most banks and sovereigns in the Eurozone are too indebted and need to repair their balance sheets before they can lend and spend freely. However, so long as money is used to pay off debts, QE will be ineffective. As it is not known how much debt needs to be shredded before lending and spending can restart, QE should be in place until there are signs of economic recovery and positive inflation. (Remember that, at that point, all debts that have not yet matured will return to the market so debts are not necessarily shredded for good).
2. All Eurozone bonds should be eligible for QE unless they are nearing default. This is because the "easing" of balance sheets works by replacing risky assets with safe assets, the shortage of which is considered responsible for the structural excess of Savings over Investments in developed economies.
3. The risk of default should be borne jointly by all the central banks in the European System of Central Banks. This solution creates the commitment to stick together that the EZ is currently missing. It does so by mutualizing the costs of QE only in case of failure. Because a solvent country will end up bearing the consequences of the default of others if the Euro breaks up, but not otherwise, the solvent countries will be committed to the success of QE. QE's success depends, in turn, on the less indebted countries starting spending money while the more indebted countries are still paying off their debts. This is a behaviour that the ECB could encourage, and has indeed encouraged, but could never impose.

The QE programme launched by the ECB on 22 January 2015 has both characteristics 1 and 2. Apart from the considerable size of the monthly purchases, the duration of the programme can be extended until the target inflation rate of the ECB is reached. Moreover, there are no restrictions on the kind of bonds the ECB can purchase so long as they are rated investment grade and, as far as EZ government bonds are concerned, these are bought in proportion to the share of national central banks in the ECB's capital. Condition 3, however, is not fulfilled because only a tiny part of the default risk associated with the QE purchases will be borne by the ECB.

Because allegedly such a design of the QE programme was necessitated by the legal boundaries of ECB action, we now move on to discuss the legality of QE under EU law.

QUANTITATIVE EASING IS COVERED BY THE ECB'S MONETARY POLICY MANDATE (ARTICLE 127(1) TFEU)

Quantitative Easing is an Open Market Operation based on Article 18.1 of the ECB Statute. Since such OMOs are monetary policy instruments recognised by the EU Treaties, the EU law allows the purchase of government bonds as such. Monetary policy instruments, however, must aim to maintain price stability as a primary objective and may support the general economic policies of the Union as a secondary, subordinated objective (Article 127(1) TFEU). Accordingly, the ECB does not exceed its monetary policy mandate only because its monetary policy measures also include economic policy aspects. Pursuant to the reasoned opinion of the Advocate General Cruz Villalón in the OMT case, the ECB is considered to have a broad discretion for the purpose of framing and implementing the Union's monetary policy. QE is supposed to have an impact on the inflation expectations in the EZ and thereby, to stimulate the economy. In a situation in which conventional monetary policy measures such as lowering the nominal interest rates are not available anymore because of the ZLB problem, one of the last remaining possibilities for a central bank to influence inflation expectations is to expand the money supply

by purchasing government bonds. This shows that the principal focus of QE is on monetary policy, as a result of which the ECB is staying within its legal mandate.

SETTING A QUANTITATIVE LIMIT ON PURCHASES OF BONDS PREVENTS A CIRCUMVENTION OF THE PROHIBITION OF MONETARY FINANCING

Even if covered by the ECB's monetary policy mandate, QE shall not violate the prohibition of monetary financing of Member States under Article 123 TFEU. In principle, any purchase of a government bond implies financing the state that issued the bond. Article 123 TFEU only rules out one way of purchasing government bonds: The direct purchase from the issuing state on the primary market. Therefore, government bonds purchases on the secondary market are allowed if they do not aim to circumvent the prohibition of monetary financing by influencing the formation of market prices for government bonds on the primary market. QE must therefore provide sufficient safeguards to ensure that its intervention does not run counter to the prohibition of monetary financing. Such safeguards can be identified in the quantitative limits on the purchases (maximum 60 bn € per month) and in the fact that QE covers the purchase of both public and private sector securities. Moreover, the overall quantitative limits on the ECB purchases are supplemented by limits on issuers (purchases can include maximum 33% of the outstanding bonds by a single issuers) and on issues (purchases can include maximum 25% of each bond issue). Consequently, investors buying bonds in the primary market have no guarantee to sell them to the ECB on the secondary market. This uncertainty ensures an unbiased formation of prices for government bonds on the primary market. This is an argument that even the German Constitutional Court supported in its order for reference in the OMT case.

NO PROHIBITED MONETARY FINANCING BECAUSE OF THE RISK OF SOVEREIGN DEFAULT

Finally, there can be monetary financing of Member States if the ECB and the national central banks have to face considerable losses from a waiver of rights (a so-called "haircut") or from the default of a sovereign. Such losses can, however, only be considered as monetary financing if the ECB had an influence on the waiver or the default. Otherwise, both cases relate only to a future and hypothetical situation entailing the restructuring of the State's debt and are not an intrinsic component of QE. Any purchase of financial assets entails the risk of default. According to the reasoned opinion of Advocate General Cruz Villalón in the OMT case, taking this risk only amounts to monetary financing when it would inevitably lead the ECB to a situation in which it faces insolvency. Such a situation, however, may never occur so long as the Eurozone exists. This is because – as mentioned before – a central bank can work with negative equity.

There is no obligation for the national central banks, as shareholders of the ECB, to "recapitalise" the ECB. This follows from Art. 33.2 of the ECB Statute, which enables the ECB Governing Council to decide that, in the event of losses, the shortfall may be offset against the monetary income of the relevant financial year in proportion and up to the amounts allocated to the national central banks. If an ECB Governing Council decision is required even to offset a shortfall against the distribution of income from seigniorage, a fortiori such a decision would be needed for the ECB to ask its shareholders to cover losses by fresh capital injections. However, the Governing Council is not obliged to make any of these decisions. In this way, the ECB Statute implicitly recognises that the ECB can work with negative equity. Eventually, the losses from the purchase of bonds that subsequently defaulted will result in lower profits from seigniorage to be distributed to Member States. However, this effect can hardly be characterized as monetary financing or a violation of the no-bail-out clause of the EU treaties (Article 125 TFEU).

The only situation in which Member States are automatically liable for the losses made by the ECB in the purchase of assets, including the bonds of a defaulting government, occurs if the ECB faces insolvency and has to be liquidated. Hence, taxpayers' money will only be necessary to compensate the negative equity of the ECB in the event of a break-up of the Euro and the following liquidation of the ECB. However, so long as QE is not designed to make ECB insolvency inevitable, the purchase of even very risky government bonds cannot be deemed to violate Art 123 and art 125 TFEU. Whether, to what extent, and under what conditions the ECB can engage in the purchase of such bonds is simply a political choice by the Governing Council of the ECB.

For those reasons, the decision of the ECB of 22 January does not cross the boundaries set by EU law. It stays even far away from these boundaries. According to the QE announcement, only 20 % of the purchases will be subject to risk sharing. The risk of losses amongst such 20 % is very low because 3/5 of these purchases will be securities from European institutions, which are highly unlikely to default, whereas only the remaining 2/5 of these purchases may include more risky government bonds.

CONCLUSION AND OUTLOOK

Unfortunately, as mentioned, the choice to limit so significantly loss sharing among Member States affects the credibility of the Member States' commitment to keep the Eurozone together and as such, may undermine the effectiveness of the QE programme. To be effective, QE needs to be complemented by spending by the public and/or the private sector. The uncertainty stemming from the persisting fragmentation of financial risk across Member States may prevent this from happening.

AUTHORS

Alessio M. Pacces, Professor of Law and Finance, Rotterdam Institute of Law and Economics, Erasmus School of Law, Erasmus University Rotterdam, Research Fellow of EURO-CEFG.

René Repasi, Erasmus School of Law, Erasmus University Rotterdam, Scientific Coordinator and Research Fellow of EURO-CEFG.

FOR FURTHER INFORMATION AND QUESTIONS

Alessio Pacces
pacces@law.eur.nl

René Repasi
repasi@law.eur.nl

EURO-CEFG

The European Research Centre for Economic and Financial Governance (EURO-CEFG) is a joint research initiative initiated by researchers from the Leiden University, Delft University of Technology and Erasmus University Rotterdam.

It aims at building a trans-European network of high-quality researchers and societal stakeholders around the interdisciplinary theme of Economic and Financial Governance in the EU.

EURO-CEFG facilitates scientific cooperation of researchers and research groups with different disciplinary backgrounds and with expertise in the different areas linked to economic, monetary and financial (market) governance.

RESEARCH FELLOWS

Fabian Amtenbrink,
Erasmus University Rotterdam
(Scientific Director EURO-CEFG)

Stefaan van den Bogaert,
Leiden University

Martijn Groenleer,
Delft University of Technology

Matthias Haentjens,
Leiden University

Markus Haverland,
Erasmus University Rotterdam

Klaus Heine,
Erasmus University Rotterdam

Madeleine Hosli,
Leiden University

Alessio M. Pacces,
Erasmus University Rotterdam

René Repasi,
Erasmus University Rotterdam
(Scientific Coordinator EURO-CEFG)

RESEARCH ASSOCIATES

Dariusz Adamski, University of Wrocaw • Kern Alexander, University of Zürich • Franklin Allen, Imperial College London • Damian Chalmers, LSE • Christoph Herrmann, University of Passau • Claire A. Hill, University of Minnesota • Rosa María Lastra, Queen Mary University of London • Dan Kelemen, Rutgers University • Deborah Mabbett, Birkbeck University of London • Donato Masciandaro, Bocconi University • Christoph Ohler, Friedrich Schiller University of Jena • Katharina Pistor, Columbia Law School • Dagmar Schiek, Queen's University Belfast • Paul Schure, University of Victoria • Takis Tridimas, King's College London • Amy Verdun, University of Victoria