# Shadow ECB Council is sceptical on size and structure of the ECB's package

At the meeting of the Shadow ECB Council on 26 September, 2014, there was a strong consensus that strong disinflation and weak economic prospects warranted ECB action. At the same time, there was near consensus that the package of measures announced by the central bank in early September would not be sufficient and there was disagreement on their appropriateness. Many members suggested large scale

purchases of securities, notably public bonds, and several suggested purchases of foreign assets or various forms of helicopter money. One of the 15 members argued for a further significant rate cut, three members argued for rate increases.

Minutes of the meeting on 26 September 2014

Some members of the Shadow Council made written comments during a pre-meeting discussion by e-mail. These are documented here:

**Elga Bartsch: QE would not do the trick**

I don't believe that the economic situation is as bad as some observers believe. More importantly I am not convinced that broad based QE including government bonds would improve the situation materially. This is not only because it is not clear to me that QE would really cause financial conditions to ease (in fact I could see a situation where bond yield and the euro exchange rate rise in the response to a QE announcement). More importantly though I think we need to bear in mind that QE tends to have negative consequences for the financial system, notably banks but also insurance companies and pension funds. Given that the euro area is so dependent on bank finance, improving the health of the sector and providing incentives to lend should take priority. The TLTROs and ABS and covered bond purchase programmes are key steps into this direction. Not only will they make sure that bank funding costs drop materially, but also will they change the relative attractiveness of the different uses of the asset side of a bank balance sheet by only offering term funding for corporate lending. Combined with changes to the investment regulations for insurers and pension funds and importantly the capital retension rules for banks they are likely to be powerful in reviving the bank lending channel. Meanwhile the weaker euro, falling oil prices and hopefully more profound reforms should keep the recovery on track until the credit impulse kicks in more powerfully in the course of next year.

**Willem Buiter: There is a lot left to be done for the ECB**

TLTRO won't have meaningful take-up until AQR-Stress Test is completed. So we'll have to wait till the December round to see numbers bigger than euro 86.2 bn. ABS and Covered Bonds backed by mortgages largely pointless as regards qualitative easing/credit easing. Expansion of balance sheet through this kind of asset purchases only works through liability side: euro weakens as excess reserves pile up. ABS backed by SME loans are desirable, but unfortunately not available on any meaningful scale.

I favour an initiative from the ECB to get the euro area banks to issue ABS and Covered Bonds backed by periphery sovereign debt. As these would be private securities the ECB/Eurosystem could purchase them in unlimited quantities. I propose Euro 500 bn for the rest of this year, with the promise of more to follow if inflation and activity don't pick up. If at the same time the European Commission relaxes the fiscal constraints on the periphery nations (including France), say by recalculating the structural/cyclically corrected budget deficits and finding that they are all at least 2% lower than was thought before, we could implement a form of helicopter money drop through the back door.

QE in the form of on ECB-equity-share weighted portfolio of 18 (next year 19) euro area national sovereign bonds will also be welcome and long as it is done on a sufficient scale. By the end of the year the balance sheet of the Eurosystem should be back at its June 2012 peak of euro 3.1 trillion. By the middle of 2015, it should be at least euro 4.1 trillion.

Other possible outright asset purchases by the ECB/Eurosystem (non-sterilised) could involve US Treasuries and JGBs. This would probably be the most effective way to bring down the exchange rate of the euro. Switzerland has been intervening in the foreign exchange markets (buying euros) on a huge scale, so there are precedents for non-sterilised foreign exchange purchases to weaken the currency.

As regards non-monetary policy actions by the ECB, the following: To help financially fragile emerging markets cope with the approaching increase in policy rates in the US (and the UK), the ECB could offer euro swap lines to the central banks of the fragile 5/10/12. These EMs could then use the euros to purchase additional US dollar reserves to counter exchange rate overshooting when zeroexit occurs in the US. With a bit of luck this would shame the Fed into making US dollar swap lines available to the fragile 5/10/12. This would help minimise the financial disruption associated with the unavoidable normalization of interest rates in the US and the UK.

**Marco Annunziata: The ECB’s mandate has to be taken seriously in both directions**

I see the latest ECB actions as fully justified because inflation is persistently below target, and the ECB’s single mandate has to be taken seriously in both directions. I regard the Eurozone’s growth outlook as poor, but not as disastrous as to require an emergency monetary policy response. Low growth is caused by a mixture of demand side and supply side factors. On the demand side, delayed balance sheet adjustments and more recently the repercussions of the sanctions on Russia play a role. Looser monetary policy can help, but to a limited extent. Fiscal policy support should be combined with tax and expenditure changes aimed at making government budgets more efficient and sustainable: in my view, given high public debt levels, we cannot simply rely on wider budget deficits. Finally, any leeway on fiscal support should be accompanied by stronger structural reforms in countries that have so far been very reluctant to take any meaningful steps. I realize this shifts the emphasis outside the ECB, but I strongly believe that what holds back Eurozone growth is weak productivity and structural rigidities.

**Sylvain Broyer: Many say Draghi was wrong, but I think he was right, once again**

Many observers said Draghi was wrong to deviate from script at Jackson Hole, since the Eurozone was not in a crisis regime this time. I think for my part that Draghi was right, once again. First: the only way for the ECB to inflate rapidly consumer prices in the context of deleveraging, overcapacities, flat commodities prices, narrowing markups through goods markets’ reforms and the digitalization of services, consists into lowering the EUR exchange rate. And second: the most efficient way to lower the exchange rate is to surprise markets.

Now, the new ECB package will help, but it will not be sufficient. It is unlikely that the ECB balance sheet will inflate as much as it has been announced by Draghi i.e. by 1000 bn of EUR by means of TLTROS injections, ABS and CB purchases. We have estimated that the TLTROS could boost credit up by 2 percentage points, in the case that interest rates in the periphery fully converge towards the core. This is no huge effect, with an optimistic assumption. On the other side, the depreciation of the euro since July will lead inflation up by 0.2 percentage points in one year. This is still not enough for the ECB to ensure “price stability”. I do not believe that a full broad QE will have much more effect on inflation. I think that helicopter money should be regarding attentively as an option for concerted monetary and fiscal policies.

**Merijn Knibbe: The only way forward is an increase of household consumption**

Aggregate demand in the Eurozone is far below medium run potential, despite a 4,5% of GDP shift in the Eurozone current account surplus during the last two years as this shift was mainly caused by restriction of demand and not by an increase of exports (even countries like Estonia are not experiencing anything like export led growth). We're stuck in a rut, mind that the new German GDP data clearly show that Germany, too, experienced a double dip, after 2008.

Private investments have reached historical lows, government expenditure is still restricted and tax increases combined with pay cuts dampen household consumption. On top of this there is this thing called a 'balance sheet recession' while the long run rate of fixed investment (expressed as a % of GDP) is clearly much lower than ten, twenty, thirty of forty years ago (my guess: about 7-10% of GDP...). Something has to compensate the combination of structurally lower investments, paying down debts and curtailed government expenditure. And we can't all run at the same time current account surpluses of 7 to 10% of GDP to do fill this gap, like the Netherlands and Germany and Switzerland did.

The only way forward is an increase of household consumption (including investment types of spending, like solar cells and the like), which means that VAT and taxes on labour have to be lowered. In an ageing society, this of course also means that cutting pensions is the wrong way to go. The pension age might be increased in countries with a medium rate of unemployment and rather disastrous demographics, like Austria and Germany. But lowering the level of pension benefits is putting the horse behind the wagon. Lower ECB interest rates clearly facilitate such policies – but governments have to enact them. Anyway: structural investment rates (SNA definition) really are lower than they used to and something has to fill the gap.

QE for the people (i.e. massive long-run low-interest refinancing of mortgage debts without refinancing fines) might be more effective than QE for the banks. Draghi would love that – governments have to enable it.

**Andrew Bosomworth: QE needs to become the central policy tool**

The eurozone remains mired in a liquidity trap in which the private sector continues to delever. Total net credit flows – across stocks, bonds and loans – to the private sector were negative 210 billion in the first seven months of this year. With consumer price inflation below 1.5% for over one year now and expectations for inflation derived from forward inflation swaps not reaching 1.75% until 2019, which is well beyond the policy-relevant horizon, it is fair to conclude that inflation expectations are de-anchoring from target. As such, the ECB is losing credibility.

Fragmentation in the credit market, while healing, remains a problem. Yet muted consumer and wage price inflation in non-programme countries combined with private sector deleveraging point to a deficiency of aggregate demand problem co-existing alongside the broken credit channel. If price stability is to be symmetric around the close-to-but-below-2% definition, monetary policy needs to be more accommodative.

The ECB's reaction function is already fully operational on two levels: via the liquidity channel it is providing unlimited amounts of low-cost funds and via the credit channel it is encouraging banks to lend via TLTROs and the soon-to-be implemented ABS and covered bond purchases.

I doubt whether rate cuts, TLTROs and credit easing (ABS and covered bond purchases) will succeed in stopping private sector deleveraging and raising inflation expectations.

Indications from banks suggest the December TLTRO will be larger than this month's auction. I estimate the combined take-up of the first two TLTROs will be 200 to 250 billion, about 50% to 60% of the theoretical maximum, and a cumulative 500 to 800 billion over the course of all TLTROs. I further estimate the stock of existing eligible ABS and covered bonds that the ECB could purchase and that would make sense to purchase at about 575 and 600 billion respectively. Realistically, the ECB ought to be able to buy between 100 to 150 bln of these securities in total, possibly a bit more if the ECB's demand induces substantial new supply. Overall, I estimate the net impact of TLTROs and credit purchase programmes will boost the ECB’s balance sheet by between 300 to 700 billion, after deducting maturing LTROs and other securities, taking it to the 2.3 to 2.7 trillion range.

With interest rates through the zero lower bound and a lack of aggregate demand an increasing problem, I think the ECB should shift it’s reaction function to the next level and concentrate on asset purchases that actively raise the size of the balance sheet. The TLTROs and credit easing policies have been decided and should be given time to prove their effectiveness. But the ECB’s credibility is at stake so it cannot afford to allow inflation and inflation expectations to undershoot the target for too much longer. If latest by the end of the first quarter of 2015 there is still no improvement of inflation and inflation expectations, or if demand conditions deteriorate between now and then, I think the ECB should adopt quantitative easing. A QE programme of 500 billion purchases of government bonds would take the balance sheet to a level that materially compresses long-term risk premia and depreciates the currency.

Accordingly, as the next step but not necessarily immediately, I favour elevating QE to the central policy tool and returning interest rates to a minimum normal range with the Main Refinancing Operation rate at 0.25% and a 0.25% corridor around that for the Deposit and Marginal Lending Facility rates.

**Julian Callow: The ECB’s goals are not well specified**

The ECB's new operational target, to expand the balance sheet back to its size in early 2012, is not well specified. We do not know why it is focused on this level, nor what the implications of attaining it would be. In my view policy is in danger of becoming confusing to the markets, with different operations and yet unclear understanding about the relative size of each operation, its expected goals and implications, and how they will interact.

I think there is an important qualitative difference between central bank operations which expand funding to banks (passive QE) and the active purchase of securities (active QE).

Previously I backed an ABS programme and it is welcome to see this. I think additionally that the time has come for the ECB to announce an ESM bond purchase programme. That said, the TLTRO programme makes determination of the size of prospective new asset purchase programmes unclear, given uncertainty about bank TLTRO demand. Therefore, I think that it is preferable for the ECB to wait to see the consequences of the second TLTRO before embarking upon a new asset purchase programme.

I do welcome the recent deposit rate reduction. It is vital for the euro to continue to depreciate to support the economy, which is showing signs of softening. That said, I think Q2 GDP in the euro area was depressed by several one-off factors, and we should get some positive growth again in Q3. Likewise, I do not think deflation risks are especially strong, given wage inflation at just under 2%.