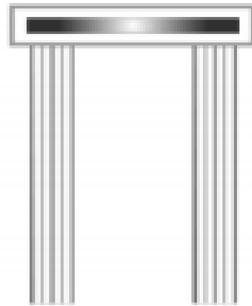

POLITEIA

QE FOR THE EUROZONE: SENSIBLE, APPROPRIATE AND WELL-CALIBRATED

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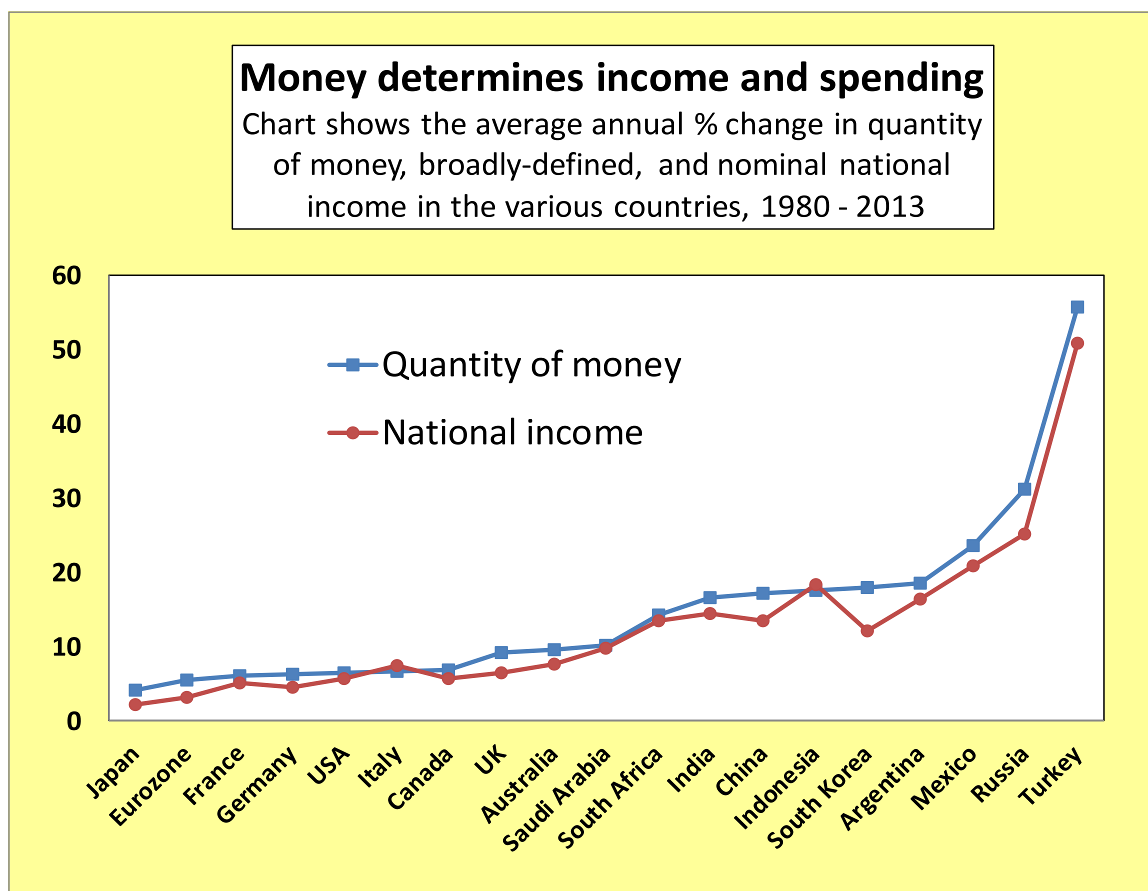
Much of the commentariat is baffled by "quantitative easing". As is widely known, QE has been widely adopted by central banks in the last few years to boost demand, output and employment, and to escape the macroeconomic *malaise* that has afflicted the advanced industrial countries during and since the Great Recession of 2008 - 10. The European Central Bank's adoption of a QE programme follows similar action by the Federal Reserve, the Bank of Japan and the Bank of England. Its main feature, the large-scale purchases of government securities with newly-created central bank cash, is familiar from the steps already taken by these three institutions. Even so Robert Lea said in *The Times* of 23 January that Eurozone QE is "a vast leap into the unknown", while Jeremy Warner of *The Daily Telegraph* had previously condemned QE "as barking up the wrong tree", and Liam Halligan in his *Sunday Telegraph* column had lambasted it as "the last refuge of declining empires and banana republics".



The general outline of the rationale for QE programmes is in fact quite simple. (The details can be hugely complex.) Over the medium and long runs increases in the quantity of money and increases in nominal national income/gross domestic product are similar, although not identical, in most countries or monetary jurisdictions such as the Eurozone. (See the chart above.) In the short run large changes in the growth rate of real money (as changes in nominal money growth are not matched immediately by changes in inflation/deflation) have powerful effects on asset markets and real demand growth. Roughly speaking, most statistical work finds that a 1 per cent increase in the growth rate of real money is associated in the first year with a 0.3 per cent - 0.4 per cent increase in the growth rate of real aggregate demand, relative to what would otherwise have happened.

To the extent that *quantitative* easing boosts the *quantity* of money, it therefore has important macroeconomic effects over various time periods. Policy-makers can influence the economy even when "the rate of interest", which might be seen as the *price* of money, has dropped almost to zero and cannot be lowered any more. (Note that the phrase "the quantity of money" refers here to a broadly-defined measure that includes all or nearly all bank deposits held by private sector agents. In the Eurozone this concept is usually labelled "M3". The quantity of money does not mean the monetary base, which is something quite different, while it is a fallacy to believe that changes in the monetary base and the quantity of money are equi-proportionate. See the final essays of my 2011 book, *Money in a Free Society*, for further elucidation. The change in real money is of course the change in nominal money deflated by the increase in prices. I apologize for the technicalities, but they cannot be avoided and are crucial to the wider discussion.)

The ECB has announced that it will be orchestrating purchases of government securities, by member central banks, equal to €60b. a month, across the entire Eurozone, certainly to late 2016 and possible for longer. Given the short-run and long-run relationships between the quantity of money and macroeconomic variables, what does this scale of purchases mean for demand, output and inflation? With our analytical framework to guide us, the answers emerge easily enough.

Eurozone M3 in November 2014 was €10,207b. and Eurozone GDP in 2014 was probably heading towards €14,500b. or so. Central bank purchases of government securities from resident non-banks (i.e., non-bank financial institutions, corporations and persons) add directly to M3. On the whole, banks do not own long-dated government securities, because of their price volatility. So the promised €60b.-a-month purchases would increase M3 by over 0.5 per cent a month, if such purchases were exclusively from resident non-banks. This would be equivalent to a 6 per cent increase in the annual rate of growth of broad money, a very major development. Unfortunately, matters are not that straightforward.

At the end of 2013 Eurozone public debt was just over 90 per cent of GDP, i.e., about €13,000b., which appears to mean that a large pool of debt securities is available for QE purposes. But we must note that at the same time,

1. The ownership of Eurozone government debt was split evenly between residents (45.7 per cent of GDP) and non-residents (45.0 per cent), and
2. Eurozone monetary financial institutions (i.e., banks) held public debt equal to 26.0 per cent of GDP and non-banks held public debt of 19.7 per cent of GDP.

The precise impact of the promised €60b.-a-month purchases on M3 is therefore partly a matter of conjecture. Three comments may give a better feel for the issue. First, purchases from the banks/MFIs will *not* – repeat, *not* – increase the quantity of bank deposits and hence M3 in the first instance. All the same, they are stimulatory. They will add to banks' holdings of cash reserves at the ECB and ease funding pressure on the weaker banks, assuming that the cash reserves spread around the banking system to some degree. They may also encourage the stronger banks to expand their businesses by making new loans, with the new loans boosting bank deposits on the liabilities side of the balance sheets.

Second, ECB purchases from non-residents also will not increase resident bank deposits in the first instance. But they will raise the level of €-denominated bank deposits in the hands of foreign banks and non-banks. If the foreign banks and non-banks are unhappy with their

enlarged euro deposits, they will convert them into other currencies (putting downward pressure on the euro) and/or use them to make purchases of goods and services *and assets* from Eurozone residents. In other words, the ECB purchases of government securities from non-residents should also help economic activity.

Finally, some of the ECB's purchases will take the ideal form. That is, they will be from non-banks, and so will expand holdings of resident, private sector bank deposits euro for euro in the first round. On the face of it, the fillip to M3 growth from this source will be small, call it €15b. - €25b. a month, which is at most 0.25 per cent of M3, equivalent to perhaps 2 per cent - 3 per cent of M3 in a year.

I concede that the 2 per cent - 3 per cent supplement to M3 growth in a year doesn't sound dramatic, and no one would claim that it will transform demand conditions in the Eurozone immediately. But a figure of 2 per cent or 3 per cent is large relative to the Eurozone's trend growth rate of real output, now widely thought to be little more than 1 per cent a year. Moreover, there will be some benefits to demand due to purchases of government bonds from banks and non-residents, and there may be some spill-over into resident bank deposits. On balance, my verdict is that

1. Eurozone M3 growth will be at least 3 per cent - perhaps even 4 per cent - higher than would otherwise have been the case in the year to early 2016, and of course the programme will still have several months to run,
2. This addition to M3 growth will boost aggregate demand growth by 1 per cent - 1½ per cent a year, again relative to what would otherwise have occurred. Given the very low trend output growth rate in the Eurozone, this is a significant change for the better. The positive effects will be operating over several quarters after the end of QE, making economic conditions more benign until late 2017.
3. The transmission mechanism from money to demand works indirectly via asset markets, as well as more directly as agents try to offload unwanted money balances. So it is altogether right and logical that Eurozone stock markets have performed well in recent weeks.
4. In the medium and long runs the increase in nominal GDP in the Eurozone will be – for a period of time similar to that in which the asset purchases were being implemented – 3 per cent or 4 per cent higher than would have been seen without QE.

Nevertheless, the long-run viability of Europe's single currency experiment remains uncertain. The Eurozone struggles in a weird constitutional limbo, sharing a single unit of account and medium of exchange, but without complete pooling of fiscal and banking sovereignty. The QE programme just announced is sensible and appropriate, and well-calibrated to the Eurozone's current predicament. It should contribute to a discernible improvement in demand and output growth relative to 2013 and 2014, and will prevent deflationary forces taking hold. Even so, the public squabbling and wrangling between the Eurozone's members will persist for years to come. The Eurozone's turmoil and confusion fully justify the UK's decision to keep its own currency.