A scarcity of government bonds could pose problems for the ECB’s quantitative easing programme

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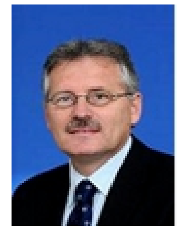
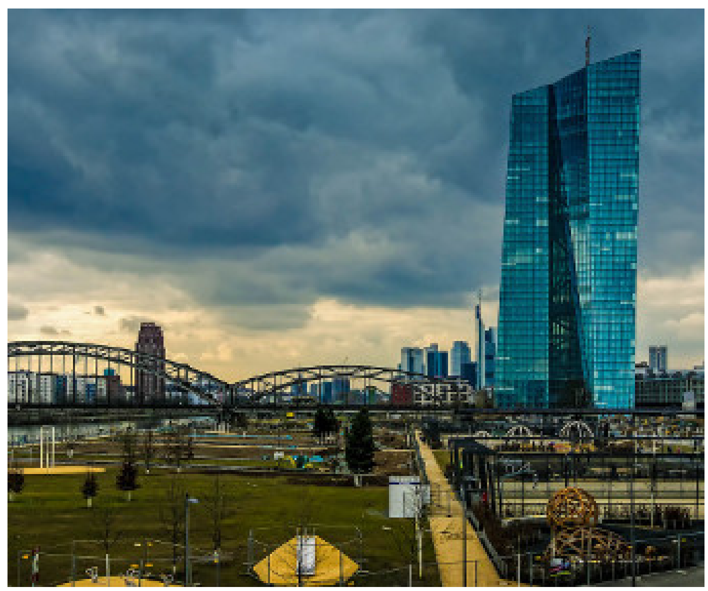


The European Central Bank’s quantitative easing programme is scheduled to start this month. **John Doukas** *writes that while the programme might well boost EU economies, there remain significant question marks over whether it is sufficient to generate substantial growth in struggling Eurozone countries. He also notes that a scarcity of government bonds could pose problems, and that the ECB should be prepared to pay higher prices for the purchase of government securities.*

On 22 January, the European Central Bank announced that it would implement a new quantitative easing (QE) programme. The policy is aimed at avoiding the ‘tail’ risk arising from the lack of growth, especially in the EU periphery (fiscally distressed southern states) as a result of the austerity policies imposed in the name of restructuring since the global financial crisis erupted in 2008.

While the programme might help to boost the EU economy by reducing interest rates and forcing the euro to trade at lower valuations against other currencies (particularly the US dollar), as well as fighting deflationary forces underway in the Eurozone, there are significant doubts whether such an expansionary monetary policy, as it has been announced, will be effective enough to revive the Eurozone economy. The reasons?



New ECB building in Frankfurt, Credit: Jonas M Luster (CC-BY-SA-3.0)

First, similar attempts in the past have failed to move the EU economy out of recession. Second, this is too late: a bold QE policy should have taken place at least 2-3 years ago. Third, monetary policy, as a substitute for fiscal policy, is subject to well-known balance sheet limitations, primarily when it is driven by the need to avoid deflation, as seems to be the ECB’s position now. Another reason is that the ECB does not yet have the full legal and, in particular, the *German* ‘green light’ to conduct a massive purchase of government debt (bonds) from the EU states.

Fourth, besides the quantitative limits of the announced QE programme, it is also designed to be ‘selective’ and not directed towards the EU states that have been economically more stagnant. Instead, as it has been announced so far, it actually favours the purchase of government bonds from EU states with stronger Eurozone economies. That is, the ones that have suffered less from the 2008 financial crisis. This, in turn, is expected to raise the gap of interest rates between the northern and southern EU states even further. Specifically, lowering interest rates in the north, but having very little impact, if any, on the cost of borrowing for the suffering southern periphery.

Fifth, unlike the US version of QE, the ECB will not engage in non-government asset purchases, which are necessary to lessen the liquidity constraints of the private sector. Hence, even if it succeeds in lowering short-term interest rates, lowering interest rates alone is not enough to stimulate the real economy as long as the private sector remains reluctant to borrow and invest. That is, a lower cost of borrowing alone is not sufficient to revise upwards business expectations, and, in turn, encourage business to invest and reduce the high rate of EU unemployment.

Sixth, given the current state of economic affairs, lower EU interest rates will encourage capital outflows outside of the Eurozone in an attempt to find higher yielding investment opportunities elsewhere. However, lowering interest rates in the southern EU periphery, which is not planned by the new QE, since there is a preference by the ECB to purchase government securities from the more creditworthy Eurozone countries, could encourage the undertaking of new investments and help these countries to achieve higher rates of growth, employment and, finally, lessen the burden of their external debt. If the ECB is to keep the Eurozone together in accordance with Mario Draghi's pledge to do 'whatever it takes', it should set a 3-4 per cent nominal GDP target rather than a 2 per cent deflation target.

Finally, the European Central Bank's plan to bring the Eurozone out of its economic discomfort by purchasing 1.1 trillion euros of bonds may be constrained, even before it starts this month. The reason is that there is going to be a shortage of new supply (scarcity of government bonds) and a lack of willing government bond sellers. Net issuance of government securities is expected to be negative for the first time while the safest Eurozone securities held by banks, insurers and pension funds are unlikely to be traded (i.e. available for the ECB to purchase). This will impede ECB efforts to buy in about 19 months the same fraction of government bonds as the Fed did in about six years of Treasury purchases.

This, in turn, will thwart the ECB's attempts to fight deflation/boost inflation. Of the ECB's 60 billion-euro monthly purchase plan, about 45 billion euros represents sovereign debt, which implies an intention to purchase 14 per cent of Eurozone government bonds outstanding by September 2016, or 18 per cent of securities from countries such as Finland, Germany, Luxembourg and the Netherlands – the only nations with two or more AAA ratings from the three major credit-assessment companies. With about 1.3 trillion euros of the region's sovereign bonds yielding less than zero per cent, bondholders of these securities will be more reluctant to sell, diminishing the overall effectiveness of the ECB's QE policy.

We should note here that it took the Fed about six years, and three rounds of QE, to raise its holdings to about 20 per cent of US Treasuries. With the Bank of England holding about 31 per cent of Britain's gilts and the Bank of Japan still adding to the holdings of that nation's debt, these purchases are reducing the amount of securities worldwide that are available for trading. Reduced government spending is also expected to contribute to a global scarcity of sovereign debt. Germany is expected to limit the amount of conventional bonds outstanding by 8 billion euros this year. In Spain, where the People's Party government has carried out the deepest austerity measures in the nation's recent history, the net issuance target for 2015 is about 55 billion euros, down from net sales of 97 billion euros in 2012.

In sum, the ECBs' late QE plan is expected to face a great deal of difficulty to find bond sellers, leaving its target in danger. The ECB should be prepared, then, to pay higher prices for the purchase of government securities in order to meet its goal of pumping money into the financial system of the Eurozone.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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