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The ECB's Quantitative Easing: Better Late Than Never

Patryk Toporowski

In March, the ECB starts a one and half year programme of purchasing government bonds from the secondary market, an operation termed quantitative easing. This follows similar steps by the U.S., UK and Japan in recent years and is intended to revive the EU economy. However, the programme is being launched very late compared to the start of the economic slowdown and the effects until 2016 will be limited. For Poland, the programme will translate into a strengthening zloty and a decrease in interest on national debt.

In January 2015, the ECB announced that in March it would begin an operation similar to the ones conducted by America's Federal Reserve (FED), the Bank of England and the Bank of Japan—quantitative easing (QE). The reason for this new operation is the threat of the so-called Japan effect in the eurozone, that is, economic stagnation accompanied by deflation despite interest rates almost at zero. Within the framework of QE, the EU's central bank will increase the monetary base by purchasing government debt securities from the secondary market (usually private banks or similar entities), and as a result, the money circulating in the economy increases as does the inflation rate, while the cost of capital decreases. The ECB plans to spend around €1 trillion on the programme from 9 March 2015 to September 2016, which amounts to €60 billion a month.

The problem, however, is that the ECB has launched its QE programme very late compared to the start of the economic slowdown and at a time when the eurozone is struggling to overcome stagnation and a lack of credit in the banking sector. The Fed launched its own programme in 2008, immediately after the first economic shockwave, while the Bank of England started in 2009. The years since 2008 could have been milder in terms of the economic effects in Europe had the ECB implemented QE immediately. Instead, many of the potential benefits of the programme have been lost with its late launch.

The ECB's Monetary Battle. The ECB's head, Mario Draghi, in facing the potential aggravation of the eurozone crisis and in order to calm down the markets, announced in 2012 that the ECB was "ready to do whatever it takes to preserve the euro." He backed up his words by launching programmes to increase liquidity in the eurozone. In 2012, the bank started Long-Term Refinancing Operations (LTRO), which are based on lending commercial banks credit interest-free. The banks, however, did not use this additional money to make credit available to their customers but chose to purchase government bonds instead.

As a result, the ECB in 2012 announced the launch of a different programme—Outright Monetary Transactions (OMT)—which were to be simply bond purchases from the secondary market of governments under bailout packages. That programme, however, did not materialize because certain requirements (known as "conditionalities") for the purchases, such as basing them on a country's progress in implementing the bailout package, appeared to be inconsistent with EU treaties.

In January 2015, however, the European Court of Justice (ECJ) ruled that OMT is in line with the *acquis communautaire* as long as the bonds purchase conditionalities are eliminated and the ECB is excluded from the monitoring process.

The ECJ's reservations on conditionality but not to the idea of government bond purchases paved the way for the introduction of QE. The ECB took the ECJ's statement and almost immediately announced its QE goal. Given the perspective of the course of the crisis, this decision could have been made at the beginning rather than now.

Belated Support for the Economic and Monetary Union. Because of the late launch of the programme, its effect will be smaller than it could have been seven years ago. Most notably, interest on public debt would not be as big as it was during the apex of the crisis. For instance, interest on Italian or Spanish 10-year bonds at the end of 2011 amounted to 7% compared to 1.5% now. This difference could have enabled states to gain access to less expensive capital at the beginning of the crisis and lower the social costs of borrowing.

Moreover, the eurozone did not benefit from a weakening of the euro, which would have increased its competitiveness in the key 2009–2011 years when there was much talk of a currency war between economic giants (i.e., China, Japan, Switzerland). This war was based on a depreciating currency, which provided a competitive edge to enterprises from a particular country. As result of this war and its lack of participation, the eurozone noted losses of industries to areas outside the currency union.

QE could have alleviated the unrest on the financial markets and cut down on speculation about the EMU's disintegration. Instead, investors raised concerns multiple times about the eurozone's stability and the problems in the currency union became a hot topic for the G-20 and others.

Even if economists differ in their approach towards the overall effect of QE on the U.S., they admit it influenced decreasing long-term interest rates. Additionally, the unemployment rate in 2014 in the U.S. and UK dropped to the same level (around 6% for either country) as the start of their programmes. Meanwhile, the eurozone unemployment increased from 7.6% to 11.6%, which according to the Fed and some economists indirectly proves the positive influence of QE on the labour market.

The assumption that QE in Europe will make a breakthrough in 2015 thanks to an increase in the money supply is not well grounded. After the long-lasting crisis, banks in the EU are reluctant to take risks or give credit to weakened enterprises. If the programme had been launched at the start of the crisis, the banking sector would be more stable and banks would be less exposed to the risk of insolvency. As a result, their approach to investment risk would be less prudent than it is nowadays and would contribute to an improved credit situation.

The Balance of the Benefits and Costs. The delay in the introduction of QE is not the only objection. There are voices, notably in Germany, that quantitative easing without structural reforms will not help revive the economies on the eurozone's periphery. Thus, they argue, that not QE but supply-side reforms should play a key role in the EU's counter-crisis strategy. These Germans are also concerned, as always, about the possibly of excessive inflation due to the programme.

The other doubt raised is about the effect on fossil fuel prices of a weaker euro because of QE. Higher prices in that sector could hamper the still sluggish economic recovery. This is an important consequence for the euro area, as the region's dependence on imported oil is 90%, compared to 60% for natural gas.

Despite these doubts, one should highlight the advantages of launching QE in 2015. Currently, the eurozone seems to be better prepared to use this assistance than before. While at the beginning of the crisis the Member States conducted their own counter-crisis policies, based on such things as public investment to boost growth, in 2015 their activity is limited by the framework of eurozone economic governance. The coordination of QE with structural reforms and economic discipline by eurozone members is more likely to contribute to an exit from stagnation than the programme alone without sound economic policy.

Also, changes in political and institutional settings could boost the positive effect of QE. Its launch well complements European Commission President Jean-Claude Juncker's investment plan as it improves access to relatively cheap capital. This in turn could increase the scale of investment in the euro area. This synergy effect would be even more clear if the EU creates a fully common capital market. Also, the additional liquidity thanks to QE would complement the proposed Banking Union, which offers banking supervision as well as resolution in case of problems.

Consequences for Poland. Although Poland remains outside the eurozone, Poland might be affected by the launch of QE. The first visible effect will be the strengthening of the zloty to the euro and thus a partial loss of price competitiveness to the advantage of the eurozone member states. This is an additional argument for the need to discuss more intensely the Polish model of competitiveness. The advantages are less and less reliable and Poland needs to focus on building other advantages than unit labour costs. A good direction for this is the creation of a stable and SME-friendly business environment and investment in human capital and technologies.

The launch of QE, though, also encourages the outflow of capital from the eurozone to countries where the rate of return is higher, and Poland is one such country. This may result in financial markets pricing Polish securities higher and, as a result, lower interest on Poland's debt.

QE may also improve the cost-benefit ratio of Poland's euro entry. The ECB's lack of room or willingness in the past to affect the euro rate and thus improve the competitiveness of the area was one factor discouraging the country from joining the currency union. The launch of the programme is a sign that the ECB will be more dedicated to intervening to provide financing and easing the moods on the market if needed. This change in the ECB's approach will not mean there is a distinct advantage to immediate euro entry; however, in discussions it can become a clear argument in favour of introducing the common currency sooner than later.