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FEATURE ARTICLE

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Eurozone Quantitative Easing (QE) €1,100,000,000,000

I am going to make a guess that Mario Draghi would be a very good poker player. The President of the European Central Bank (ECB) announced yesterday that the ECB will begin purchasing €60bn worth of Eurozone government debt monthly in March and will continue those purchases until September 2016 (€1.1 trillion in total or €1,100,000,000,000). Cleverly however, which is why I think he would be a good poker player, Mr Draghi managed expectations ahead of the announcement – and then beat them!

What is QE?

Quantitative easing (QE) is another form of monetary policy. With growth in the Eurozone remaining at just 0.2% in the last quarter and inflation turning negative in December and having taken Eurozone very short-term interest rates as low as possible (0.05%) plus attempting to boost lending by offering cheap loans to banks, the theory is that QE will reduce longer-term rates as well which in turn, should help to stimulate the Eurozone economy.

In simple terms QE is basically the central bank printing money. (In this respect I have a vision of Mr Draghi going down into the basement of the ECB and crying “start the presses!” but in today’s electronic world the reality is very much different.) Essentially the ECB will be purchasing Eurozone government debt, using money it has simply created on its balance sheet out of thin air. The theory is that the increased demand for these assets should lower their rate of interest and the cheaper level of borrowing should then boost the economy. Thus quantitative easing is the same principle as printing money as it is a deliberate expansion of the ECB's balance sheet and the monetary base.

The QE undertaken by the ECB is supposed to have two main effects. The first is through the direct effect on retail banks’ balance sheets. As a result of the credit crunch the balance sheets of retail banks have been severely affected and consequently they have reduced lending (the “oil” of the economy) With more cash on their balance sheets these banks should decide to lend more to businesses and individuals, and increase the amount of activity in the economy that way. The second effect is through the cost of borrowing. When the ECB buys Eurozone government debt, it reduces the supply of those assets in the economy. That should increase the demand for new bonds and, at the same time, make it cheaper for businesses to borrow together with the fact that lower interest rates on the securities that the ECB are buying may also encourage banks to lend rather than keep securities which are paying low interest.

Are there any risks?

We should all remember that QE is, in fact, a high-risk strategy. If it is not done aggressively enough retail banks will remain unwilling to lend. QE also runs the risk of creating too much money with the result that instead of simply preventing deflation it results in a period of high inflation. This is because when there is too much money in an economy, chasing a limited supply of goods, prices generally rise, unless of course there is sufficient “slack” to enable the supply to increase.

There is also the danger of a “bubble” developing in the government bond markets. This could happen because as government bonds rise in price this encourages investors to buy and interest rates to fall. However, prices could collapse at a later date when QE is stopped or reversed, causing long term interest rates to rise at too early a stage in the business cycle.

The ECB has not gone down the path of full “risk sharing”. QE for the Eurozone is different because the ECB will purchase the debt of not just one country, as was the case with US, Japanese and British QE, but of 19 different countries in very different states of economic health. That raises potential risk implications as the sovereign debt of one country may be riskier than another and European taxpayers would potentially have to foot the bill if any one country defaulted on its debt. But the ECB plan has been designed so that only 20% of the risk of default is shared. The rest will be backed by the national central banks. (It is interesting to note that Greece and Cyprus are excluded from the QE programme announced as their debts are not “investment grade” – meaning the two most indebted countries in the Eurozone are not helped directly by the QE announced.)

Finally there is the fact that QE will lead to a lower value for the euro. This is because it is potentially less attractive to hold the euro if the value of the euro is going to be reduced by increasing money supply. So you now have a situation where two of the largest and most powerful exporters, Germany and Japan, are benefiting from artificially cheap currencies – the question is whether that is a situation that the rest of the world is prepared to tolerate for any length of time or whether this could result in “currency wars”.

Why are the Germans so against QE?

The Germans are against it because they believe that QE from the ECB is just offering a "sticking plaster" to the weaker peripheral economies in the Eurozone who need to push through structural reforms to improve competitiveness.

As an aside here you may wonder, as I initially did, why the ECB will be purchasing government debt in the marketplace that may have only recently been issued to finance various government deficits. Well the answer is that according to the Maastricht Treaty, EU member states are not allowed to finance their public deficits by printing money. That is why the ECB will buy government debt from financial institutions and the secondary market, not directly from the central banks. Thus the ECB is in effect "printing money" to prevent deflation, it is not printing money to help governments finance their deficits. It is also important to note that QE is seen as a temporary policy, the ECB expects to sell the debt back into the market when the Eurozone economies recover. The ECB says that QE is purely a monetary tool in line with its mandate to ensure stable prices.

It is also interesting to note that in the past the ECB has already bought up sovereign bonds of a number of the countries hardest hit by the current crisis, such as Greece, Portugal and Ireland. But these purchases were not considered QE because they were targeted specifically at the countries concerned and not on a wide scale.

Finally, in addition the ECB can in theory also purchase corporate debt, but the market for sovereign debt is much bigger and will therefore have a much bigger impact.

Conclusion

The QE announced yesterday is not the solution to any of Europe's economic problems and really only buys time. It reassures investors that no one is going to be allowed to "go bust". The ECB is willing to finance the huge levels of debt that currently still exist. The real solution lies in the Germans loosening fiscal policy to promote growth and the French and countries of the periphery freeing up their labour and product markets.

The problem is that the solvent countries of the Eurozone, most notably Germany continue to refuse to rebalance their economies to soak up more consumer spending and generate growth by running a budget deficit. Germany will not use Keynesian fiscal policy to promote extra growth which means periphery countries such as Portugal, Ireland, Italy, Greece and Spain have been forced into severe austerity.

Now that the ECB is doing QE it means all the major economies around the world are in effect on long-term life support from printed money. The market for government debt is, for now at least, effectively nationalised and does not reflect market forces but countries creating artificial demand for their own debt.

Ultimately for a private client investor with all of this happening whether now is the time to invest in Europe and if so which countries and what exposure to have is one that in my opinion is best left to a professional fund manager as part of an overall investment strategy that is linked to the investors aims and objects, risk profile and capacity for loss.

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