

The ECB's Expanded Asset Purchase Programme

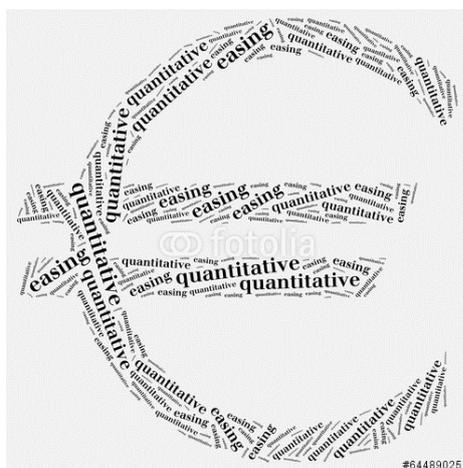
Will quantitative easing revive the euro area economy?

SUMMARY

On 22 January 2015, the European Central Bank (ECB) launched its Expanded Asset Purchase Programme (more commonly known as quantitative easing, or QE) with the aim of reviving the euro area economy.

This unconventional monetary policy instrument – under which the European Central Bank will create new money to purchase euro-denominated, investment-grade securities issued by euro area governments and European institutions – has generated lively debate among policy practitioners, academics and the media. The results achieved in countries that have previously implemented QE (the US, UK and Japan) have been mixed. But discussions on its introduction by the ECB have been particularly lengthy since the euro area presents particular challenges that relate to the legality and the feasibility of the programme, and these may impede the ECB's programme from fully realising its potential.

These challenges are also the reason why the ECB stressed during the press conference following its decision to launch QE that the programme will not be a panacea, but must be accompanied at national level with structural reforms, as well as fiscal policies that support the overall recovery of the economy.



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Glossary

Eurosystem: The Eurosystem comprises the ECB and the national central banks of those countries that have adopted the euro.

Deposit facility: A [standing facility](#) of the Eurosystem which counterparties may use to make overnight deposits at a national central bank.

Main refinancing operation: A regular open market operation executed by the Eurosystem for the purpose of providing the banking system with the amount of liquidity that the former deems to be appropriate.

Marginal lending facility: A standing facility of the Eurosystem which counterparties may use to receive overnight credit from a national central bank at a pre-specified interest rate against eligible assets.

Source: [ECB glossary](#)

Issue

The [primary objective](#) of the ECB's monetary policy is to maintain [price stability](#) – that is 'a year-on-year increase in the harmonised index of consumer prices ([HICP](#)) for the euro area of below 2%'.¹ According to the ECB, this is the best contribution monetary policy can make to economic growth and job creation. To assess the risks to price stability and take the appropriate decisions, the ECB analyses economic developments from two perspectives: [economic](#) and [monetary](#).

In the economic and monetary analysis it published in [December 2014](#), the ECB observed that, 'The risks surrounding the economic outlook for the euro area are on the downside... [the analysis confirms] the need to closely monitor the risks to the outlook for price developments over the medium term and to be prepared to provide further monetary policy accommodation, if needed'.

This analysis was followed by a decision on 22 January, to pursue an 'Expanded Asset Purchase Programme' (EAPP). The programme is expected to have a positive impact on the economy's growth and to raise inflation, bringing it back to the desired level of [lower than but close to 2%](#). However, the decision, and its preparation, generated lively debate in the ECB, as well as among politicians, academics and journalists.

Conventional and unconventional monetary policy instruments

The main 'conventional' instrument the Central Banks have at their disposal to implement monetary policy is that of interest rates; they raise them when the economy overheats and lower them when they wish to [stimulate the economy](#).

Since the beginning of the crisis in the euro area, this has been the modus operandi of the main decision-making body of the ECB, the [Governing Council](#). It repeatedly adjusted its three [key interest rates](#) – the rate for the deposit facility, the rate for the main refinancing operations and the rate for the marginal lending facility – downwards, to provide incentives to the economy to fight slowing growth and [disinflation](#).

Since June 2014 however, the rate for the deposit facility has been set below zero and the other two rates are very close to zero. Given that even such low rates have failed to stimulate the economy, the European Central Bank decided to resort to a non-standard measure, EAPP. Similar unconventional measures were implemented by the Bank of Japan in 2001 and by the Federal Reserve and the Bank of England since 2008. Although

the names of the specific programmes and their details differ, they are commonly referred to as 'quantitative easing'.

What is quantitative easing?

[Quantitative easing](#) (QE) is 'an unconventional form of monetary policy where a central bank creates new money to buy financial assets, like government bonds'.

Under QE, a central bank creates money and [uses it to purchase](#) financial assets from private investors such as banks, pension funds and insurance companies. This process is electronic and does not involve printing banknotes: the central bank creates money by increasing the credit in its own account.

This process works through various [transmission channels](#):

- by announcing large-scale asset purchases, the central bank signals to market participants its commitment to keep interest rates low in the future (because if it chooses to increase them, the [price of the bonds](#) it purchased will fall and it will have to bear significant losses on them);
- the low interest rates prompt investors to look for better yields on government bonds elsewhere, which in turn should contribute to lowering the value of the domestic currency and boost exports;
- by purchasing a large quantity of assets held by insurance companies and pension funds, the central bank encourages them to [rebalance](#) their portfolios into riskier assets, such as corporate bonds or stocks. This, then, stimulates expenditure by [increasing wealth and lowering](#) borrowing costs;
- by purchasing assets from the banks, the central bank provides them with [extra money](#); given that, at the moment it costs banks to deposit money in the ECB they should, in principle, use the extra amount available to finance more loans;

Results of QE in the US, the UK and Japan

The results of the previous three major QE programmes have been mixed.

In 2014, [researchers](#) from the Bank of England found that asset purchases have a statistically significant effect on real GDP, with purchases amounting to 1% of GDP leading to a rise of 0.36% in real GDP and of 0.38% in the consumer price index for the United States, and a rise of 0.18% in real GDP and of 0.3% in the consumer price index for the United Kingdom. In addition, in a [press release](#) that coincided with the end of QE in the US (in October 2014), the Board of Governors of the Federal Reserve observed that 'there has been a substantial improvement in the outlook for the labour market since the inception of the current asset purchase program'.

In Japan, however, although QE [contributed to](#) the reduction in longer-term interest rates, aided weaker Japanese banks and encouraged greater risk-tolerance in the financial system, it [did not contribute](#) to raising inflation and, in addition, the resulting depreciation of the yen [did not have](#) the expected effect on exports.

The ECB's EAPP

Under EAPP, the ECB will add the purchase of 'euro-denominated [investment-grade securities](#) issued by euro area governments and European institutions' to its existing purchase programmes' (that is, the programmes for the purchase of asset-backed securities ([ABSPP](#)) and covered bonds ([CBPP3](#)) by the Eurosystem²).

The combined monthly purchases under the three programmes will amount to €60 billion. They will start in March 2015 and will be carried out for 18 months or 'until a

sustained adjustment in the path of inflation towards the ECB's objective of lower but close to 2%' is observed.³

The purchase will be based on the Eurosystem national central banks' shares in the ECB's [capital key](#). They will be done in the [secondary market](#) and amounts purchased will never exceed one third of a country's debt issuance, or 25% of any given issue.

Certain additional eligibility criteria will be applied in the case of countries under an EU/IMF adjustment programme.⁴

Finally, 'with regard to the sharing of hypothetical losses, (...) 20% of the additional asset purchases will be subject to a regime of risk sharing'.⁵

Points of concern

The concerns expressed in relation to the programme can be grouped in two categories.

The first category relates to the *legality* of such programmes and was formulated in a request by the Federal Constitutional Court of Germany for a preliminary ruling from the Court of Justice of the EU in relation to a [similar programme](#) which has not yet been implemented – the Outright Monetary Transactions. The German Court asked the Court of Justice:

- a. whether that programme [OMT] is a monetary policy measure and, by extension, falls within the scope of the ECB's mandate;
- b. whether the measure meets the prohibition on monetary financing laid down in [Article 123\(1\) TFEU](#).

The [Opinion](#) of the Advocate General published on 14 January 2015 partly assuaged those concerns, since it considered that the programme complies with Articles 119 and 127 TFEU, provided that the ECB refrains from any direct involvement in the financial assistance programmes to which the programme is linked, and complies strictly with the obligation to state reasons and with the requirements deriving from the principle of proportionality. This opinion – pending the decision of the Court itself – was [interpreted](#) by a number of commentators as 'giving the green light' to quantitative easing in the euro area.

The second category groups concerns that relate, not to the legality of the programme, but to its *feasibility* – whether the particular structure of the European economy and its prevailing conditions will prevent the programme from reaching the expected results. Such concerns are the following:

- as explained above, the rationale behind QE is to purchase large quantities of euro area euro-denominated securities in order to lower their yields and push investors into equities or corporate bonds. However, with the exception of Greece, interest rates on euro area government bonds kept falling since July 2012, after the announcement by ECB President, Mario Draghi, that the ECB would do '[whatever it takes](#)' to save the euro. They are therefore already at a [very low level](#), therefore reducing significantly the scope of QE;
- the fact that [about 80% of the financing of the real economy](#) in the euro area originates from the banking sector implies that the success of the EAPP depends ultimately on the banks' willingness to lend. Nevertheless, under strained financial conditions, banks may [choose to hold](#) those central bank injections of money to increase their [capital buffers](#), instead of letting it trickle down to the real economy through lending. After all, the latest [quarterly lending survey](#) of the ECB reveals that:

'Across all loan categories, the net percentage change in credit standards in the fourth quarter of 2014 remained well below historical averages calculated over the period since the start of the survey in 2003'.

Outlook

The EAPP is part of the ECB's efforts to stimulate growth in the euro area and meet its objective of inflation lower but close to 2%. Only time will show whether the programme will reach the expected results. Whatever the result may be, though, attention must be paid to Draghi's comments when questioned at the press conference, which also reflects the position the ECB has adopted in recent monthly bulletins:

What monetary policy can do is to create the basis for growth, but for growth to pick up, you need investment. For investment you need confidence, and for confidence you need structural reforms. The ECB has taken a further, very expansionary measure today, but it's now up to the governments to implement these structural reforms, and the more they do, the more effective will be our monetary policy (...) It's very important to have in place a so-called growth-friendly fiscal consolidation for confidence strengthening (...) But for this now, we need the actions by the governments, and we need the action also by the Commission, both in its overseeing role of fiscal policies and in its implementing the [investment plan](#), which (...) now has to be implemented with speed. Speed is of the essence.

Main references

R Haltom & AL Wolman, [A Citizen's Guide to Unconventional Monetary Policy](#), December 2012.

BW Fawley & CJ Neely, [Four Stories of Quantitative Easing](#), St Louis Fed Review, January 2013.

MAS Joyce, Z Liu & I Tonks, [Institutional investor portfolio allocation, quantitative easing and the global financial crisis](#), Bank of England working paper, September 2014

C Groth & P Westaway, '[Deflation](#)', in BOE Quarterly Bulletin, Q1 2009).

Endnotes

¹ Therefore, not only inflation above 2% but also deflation is [inconsistent](#) with price stability.

² On January 23rd 2015, the holdings at amortized cost of the programs were € 2,266 billion for the ABSPP and € 37,202 billion for the CBPP3.

³ Although this formulation might create the impression that the program is open-ended (that is, won't finish on September 2016 if the results have not been attained), there were no formal commitments from ECB in that direction.

⁴ This formulation, which summarizes a statement made on January 8th, in effect subordinates the purchase of Greek sovereign bonds, to the signature of another financial [assistance agreement](#).

⁵ This formulation has been interpreted as a concession to German Members of the ECB, who expressed concerns with having to shoulder the losses in the event of a country's default and subsequent exit from the euro area.

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