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The dark sides of QE

Backdoor socialisation, expropriated savers and asset bubbles

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While European central bankers commend themselves for the scale and originality of monetary policy since 2012, this self-praise appears increasingly unwarranted. The reality is that since Mr Draghi's infamous "whatever it takes" speech in 2012, the eurozone has delivered barely any growth, the worst labour market performance among industrial countries, unsustainable debt levels, and inflation far below the central bank's own target.

While the positive case for European Central Bank intervention is weak at best, it seems that the negative repercussions are becoming overwhelming. This paper outlines the five darker sides to current monetary policy.

The first is a paradox of ECB intervention: that monetary policy stifled the very reform momentum it sought to create. Up until July 2012, high interest rates and refinancing threats forced governments to be serious about reforms. Indeed, pre-2012, more than half the growth initiatives recommended by the OECD were being implemented across the eurozone. But last year just twenty per cent were. ECB intervention has curtailed the prospect of significant reforms in labour markets, legal systems, welfare systems, and tax systems across the continent.

Second, bond prices have lost their market-derived signalling function. Since investors began to anticipate sovereign purchases by the central bank in late 2014, intra-eurozone government bond spreads have been locked together. In turn, misrepresentative sovereign yields distort the whole fixed income universe that is priced off government debt.

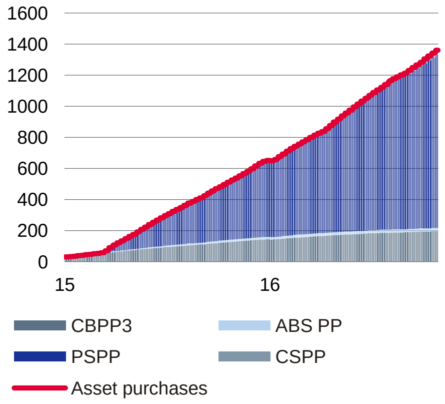
Perhaps the darkest side of ECB monetary policy is the increasing concentration of risk on the eurosystem balance sheet – expected to be EUR 2tn by March 2018. In the event of a debt restructuring of a eurozone member, the liabilities of the national central bank are likely to be borne by the taxpayers of the other eurozone member states, even if losses are spread over a long period. Fundamentally, however, the debt will have been socialised.

Fourth, ECB intervention has not been a net positive for eurozone savers. While high and stable revaluation gains have buttressed total returns over recent years, this is clearly a one-time gain. Today, rising energy prices, the shortage of high coupons and ultimately mean-reversion are likely to take their toll.

Finally, the misallocation of capital caused by ECB policy is preventing creative destruction and causing asset bubbles. Increased lending has gone mostly to low quality existing borrowers while obviating troubled banks from the need to write down loans. Without creative destruction in ailing industries, investors in high-saving countries have simply bid-up the price of healthy assets.

The ECB's holdings from its APP 1

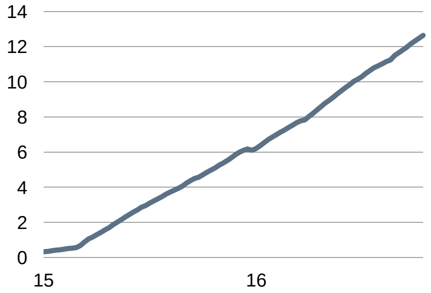
ECB asset purchases, bn EUR



Source: Bloomberg Finance LP

ECB put over 12% of GDP into bonds 2

ECB bond purchases, % GDP



Sources: Bloomberg Finance LP, Eurostat, Deutsche Bank Research

The ECB believes its policies are justified

European central bankers have proclaimed for seven years that they have “countered the threat of a new great depression” as Mario Draghi himself put it to the Bundestag on September 28. While the ECB should be commended for quick acting during the financial emergencies of recent years, this self-confidence seems increasingly unwarranted.

The truth is that since Mr Draghi’s “whatever it takes” speech in 2012, the eurozone has delivered barely any growth, the worst labour market performance among industrial countries, double digit unemployment rates, more than twenty per cent youth unemployment, unsustainable debt levels, and inflation rates far below the central bank’s own target.

By some measures, indeed, the situation is worse than during the great depression. Unemployment in France and the periphery is around 13 per cent, higher than the ten per cent French average from 1930 to 1938. And without a buoyant German economy the numbers would be much worse. Given the aggressiveness and unconventionality of monetary policy since 2012, it seems fair to ask whether the ECB’s approach bears some of the blame for Europe’s woes.

After all, the scope of central bank intervention since 2012 has been unprecedented. In July of that year, the ECB guaranteed to bail out countries in need via Outright Monetary Transactions, a policy of stepping into public debt markets as buyer of last resort. OMT has not been used, but three years later the ECB launched the Public Sector Purchase Program, which, over the subsequent twenty months has surpassed €1tn. Additional purchases by the PSPP’s smaller siblings, the Covered Bond Purchase Programme and Asset-Backed Security Purchase Programme, lifts the total to €1.4tn, or 13 per cent of eurozone output. If QE is extended by another 12 months and these three programs continue as is, the ECB will own a fifth of the eurozone’s public debt by March 2018, up from a tenth today.

President Draghi told the Bundestag that the ECB’s measures “are working: they are contributing to keeping the recovery on track.” But this is merely one side of the story – arguably the negative repercussions of these policies are now greater than the benefits. This paper concentrates on the five biggest repercussions. First, while ECB asset purchases did indeed reduce the risk premia for investing in periphery assets, ultimately that success has eroded the prospects of reforms. Second, bond prices have lost their signalling function. Third, by heaping credit risk onto the eurosystem, the ECB has increased the risk to core country balance sheets and their taxpayers. Fourth, savers are struggling. Fifth, there is no creative destruction and asset bubbles continue to expand.

We address each of these repercussions in more detail below.

1. Monetary policy has stifled needed reforms

After a combined monetary and fiscal policy easing effort during the 2009 crisis, an unspoken deal was struck between the central bank and eurozone governments. Monetary policy would remain extremely loose to allow fiscal policy to consolidate. Public finances – which had deteriorated substantially due to the recession, counter-cyclical spending decisions and support for the financial sector – needed to be brought under control and difficult productivity-enhancing reforms undertaken.

But politicians need compelling reasons to risk their job on reforms – the losers are too visible while the winners are not immediately apparent. Up until July

2012, this natural reticence was countered by the urgency of exorbitantly high interest rates and risk premia, as well as the threat of not being able to refinance sovereign debts. Failure meant a rescue program provided by the Troika, conditional on reforms and unpopular spending cuts.

But any incentive to reform disappeared with the guarantee to bail out countries in need via OMT. At the time, the justification was that different sovereign yield spreads signalled a breakdown in the transmission of monetary policy rather than reflecting different country-specific risks. Nevertheless, the OMT announcement was a lifeline for the periphery. The average risk-premia above German yields fell almost five percentage points for Spain, Italy, Ireland, Portugal and Greece, with immediate benefits. For example, Italy's interest payments dropped by one-third, despite an increase in debt-to-output.

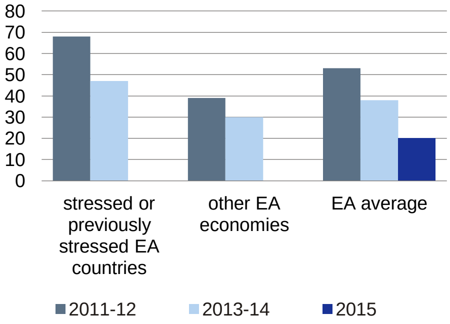
But this OMT lifeline, like the chance afforded by the drop in interest rates immediately after joining the eurozone in 2000, was essentially squandered. Prior to 2012 high interest rates and refinancing threats forced governments to become serious about reforms. In those years more than half of the growth initiatives recommended by the OECD were being implemented across the eurozone. Last year, by contrast, just twenty per cent of these reforms were.

Since 2012, policies such as OMT and PSPP have prevented the eurozone facing hard realities. Peripheral countries do not generate enough growth to reduce high levels of indebtedness and unemployment. And there is no prospect of significant reforms in labour markets, legal systems, welfare systems, and tax systems. With no growth and 2.5 per cent fiscal deficits, Italy's three-figure sovereign debt level is unsustainable.

It is not just that the ECB apparently misread European politics. It also had unrealistically optimistic expectations about the recovery path of the global economy. A combination of strong global demand and a much weaker euro would certainly have increased the chances of budget consolidation and productivity-enhancing reforms. But in fact global growth rates have hovered around three per cent, substantially below pre-crisis levels of close to five per cent, while the euro remained much stronger than widely expected. Both (mis)judgements, on the incentives of political actors as well as the global growth trajectory – which was not only made by the ECB – substantially doomed the unspoken deal between the ECB and governments from the start.

Reform progress has slowed 3

Share of OECD Going for Growth recommendations implemented, %

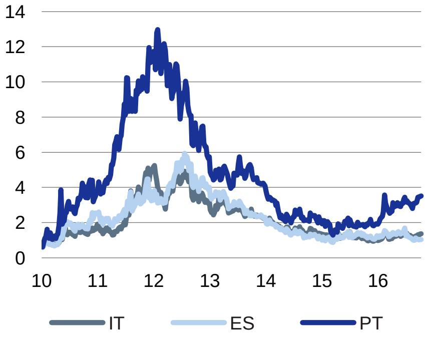


The data for 2015 refer to fully implemented measures and are not available for individual countries. The stressed and previously stressed countries are Ireland, Greece, Spain, Italy, Portugal and Slovenia. "Other EA economies" comprises the euro area economies not captured in the former group. Cyprus, Latvia, Lithuania and Malta are not captured in the OECD report

Sources: ECB, OECD

Yield differentials 4

Yield differentials over German 10Y-government bonds, %-points



Source: Bloomberg Finance LP

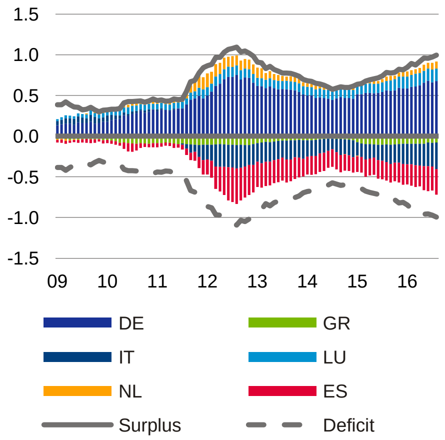
2. Bond prices have lost their signalling function

Another casualty of ECB policy is financial analysis. Since the last few months of 2014, when markets began to anticipate sovereign purchases by the central bank – subsequently announced in January 2015 – intra-eurozone government bond spreads have been more or less locked together. For example, Italian and Spanish bond spreads versus bunds have hovered in a 120 basis points range, notwithstanding the political risks in both countries. By contrast, Portuguese bond spreads have increased almost 120 to 310 basis points during the past 12 months, due to heightened concerns that the only remaining agency rating Portuguese debt as investment grade might change its assessment – which ultimately has not happened – thereby making them no longer eligible for quantitative easing.

Such detachment of domestic bond yields from changing political and fiscal risks can be attributed to ECB asset purchases. Depressed or misrepresentative sovereign bond yields not only shield politicians from market oversight. They also distort the whole fixed income universe that is priced off government debt. The dislocations they cause in the meantime are considerable, but they will probably become much more detrimental, once these distortions ultimately unwind.

Germany's Target 2 balance dominates 5

Target 2 balance, tr EUR



Sources: Haver, ECB

3. Mounting strain on the eurosystem balance sheet

Potentially the biggest negative repercussion of ECB monetary policy is the fate of the substantial claims by the central bank on member countries held through the eurosystem balance sheet. Based on the potential losses a core country is theoretically on the hook for given the costs associated with the two main rescue funds (EFS and ESM), quantitative easing and Target2, it is inconceivable that any member country would be allowed to fail, save a small one with limited contagion effects.

This has long been a shadow over the whole quantitative easing effort. To dissipate concerns that losses would be socialised within the eurosystem in the event of a default, the ECB arranged that of the 88 per cent of the PSPP purchases that go into eurozone sovereign bonds, four-fifths would be bought by the relevant national central banks, based on a capital key. In effect, the Bundesbank buys German bunds while the Banca d'Italia purchases BTPs, with no risk-sharing between the two. The remaining 12 per cent is earmarked for bonds issued by international organisations and multilateral development banks.

But this is a fragile safeguard. In the event of a debt restructuring of a eurozone member, it hardly seems feasible that its national central bank would be left to its own devices, especially since it could not expect any support from its own government. This leaves the risk that the final backstops are taxpayers of other eurozone member states. They would then have to pay, if only through forgoing potential profit transfers from their national central bank over a long period. Fundamentally, however, the debt will have already been socialised.

What would member states be liable for? It is necessary to count both the ECB's balance sheet as a whole as well as the Target2 balances between eurozone countries. On the former, assuming an extension until March 2018 and share of sovereign bonds between €55bn and €60bn in the monthly total of €80bn, the eurosystem's holdings of government bonds would roughly double compared with the level reached end August 2016, to about €2tn. Among these holdings are German bonds worth €525bn, French bonds worth €415bn, Italian bonds worth €360bn and Spanish bonds worth about €260bn.

A default scenario is unlikely to happen while quantitative easing is ongoing, especially since the ECB has said that asset purchases would not stop before the inflation outlook has normalised. In any case, in a proper default and exit from the euro, the liabilities encountered via an involuntary socialisation of quantitative easing losses might prove a minor part of the overall financial damage a remaining eurozone country might suffer. This is because during the built-up of such extreme stress Target2 imbalances would surge.

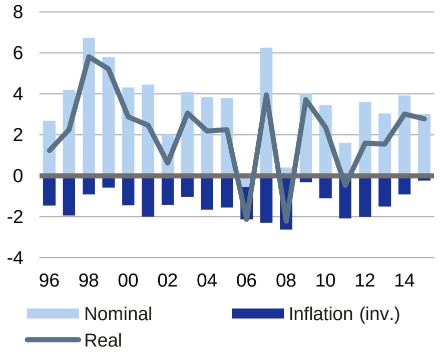
Yet Target2 imbalances are already elevated and will continue to rise. These imbalances, which are a proxy for the accumulated current account deficits or surpluses of eurozone member countries to each other, first became an issue during the periphery funding crisis in the first half of 2012. Then, capital flight from periphery countries to core economies increased imbalances substantially. These subsequently narrowed in 2013 and 2014 after President Draghi's "whatever it takes" speech. However, they have subsequently moved back to levels experienced during the heights of the bank funding crisis in 2012.

As researchers from the Dutch Central Bank suggest in a recent article,[1] this is partly due to quantitative easing. Investors who sell assets under quantitative easing to their national central bank in vulnerable countries have tended to put the proceeds into bank deposits in countries with the highest perceived creditworthiness. The recent surge in Target2 imbalances is slightly different

[1] Dutch National Bank (2016).Target2 imbalances reflect QE and persistent fragmentation within the euro area. 06/16/2016.

Falling inflation buttressed returns 6

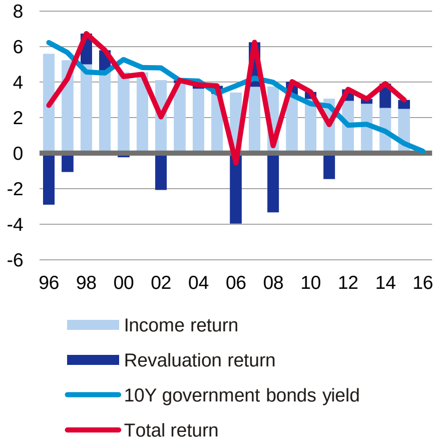
Total return, fin. assets. ex. equity, %



Sources: Deutsche Bank Research, Eurostat

Government bond yields only one piece of the puzzle 7

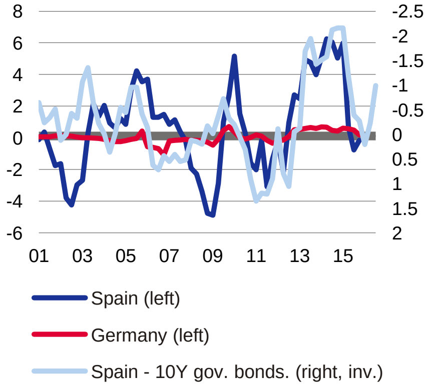
Germany, %, based on financial assets excl. equity and real estate



Sources: Deutsche Bank Research, Bloomberg Finance LP, Eurostat

ECB policy and Spanish revaluation gains 8

Revaluation return of ins./pens. schemes % (left); yield, %-points, yoy (right, inv.)



Sources: Eurostat, Deutsche Bank Research, Bloomberg Finance LP

compared with 2012 in that it is supply-driven (quantitative easing) rather than demand-driven (capital flight). But the underlying logic is the same.

It is not difficult to imagine in times of extreme crises that both drivers push Target2 imbalances to unprecedented levels. In August, Germany was running a surplus of €680bn, while the largest deficits were recorded by Spain (€315bn) and Italy (€330bn). Given a default, any losses would be allocated in accordance to the ECB's capital key, meaning Germany takes slightly more than a quarter. However, the actual share would increase as any country in trouble would obviously not participate in the loss allocation.

For now the ECB can treat the DNB's findings with regard to quantitative easing and Target2 as academic. However, it requires little imagination to see Target2 levels at new highs if a large country suffers a crisis. Of course, bailouts in the hundreds of billions of euros by core country taxpayers were not intended by domestic or European policymakers when designing the European monetary system. Even in recent times they do not acknowledge the possibility of such bailouts happening. When the German constitutional court ruled on participation in the Greek rescue package, for example, one of the guiding principles was that whatever happens, liabilities should not reach levels that curtailed the parliament's budgetary authority. Given the implicit liabilities generated within the eurosystem, one can ask whether we are not already beyond that point.

Moreover, it is not just about actual costs but about the democratic mandate that underpins the eurosystem. As early as 2011, Bundesbank president Jens Weidmann strongly suggested that the ECB did not have the democratic mandate to accumulate such risks on the German central bank's balance sheet. If bailouts on such a vast scale do materialise, the public anger towards bailing out banks after the financial crisis could be mild in comparison.

4. Difficult times for savers

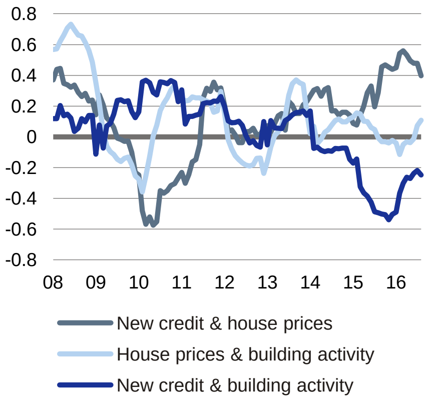
The effect on savers' ability to plan and execute long-term planning is another negative externality of the prolonged low and negative interest rate environment. For German households thus far, the ECB and Bundesbank are correct in pointing out that the impact on savers has so far been limited, but it is not clear for how long this can continue.

Consider that nominal total returns for German households have averaged 3.4 per cent over the past four years, similar to the average throughout the 2000s and similar to the rest of the eurozone. In fact, real returns even trended upwards due to declining inflation since 2012. Even nominal returns on interest-bearing investments did not slip below two per cent until 2015 because a large proportion of longer-dated and mostly higher-coupon investments dampened the effect of evaporating market returns. High and stable revaluation gains have also buttressed total returns over recent years. In this sense, the evidence suggests that savers have not yet suffered the full brunt of ECB monetary policy.

However, many of these effects are unrepeatable and likely to be exhausted. First, slowly rising energy prices are pushing headline inflation up this year and next, weighing on real returns. Then the buffering effects of long-term interest-bearing investments with high coupons are likely to recede as households own fewer such assets. Finally, the scope for further significant revaluation gains is likely to be limited given already-high valuations and the fact that revaluation returns are ultimately mean-reverting over the long term. The risk is a scenario in which real total returns for German household savings turns negative, while the benefits to the real economy of the interest rate extremes are not obvious.

German residential real estate market: Not what you wish for 9

Correlation of yoy-growth rates, last 24M



Sources: Deutsche Bank Research, Hypoport, Deutsche Bundesbank, Federal Statistical Office

5. No creative destruction, many asset bubbles

While ever-lower rates were meant to encourage real economic activity, investment opportunities remain scarce due to the lack of structural reforms and creative destruction in inefficient industries. OMT and the collapse in bond spreads benefited the worst-quality borrowers disproportionately. In their paper “Whatever it takes: The Real Effects of Unconventional Monetary Policy”[2], Acharya et al. show that peripheral banks with large holdings of national sovereign debt enjoyed a “recapitalisation through the backdoor” from revaluation gains. These banks increased lending, but mostly to low quality existing borrowers. Such firms benefitted from rates often below what high-quality public borrowers had to pay, and used cheap funding to repay debts, instead of financing employment or investment. The authors show OMT supported “zombie companies” via evergreening, which prevented banks from the need to write down the existing loans.

Moreover, the paper also shows that the misallocation of capital is hampering employment and growth in the eurozone. In industries with a high share of such zombie firms, quality companies have to pay higher interest rates and invest significantly less than good companies in sectors with a small share of zombie companies. This supports the view of the OMT announcement as impairing creative destruction and depressing product prices. Since PSPP extended the yield compression generated by OMT this argument also applies to the current monetary policy configuration.

Without the creative destruction of ailing industries, investors have simply bid-up the price of healthy assets. These now function as the exhaust valve, especially in countries with substantial net savings. The flipside of tumbling yields across Europe is therefore inflated asset prices and a general hunt for yield. For example, developments in the German residential housing market are worrying, with increasing overvaluation in several segments of the market due to low mortgage rates. Mario Draghi himself has acknowledged the risk of prolonged highly accommodative policy for financial stability.

The way forward

The euro’s design – a combination of unified monetary policy and national fiscal policy where rules can be ignored without sanction – is flawed. But with Mr Draghi’s promise of “whatever it takes” the implied moral hazard was pushed into a much larger dimension.

There are two broad options now. The eurozone could move towards fiscal union and the sharing of liabilities. Alternately, policymakers could install a system more geared towards individual fiscal responsibility, via re-introducing market-based pricing of sovereign risks. The former is not being proposed by any national politician in the eurozone, because it is unpopular. The second could be the ideal solution, though it is difficult to imagine politicians seeking re-election in the periphery to back a move to raise risk premia on their own assets. Moreover it would likely also be rejected by the ECB, since it would – at least in the ECB’s own logic – undermine the effects of its monetary policy.

And so the ECB is stuck, as it has been since 2012, between an unfavourable equilibrium of low growth, high unemployment and zero reform momentum on the one hand, and growing risks to core country balance sheets on the other. It remains to be seen how it will escape from this dilemma of its own making.

[2] V. Acharya, T .Eisert, C. Eufinger, C. Hirsch (2016). Whatever it takes: The Real Effects of Unconventional Monetary Policy. May 2016.

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