MAX-PLANCK-GESELLSCHAFT

Social and Behavioural Sciences

The power and impotence of billions

August 03, 2015

On the political economics of the European Central Bank's bond-buying programme

An economic recovery plan which works through the wealth effect - such as the European Central Bank's bond-buying programme - favours the wealthy first and foremost.
© Kai Pfaffenbach / Reuters

A commentary by Benjamin Braun

The days between March 9 and 18, 2015 will long be remembered in Frankfurt. The European Central Bank began implementing its gigantic bond-buying programme in the course of which it will acquire government bonds and other securities to a value of 60 billion euros every month until September 2016. As the consolidated European state described by Wolfgang Streeck has lost all fiscal will to act, the ECB's "quantitative easing" monetary policy represents a welcome contribution to the economic recovery of the eurozone. Nevertheless, a few days after the programme started, a wave of protest of unheard of aggression rolled through the city, directed against the new ECB headquarters which so vividly embodies its new power. In the meantime, the German share index reached a record high of 12,000 points - while the media never tired of attributing the blame for a supposed "investment crisis" to the ECB. How does all this fit together?

What is quantitative easing?

In a similar way to earlier, smaller purchase programmes, the Eurosystem acquires fixed-interest securities at the market rate and holds them until the issuer redeems them at face value. The Eurosystem means the ECB and national central banks. The counterparties are the banks in the eurozone but also insurers and investment funds. The securities are private, mortgage-backed and asset-backed securities (including securitized corporate loans and property loans), but primarily they are government bonds issued by member states in the euro. In order to pay the market price for the securities, the Eurosystem transfers freshly printed central bank money to its counterparties. Quantitative easing, therefore, denotes monetary relaxation created by increasing the central bank money supply. However, its effectiveness depends less on increasing the money supply than on reducing the number of quality bonds in circulation.

This accentuated shortage drives the price of government bonds up and depresses their yield which represents a guide to the long-term level of interest rates in the economy. Quantitative easing is thus supposed to relax financing conditions in an economy where short-term interest rates are already close to zero. As a measure, it aims to stimulate demand from investments, consumption and from abroad (lower interest rates weaken the exchange rate of the euro), and thereby to lift the rate of inflation towards the target of just under two percent. In addition, the decline in yields for low-risk bonds is intended to persuade banks and investors to shift their portfolios towards forms of investment that are less liquid (loans, property) or more risky (shares), which will tend to have a positive effect on demand in households and companies. The danger of a bubble forming in these investment classes is real, and represents a calculated risk taken by the Central Bank in adopting this policy.

Who benefits?

If it materializes, the effect of quantitative easing on the economic cycle will therefore be the consequence of intentionally induced asset price inflation. This certainly makes sense in the "balance sheet recession" that is still being felt across wide areas of the eurozone: higher asset prices strengthen the balance sheets of those who own financial and property assets, and they in turn, so the theory goes, will increase their investment expenditure or their consumption.

Does this mean that the owners of assets will derive above-average benefit from the ECB's bond purchases? How does that fit with the German hysteria with regard to the "investment crisis" allegedly caused by the ECB? There are two things to be said about this. First of all, on the question of who is to "blame" for the low level of interest rates. "It was the central banks", states the Frankfurter Allgemeine Zeitung on March 21, 2015, summarizing the consensus in the German press. "Worldwide pessimism", counters the economist, Robert Schiller, in the same edition – who regards the impact made by central banks as overestimated. Economists such as Larry Summers or Carl Christian von Weizsäcker even see stagnation and zero interest rates as a permanent state of ageing societies with chronically weak demand. We may find it hard to come to terms with the fact that central banks are pushing interest rates further downwards by half a percentage point with their quantitative easing, but it is not in their power to raise interest rates permanently in the current situation. As long as companies are not investing in productive capital, where are the returns to come from which would finance higher interest rates on savings?

The second comment addresses the question of how the financial wealth of the rich can grow while the middle classes bemoan the fact that their savings are shrinking. The reasons are primarily to be found in the different investment behaviour of the two groups. The former invest their wealth in shares, bonds and property while the latter confine themselves largely to saving with banks and insurance companies. To use two terms which are not very helpful but frequently used in public debate: the "savers" are suffering from the low interest rates on savings accounts and life insurance policies which is nothing other than the other side of the coin to the rise in the prices of securities caused by quantitative easing which directly improves the net assets position of "investors".

At the end of the day, however, the conservative attitude displayed by German savers is no more than an exacerbating factor in a more underlying problem: an economic recovery plan which works through the wealth effect favours the wealthy first and foremost. To the extent that quantitative easing improves the economic situation and employment, weaker income groups will of course also benefit and indeed they will be the main beneficiaries. Nevertheless, there is a crucial difference here between fiscal spending programmes and monetary purchase programmes: the former constitute an incomes policy for wage-earners and the latter, to overstate the point a little, an incomes policy for pensioners. It would be irresponsible not to grasp the straw offered by quantitative easing in the still precarious economic environment of the eurozone. In times of dramatically increasing inequality, savers, voters and activists would nevertheless be well advised to resist any permanent inclusion of this measure in the toolbox of macro-economic stabilisation policy.