The Economist

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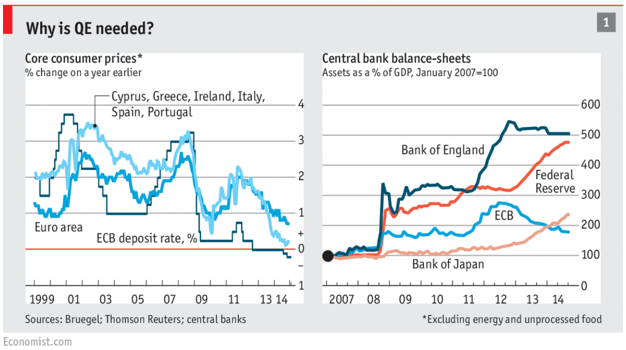
Public Sector Purchase Programme (PSPP), started on 9 March 2015

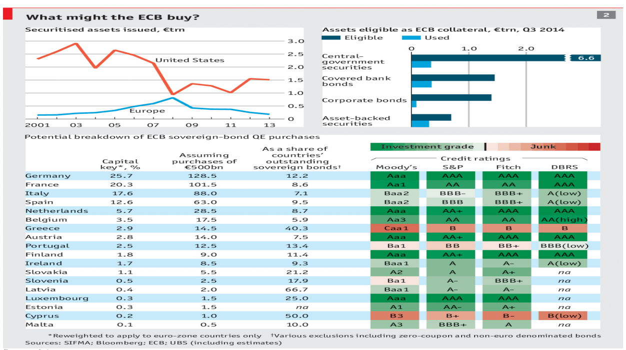
In graphics

QE in the euro zone

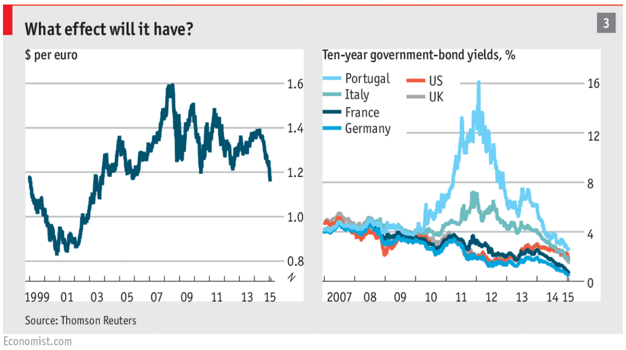
Jan 20th 2015, 15:04 by THE DATA TEAM



THE European Central Bank is poised to take a momentous decision when its governing council meets in Frankfurt this Thursday. The ECB is expected to embark upon a big programme of quantitative easing, the creation of money to buy financial assets. The economic case for QE is strong. The recovery since the double-dip recession between late 2011 and early 2013 has been weak and faltering, while inflation has tumbled, with consumer prices actually falling in the year to December. The ECB has sought to combat "lowflation" through a variety of means (http://www.bruegel.org/publications/publication-detail/publication/826-addressing-weak-inflation-the-european-central-banks-shopping-list/) , including charging banks that leave money on deposit with it through negative rates. But what it has not done is what other central banks have tried, which is to carry out a big QE programme, which would boost its balance-sheet, injecting money into the economy and stimulating activity.



The ECB's decision is not just momentous but controversial because it will involve the purchase of sovereign bonds. The central bank has already been carrying out a variant of QE by buying private financial assets, mainly covered bonds, a particularly safe form of debt issued by banks. But if the ECB is to buy in bulk—a programme of €500 billion ($580 billion) is expected—it will have to buy sovereign bonds because they are much the biggest market. That will allow the ECB to intervene without distorting things, at least for bigger sovereign-debt issuers. However, this worries the Germans, who fear that QE will ease the pressure on countries like Italy to push through crucial structural reforms and also fret about potential losses from buying debt which is far riskier than theirs. As a result it seems likely that each of the national central banks in the euro zone will be largely responsible for buying the bonds of its own country, perhaps in amounts that reflect its subscription to the ECB's capital base, and will have to bear any losses on its own.



The euro zone's version of QE will boost the economy and combat downward pressures on inflation through two main channels. One is that the very decision to push through so controversial a measure will show how serious the ECB is about getting inflation back towards its target of nearly 2%. The other is by weakening the euro. These channels differ from the programmes launched by the American and British central banks in late 2008 and early 2009. These programmes worked both through boosting confidence, which had plummeted because of the financial crisis, and by bringing down long-term interest rates. Government-bond yields have already fallen so far in the euro area on hopes of QE that they may not come down much more. Yet actual as opposed to prospective QE is nonetheless vital in order to validate those expectations. The likely compromise over risk-sharing within the euro-zone central-banking system may cast a shadow over the effectiveness of QE, however. The even bigger danger is that it is coming too late to arrest a slide towards sustained deflation.