

From Pawnshop to Used Car Dealer. You Want To Impress Me? Buy New Cars. ECB QE. Will It Work?

The ECB, from pawnshop to used car dealer:

If you want to get more money out there into the economy, and get that money circulating instead of sitting in a dusty corner, you can't just be a pawnshop. Lending cash against investment grade bonds is a pawnshop business, a.k.a. LTR0. Buying bonds in the secondary market is a used car business. You want to get the economy going, buy some new cars. Supplying money is one thing, stepping in where private demand is deficient is another. Buying used cars pushes used cars around at increasing prices making profits for other used car dealers but it does little for car manufacturers, output and employment.

And yet the ECB's mandate excludes purchasing primary issues since this appears to be interference in fiscal policy. Purchasing secondary market issues apparently is not despite the issuers being clearly the same. Somewhere there is an argument that buying bonds from private holders does not explicitly bail out the issuers. True I guess. Bail out the holders of the debt, not the borrowers. Perverted but true.

Will QE work? The European economy is already recovering, so the timing of the announcement is fortuitous. Because trend growth globally, not just in the Eurozone, is slower than before 2008, policy will continually be miscalibrated. The European economy has slowed, but it has also very likely hit bottom and will recover. And now, the ECB and their QE will get the credit for it. On its own, QE would not have worked.

QE depresses cost of debt, debt which nobody wants to incur. QE also depresses yields which are already well below US treasury yields. The analogy of pushing on a string was never more appropriate.

What is needed is more demand for goods and services, not more supply of credit. In the absence of private demand, governments need to target a budget deficit. Yet Europe is obsessed with fiscal restraint and budget discipline. What is ultimately required is a bond purchase program which is free to buy primary issue not only of sovereign debt but also of covered bonds and ABS. A To-Be-Announced mechanism of ABS and covered bond issues should be underwritten by an ECB asset purchase program. By actively encouraging demand instead of passively enabling it, policy makers might be able to awaken the moribund economy.

The current policy lifts asset prices but does little to address underlying demand deficiency and the failure of factor markets clearing. The ECB will simply have to do more later on thus fuelling a protracted asset boom while output and employment languish.