

The ECB must reconsider its plan to tighten

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The constraints on the central bank taking effective action are a permanent threat to stability



When the US and China catch an economic cold, the eurozone gets influenza. Nobody yet knows quite how serious the slowdown in the world economy is going to be. But the eurozone has, not surprisingly, proved the most vulnerable of the world's large economies. It is economically and politically crucial that its economy escapes another recession. The authorities need to reconsider their policy stance forthwith.

Since the turn of the year, there has been a modest recovery in China, according to forecasts by Gavyn Davies. Even so, growth is slow by its standards. In the US, the probability of a strong expansion has fallen from 80 to 20 per cent for this year. In the eurozone, meanwhile, the probability of a strong expansion has fallen to negligible levels. Its chances of a recession — two successive quarters of negative growth — are estimated at about 25 per cent.

Similarly, between January 2018 and February 2019, consensus forecasts for this year have been downgraded substantially more in the eurozone than in other large high-income economies. In January 2018, for example, the eurozone was forecast to grow 1.8 per cent in 2019. That is now down to 1.3 per cent. Meanwhile, US growth in 2019 was forecast at 2.4 per cent in January 2018 and is now 2.5 per cent. It seems quite certain that the European Central Bank's forecasts for growth and inflation will be revised down. (See charts.)

This vulnerability of the eurozone to

external shocks is no surprise, given the heavy exposure of Germany, its strongest economy, to world trade. Worse, the spectres of sovereign default and "redenomination risk" — that is, a break-up of the eurozone — may re-emerge. In a recent paper, Marcello Minenna of Consob (Italy's securities regulator) argues that divergent perceptions of credit risk across member states reinforce divergent competitiveness in goods and services. This puts businesses in peripheral countries at a persistent disadvantage, which becomes worse in times of stress.

The eurozone is far worse equipped to deal with adverse shocks than, say, Japan. The ECB would never be allowed to purchase government bonds on the recent scale of the Bank of Japan. Yet deflation would gravely damage the effectiveness of monetary policy and create severe stresses in specific member states. Even very low inflation is dangerous enough. That is why the ECB was justified in adopting exceptional measures, including quantitative easing, during Mario Draghi's presidency.

In years to come, radical reforms may reduce the fragility of the eurozone. For now, the burden of minimising the dangers falls mainly on the ECB. Today's position is really worrying. Core inflation is stuck at close to 1 per cent, while the ECB's interest rates are essentially zero. What then could it do if an adverse shock caused another big recession?

Given all this, it is hard to see a good economic case for ending asset purchases, at least in the absence of other credible policy options. Surely a far big-

ger effort needs to be made to raise inflation. The explanations seem to be political and legal. The political reason is the hostility to asset purchases in some countries. The ECB is also subject to two quasi-legal constraints. First, holdings of debt should reflect the relative importance of the sovereign issuers, as indicated by their share in the capital of the ECB. Second, holdings of any issuer's liabilities should not exceed 33 per cent of the total. The aim of that is to minimise the risk of becoming a dominant creditor of any eurozone government. Limits on holdings of any given issue can also be as low as 25 per cent. But last June, ECB holdings of German public debt were already 22 per cent. If the ECB were to continue with large-scale asset purchases it might violate one of its constraints: it would either hold too high a proportion of one issuer's debt or hold more of that issuer's debt in its portfolio than the country's share in its capital.

These constraints exist to prevent the ECB from becoming the dominant financier in some cases or from providing especially large support to countries with large debts (such as Italy). Yet it is also possible to argue that further purchases of German debt, with its ultra-low yields, would achieve very little.

Assume, then, that substantial further asset purchases are ruled out. What else might manage the downside risks that are emerging for a eurozone that already has ultra-low intervention rates and low inflation? One possibility is fiscal expansion. In Germany that would clearly make a great deal of sense. The country's determination to eliminate its

fiscal deficit has been hard to understand. But for fiscal policy to work across the eurozone, something rather bigger might be needed. One possibility might be for the ECB to buy bonds issued by an EU institution, such as the European Investment Bank, in support of a huge investment programme.

The painful truth is that the eurozone is very close to the danger zone, as the combination of persistently low core inflation with the recent economic slowdown shows. It is easy to understand why the ECB felt it should halt asset purchases: it wanted to prove that this was a tool it could use in exceptional circumstances and then cease to use.

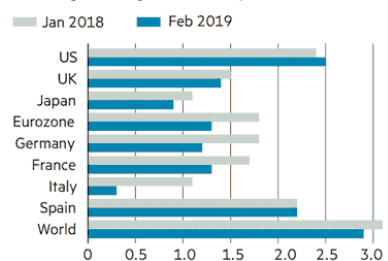
Yet the constraints upon effective action — both monetary and fiscal — are a permanent danger to stability. It would take just one sizeable negative shock to put the eurozone into another severe crisis. It would be far better if it were much further from the danger zone, especially on inflation. To counter the claim that further unconventional policy is either unwise or illegal, the ancient Romans would have given a simple reply: the safety of the republic is always the supreme law. If the system is not safe, nothing is.

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The eurozone is very close to the danger zone because of persistently low core inflation

Eurozone downgrades for growth in 2019

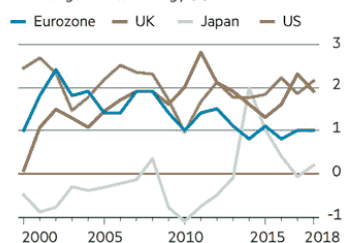
Forecast growth in gross domestic product



Sources: Consensus Economics; OECD; Bruegel

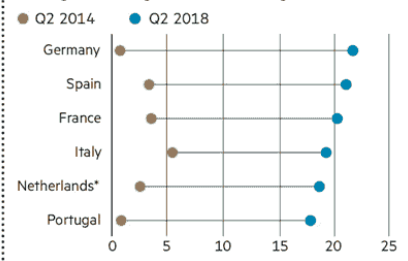
Persistently low eurozone core inflation

Annual change in consumer price index, excluding food and energy (%)



ECB bond holdings become large

Holdings of sovereign bonds outstanding (%)



* Data refer to 2015