ECB's Draghi looks to bigger guns to kick-start EU economies

By Eric Reguly
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It is glaringly obvious that the European Central Bank's mass purchases of bonds – quantitative easing – is not working well. Designed to stoke inflation and revive moribund euro zone economies, it is doing neither, at least not yet.

But ECB president Mario Draghi isn't ready to throw in the towel. While the QE program was not extended or enlarged on Thursday, he used his press conference to insist that all options were still on the table. "If warranted, we will act to use all the instruments available in our mandate," he said, a hint that more is to come to get the job done, just not now.

But as the ECB's bazookas replace rifles and rifles replace pistols, where does it end? Is helicopter money – the creation of free money that would be deposited in savings accounts – next? Or might Mr. Draghi's QE program add equities to its purchase list, as the central banks of Switzerland and Japan, among others, have done? Mr. Draghi said that neither option had been discussed. But if more is better, then most has to be best. Using this logic, the purchase of equities might have to be considered even if it could warp the stock market beyond recognition.

So far, QE's performance has been underwhelming in spite of the program's periodic intensification. With disinflation (slowing price increases) threatening to turn into outright deflation (falling prices), the ECB launched QE in March, 2015. At first, the program was to last until this month. The target end date was extended early this year and is now March, 2017, and is unofficially open-ended.

Initially, purchases were set at €60-billion ($87-billion) a month. The figure is now €80-billion. At first, only sovereign bonds were dropped into the ECB's shopping cart. The cart now includes regional government bonds and corporate bonds (though not bank bonds).

By the end of August, the ECB's holdings of public-sector debt alone had reached €1.2-trillion.

The result: Inflation, expected at about 0.2 per cent this year, is still way under the ECB's target rate of close to 2 per cent (in Spain, inflation is negative). Growth across the 19 euro zone countries was just 0.3 per cent in the latest quarter. Growth is flat in France and Italy, the region's second- and third-largest economies. Unemployment is below its crisis peak, but, apparently stuck at a bit more than 10 per cent, it's still way too high. Youth unemployment in the Mediterranean countries is obscene and investment spending has stalled, even though QE was supposed to pry open the investment spigots.

The best that can be said about Mr. Draghi's QE program is that the main economic figures, if not improving a lot, are at least not deteriorating a lot. In other words, the euro zone's zombie status persists.

The next edition of QE might include new asset classes – perhaps equities – if for no other reason than the ECB is bumping into the limits of what it can buy on the sovereign bond front.

These limits are largely self-imposed. The ECB limits itself to buying no more than 33 per cent of new bond issues; it won't buy bonds whose yield is less than its own deposit rate of minus-0.4 per cent, ensuring that the vast majority of German sovereign bonds are no longer eligible; it could scrap the "capital key," which would allow the purchases of more bonds from

smaller euro zone countries (the key governs the amount of potential purchases, based on the relative size of those economies).

Or it could buy equities.

Equity purchases by central banks are fairly rare, but it does happen. According to the Wall Street Journal, Switzerland's central bank has loaded up on some $10-billion (U.S.) of stocks, including big-name American companies such as Apple and Coca-Cola. The Bank of Japan's holdings of equities and exchange-traded funds are of similar size.

In theory, buying equities makes sense. If the ECB is running out of bonds to buy, why not add stocks? It would also make sense to diversify the ECB's asset holdings. Bonds might be wildly overvalued; European equities might not be.

But the risks of buying stocks are enormous. Various central banks in Europe have already disfigured the bond and lending markets by pushing rates into negative territory, resulting in bizarre spectacles such a savers potentially facing fees on their savings and some Danish homeowners – those with variable-rate mortgages – actually earning interest on their mortgages rather than paying interest.

Since the equity markets are typically more volatile the bond markets, any ECB purchases could trigger wild swings in prices. And what happens when the equity purchases stop? Values could plummet. Imagine if the ECB were to put an end date on equity purchases, as it did with the bond purchases. The result would be market chaos, with hedge funds and other investors gaming the program, making it impossible to judge the true value of stocks.

Worse, buying equities would deliver the message that the ECB is desperate, that it's only option is to dive deeper into the monetary rabbit hole.

Here's another idea for the ECB: Do nothing.

For years, Mr. Draghi has pleaded endlessly with national governments to reform and stimulate their economies, because the ECB's monetary policy can do only so much. He did so again on Thursday, this time more intensely than usual. Mr. Draghi must realize that his stimulus measures, dominated by QE, have given governments cover to do almost nothing. Since the ECB was doing all the heavy lifting, governments did not have to risk alienating their voters by, say, overhauling pension systems, busting up the anti-competitive trade guilds – from pharmacists to taxi drivers – or fixing dud banks.

Imagine if Mr. Draghi had announced that QE is to wind down: Over to you, prime ministers and finance and industry ministers. That might deliver the shock that the euro zone countries need to get their sorry acts together. QE alone clearly is not the way to get the economy going. Economic reform is essential.