Payden&Rygel

Economic Update

THOUGHTS FROM OUR ECONOMICS TEAM

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...BUT WHAT DOES QE HAVE TO DO WITH INFLATION?

The ECB is doing QE to cause inflation. But QE doesn't cause inflation.

The above is, in our opinion, the most important takeaway from Thursday's news. The ECB announced its much anticipated asset purchased program, dubbed "QE" by the marketplace. In March, the ECB will begin buying EUR60 billion bonds per month through September 2016. If things go as planned, that sums to EUR 1.1 trillion in fixed income securities over the next 18 months.

During introductory remarks, ECB President Mario Draghi explicitly linked the asset purchase plan to the central bank's inflation objective. Asset purchases, he guided, would continue until "we see a sustained adjustment in the path of inflation which is consistent with our aim of achieving inflation rates below, but close to, 2% over the medium term." At present euro area wide core inflation is growing at just 0.7% year-over-year.

In the aftermath of Thursday's ECB meeting we've seen headlines suggesting the ECB unveiled its "bazooka" and that the "ECB exceeded expectations." But we wonder: what does this have to do with inflation?

Didn't we learn QE doesn't cause inflation? In the last six years we have witnessed the closest thing to a laboratory experiment we will see in macroeconomics. Despite bond-buying campaigns by major central banks across the globe, consumer prices have not increased at a faster rate. Anywhere you look—the US, the UK, Japan, China, Switzerland, Europe—inflation is below 2%. Why should *this* QE program be any different?

We think QE is even *LESS* likely to solve Europe's problems than it did the US problems when the Fed launched its asset purchase program! QE's proponents have advanced four main arguments. We offer skepticism on all four fronts.

First, the textbook explanation of QE says that it works through the "portfolio balance channel" effect, where a central bank forces yields lower by reducing the outstanding supply of safe assets than can be held by the public. Investors rebalance their portfolios toward higher yielding investments, routing capital away from government bonds and into the real economy. In effect, this discourages "hoarding" and stimulates economic activity and inflation. This is how Ben Bernanke sold QE.

But in Europe, banks play a more important role than the capital markets (as in the US). Consequently, forcing European investors to "rebalance" will not be as effective as QE may have been in the US. And the data shows that both private bank credit and private firm growth are *still* contracting in the euro area. No wonder the unemployment rate remains above 11%. QE fails to address the root cause of the economy's weakness.

The second argument for QE suggests that the printing of euros by the ECB to buy euro-denominated bonds will cheapen the euro *vis a vis* its major trading partners, boosting growth and inflation. Indeed, external trade is a bigger share of euro area GDP than many of its major currency bloc peers. Exports of goods and services account for 45% of euro area GDP, 46% of German GDP but just 14% of US GDP and 16% of Japanese GDP. So a weaker euro may help. Our cautious optimism stems from the Japanese experience of 2013 where, after the yen depreciated by roughly 30%, annual export growth averaged 9%. The euro is down 18% from its peak, how much will trade jump? And will the currency effect be a one-time shot?

Proponents also argue that QE *could* act as a signal that interest rate hikes will not occur before 2017 at the earliest. But, such "forward guidance" about the future path of short-term interest rates—though tried in Canada, the UK and the US—also failed to revive inflation.

The final argument we hear in favor of ECB QE is, "Well, it can't hurt and they have to do something." In fact, it can hurt. Just like an ill patient spending precious time and resources on unproven cures, bond buying campaigns tie up high quality securities on central bank balance sheets, impeding overall financial market liquidity. What is more, focus on QE distracts from the real (political and social) reforms which might actually help the economy heal faster. Perhaps Larry Summers said it best today at Davos: "We have to recognize that the era when central bank improvisation can be the world's growth strategy has come to an end."

Have investors finally learned the lesson about QE and inflation?