Martin Feldstein: QE's shortcomings in Europe

Why has the US Federal Reserve's policy of quantitative easing (QE) been so much more successful than the version of QE implemented by the European Central Bank (ECB)? That intellectual question leads directly to a practical one: Will the ECB ever be able to translate quantitative easing into stronger economic growth and higher inflation?

The Fed introduced quantitative easing - buying large quantities of long-term bonds and promising to keep short-term interest rates low for a prolonged period - after it concluded that the US economy was not responding adequately to traditional monetary policy and to the fiscal stimulus package enacted in 2009. The Fed's chairman at the time, Ben Bernanke, reasoned that unconventional monetary policy would drive down long-term rates, inducing investors to shift from high-quality bonds to equities and other risky securities. This would drive up the value of those assets, increasing household wealth and therefore consumer spending.

The strategy worked well. Share prices rose 30 per cent in 2013 alone, and house prices increased 13 per cent in the same 12 months. As a result, the net worth of households increased by $10 trillion that year. The rise in wealth induced consumers to increase spending, which restarted the usual expansionary multiplier process, with the GDP up by 2.5 per cent in 2013 and the unemployment rate falling from eight per cent to 6.7 per cent. The expansion continued in subsequent years, bringing the current unemployment rate down to five per cent - and the unemployment rate among college graduates to just 2.5 per cent.

The ECB has been following a similar strategy of large-scale asset purchases and extremely low (indeed negative) short-term interest rates. But, although the policy is the same as the Fed's, its purpose is very different.

Because Europe lacks the widespread share ownership that exists in the United States, QE cannot be used to stimulate consumer spending by raising household wealth. Instead, a major if unspoken purpose of the ECB's low-interest-rate policy has been to stimulate net exports by depressing the value of the euro. The ECB succeeded in this, with the euro's value falling by some 25 per cent - from $1.40 in the summer of 2014 to $1.06 by the fall of 2015.

I have been an advocate of reducing the value of the euro for several years, so I think this

strategy was a good one. But, although the fall in the value of the euro has stimulated the euro zone's net exports, the impact on its members' exports and GDP has been quite limited.

One reason for this is that much of the euro zone countries' trade is with other euro zone countries that use the same currency. Moreover, exports to the US don't benefit much from the decline of the euro-dollar exchange rate. European exporters generally invoice their exports in dollars and adjust their dollar prices very slowly, a point made clear in an important paper that Gita Gopinath of Harvard presented at the Federal Reserve's Jackson Hole conference in August 2015.

As a result, total net exports from the euro zone rose less than Euro 3 billion ($3.2 billion) between September 2014 and September 2015 - a negligible amount in an Euro 11 trillion economy.

A further motive of the ECB's bond purchases has been to increase the cash that euro zone banks have available to lend to businesses and households. But, as of now, there has been very little increase in such lending.

Finally, the ECB is eager to raise the euro zone inflation rate to its target of just under two per cent. In the US, the QE strategy has increased the "core" inflation rate - which excludes the direct effect of declining prices of energy and food - to 2.1 per cent over the past 12 months. This has been a by-product of the increase in real demand, achieved by reducing unemployment to a level at which rising wages contribute to faster price growth.

This strategy is unlikely to work in the euro zone, because the unemployment rate is still nearly 12 per cent, about five percentage points higher than it was before the recession began. The ECB's quantitative easing policy can probably achieve higher inflation only through the increase in import prices resulting from a decline in the value of the euro. This very limited process still leaves core inflation in the euro zone below one per cent.

ECB President Mario Draghi recently responded to the new evidence of euro zone weakness and super-low inflation by indicating that the bank is likely to ease monetary conditions further at its next policy-setting meeting in March. This could mean further reducing already-negative short-term interest rates and expanding and/or extending its bond-purchase program.

Euro zone financial markets reacted in the expected way. Long-term interest rates fell, equity prices rose, and the euro declined relative to the dollar. But past experience and the reasons spelled out here suggest that these policies will do very little to increase real activity and price inflation in the euro zone. To make real progress toward reviving their economies, the

individual countries need to depend less on quantitative easing by the ECB and focus squarely on structural reforms and fiscal stimulus.

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