

Quantitative Easing and Deflation in a Creditor Economy

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The world seems to be divided now between happy debtors and unhappy creditors. During the acute phase of the financial crisis it proved to be dangerous to be a debtor as risk aversion rose suddenly, and many debtors experienced difficulties in servicing their debt or simply rolling it over. During that time Germany appeared to be in a strong position as its economy proved resilient to the financial crisis. However, the world has moved on. Risk aversion has fallen again and the world is awash with liquidity and excess savings desperately looking for some return in an environment characterised by zero interest rates and an absence of inflationary pressures. In particular, the Anglo-Saxon debtor nations such as the U.K. and the U.S., which both have sizeable external deficits, are growing more quickly than creditor countries like Germany or, for that matter, the rest of the euro area in general.

This reversal of fortunes has its economic logic, which is seldom recognized. The basic problem is that the standard guarantee against deflation is ultralow interest rates supported by vast central bank purchases of government bonds. However, this approach might not work or, worse, might even be counterproductive in creditor economies like Germany and other European countries.

At the G-20, as in other international forums, it is now widely felt that the European Central Bank (ECB) should do “something” to prevent the euro area from sliding into outright deflation. This “something” is usually taken to be the massive outright purchase of securities on the open market. The ECB has already announced its intention to buy large, but unspecified, amounts of asset-backed securities, but it is shying away from

large-scale purchases of public debt such as those undertaken by the Federal Reserve or the Bank of England under their quantitative easing (QE) programs.

All these variants of asset purchases (asset-backed securities or public debt) share one aim, namely to lower interest rates in the long term. Short-term interest rates are already close to zero for most assets of low risk (even the governments of Italy and Spain can now refinance their debt at less than 1 percent for maturities up to two years). The only rates that can still go down are thus longer-term interest rates. These rates are already around 1 percent for Germany, but the rates on Spanish and Italian government debt are still around 2.5 percent. For the latter there is thus more room for downward movement. The ECB might thus be able to push long-term interest rates a bit lower.

The question too seldom asked, however, is whether even lower long-term interest rates would solve the euro area’s deflation problem.

Discussion on the need to do something to prevent deflation has so far proceeded along predictable national patterns: Creditors do not object to deflation since it increases the real value of their investment. Deflation is thus not viewed as a problem in economies dominated by creditors and vice versa in debtor countries.

In a closed economy, to every credit there must be a corresponding debt. But this is not the case if one considers individual countries. Some countries have a large foreign debt burden, whereas others find themselves in a large creditor position.

The U.S. and Germany (or Japan) are at opposite extremes of the creditor-debtor spectrum. The U.S. has run current account deficits for over 30 years and has enjoyed the “exorbitant privilege” of being able to pay for its external deficits by issuing debt denominated in its own currency. Foreigners hold about \$7 trillion worth of U.S. bonds (mostly Treasury paper). A reduction of the yield by 1 percentage point yields a net gain of about 0.5 percent of GDP and the investment income balance of the U.S. has indeed improved since the start of QE by about 0.7 percent of GDP, although its net foreign investment position has continued to deteriorate. For the U.S., lower interest rates thus represent a considerable income gain.

This implies that a reduction in U.S. interest rates will benefit the country as whole, relative to the creditor countries, like Japan or Germany, because both of these countries have run large external surpluses for a long time and have thus accumulated large external assets, mostly in fixed income. Creditor countries like Japan and Germany would thus lose out in terms of interest income when the central bank engineers lower (long-term) interest rates. It is thus not too surprising that the investment income balance of Germany has not improved much over the last few years, although its net creditor position has further ballooned as the country continues to run large current account surpluses.

Within the euro area, for which external accounts have until recently been close to balanced, one finds a similar debt/creditor dynamic involving Germany and the Netherlands relative to much of southern Europe. In part, this difference explains the hostile stance on QE in the German financial press¹ and the increasingly desperate calls for more action by the ECB from the over-indebted periphery of the eurozone. But how effective would large-scale quantitative easing be in the euro area? The aim of QE or any form of asset purchases is, as mentioned above, to lower long-term, market interest rates. In financial market terms, the purpose of QE is essentially to flatten the yield curve. This implies that QE can be effective only in econ-

omies in which changes in the long-term market rates (say, 10-year) play an important part in the private sector.

In Europe most corporate sector investment is financed by bank loans, whose maturities are typically not very long term (ordinarily not much more than five years) given that banks themselves have little secure long-term financing. Moreover, given this financing structure of the banks, many long-term bank loans are extended on floating rates. Lower 10-year rates are thus unlikely to have a strong impact on the financing conditions of the corporate sector, and thus little impact on investment in the euro area.

By contrast, in the U.S. a much larger proportion of investment is financed via the issuance of bonds, which can have a longer maturity than bank loans (and which are priced on the basis of the government bond yield curve). This implies that QE could lower the cost of capital for the corporate sector in the U.S.

For households, the main impact of lower interest rates is seen in mortgages. Here again the euro area is quite different from the U.S. and also is experiencing sharp regional differences.

Loans in the southern part of the euro area are mostly on floating rates. This constitutes an advantage right now given that short-term rates are close to zero. But it also implies that QE would not reach southern European households whose mortgages are indexed to the Euribor rate and are already close to zero. This applies in particular to Spain where mortgage debt exploded with the construction boom. In Italy mortgages are less important, but Italian enterprises are highly indebted. But their bank loans are usually short-to-medium-term and are thus also not likely to change much even if the Italian government can refinance its debt at lower rates.

In the U.S., the typical 30-year mortgage is formally at a fixed rate. But in reality a U.S. household always has a prepayment option should interest

rates fall. This implies that a fall in 10-year rates can have, and was widely expected to have, an impact on household spending because lower long-term rates typically lead to waves of mortgage refinancing, leaving households with lower monthly payments and thus higher disposable income. This mechanism does not operate in the euro area because mortgage rates are usually floating in the south and fixed without a pre-payment option in the north.

An indirect effect of QE is usually expected through its impact on asset prices, especially housing. Here again the U.S. example is misleading for Europe. Owner occupancy rates are high in the U.S. and the financial system allows households to extract equity in their homes relatively cheaply, either via second liens or by refinancing the entire mortgage. This is not possible in most of Europe, and especially not in Germany, where loan-to-value limits remain conservative, refinancing is costly and where most banks would frown on second liens based on higher house values for the purpose of financing higher consumption.

Higher equity prices would also do little to stimulate consumption in Germany given that the majority of the shares in publicly traded companies are held by foreigners, while German households own very few shares. By contrast, those U.S. households that do save hold a substantial share of their portfolios in shares.

Differences in the financial structure thus interact and sometimes compound the debtor versus creditor differences across the Atlantic. QE might work in a debtor economy with a flexible financial system, but not in a creditor country with a conservative financial system, as in Germany (and a number of northern European countries have similar structural savings surpluses, as shown in Box 1).

Moreover, the indirect impact of QE on asset prices is bound to increase inequality, and might thus have a negative impact on demand.

Once more, the U.S. experience, where higher

house prices stimulate consumption, is misleading. In the U.S. an increase in house prices allows the owner to take out additional credit in the form of a home equity loan. These loans might be higher risk for the banks when house prices fall, as they did after 2008. But the risk to the consumer is limited since most mortgages are either de jure or de facto “no recourse,” meaning the mortgage holder can walk away from his or her debt in case of payment problems. This encourages higher consumption on the back of higher housing prices.

This is not the case in Europe, especially in Germany, where house prices have been increasing lately. But increasing house prices in Germany risk dampening, rather than fostering consumption demand. Only a little over 40 percent of German households own their place of living. Most households just see rents increasing, which reduces their disposable income and lowers consumption. Moreover, in Germany, the average is misleading: House prices are increasing in the major cities, but falling in the countryside. Home ownership rates are typically higher in rural areas where families build their own homes, but lower in large cities where renting is more prevalent. An increase in house prices thus shifts wealth from the relatively less prosperous (the rural and those renting in general) to those who own the housing stock, who tend to be relatively wealthy. This implies that higher house prices shift wealth and income towards the better off. Since the latter have typically a lower propensity to consume, it follows that the impact of a policy of low interest rates, whether through QE or other means, might not have the desired effect of stimulating consumption.

The same reasoning applies, *mutatis mutandis*, for the impact of QE on other asset prices, such as equity prices. Holdings of equity are typically concentrated even more than income and wealth in general. The recent large increases in stock prices, which are thought to be at least partially a product of QE, thus contribute to the trend increase in inequality that has been documented recently by the French economist Thomas Piketty.

BOX 1: GERMANY AND THE NORTHERN EUROPEAN EXCESS SAVINGS AREA

An emphasis on Germany seems justified within the context of Europe, although Germany represents less than 30 percent of eurozone GDP. Germany is important, but not dominant in Europe.

In the context of the G-20 the focus on Germany hides the fact that the country represents the tip of a larger northern European iceberg: Excluding English-speaking states, all northern European countries with a Germanic language are running a current account surplus. Indeed, the Netherlands, Switzerland, Sweden, and Norway are all running surpluses that are larger as a proportion of GDP than Germany's.

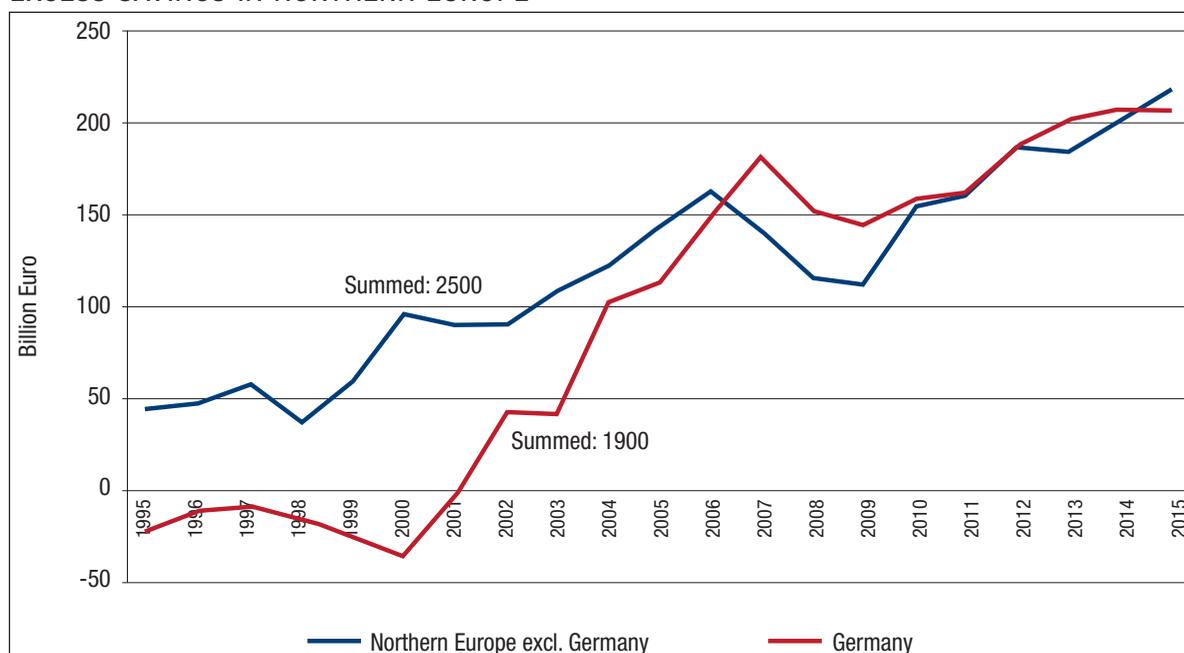
These small countries' combined annual external surplus is more than 200 billion euro (over \$250 billion), slightly more than that of Germany alone (see figure below). Moreover, their surpluses have been more persistent than those of Germany, which 10 years ago had a current account deficit while its linguistic kin were already running surpluses of a similar size to today. Over the last decade, this group of

small countries has recorded a cumulative surplus that is even larger than that of China.

Today, the counterpart to northern European excess saving is 'Anglo-Saxon' dissaving: All English-language countries are running current account deficits (and have been doing so for some time). Taking the United States, the United Kingdom and major Commonwealth countries together, the sum of the Anglophone current account deficits amounts to more than \$600 billion, or roughly 60 percent of the global total of all external deficits, somewhat larger than the combined northern European surpluses of around \$500 billion.

It is not surprising that national policymakers and news media in Anglo-Saxon countries are complaining of the German surplus. But Germany constitutes 'only' half of the problem. If QE does not work in Germany, as argued here, it might not work in the rest of northern Europe either.

EXCESS SAVINGS IN NORTHERN EUROPE



Source: Adapted from <http://www.ceps.eu/book/germany-scapegoat>.

The one channel through which unconventional monetary policy could have a stronger impact in the euro area than in the U.S. is the exchange rate. The share of exports in GDP is almost twice as high in the euro area than in the U.S. However, it is doubtful that QE by the ECB would have a strong impact on the exchange rate, which is driven generally more by short-term rate differentials. Given that short-term rates are already zero throughout most OECD countries, it would appear that there is little the ECB could do to ensure a devaluation of the euro short of outright foreign exchange intervention. Moreover, any implicit exchange rate policy of the ECB could represent a zero-sum game at the global level, resolving some problems in Europe at the expense of the rest of the world, whose recovery might then be weaker.

The key problem of the euro areas is weak domestic demand in Germany (and other northern European surplus countries). This problem might actually be made worse by an attempt to drive down long-term interest rates through QE. A German household trying to increase its retirement income would have to save even more to achieve a certain target if interest rates were to go down. Close to two decades of near-zero interest rates in Japan also did not lead to a reduction in the Japanese savings surplus. Browbeating the ECB into a large-scale QE program might not lead to the desired result.

So what could make northern Europe spend more? It is tempting to conclude that only a strong fiscal expansion would do the trick given that northern Europe is one of the few regions in the world that still has “fiscal space.” But the past has shown that the northern European surplus does not depend strongly on fiscal policy. Moreover, it is unlikely that this “fiscal space” will be used given that unemployment remains low throughout northern Europe. The governments in the region do not have a domestic incentive to run higher deficits and all of them think that they escaped the crisis only because they had run tight fiscal policy during the boom years. The German surplus had been a feature of the global economy for decades until the mid-1990s. Only the shock of unification led to its disappearance. The German surplus has now returned with a vengeance, and has been doubled by the surpluses of the other countries in the region.

Would stronger northern European demand solve southern Europe’s problems? This seems unlikely given that exports to northern Europe constitute only a small fraction of southern Europe’s GDP. Studies with large models have repeatedly con-firmed this conclusion. However, northern Euro-pean excess savings constitute a serious issue for a global economy still short of demand. This issue should be on the agenda of the G-20, not just Eu-rope’s, but it is unlikely that it will be resolved any time soon.