Unintended consequences of the ECB's quantitative easing programme could undermine Europe's recovery

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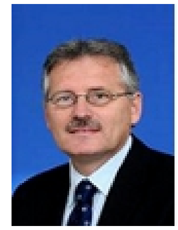

Earlier this year, the European Central Bank began implementing a quantitative easing (QE) programme. **John Doukas** *writes that while conventional economic thinking would suggest QE should provide short-term benefits to European economies, it may also be having unintended consequences by giving certain sectors of society, particularly those at or near retirement age, less incentive to spend. He argues that the net effect of the policy could be to undermine, rather than help, Europe's economic recovery.*

In a previous article, I argued that the scarcity of government bonds could force the ECB to pay higher prices for the purchase of government securities in an attempt to implement its new quantitative easing (QE) programme, which could dent its effectiveness after all. So far, the soaring cost of borrowing government bonds in secured lending markets, which could clog up Europe's financial system by further shrinking repo markets (a source of funding essential to the smooth functioning of bond markets), provides evidence in support of this view.

There is a bond market bubble (high bond prices) with long-term rates being extremely low while economic activity (recovery) remains anaemic. Apparently, QE, in the US and other developed countries, has not been as helpful as conventional economic thinking would expect. Put simply, monetary policy has failed to boost aggregate spending, but why has this been the case?

Demographic changes and quantitative easing

Demographic changes show that birth rates have decreased over the past decades considerably and are expected to remain low while life expectancies continue to increase in Europe and many countries around the world. As a result, the focus in this article is to highlight a more fundamental limitation of the ECB's quantitative easing as a means to boost the Eurozone's economic activity from the point of view of demographic changes (i.e. rising ageing and life expectancy). In brief, the question of how QE works in the presence of demographic aging is of increasing interest to a significant segment of the economy (baby boomers and retirees) and the way it affects its growth prospects.

Recall that one of the main objectives behind QE is to raise the value of assets, by lowering interest rates, known as the "wealth effect". That is, to make individuals wealthier, thus motivating them to spend more and, in so doing, stopping deflation. The lowering of long-term rates, in turn, is conventionally believed not only to raise aggregate spending but investment as well. So QE intends to boost economic activity, through increased aggregate spending, investment. This is also expected to reduce unemployment. The wealth effect of QE is based on the belief that investors make spending (and investment) decisions based on "absolute", rather than "relative" wealth and that demographic changes do not matter. This erroneous assumption is critical for the success of QE policy especially when the demographic mix tilts toward ageing investors.

However, in reality, individuals, particularly older ones, make decisions based on "relative" wealth (i.e. the funded status of their retirement income stream). More precisely, QE has the tendency to make investors poorer (i.e. experience a "negative" wealth effect) by reducing the funded status of their retirement (relative wealth). In other words, lower interest rates increase the price of retirement income, which, in turn, reduces individuals' relative wealth. Lower relative wealth means that individuals (retirement pension funds too) need to spend more wealth (assets) to purchase the same retirement income stream.

On the other hand, higher interest rates increase individuals' relative wealth – particularly those near retirement age – and therefore they need to spend less wealth to purchase the same retirement income stream. In other words by lowering or keeping interest rates at extremely low levels, monetary policies that have been adopted in several counties in recent years, and in particular after the 2008 financial crisis, have reduced the funded status of retirement income, forcing people to save more in an attempt to maintain their purchasing power.

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This naturally results in less aggregate spending and business investment. This is the opposite of what QE is intended to achieve: in fact, QE is hurting baby boomers, an increasing number of individuals in European countries, who care more about their post-retirement income stream (financial survival), leading them (pension fund managers too) to invest in more risky assets in an attempt to realise higher returns in order to be able to fund their post-retirement spending needs (liabilities). Investing in risky assets (a hedging strategy against the low interest rates of QE policies), forces assets (equities now and real estate before the 2008 crisis) to trade above fundamental (intrinsic) values, resulting in bubble phenomena with dramatic consequences for the real economy (as we know from the 2001 tech and 2008 real estate bubbles).

Simply put, QE forces the value of liabilities, for most private and public pensions, to rise more than the value of assets in which the funds are invested. And this may be the reason that most pensions are underfunded in many countries. This unintended consequence of quantitative easing which results in less consumption, less investment and greater retirement uncertainty is more severe today in Europe where the demographic ageing is more pronounced than 1-2 decades ago. An interest-rate increase, then, is essential for the financial health of pensions because low rates erode the funding levels of pension plans, exerting huge financial burdens on the sponsors and threatening the security of private and public pensions.

QE is a risky policy because it hurts savers' retirement incomes. Since baby boomers attach greater importance to funding retirement than current spending, QE inevitably abates the chances of economic recovery because it motivates them to save than spend in order to meet their future financial obligations. In addition, baby boomers being a wealthier class have lower spending needs than other individuals. This, then, induces them to invest more than consume, driving asset prices even higher.

Therefore, the wealth effect of QE is unlikely to stimulate consumption spending, as it would 2-3 decades ago, and investment. On the contrary, it is more likely to have the opposite effect which, in turn, will depress business investment, as we know from the US experience in the last 5-6 years and the more recent ECB quantitative easing policies. In fact, reality shows that companies divert money from their business to the stock market through buybacks (the purchasing of their own equity shares) over capital spending. More than two thirds of large company profits in Europe and US has been spent on buybacks and dividends, inflating asset prices. Low interest rates drive investors into riskier investments like equities increasing the paper value of corporate equities over their tangible worth.

The increasingly ageing European population raises new and, perhaps, more serious doubts, about the power of the ECB's quantitative easing, as one of its main monetary tools to boost the stagnant EU economy through lower interest rates, by imposing unintended damage on all types of pensions. In sum, the continued QE policies will likely produce a "negative" wealth effect, by accelerating pension plan freezes and closings, driving consumption spending and business investment to lower levels and, thus, prolong the recession.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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About the author

John Doukas – *Strome College of Business, Old Dominion University, Virginia*

John Doukas is the founding and managing editor of *European Financial Management* (EFM) and the founder of the European Financial Management Association (EFMA). He is the William B. Spong Jr. Chair in Finance and Eminent Scholar at Strome College of Business of Old Dominion University, Virginia (United States). He is also a Research Associate of the Judge Business School at the University of Cambridge (United Kingdom). He earned his PhD in Financial Economics at Stern School of Business, New York University.

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