Conflict erupts over European Central Bank's return to "quantitative easing"

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A bitter conflict, characterised by one leading banking economist as a "War of the Roses," has broken out in European banking and financial circles over last month's decision by the European Central Bank to further loosen its monetary policy.

At its meeting on September 12, the ECB's governing council decided to send its base interest rate further into negative territory. It is reducing the rate from minus 0.4 percent to minus 0.5 percent, and resuming its €2.6 trillion asset purchasing program, after a hiatus of nine months, at the rate of €20 billion a month.

There was an immediate response. Reflecting the long-standing opposition to the quantitative easing policies in German financial circles, the *Bild* tabloid depicted the outgoing ECB president Mario Draghi as "Count Draghila"—a vampire, sucking dry the investments of savers. This has been a continuing theme of this section of the press.

On this occasion, however, it received support from higher levels. The day after the meeting, Klaus Knot, the head of the Dutch national bank, issued a statement calling the ECB's actions "excessive." Jens Weidmann, president of Germany's Bundesbank said Draghi was "overshooting the mark" and Robert Holzmann, the head of Austria's central bank, said the decision was a "possible mistake."

Two weeks after the decision, the rift over the ECB decision was highlighted by the decision of the German representative, Sabine Lautenschläger, to resign from the ECB's executive board. A known opponent of a further easing of monetary policy, her term did not expire until 2022.

According to the initial reports of the September meeting, as many as nine members of the 25-member governing council spoke out against the decision. The extent of the opposition has been confirmed in the minutes of the meeting released last week. These show that while there was broad agreement on the need to take action to counter the ongoing slowdown in the eurozone economy, there was significant opposition to the package announced by Draghi.

Most of the opposition centred on the decision to resume bond purchases. The minutes recorded that "a number of members" argued that the case for such action was "not sufficiently strong."

In announcing the decision, Draghi told a news conference there was a "clear majority" in favour of the measures" and that an "ample degree of monetary accommodation" was needed to ensure 2 percent inflation over the medium term.

However, it has since emerged that the decision to restart the bond-buying program was taken over the objections of ECB officials. Three members of the ECB's governing council leaked the contents of a letter sent to Draghi by the central bank's monetary policy committee days before the decision which advised against the resumption of asset purchases.

Reporting on the leak last week, the *Financial Times* said it came as opponents of Draghi's loose monetary policy "fight a rearguard action to put pressure on [former International Monetary Fund managing director] Christine Lagarde for her to change course after she takes over at the ECB on November 1."

It is not the first time the committee's advice has not been followed, but it is a relatively rare occurrence. The ECB did not officially comment on the leak but the ECB vice-president Luis de Guindos called for internal critics on the governing council not to make public their dissent.

"There are 25 of us and, for sure, there are sometimes different views, but when a decision is taken by a clear majority, it is important to defend it," he said. "It would be much better if we tried to reduce the level of surrounding noise."

However, in view of the widening differences, the "noise" level seems certain to rise, not decrease. This is because there is a deepening rift over the direction of monetary policy in view of its failure to provide a real boost to the eurozone economy.

Pointing last week to the intensification of the conflict, Carsten Brzeski, chief economist for Germany at ING, said: "The ECB seems to be in the middle of a War of the Roses. Christine Lagarde's first task as new ECB president will be

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to fix the rift."

The widening divisions make that a tall order. The extent of the gap was highlighted by a statement issued in the name of six former central bankers earlier this month.

It said the loose monetary policy of the ECB was based on "the wrong diagnosis" and risked eroding the ECB's independence.

"As former central bankers and as European citizens, we are witnessing the ECB's ongoing crisis mode with growing concern," the statement signed by former German, Austrian, Dutch and French central bankers said.

"The ECB essentially justified in 2014 its ultra-loose policy by the threat of deflation. However, there has never been any danger of a deflationary spiral and the ECB itself has seen less and less of a threat for some time. This weakens its logic in aiming for a higher inflation rate. The ECB's monetary policy is therefore based on a wrong diagnosis."

The statement reflected long-standing opposition within German financial circles to the ECB bond buying program on the grounds that it is not legal.

"From an economic point of view, the ECB has already entered the territory of monetary financing of government spending, which is strictly prohibited by the [1992 Maastricht] Treaty," the statement commented.

It said the "suspicion that behind this measure lies an intent to protect heavily indebted governments from a rise in interest rates is becoming increasingly well founded." There have been numerous claims, emanating from German financial and political circles, that the ECB makes policies that favour southern European countries and involve a redistribution of wealth.

The statement said negative interest rates would only "favour the owners of real assets" and "create serious social tensions."

It warned that lowering interest rates on safe investments such as government bonds had longer term consequences for financial stability.

"The search for yield boosts artificially the price of assets to a level that ultimately threatens to result in an abrupt market correction or even a sharp crisis," the statement noted.

In a comment published in the *Financial Times* yesterday Jean-Claude Trichet, Draghi's predecessor as ECB president, disagreed with the memorandum. He wrote that where they saw negatives "I see success, continuity, unprecedented challenges and a question about the limitations of monetary policy." He claimed that as a result of the ECB policies, in response to the worst financial crisis since the second world war, "resilience was assured."

In contrast to Trichet's measured tone, the level of the underlying tensions was indicated in a blistering editorial published in the same newspaper on October 6.

Characterising the statement as a "roar of the dinosaurs," it said only one thing could match "the hollowness of the complainants and that is the hollowness of their complaint. Their memorandum reveals them as the Bourbons of central banking: they have learned nothing and forgotten nothing."

The editorial claimed that if the history of the euro and the global economy demonstrated anything, "it is that the true risk both to the eurozone economy and the ECB's mandate is a policy that is too tight, not one that is excessively loose."

Pointing to the national conflicts at the centre of the row over ECB policy, it said the "hard money dogma reflects a deeper disagreement that predates the euro, over whether Europe is governed in Germany's image or Germany in Europe's."

The editorial pointed out that low interest rates are a global phenomenon, as is the economic slowdown, with central banks keeping rates at historic lows. "The [US] Federal Reserve has reversed its tightening and thinks it may have gone too far in selling off bonds bought in quantitative easing. If the signatories are right, it is not just the ECB but the entire outside world that is mistaken."

However, this is not a refutation of the claim that the supply of endless amounts of cash to the financial markets contains within it the seeds of another financial crisis. It merely points to the inherent contradictions in the policies of the ECB and the other major central banks.

A decade of so-called "unconventional monetary policies" has failed to bring about a genuine revival of economic growth. The low-interest rate regime has not led to increased capital investment and industrial expansion but has only created the conditions for another financial meltdown.

This is because by lowering the yield on government bonds and other more secure financial assets, the monetary policies of the world's central banks have promoted the search for yield through investments in ever riskier financial assets. Those are likely to be the first hit in a global recession, the signs of which are becoming ever more evident.

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