Economics

ECB's Open-Ended Push Leaves It More Isolated

The central bank's aggressive move makes it shoulder even more of the economic burden.

By Mohamed A. El-Erian
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Mario Draghi, president of the European Central Bank, is leaving an aggressive policy for his successor.
Photographer: Alex Kraus/Bloomberg

The European Central Bank on Thursday sent the message that it is still "all in" in trying to bolster an economy facing an increasing risk of recession, deflation and financial instability – with or, as of now, without the help of other policy-making entities in the euro zone. And in adopting an open-ended approach to unconventional monetary policy measures, it has also defined the path for Christine Lagarde, who is set to succeed Mario Draghi in about six weeks as the head of the world's second-most-powerful central bank.

Have no doubt about the aggressiveness of these measures, and not only because the ECB cut the deposit rate into even deeper negative territory – 10 basis points to minus 50 basis points – adopted tier pricing to try to contain damage to the banking system and resumed bond purchases at a pace of 20 billion euros a month. The move also includes an open-ended commitment to QE and even more aggressive guidance on rates despite growing worries about unintended consequences and collateral damage.

At his highly watched press conference, Draghi justified this action by citing concerns about the regional economy, which include “protracted weaknesses” and the persistence of high risks and downward inflationary pressures. Part of this is due, again according to Draghi, to uncertainties associated with geopolitical tensions, the trade conflict and emerging market instability.

But such aggressive policy is not without costs and risks, and not just for the ECB. Three issues are particularly notable:

First, the ECB is now even more alone in carrying the bulk of the euro zone’s policy burden. Its strong hope – indeed, its salvation – is that the recent more positive (or, at least less negative) signals about fiscal and structural reform measures will lead to a meaningful and comprehensive pro-growth policy package.

Second, many other central banks are being pushed further into a corner, forced to follow the ECB in loosening monetary policy and increasingly stretched to contain the adverse effects on the functioning of the economy. The problem is most acute for small open European economies with many regional trade links and independent monetary and exchange-rate policies such as Denmark and Switzerland. If they fail to follow the ECB, their currencies will strengthen and harm domestic economic activity. But if they do – and in all likelihood they will – they (and others) face even higher risks of economy-wide resource misallocations, excessive risk taking, greater medium-term financial volatility and uncertainty about longer-term products such as life insurance and retirement plans.

Then there is the Federal Reserve, the world’s most powerful central bank. The ECB’s actions will render it even more vulnerable to political pressure from the White House. The actions also increase the risk of a currency war when trade tensions still persist. President Donald Trump wasted no time in reacting on Twitter, noting the ECB’s efforts to depreciate the euro, thereby harming U.S. exports

Draghi will retire from the ECB leaving behind him both a legacy as an uber activist central bank and a clear policy path for his successor. Yet his courage and steadfast bold efforts, as notable as they have been, have not been matched by action in national capitals to step up pro-growth structural reforms, loosen fiscal policy when possible and strengthen the regional economic and financial architecture – key policy priorities that he again stressed at his press conference.

Absent a change in this, the ECB’s approach risks not just proving insufficient to deliver what the European economy needs, but also could inadvertently render its medium-term economic and financial underpinnings even more vulnerable to internal and external economic shocks, as well as political uncertainties.

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