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ECB TURNING INTO A "BAD BANK"? NONSENSE

Berenberg Macro News

- **Inflation far below target and weak growth require an ECB response**
- **ECB asset purchases help to reduce the risk of a costly recession**
- **ECB critics fall victim to a "lump of risk" fallacy**
- **Less risk, more ECB profit: good news for Eurozone and German taxpayers**
- **Comparing the bonds targeted by the ECB to US sub-prime is grossly misleading**

Adequate ECB policy reduces risks

For five years, many German academics and the mass media have warned that the unconventional policies of the European Central Bank (ECB) would lead to higher inflation. Year after year, the facts have proven them wrong. Inflation has fallen to just 0.3% for the Eurozone instead. Even Germany has never before enjoyed such a long period of stable low inflation than it has since the ECB took over the reins of monetary policy at the end of 1998.

Now the doom mongers are warning that the ECB is turning itself into a "bad bank", potentially placing a huge burden on German taxpayers who – via the Bundesbank share in the ECB – de facto own 27% of the ECB. Once again, these experts are getting their logic upside down. The opposite of what they claim is correct: by pursuing an adequate policy as required by its mandate, the ECB is helping to reduce risks for all taxpayers in the Eurozone, including the German taxpayers. Among the mistakes the ECB critics make, they seem to fall victim to a "lump of risk fallacy".

What is behind the claim that the ECB is now turning into a bad bank? The ECB has decided to pursue a more expansionary monetary policy by purchasing asset-backed securities and covered bonds, potentially to the tune of €300 bn. The ECB decision makes sense. Inflation is far below the de-facto target of 1.9%. The confidence shock of Putin's aggression against Ukraine and other geopolitical risks have dealt a significant blow to the near-term outlook for the Eurozone economy. Nothing in the current data points to a major rise in inflation in the coming years. In such a situation, the ECB's mandate requires the bank to inject additional stimulus in order to get inflation closer to target over time. With interest rates already close to 0% and with generous conditions for the ECB's conventional refinancing operations, asset purchases are the logical next step for the ECB. If the ECB simply stayed put while the economy weakened and inflation continued to undershoot the target, the ECB would violate its mandate.

Good news for taxpayers

But what will ECB asset purchases mean for taxpayers? Simple answer: it's good news for taxpayers. The ECB will buy interest-bearing assets in exchange for central bank money which the ECB can create at virtually zero cost. As a result, the ECB will earn an extra profit which will largely accrue to the national central banks of its member countries. Once the Bundesbank distributes these extra profits to the German federal budget, the German taxpayers will benefit directly.

But won't the ECB incur huge risks by buying dodgy bonds, the kind of bonds that once contributed to the US sub-prime crisis ? This oft-heard assertion is wrong. US-style "sub-prime" mortgage bonds barely exist in the Eurozone. For all structured finance assets in Europe, the default rate from the beginning of the US financial crisis in July 2007 throughout the post-Lehman and then the euro crisis until late 2013 was a mere 1.5%. For the major asset that the ECB will actually buy, so called residential mortgage-backed securities (RMBS), the European default rate was just 0.1% (source: AFME securitisation data report, Q2: 2014, p. 3). Consumer finance asset-backed securities (ABS), which the ECB will also purchase, had a default rate of just 0.04%. That compares to an 18.4% default rate for ABS on US loans including subprime loans during that period. Throughout the worst of the financial crises, the default rate in Europe on the kind of assets the ECB will buy was extremely low. To use the post-2007 US experience with dodgy US paper to discredit the ECB's plans to buy the very different private-sector securities available in the Eurozone is grossly misleading, to put it mildly.

In addition, the ECB will employ some important safeguards. First, ECB purchases will focus on investment-grade paper. More than 90% of the rated securities in the €1.5bn European securitisations market have investment grade credit ratings. Second, the ECB will only buy paper that is structured in a transparent way, again reducing risks. Third, while the ECB will buy small amounts of paper from Greece and Cyprus without an investment-grade rating, the ECB will do so only if these countries stay in an EU-supervised adjustment programme to strengthen their economies and hence contain the risks.

The "lump of risk" fallacy

Most importantly, the critics accusing the ECB of potentially burdening German taxpayers with big losses make what is a beginner's mistake in economic analysis. We can call it the "lump of risk" fallacy. They seem to assume that "risk" is a constant that can only be redistributed. So if the ECB now buys securities, the ECB would take the risk off the balance sheets of the banks and private investors selling the paper and take the same risk onto its own balance sheet, to the potential detriment of the taxpayers who are the ultimate owners of the ECB. That misses the major point: risk is not a constant that can only be redistributed. An adequate central bank policy reduces the risks of recession and financial crises.

In the current environment, a further monetary stimulus is required to stabilise confidence and support weak demand in the Eurozone. Otherwise, the risk that the Eurozone including Germany may fall into recession would be significant. For taxpayers, recessions with their rise in unemployment and fall in tax revenues are very expensive. By adding a further monetary stimulus, the ECB lowers the overall level of risk in the Eurozone and German economy. Incidentally, an adequate monetary policy also reduces further the very low default rate for the kind of assets which the ECB will buy. The ECB policy is geared towards meeting its mandate. This policy will benefit and not harm the German taxpayer.

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