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SEVEN QUESTIONS TO KERSTIN BERNOTH AND PHILIPP KÖNIG

ECB Bond Purchases: »No Panacea for Deflation«

1. Professor Bernoth, Dr. König, by purchasing government bonds, the European Central Bank aims to avert impending deflation in the euro area and, in the medium term, bring the inflation rate back up to just under two percent again. How likely is this method to succeed? Kerstin Bernoth: We only have limited experience of kinds of purchasing programs. Only a very small number of central banks have ever made use of these programs. Consequently, it is extremely difficult to assess their effectiveness. However, we can assume that it will not be a panacea that will protect the euro area from the threat of deflation in the long term.

2. What are the causes of these weak price trends in the euro area? Philipp König: Weak price trends in the euro area have been caused partly by plummeting oil prices and low energy prices. However, weak inflation also persists in the euro area's crisis countries, in particular Spain, Greece, and Ireland. This is the result of a macroeconomic adjustment to restore the price competitiveness of these countries, the continuing adjustment of banks' balance sheets, and debt reduction in the public and private sectors.

3. What impact has the ECB's government bond purchasing program had on the euro countries' debt burden? Philipp König: When the ECB purchases a government bond and the national government subsequently makes interest payments to the ECB and/or the national central bank, this money then flows back to that government as part of the central bank's standard profit distribution process. So, the temporary purchase of government bonds reduces the interest burden of the member state.

4. Interest rates are already very low. Are further marginal interest rate cuts likely to have any impact at all? Kerstin Bernoth: This is precisely the problem. Interest rates cannot really get any lower. Consequently, the intended interest effect, in other words, to use lower interest rates to boost the economy and, in turn, to push prices up, is likely to be limited. There are various studies examining the effect of purchasing programs in the US and UK which indicate that the interest rate is decisive for the effectiveness of these programs.

5. The majority of European companies are financed by bank loans. Is the ECB's purchasing program likely to stimulate lending? Kerstin Bernoth: A key reason for the low level of lending in the euro area is that the private and public sectors are still tied up in the debt reduction process. Too high an interest rate level or too little liquidity in the banking or financial sector plays a more minor role. Bearing this in mind, we can assume that the ECB's purchasing program will not get to the root of the problem of weak lending even if there were to be a significant drop in interest rates.

6. What overall negative effects might the ECB bond purchasing program have? Philipp König: By purchasing government bonds up to a maximum of 52 billion euros per month, the ECB will become one of the main creditors of the member states. This creates a risk of what is known as fiscal dominance, which might mean any effective control of inflation is complicated by fiscal considerations.

7. With its bond purchasing program, the ECB has sent a long-term signal. How long will the ECB have to follow its low interest rate policy? Kerstin Bernoth: The ECB will certainly continue with its low interest rate policy for as long as inflation expectations and the actual inflation rate remain at such a low level in the euro area. The ECB will continue to purchase government bonds at least until September 2016 and we should expect base rates to stay as they are until then.

Interview by Erich Wittenberg

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