EUROPE FILE

ECB's Draghi Takes a Gamble on QE-lite

Bond-Buying Might Ease Pressure on Countries That Need to Reform

By SIMON NIXON

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Mario Draghi, president of the European Central Bank looks towards photographers as he arrives for the ECB's monthly news conference in Frankfurt last Thursday. *Reuters*

It was a watershed moment. All year, the European Central Bank has faced growing pressure—from governments, markets, the mainstream economics establishment, the International Monetary Fund—to embark on a large-scale government bond-buying program. And all year, the ECB had resisted, arguing repeatedly that quantitative easing would yield little benefit in the eurozone's bank-centric, structurally challenged economy and warning of the political and moral hazard that would arise as a result of exposing the ECB balance sheet directly to sovereign credit risk.

Yet last week, Mario Draghi threw those concerns aside, pushing through a decision by the bank's governing council to cut interest rates and to embark on a program of large-scale bond purchases.

Although the ECB will buy only asset-backed securities and covered bonds for now, the market understood that a taboo had been broken. Mr. Draghi's statement that the ECB's aim was to restore its balance sheet to its size in early 2012, signaling a possible €1 trillion ($1.29 trillion) expansion, showed that the bank has shifted its focus to money-printing. The euro tumbled, bond yields fell and stocks rallied on the news.

What sparked this change of heart? Policy makers point to a string of weak data from across the eurozone in August, including stalled growth and falling inflation. Although the ECB's own forecasts showed only minor adjustments to its 2015 and 2016 growth estimates and no change to its inflation forecast, policy makers were unnerved by market indicators suggesting inflation expectations were falling both in the short and medium term. They feared that, once lost, confidence in the ECB's ability to hit its inflation target could be hard to regain, and that fears over deflation could become self-fulfilling.

Even so, Mr. Draghi only appears to have made his mind up late in the day. In his speech at last month's annual central bankers' gathering in Jackson Hole, Wyo., the crucial paragraphs paving the way for last week's action were initially dropped and then reinserted into the text after it was released, suggesting a degree of hesitation. But the speed at which Mr. Draghi followed up on his dovish words caught members of the governing council by surprise. The Bundesbank only received the background papers for the proposed new asset purchase program on Wednesday, causing its president, Jens Weidmann, to interrupt his family vacation.

The Bundesbank believed the rush was unnecessary, according to people familiar with its thinking. In common with some other members of the ECB's governing council, Mr. Weidmann wanted more time to assess the impact of policies announced in June—some of which, including new ultracheap long-term loans for banks, have yet to be implemented. It also argued that linking the bond-buying program explicitly to the size of the ECB's balance sheet was a major policy shift that should be based on deeper analysis and discussion. After all, the ECB itself used to point out that there is nothing in economic theory to suggest that the size of a central bank's balance sheet is correlated to growth. By agreeing on this new policy target, the ECB was paving the way for government bond purchases, given a shortage of suitable private sector assets.

Mr. Draghi's decision to override Bundesbank opposition, relying on what he called "a comfortable majority," was significant. It signals that Mr. Draghi has abandoned his quest to move forward by consensus, perhaps calculating that a consensus behind quantitative easing was unlikely ever to be possible. It signals that there is now a clear path to government bond purchases if the economy and inflation don't recover. And it shows he won't allow German opposition to stand in his way.

The result is that the eurozone is now in uncharted territory. If the conventional wisdom is right, Mr. Draghi's capitulation should mark the moment the eurozone starts to recover. His latest implicit promise to do "whatever it takes" has already caused the euro to fall below $1.30, a 6.5% fall since May, and while ECB policy makers won't discuss it publicly, there is no doubt that they see a further weakening of the euro as one of the key transmission mechanisms by which bond-buying will boost inflation and growth.

They are also betting the combination of quantitative easing, negative interest rates and cheap loans to banks pushes up the prices of real assets, encouraging home-buying and construction and so fueling domestic demand, the so-called portfolio-rebalancing effect.

But if the skeptics are right, then quantitative easing may deliver little economic benefit while deepening the political rift in the eurozone. Mr. Draghi himself continues to warn that monetary policy alone can do little to boost demand for loans unless countries undertake reforms to remove structural impediments to investment. Recent research from Goldman Sachs shows that much of the divergence of fortunes between Spain, where growth is accelerating, and Italy, which has slid back into recession, can be explained by Italy's failure to overhaul its labor and product markets.

The risk is that with government bond yields already driven to record lows, the pressure on countries such as France and Italy that have ducked serious reform for five years will now be reduced further.

If Mr. Draghi's QE-lite can't pull the eurozone out of its slump, the ECB will soon be buying government bonds in the teeth of certain opposition from the Bundesbank and Berlin, including legal challenges. To add to the atmosphere of mistrust, Mr. Draghi used his Jackson Hole speech to encourage governments to take on more debt with his call for flexibility in the interpretation of eurozone fiscal rules and for governments to take account of aggregate fiscal conditions in the eurozone when setting national budgets. That is stoking fears that the ECB will end up buying large quantities of the bonds of governments whose credit quality is deteriorating.

Mr. Draghi may argue he is only acting in line with his mandate, having been put in an invidious position by political failures elsewhere. But he has set the eurozone on a course from which a very different kind of currency union to that envisaged in the European treaties may emerge.

Write to Simon Nixon at simon.nixon@wsj.com