€4.5 Trillion Balance Sheet Needed for the ECB to Achieve the Same Firepower as the Fed

Since the onset of the financial crisis, the European Central Bank's balance sheet has doubled in size—from €1.5 trillion in June 2008 to €3.1 trillion in August 2012. That's impressive, but much less so than what most of the other major central banks have done, often in a much shorter time span. So the idea that the ECB is about to make use of further unconventional tools should be no cause for concern. In fact, for the Eurozone to stand a fighting chance of survival, the ECB will have to pull out all the stops, going at least as far as the Fed and the Bank of England. That will mean boosting its balance sheet by another €1.5 trillion or so to a total of roughly €4.5 trillion. What should be a cause of concern is that the break with the past the central bank is about to make will prove to be less bold than required.

Questionable Objections

There has been no lack of fear-mongering lately on the supposedly devastating consequences of expanding the central bank's balance sheet. According to some commentators, the ECB is about to do irreparable damage by purchasing sovereign bonds issued by distressed Eurozone countries without sterilizing those purchases (i.e., neutralizing their impact on its balance sheet by increasing the interest rate on the deposit facility available to Euro system banks). This, they warn, will set the stage for galloping inflation, which will saddle future generations with an unbearable burden—in essence, compelling them to pay for the irresponsible behavior of their elders. **Such assertions are open to question, however**.

· First of all, it is hard to say which of the two currently conceivable options available to the Eurozone will ultimately cause greater pain to future generations.
- Is it deflation, the logical outcome of the crisis management policies favored until now, which will eventually leave an entire generation jobless, wreck what is left of Europe's industrial capacity, unfailingly worsen an already heavy debt load and make the breakup of the monetary union inevitable?
- Or is it inflation, which may initially push unemployment at least as high, hinder investment and erode the value of savings, but could also reduce the total debt stock over time and perhaps counteract the devastating overvaluation of the euro?

It is pointless to argue that neither deflation nor inflation is desirable, given that there is no third option. So the most sensible approach to choosing between these two evils is to go with the one that offers us a chance of eliminating the root cause of the crisis, i.e., excess debt.

· Second of all, **spiraling inflation simply isn't about to happen**. Even in the best-case scenario, the bruises left on the European economy by the events of the past two years won't go away for some time to come, and it will take a lot more than action by the ECB alone to offset their deflationary impact on the region—and beyond

· Last of all, **the ECB's balance sheet has so far seen only limited expansion**. Although some observers panicked when it exceeded the size of the Fed's balance sheet at the beginning of the year, the comparison is largely invalid. Because bank intermediation is structurally more important in the euro area than in the United States, the central bank balance sheet is necessarily larger. Prior to the crisis, the ECB's total assets were equal to about 15 percent of eurozone GDP, a ratio that was two and a half times higher than in the United States or the United Kingdom, and twice as high as in Japan before the BoJ moved to unconventional policies in 1998.

The ECB Lagging Far Behind

The absolute or relative size of the ECB's balance sheet is a less relevant metric than its rate of increase since the financial meltdown. And on that count, the Eurozone has been lagging far behind. While the ECB has doubled its balance sheet over the past four years, the Fed's got two and a half times larger in the six-month period following the 2008 meltdown, eventually rising to three times its pre-crisis size by mid-2011. Moreover, the Bank of England, which initially responded in much the same way as the Fed, seriously upped the ante from late 2011 onward, with the result that its total assets have increased fourfold since the onset of the crisis. Even the Bank of Japan went further than the ECB, at least in the early stages of deflation in 1998. As is well known, when the BoJ subsequently pulled back in what had become a highly deflationary global environment, the Japanese economy found itself trapped in a deflationary slump, with the national debt rising from 100 percent of GDP in 1996 to 150 percent in 2002, and to over 200 percent today.

A particularly telling sign of the ECB's overcautious approach since the start of the crisis is that the bulk of its additional assets were acquired through two Long-Term Refinancing Operations (LTRO), which have had very little impact on the market for outstanding sovereign debt.
The ECB is finally poised to make use of further unconventional policy tools, hopefully more powerful ones than up until now. Not only is this not disturbing; the opposite is true. **For the Eurozone to stand a fighting chance of survival, the ECB will have to pull out all the stops, going at least as far as the Fed and the Bank of England—especially because it will be taking action much later. That will mean boosting its balance sheet by another €1.5 trillion or so to a total of roughly €4.5 trillion. The trouble is that the break with the past the central bank is about to make may well prove to be less bold than required.**

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