



QE3, OMT => The impotence of central banks

### **Hoping that something will turn up**

The ECB introduces (potentially) unlimited Outright Monetary Transactions (OMT), designed to bring down long-term borrowing costs and above all spreads within the euro area. The Federal Reserve introduces (potentially) unlimited purchases of mortgage-backed securities to the tune of \$40 billion per month, designed to bring down long-term interest rates. Is this finally the central bank bazookas, the weapons markets cannot withstand? Yes – and no.

Yes, in the sense that of course a central bank can spend unlimited amounts of money, the money it has the power to create out of thin air. As long as the purpose for which it is spending the money feels more important than the other consequences of that expenditure – swelling balance sheets, the accumulation of risk etc – there is no problem. The comments by Panicos Demetriades, the Governor of the Central Bank of Cyprus in an interview yesterday that the mere threat of ECB unlimited intervention was enough and that the bank may well never have to spend a cent actually buying bonds are probably too optimistic. But there is no question that it is a brave investor who is prepared to test a central bank's mettle if it really means what it says.

But another issue is more important, namely, what will all this accomplish? US interest rates are not high, with the 10-year Treasury yielding around 1¾% and the 30-year just under 3%. Nor have they been high for a long time. It is highly unlikely that interest rate levels have deterred anyone from borrowing over the last two years. That deterrence is more likely to come from excess debt in the household sector, the need to deleverage and the consequent economic weakness.

In the euro area, spreads and absolute borrowing costs have of course been high in some countries. So the ECB's action should have an effect. But there are also inherent risks. One obvious one is that if the ECB intervenes massively to buy bonds with a remaining maturity of up to three years, the yield curve could steepen. Another is that governments will be encouraged to issue debt at the shorter end, leading to a shorter overall maturity profile and – in the future – the need to roll over debt much more rapidly. Italy, eg, was in this painful situation in the 1990s but has since managed to lengthen substantially the maturity of its debt. If Italy were to accept ECB conditionality in return for intervention, it would be tempted to reverse this development, ultimately leaving it worse off.

But, more importantly, the ECB's OMT will by itself not improve the growth performance of the southern European economies in the slightest. For that, you primarily need the structural reforms which are currently being resisted by voters and generally only tepidly advanced by politicians (varying from country to country). Moreover, there is always the risk that, whatever conditionality is imposed, the relevant countries (or, rather, their governments) will attempt to ease the terms once the OMT is implemented, leaving the ECB with the painful dilemma of continuing without conditionality, ceasing to buy or possibly even selling what it bought, in both the of latter cases being blamed for a deterioration in market sentiment.

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There is also the point that any kind of price distortion brought on by government intervention can only mask and suppress underlying price developments. One day the Fed will withdraw its monetary policy easing, one day the ECB will cease the OMT. Are markets then not likely to overreact the other way, prompting calls for a bond market 'Draghi/Bernanke put'?

Ultimately, the responsibility for solving the crises rests with governments. *Not* because they can create growth; if they could, would they not have done so long since? But because they can create the *conditions* for growth, primarily by deregulating labour and product markets and simplifying tax structures. But that takes political will.

Meanwhile, the ECB and the Fed are deploying their bazookas, not as a sign of strength, but as a sign of their weakness. All they can do is buy time and hope that something will turn up. It did for Mr Micawber; but *David Copperfield* is a work of fiction. In real life, buying time may not be enough.

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