QE2 *Craziness*

The missing logic of this strange approach.

By Benn Steil

Imagine that you get in the shower, turn on the water, and nothing comes out. You call a plumber, who tells you that there are holes in the pipes, and that it will cost you $1,000 to repair the holes. You tell him to turn up the water pressure instead.

Sound sensible? Well, this is the logic behind the U.S. Federal Reserve's second round of "quantitative easing" (QE2), its strategy to keep flooding the money pipes until credit starts flowing freely again from banks to businesses.

You wouldn't expect this to work in your shower, and there is little reason to expect it to work in the commercial lending market. The credit-transmission mechanism in the United States—and elsewhere—has been seriously damaged since 2007. Small- and medium-sized businesses in the United States depend on small- and medium-sized banks for access to vital credit, yet too many of these banks remain zombies, unable to lend because their balance sheets are littered with bad commercial and real estate loans from the boom years.

The U.S. Troubled Asset Relief Program was an opportunity to force banks to disgorge bad assets—and thus repair the credit pipes. Instead, banks were obliged only to take equity injections from the government, which they consider politically toxic. As a result, the banks have been focused on returning the bailout funds at the earliest opportunity, rather than using them to boost lending.

The net result is that, even though the Fed has pushed its short-term lending rate down to zero, most banks will only lend on the basis of vastly greater collateral, and at much higher real interest rates, than before the bust. So now America plows on with the cheap option: flood the pipes and see what comes out.

Make no mistake: something will come out, though not necessarily where it should. We have already seen the liquidity intended to boost U.S. bank lending instead leak through the cracks into markets as diverse as agricultural commodities, metals, and poor-country debt.

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Paul Krugman

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What is remarkable about this is that some of QE2's most prominent cheerleaders actually think that wherever new demand shows up is fine and dandy. After all, it is only "aggregate demand" that matters to the Keynesian faithful. To worry about the composition of demand is silly; it only complicates the algebra.

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But neither the United States nor the world can afford a sequel. The outside world, which relies on the dollar as its primary trade vehicle and therefore reserve asset, cannot be expected to watch passively as dollars continue to pour into their currency, commodity, and asset markets, with no clear end in sight.

Europe, Germany in particular, has been highly critical of the U.S. approach of placing its central bank at the center of its recovery strategy. But the eurozone is doing the same.

Consider the Irish bailout sorcery. The Irish National Asset Management Agency was set up in 2009 to clean up Irish banks' balance sheets. But it does this by giving the banks newly conjured government IOUs—not euros—in return for dodgy debt. The banks then dump the IOUs on the European Central Bank, which then provides the actual cash.

Since NAMA swaps IOUs for bank debt at only about half their face value, the three-way transaction can result in a €1 capital loss for every €1 the banks get from the ECB. Of course, the IOUs now lodged with the ECB may themselves have to be written down, threatening to undermine the ECB's own balance sheet.

What is the logic of this crazy carousel? German banks hold at least €48 billion in Irish bank debt, British banks hold another €31 billion, and French banks hold €19 billion. Since June 2008, German, British, and French banks have withdrawn €253 billion worth of credit from Irish banks and other Irish borrowers—70 percent of the total foreign funds withdrawn. These countries' authorities are now trying to shield their banks from losses by feigning neighborly concern for the Irish government.

For decades, the United States and Europe lectured the world on the importance of cleaning house in the wake of a financial crisis: in particular, repairing or resolving zombie banks. It is time to swallow our own medicine and resume the hard work of repairing our banking systems. To rely instead on central banks to refloat the U.S. and European economies is an abdication of responsibility that will cost us dearly in the future. ◆

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