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No magic medicine to fix global finances

By Robin Harding in Washington and Ralph Atkins in Frankfurt

Global economic policymakers who looked in the medicine cabinet this week as their patient began to show signs of a recessionary relapse will not have liked what they found. Some of the best treatments have run out and many of those that remain are experimental or have unpleasant side effects.

The problem they face is debt. Consumers in rich countries are saving to pay down their debts. During the recession, governments ran up their debts and provided an alternative source of demand but now they have either run out of capacity to do so – as in Greece and Ireland – or run out of political will – as in the US or UK.

"In advanced economies, policymakers clearly have their backs against the wall," says Eswar Prasad, senior fellow at the Brookings Institute in Washington. They have run out of "easy or palatable solutions".

What policymakers need is a tool that will either get rid of some of the debt or else persuade consumers to keep spending and let the economy grow its way out of the problem over time.

Monetary stimulus risks inflation

Monetary policy is one way to try to keep consumers spending. By driving interest rates ever lower for ever longer, central banks can make it less attractive to save and more attractive to spend and invest. The trouble is that the tool seems to have limited effect: will any level of interest rates persuade somebody whose mortgage is larger than the value of their house to borrow more?

The Fed is still trying: it has promised to keep interest rates close to zero until mid-2013 and is considering other options. The European Central Bank also has room to cut interest rates, having raised its main policy twice this year – most recently by a quarter percentage point in July to 1.5 per cent – although after the ECB's August meeting, Jean-Claude Trichet, ECB president, left the impression the next move would still be upwards.

In the UK, Sir Mervyn King, governor of the Bank of England, signalled last week that the monetary policy committee was reluctant to follow the Fed's lead in pledging to keep interest rates on hold for a set period of time. However, he said that the MPC could sanction more asset purchases, but only if signs emerged that inflation was likely to fall below the 2 per cent target in the medium term.

Michael Saunders of Citi said: "If we get another couple of bad weeks in equity markets and surveys continue to fall sharply, like the Philadelphia Fed reading did, then we'll see more [UK] quantitative easing – perhaps even as early as September."

But central banks have so far refused to hazard more drastic options that could drive up inflation – which would erode debt burdens – or even create a risk of inflation. They consider the permanent costs of doing so to be far too high.

No room for fiscal stimulus

Central banks may have to act, however, because governments are paralysed. Fiscal policy should work better than monetary policy to boost demand in a debt trap and markets are signalling that they want to lend to core governments. Ten-year US Treasury yields fell below 2 per cent, their lowest since the 1950s, at one point this week.

"The approach still has to be to calibrate how to maintain fiscal stimulus in the short-term, while sending a signal that governments are serious about tackling debt in the long-run," says Mr Prasad.

But the politics of government stimulus is poisonous. President Barack Obama has signalled that he will try to persuade Congress to extend some tax breaks into next year but that will merely reduce the drag from tighter US fiscal policy. Germany, keen to preserve its reputation for fiscal prudence, has introduced a "debt brake". In the UK, Victoria Cadman of Investec Securities says: "With investors focusing on misbehaving sovereigns, the government's hands are tied."

Dealing with the debt

That leaves a more direct effort to reduce or redistribute the debt in the system. In Europe, that could mean either writing off some of the debt owed by countries such as Greece or else finding a way for core countries such as Germany to underwrite it.

A move to commonly issued "eurobonds" is backed by many, especially in southern Europe – but strongly opposed by Germany, which fears setting the wrong incentives for governments and of paying higher borrowing costs itself as a result. According to a senior EU official, the European Commission is preparing an analysis of eurobond options, expected to be finalised this winter, which could be the start of a legislative push for the programme in Brussels.

The idea of increasing the size of the European Union's bail-out fund is almost as controversial. Thomas Mayer, chief economist at Deutsche Bank, and Daniel Gros, director of the Brussels-based Centre for European Policy Studies, have floated an alternative idea – letting the bail-out fund borrow from the ECB. That would boost its firepower in the case of financial meltdown but could face legal obstacles and worries at the ECB that it was simply financing governments by the back door.

Fixing the banks

But the trouble with any measure to reduce debt is that most of it is owed to banks, which will struggle to bear the blow. That means a final part of the policy mix may have to be injecting more capital into banks.

Elga Bartsch, European economist at Morgan Stanley, said: "One big difference between the US and Europe is that in the US there was a very aggressive recapitalisation of banks through the Tarp. It would help a good deal in reducing stress in the European financial system and that would contribute towards resolving the debt crisis."

There is no magic medicine and the best solution would be a combination of all of these policies, wrapped up in a show of political will that restored confidence to the global economy. But political will is in short supply – and that may be the most worrying economic sign of all.

Additional reporting by Peter Spiegel in Brussels and Claire Jones in London